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# An Investigation of the Effect of Civil Liberties and Political Rights on Foreign Direct Investment

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**Amir Hermidas**

Supervisors: Dr Fragkiskos Filippaios, Dr Kent Springdal, Dr Theresa  
Woodward



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## ***Declaration***

*The author hereby declares that, except where duly acknowledged and referenced, this research study is entirely his own and has not been submitted for any degree or other qualification at Kingston Business School, Kingston University of London or any other third level institution in the UK or abroad.*

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***Amir Hermidas, September 2013***

## *Abstract*

Globalization has affected the economic activity of the countries across the world through liberalization of trade and exchange regimes. Moreover, the enhancements in information technology in turn have made it possible for firms to coordinate their activities in a more efficient way, in recent decades. In this setting it is easier for firms to outsource their activities to other countries through Foreign Direct Investments (FDI) in order to gain competitive advantage. FDI has been considered as one of the factors that significantly influence the economy of countries through affecting the balance of payments, increasing employment, transfer of technology and resources. Since FDI is generally considered as one of the factors that has a great potential to contribute to economic activity of the countries, particularly in case of developing and less developed countries, the disparity in the level of FDI flows observed in case of many developing countries has led to plethora of research on the subject relating the inequalities to macroeconomic factors, institutional factors, and economic geography. In spite of the fact that the literature on FDI, is well developed on a number of areas, the literature on the effect of institutional factors on FDI activity, and in particular the effect of civil and political liberties on FDI flows remains limited and subject to contrary results that renders it inconclusive.

This research explores the effect of civil and political liberties on FDI flows. In doing so, we review the literature on determinants of FDI, and establish the firms' motivations as factors that affect their FDI behaviour. Furthermore we introduce, and conceptually bridge the Varieties of Capitalism of Hall and Soskice (2001) into IB literature, in order to distinguish between the behaviour of firms from various market economies (i.e. LMEs, CMEs, and Nordic) based on the labour law policies of the firms' home countries. Consequently the incorporation of VoC into IB literature allows us to build on the works of Due et al (1991) and Gold (1993) and Hall and Soskice (2001), and explore the effect of the differences that exist in the way firms in different market economies coordinate their activities, and afford us the possibility of explaining the firms coordination of their FDI activity in the light of their market structures, and underlying institutional differences that influence their behaviour with regard to FDI.

We also review the literature on institutional determinants of FDI in order to enrich our understanding of the institutional factors that influence FDI activity. In reviewing the literature on institutional determinants of FDI, we specifically adopt meta analysis methods in order to examine whether there are systemic biases introduced to the literature through the common choices made in terms of scale and study properties (i.e. the choice of country level analysis, data range and decade influences; etc.). We find that firms' motivations influence the type of relationships found between FDI and the existing level of civil and political liberties in countries. The use of composite measures such as democracy instead of their disaggregated individual constructing sub measures such as civil and political liberties generally leads to provision of distorted results. We also find that the choice of host country influences the relationship between FDI and democracy as well as political liberties. Similar to the arguments put forward by Busse (2004) we find that FDI activity has been subject to changes in different decades as a result of changes in the firms' motivations and market structure.

Moreover, we theoretically explore the effect of civil liberties and political rights on the initial cost of FDI and thereby FDI activity. The models provided build upon the works of Grout (1984); Hart and Moutos (1995) and Adam and Filippaios (2007). It is assumed that the decision of FDI is influenced by the initial cost of investment into the designated host

country. Therefore, firms are considered to bargain with employee representatives (labour unions) in the host country before deciding upon their investment abroad, in order to obtain full information with regard to the initial costs of investment. Our theoretical model demonstrates that the effect of civil liberties channelled through union power in the bargaining processes over wages and employment, on aggregated FDI flows is negative, while the effect on sectoral FDI flows is non-linear where the non-linearity stems from the level of labour to capital share of production of specific sectors considered. Furthermore, our theoretical model shows that the effect of political rights channelled through taxes on income and profit tend to be positive on FDI flows irrespective of the level of aggregation.

Our empirical investigation of the theoretical findings using the data on the FDI from 8 host countries into 140 developed, developing and less developed host countries for the period of 1990-2009, show that the effect of civil liberties on aggregated FDI flows is negative, while a positive effect is reported for the effect of political rights on aggregated FDI flows. In contrast, considering the effect of civil and political liberties on sectoral FDI (manufacturing and services sectors) we find a non-linear effect reported for both factors, indicating that the effect of civil and political liberties on sectoral FDI flows are non-linear across sectors. Our sensitivity analyses explores the effect of civil and political liberties on aggregated and disaggregated FDI flows into two main group of countries: countries with high and moderately high level of civil liberties; countries with moderately low level of civil liberties. The results provide further empirical evidence on the non-linear effect of civil and political liberties on sectoral FDI flows into host countries with various levels of civil liberties. However, the effect of civil liberties is shown to be linear and negative on aggregated FDI flows into all countries, irrespective of their level of civil liberties. In contrast a non-linear effect of political rights on aggregated FDI flows into host countries with various levels of civil liberties is observed.

This research contributes to the literature in several ways: Firstly, it contributes to the theory by bridging the IB literature to the literature from political science on Varieties of Capitalism. Secondly, it provides a theoretical framework, and empirical analyses that explore the FDI activity in the sectoral level. Thirdly, it demonstrates that the use of aggregated data leads to findings linear relationships where the in reality the effects of civil liberties and political rights on FDI are not linear. Fourthly, it provides a number of recommendations for future research.

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## *List of Abbreviations*

FDI	: Foreign Direct Investment
VoC	: Varieties of Capitalism
LME	: Liberal Market Economy
CME	: Coordinated Market Economy
PR	: Political Rights (political rights and political liberties are used synonymously)
CL	: Civil liberties
MNE	: Multinational Enterprise
TNC	: Transnational corporation
IB	: International Business
Union	: Labour or trade union
NAICS	: North American Industry Classification System
ISIC	: International Standard Industrial Classification
SIC	: Standard Industrial Classification
NACE	: Statistical Classification of Economic Activities in the European Community
OECD	: Organization for Economic Cooperation and Development
BEA	: Bureau of Economic Analysis
EU	: European Union
WB	: The World Bank
IMF	: International Monetary Fund

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# **Chapter 1 : Introduction**

## **1.1. Introduction**

Globalization has affected the economic activity of the countries across the world through liberalization of trade and exchange regimes. The enhancements in information technology in turn have made it possible for firms to coordinate their activities in a more efficient way. In this setting it is easier for firms to outsource their activities to other countries (through direct and indirect investments) in order to gain a competitive advantage. The investments abroad in general can be divided into two main types of investments, namely the foreign direct and indirect investments. These movements of capital influence the economy of all countries, in particular the economies of host countries attracting foreign investment. This research focuses on Foreign Direct Investment<sup>1</sup> (FDI).

Foreign Direct Investment (FDI) has been considered as one of the factors that significantly influence the economy of countries through affecting the balance of payments, increasing employment, transfer of technology and resources. While the effect of FDI on economic growth of countries is still debated (Alfaro et al. 2005) both in aggregated and sectoral levels, the existence of its effect on economies is widely accepted. The empirical evidence provided by UNCTAD<sup>2</sup> indicates that the global FDI has increased from 697,913 million (USD) in 1980 to 22, 812,680 million (USD) in 2012, while the level of FDI into developing economies (excluding china) has increased from 295,206 million (USD) in 1980 to 1,401,725 million (USD) in 2012. The disparity in the level of FDI flows observed in case of many developing countries has led to plethora of research on the subject relating the inequalities to macroeconomic factors, institutional factors, and economic geography.

## **1.2. Research Problem**

The determinants of Foreign Direct Investment (FDI), both in terms of the level of FDI as well as its composition have been of great debate over the past seventy years. Examples of such works are Root and Ahmed (1978) and Asiedu (2006) that mainly focus on the

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<sup>1</sup> The definition of Foreign Direct Investment (FDI) and related concepts, considered in this research are provided in Appendix 1.1.

<sup>2</sup> <http://unctadstat.unctad.org/TableViewer/tableView.aspx?ReportId=89>

level of FDI, and Javorcik (2004) and Gwenhamo and Fedderke Gwenhamo and Fedderke (2010) who take into account the composition of FDI. The first instances of the scholarly work on FDI can be traced back to the post World War II in the works of Hymer (1960) and Aliber (1971). Since then determinants of FDI have been explored in a number of disciplines, mainly; Economics, International Business, Finance, Business and Management, and Political Economy. Consequently, one can approach the topic from a variety of angles. North (1990) is one of the first scholars who establishes a link between institutions and investment, while mainly considering the influence of institutions on the economic activity and investment. However, an overview of the literature on FDI shows that the literature has been greatly neglecting the influence of institutional factors on FDI up until recently.

The definition of institution adopted in this research is in the same wave length with the one adopted by Dunning and Lundan (2008), Hall and Soskice (2001) and is mainly drawn from the works of North (1990, 1994, and 2005). This definition considers the institutions as “a set of rules, formal and informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy”. Adopting this view of institutions, we consider ‘Democracy’ to be a product of well-functioning, high quality institutions that provide an environment in which there exists high level of political and civil liberties. Therefore our premise following Adam & Filippaios (2007) is that it is possible to view the level of democracy as a composition of the level of political and civil liberties in a state, where all these elements are products of institutions in that state.

In recent years, the literature on determinants of FDI has shifted its attention towards the institutional factors. The studies that consider the effect of institutional factors on FDI include the works of Fathi, et al. (2008), Méon and Sekkat (2004), and Mottaleb and Kalirajan (2010) who generally find evidence supporting a significant positive relationship between FDI and institutions. Other studies considering the influence of the level of democracy in host countries on inward FDI have reported contrasting results. The first group of these studies including Harms and Ursprung (2001) found a positive significant relationship, while the second group including Huntington and Dominguez (1975), Wintrobe (1998), and Greider (1998) have reported a negative relationship.



The recent strand of literature on the effect of institutional quality of the host countries on their FDI inflows has focused on the disaggregated measures that constitute the institutional quality of the host countries, mainly civil liberties and political rights. However, in spite of existence of numerous studies on the topic, the literature on the effect of political and civil liberties on FDI is far from being conclusive. For instance, authors such as Huntington & Dominguez (1975), Wintrobe (1998), Greider (1998) provide discussions and evidence in favour of the idea that multinational enterprises (MNEs) tend to invest in countries with low level of liberties (countries with high levels of repression) while others such as Olson (1993), McGuire & Olson (1996), Ursprung and Harms (2001) provide discussions and evidence contrary to the later arguing that MNEs invest more in countries where democratic rights of people are respected. Others such as Przeworski, Limongi and Voigt (2003) argue that none of the two arguments are convincing. Recent studies including Li and Resnick (2003), Adam and Filippaios (2007), Asiedu and Lien (2011) tend to provide evidence in favour of existence of non-linear relationships between the two.

### **1.3. Research Aims and Research Questions**

This research aims to explore the effect of civil liberties and political rights on FDI, in order to better explain the FDI activity. Accordingly we aim to identify the effect of Civil Liberties and political rights on aggregate (total) FDI flows. Furthermore, authors such as Blonigen (2005) have emphasised the importance of considering sectoral FDI by discussing that various variables have different effects on FDI in different sectors and industries. Proponents of this view argue that the use of aggregated data generally leads to provision of results that embody a composition of effects from various sectors in one aggregated effect reported for aggregated (total) FDI, leaving the researchers with often non significant and misleading results. Therefore authors suggest that using disaggregated FDI data provides a more clear evidence of how variables impact FDI flows in certain industry level.

Considering the latter, this research aims to explore the effect of the level of civil liberties and political rights of host countries on their FDI activity both in terms of total FDI, and sectoral FDI. In other words our aim is to investigate the effect of civil liberties and political rights on total FDI, manufacturing FDI, and services FDI, in order to examine

whether the effect of civil liberties and political rights on FDI is sensitive to sectoral composition of FDI. The latter helps in distinguishing between the way civil liberties and political rights affect aggregate FDI activity in comparison with sectoral FDI activity, and in turn provide information with regard to the determinants of FDI in both aggregate and sectoral level. Thus our second set of aims is to identify the effect of Civil Liberties and political rights on sectoral (disaggregated) FDI. Furthermore, we are interested in exploring whether the effects of civil liberties and political rights on disaggregated are linear across sectors.

Moreover, this research aims to examine the effect of institutional quality of the countries on their FDI activity. In order to do so, we incorporate the constructs provided in other branches of social sciences, mainly political economy, to inform our own. In particular we review the Varieties of Capitalism framework of Hall and Soskice (2001), in order to distinguish between different types of institutions.

Hall and Soskice (2001) provide a new framework for understanding the institutional differences and similarities amongst developed economies in order to bridge the business studies and political economy. Building on earlier works on the “theory of the Firm” by Coase (1937) as well as further works inspired by the latter, mainly, the works of Williamson (1976; 1985) on “Transaction Costs Theory” (TCT), they locate the firm as the main building block of the analysis. By doing so they place the firm as the central unit of analysis in their work, similar to microeconomics, while exploring perspectives that traditionally have been viewed as the ones central to macroeconomics<sup>3</sup>. Furthermore, authors adopt a perspective in ‘Varieties of Capitalism’ that considers markets as the institutions that support relationships of particular types, “marked by arm’s length relations and high levels of competition” (Hall and Soskice 2001, pp.9-10). Furthermore, authors consider the legal system to be the concomitant to the markets as they support and maintain the formal contracting as well as encouraging relatively complete contracts.<sup>4</sup>

The VoC (Varieties of Capitalism) framework is an actor based approach that adopts a relational view of the ‘Firm’, in which firms are expected to seek to develop their core competencies by undertaking different types of activities and strategies. Therefore the

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<sup>3</sup> Namely the types of economies, characteristics and qualities of institutions, their structure, as well as the social and cultural characteristics of the nations, and the way they affect the markets, and their participants.

<sup>4</sup> For further reading refer to Teubner(1995, 1996, 2001) and Casper., S., (1997, 1999)

success of the firm is significantly related to its ability to coordinate with a range of actors that it is involved with (such as employees, clients, suppliers, other businesses, shareholders, etc.). In order to distinguish between the types of relationships that a firm generally coordinates to function, Hall and Soskice (2001, p.6) provide a five spheres classification in which the relationships that a firm has to develop in order to resolve its coordination problems<sup>5</sup> are divided into; industrial relations, vocational training and education relationships, corporate governance, inter-firm relations, and finally the sphere of employees.

From the perspective of VoC, national political economies can be categorized based on the ways in which firms address the coordination problems that they face with their relationships in each of the five spheres. In this perspective, Two types of political economies are introduced which are at the poles of the main spectrum where all nations can be arrayed. The first of these political economies is the Liberal Market Economies (LMEs) and the second is Coordinated Market Economies (CMEs).<sup>6</sup> By incorporating the VoC framework into our conceptual arguments and theoretical framework we distinguish between home countries that belong to different types of market economies and explore whether there are significant differences between the way firms from LMEs and CMEs coordinate their activities with regard to FDI. Therefore our set of aims with regard to institutional factors go beyond the traditional institutional approaches, in that we not only aim to consider the effect of institutional factors on FDI in a country level, but also we aim to explore the effect of the types of economies that the foreign firms originate from on their FDI activity. Therefore our third set of aims is to investigate the effects of institutional quality on FDI flows, and to explore whether there are differences between the ways firms from various market economies coordinate their FDI activity.

The objectives of our research are as follows: Firstly, we intend to explore the effect of the level of civil liberties, and political rights in host countries on the level of aggregated (total) and disaggregated (sectoral) FDI flows into them. Secondly, we aim to explore the linearity of the effects of civil liberties and political rights on FDI flows. Thirdly, we would like to whether the consideration of the type of market economy from which MNEs originate provides some information with regard to their FDI activity.

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<sup>5</sup> which are related directly to its core competencies

<sup>6</sup> Varieties of Capitalism (VoC) framework will be introduced and incorporated into IB theory through discussions provided in 2.6.2, and further on incorporated in a mathematical manner into the theoretical model of chapter 4.

Collectively, our research aims to provide a valuable contribution to the existing research through an analysis of the effect of civil and political liberties on aggregated and disaggregated FDI flows, and offers a new insight into a research area not yet fully explored by the academic community.

#### **1.4. Research Justification and Research Contributions**

We have been prompted to research the effect of civil liberties and political rights on FDI flows due to paucity of research on the subject and inconclusiveness of the findings of the literature. Furthermore, we believe that our research makes significant contributions to theory and practice.

##### **1.4.1. Paucity of Research and Inconclusiveness of the Findings**

As mentioned in section 1.2 the literature on determinants of FDI which has been traditionally populated by studies that strive to explain the FDI activity through neo-classical economics and economic geography type models have fallen short of provision of credible explanations. Thus the recent literature has shifted its attention toward the institutional determinants of FDI. The most recent strand of literature includes the works of Busse (2004), Busse Hefeker (2005), Asiedu and Lien (2011), Adam and Filippaios (2007), and Li and Resnick (2003) who explore the effect of civil and political liberties on FDI. However, the findings remain inconclusive.

The thorough review of the literature on the effect of civil and political liberties on FDI provided in chapter three shows that the literature on the subject is rather scarce and inconclusive. For instance the studies that have considered both civil and political liberties fall into two groups. First group including the studies of Busse (2004), and Busse and Hefeker (2005), generally have found a positive relationship between civil and political liberties and FDI. The second group including the works of Asiedu and Lien (2011), Adam and Filippaios (2007), and Li and Resnick (2003) have found a non-linear relationship where the non-linearity is introduced through different factors<sup>7</sup>, or by the consideration of different aspects of democracy<sup>8</sup> or institutional elements. Therefore the literature that has

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<sup>7</sup> i.e. the level of natural resources in the host country.

<sup>8</sup> i.e. Based on arguments put forward by Li and Resnick (2003), democratic governments have a positive effect on FDI by strengthening property rights and have negative effects on FDI through provision of democratic constraints on elected politicians; reducing the host government's ability in providing the MNEs with generous financial and fiscal incentives;

considered the effect of civil liberties and political rights on FDI is populated by a handful of studies that have produced mixed, contradictory, and inconclusive results. A number of studies that have considered the effect of either civil liberties, or political rights on FDI flows similarly are populated with only a handful of studies that remain inconclusive.

Therefore, considering the short comings of the current literature on the effect of civil and political liberties on FDI, this research aims to attempt to investigate the effect of civil liberties and political rights on FDI flows in a novel manner. Furthermore, there are no studies, to the best of our knowledge that have explored the effect of civil liberties and political rights on sectoral FDI, thus we aim to explore the effect of civil and political liberties on both aggregated and disaggregated FDI flows.

#### **1.4.2. Contributions to the literature**

The paucity and inconclusiveness of the literature on the effect of civil and political liberties on FDI flows has an impact on our research. Firstly, we review the literature on the effect of civil and political liberties on FDI, and conduct a Meta analysis in order to explore whether there are intermediating factors that affect the findings of the researches in the literature on the subject. The latter informs our research design and formulation of our theoretical, as well as empirical analysis. Secondly, we develop a theoretical model which bridges traditional theories in the Economics and Finance (Transaction Cost Theory), and International Business (Behrman (1974) taxonomy of firms' motivations) with Political science (Theory of Varieties of Capitalism). Through our theoretical framework we provide a set of arguments based on which we theoretically explore the effect of civil and political liberties on FDI. Furthermore our review of the literature and conceptual arguments allow us to establish the environmental aspects that affect FDI activity. The theoretical model draws on the knowledge from various branches of social sciences in determining the effect of civil liberties and political rights on FDI flows in both aggregated and disaggregated levels. In particular we internalize the VoC framework into the heart of our model and provide theoretical discussions on both aggregated and disaggregated levels.

Furthermore, our empirical analyses contribute to the literature by examining the effect of civil and political liberties on aggregated and disaggregated FDI flows. Sensitivity

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and finally provision of protection for the indigenous business through provision of wide access to elected officials and political participation.

analysis of the empirical findings allows us to further explore our theoretical and empirical findings and avoid provision of results that are prone to various biases.

To the best of our knowledge, our study is the first to theoretically internalize VoC framework into analysis of the effect of civil and political liberties on FDI, and to theoretically examine the effect of civil and political liberties on FDI in sectoral level.

Considering our empirical contributions, our empirical investigation uses Quantile Regression Modelling (QRM) and analysis that has not been used in examining the effect of civil and political liberties on FDI. Furthermore, our empirical investigation is the first study that examines the effect of civil and political liberties on FDI flows at country level as well as sectoral level. Finally, this research provides the first Meta analysis of the literature that has considered the effect of civil and political liberties, institutional quality and democracy on FDI flows, which on its own, contributes significantly to the general knowledge in the field.

Finally, since the literature on the effect of host countries' level of civil liberties and political rights on FDI is still in its infancy, provision of studies such as ours sheds more light on the topic and by doing so elevates the level of understanding, and promote further considerations and policy related discussions that can potentially provide a basis for practical policy decision making in the future.

## **1.5. Thesis Overview**

In this section we review the process and structure of this thesis. This study consists of two main research blocks: a theory building (theoretical model) component and a theory testing (empirical) component. The theory building part of this study entails a review of the literature on FDI (chapter 2), a thorough review of the literature on the effect of civil and political liberties on FDI accompanied with a Meta analysis of the literature on the subject (chapter 3), followed by introduction and discussion of arguments that lead to construction of our theoretical model (chapter 4). The theory testing component of our study consists of data mining and preparation (chapters 5 and 6) and empirical investigation of theoretical findings using regression analysis (chapter 7). A brief review of each of the chapters is provided below.

Chapter 2 – The literature review of chapter 2 mainly focuses on a broader topic of determinants of FDI and provides some information with regard to theories put forward to explain FDI activity. Moreover, the VoC framework introduced by Hall and Soskice (2001) is reviewed in order to conceptually categorise different types of economies, as well as providing a basis for conceptual developments in chapter four. Consequently the incorporation of VoC into IB literature allows us to build on the works of Due et al (1991) and Gold (1993) and Hall and Soskice (2001), and explore the effect of the differences that exist in the way firms in different market economies coordinate their activities, and afford us the possibility of explaining the firms coordination of their FDI activity in the light of their market structures, and underlying institutional differences that influence their behaviour with regard to FDI.

Chapter 3 - The review of the literature that explores the effects of civil and political liberties on FDI. This chapter reveals a gap in our research area and justifies the need to create a new theoretical framework/model. Furthermore, a Meta analysis of the literature on the effects of civil and political liberties on FDI is conducted in order to investigate whether there are specific aspects of the research design that might influence the results of this research.

Chapter 4 – The theoretical model is constructed and sets of comparative hypotheses are consequently provided for empirical investigation. This chapter is the theory building component of this thesis.

Chapters 5 and 6 - Outlines the methodology we adopt in order to empirically test our theoretical findings. It provides discussions on the philosophical standpoint of the thesis and within this context carry on deliberating the methodological perspectives. Following the latter we review the sample description, data characteristics, data collection, and data manipulation. Subsequently we discuss the methodology of data analysis that includes: review of variable based approach; data set and its characteristics; regression analysis and discussions on research legitimacy which encompasses a section on the limitation of this research. Finally, using ANOVA method we proceed to preliminary analysis of data.

Chapter 7 – Empirically tests the theoretical findings of chapter four by exploring the effect of civil and political liberties on aggregated and disaggregated FDI flows, and

provides discussions on the findings. Furthermore, the sensitivity analyses of the results are conducted by provision of regression analyses over groups of host countries with various levels of civil liberties and relevant discussions.

Chapter 8 – Outlines the key research outcomes and proposes recommendations concluded from our study. Furthermore the discussions on the contributions of this research to literature and practice, as well as research limitations are provided. Subsequently, we provide a number of recommendations for future research on the field.



## **Chapter 2 : Literature Review**

### **2.1. Introduction**

This chapter aims to review the International Business (IB) literature on FDI and discuss the development, context and coverage of each theory, in order to inform the reader of the existing theories on the FDI activity. This is a rather standard task given our deductive positivist approach which by tradition emphasises the review of the existing theories and literature on a subject in order to inform the researcher of the existing work, and hence enable him/her to deduce a set of hypotheses that should be tested. The general methodological considerations are covered in chapter six.

The review of the literature is provided in a chronological manner, in order to follow the progression of the literature on the subject. The chronological organization of this chapter allows provision of developments made in each decade since the birth of IB theories on FDI flows in parallel to the general consensus and developments made in comparative capitalism, and institutional and organizational views of social structures, in particular firms.

In particular, this chapter reviews the literature on FDI by focusing on the developments made with regard to MNEs' motivations rather than OLI paradigm of Dunning (1980), and by doing so considers the micro drivers of FDI activity, namely the firms' incentives and motivations of FDI introduced by Behrman (1974). The latter is related to the design adopted by this research that builds on the Organization Theory of Coase (1937) placing firm at the centre of analysis. Moreover, we discuss the Varieties of Capitalism ideas mainly developed in political science and political economy arena, in order to familiarise the reader with such ideas. This task is mainly motivated by our consideration of VoC framework in relevance with our research question that investigates the effect of the level of civil and political liberties (rights) on the FDI activity. In particular, the varieties of Capitalism (VoC) framework introduced by Hall and Soskice (2001) is reviewed in order to conceptually categorise different types of economies, as well as providing a basis for conceptual developments in chapter four. The firms' motivations of FDI introduced by Behrman (1974) and affiliation of firms to a particular type of market economy following VoC framework, are later on used for provision of the theoretical model of chapter 4 that assumes a transaction cost type of construct (it only considers the monetary drivers of FDI

activity and shies away from non-monetary incentives) in exploring the effect of civil and political liberties on FDI.

The structure of this chapter is follows: in the section 2.2 we review the search strategy that is considered for provision of the material for the literature review. Sections 2.3, and 2.4 review the IB theories on FDI activity, from their early origins prior to and in 1960s and early 1970s, and further developments made in IB theory in explaining the FDI activity during 1970s-1980s and the taxonomy of firms' motivations from FDI activity provided by Behrman (1974). Since this research mainly builds on the firms motivations of FDI, Behrman's taxonomy of firms' motivations is discussed in length in order to inform subsequent developments made in future chapters. Section 2.5 reviews the developments made in IB theory in explaining the FDI activity in 1980s and 1990s, in particular it reviews the OLI paradigm of Dunning. Subsequently, in section 2.6, the IB literature on FDI in post 2000s era is reviewed. However, it is worthy to note that our research mainly builds on firms' motivations to investigate FDI activity. Consequently, we shy away from provision of lengthy reviews of the recent developments made in OLI paradigm and keep the discussions fairly brief. In turn the Varieties of Capitalism (VoC) framework provided by Hall and Soskice (2001) is reviewed and discussed in section 2.6, allowing us to distinguish between the ways firms from Liberal Market Economies (LME) coordinate their activities in comparison to their Coordinated Market Economy (CME) counterparts. Section 2.7 incorporates the VoC framework into IB theory by discussing relational view of VoC framework and the coordination spheres of firms. The arguments developed in this section will be further developed and used in the construction of the theoretical model in chapter 4, and the empirical analysis of chapter 7, in order to better explain the FDI activity of the firms. Finally, section 2.8 provides an overview of the developments discussed, from the origins of the literature on FDI flows up to date.

## **2.2. Search Strategy**

The process of literature review is a continuous process in provision of current academic research. This notion is well represented by the diagram of Booth et al. (1995) provided in the figure below:

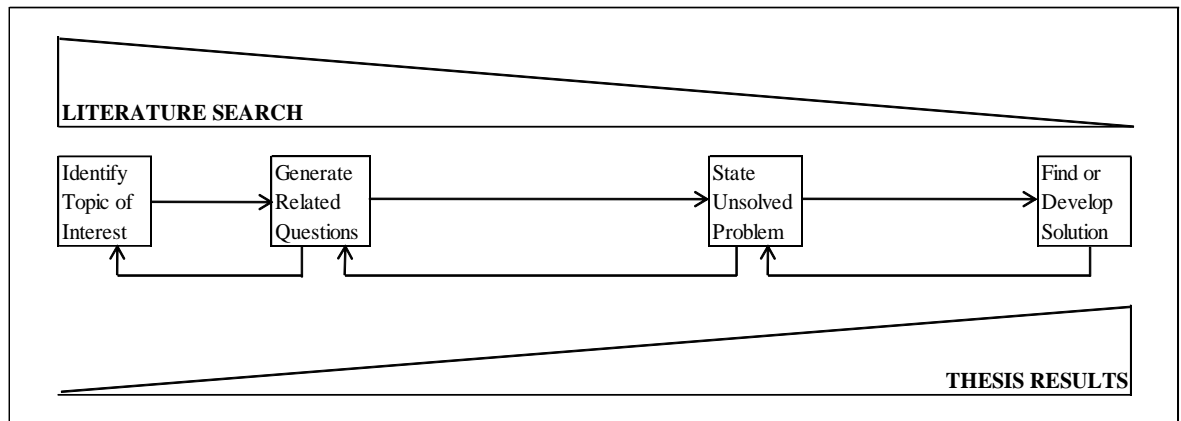


Figure 2-1: A Flow Diagram of a Literature Review – Source: Booth et al. (2005)

The main goal of the literature review of this section is to; First, identify and review the existing theories on determinants of FDI; second, investigate the strands of literature on factors affecting Foreign Direct Investment (FDI); third, to find the existing gaps in the literature on FDI and MNEs motives, behaviour and factors affecting them. The literature sources available can be divided into three main categories. First, is the primary sources which are rich in terms of detail but hard to collect (the examples of the latter are; reports, conference reports, company reports and etc.). Second, the secondary sources that in general aim at a wider audience than primary sources, and are easier to collect and better covered by tertiary literature. Finally, the tertiary literature sources that according to Saunders (2003, p.51) are “designed either to help to locate primary and secondary literature or to introduce a topic”. Saunders (2003, p.55) recommends that before commencing the literature review, researcher should undertake three main elements, namely; defining research parameters, generating search words and finally, discussing the ideas as widely as possible.

In defining the parameters of a research the following elements are of importance; language of publication, subject area, business sector, geographical area, publication period and literature type. (Bell, 1999)

In this thesis, the language of the research is the English language; the subject area is the determinants of FDI decision, motives, and behaviour and FDI movements as a result of them. The sectors taken into account are all sectors. The geographical area is all areas. The publication period is from 1970 to 2013. Literature is mainly extracted from secondary sources, namely; Academic journals, books, conference papers. However, this thesis

considers briefly the primary sources by reviewing some unpublished papers in order to provide a greater scope of the standing literature on the subject. Finally, a number of tertiary sources are used that are cited accordingly.

Moreover, this chapter reviews the established theories of FDI in IB literature, Organization theories and VoC theories. The process of data collection is conducted in four main steps: First, the primary sources of data reviewed are the two main reference books of Dunning and Lundan (2008) on theories of FDI, and Hall and Soskice (2001) on Varieties of Capitalism. Second, in order to expand on the existing literature reviewed in the core text books, the relevant studies mentioned in the text are collected and reviewed. Third, in order to enrich the review of the literature a snow ball sampling method is adopted using the core text books and relevant studies mentioned therein in identification and collection of relevant literature. Fourth, a further search is conducted by searching the ECONLIT, NBER, REPEC, ECON PAPERS and JSTOR databases, on the Internet using keywords such as “FDI and civil liberties”, “FDI and political liberties”, “FDI and democracy”, “FDI and institutions” and “FDI”, and through review papers on determinants of FDI. The selection of these databases for extraction of the articles is mainly driven by the fact that they tend to provide the most extensive set of articles, with some concentrating more on the printed papers (i.e. JSTOR) and others more focused on the provision of working papers and white papers (i.e. REPEC, EconLit). Out of the thousands of articles briefly reviewed, the overall number of papers extracted for the analysis at the first stage was about 239 papers. The search criteria adopted in the fourth step takes into account the following criteria in filtering the relevant literature to our research question; (1) Dependent variable of the papers is FDI. (2) Papers have considered one or multiple of the factors (institutional, political, and civil) in their analysis either exclusively or inclusively. (3) Papers examine the effect of one of the factors (Institutional, Political, Civil Liberties) on FDI.

After explaining the research criteria, research parameters and the data collection method applied for provision of the sample, in the next section, we start the chronological review of the literature.

### 2.3. Overview of the developments made in 1960s and early 1970s

Prior to 1960s there was no established theory of MNE or of FDI (Dunning and Lundan 2008). However a number of scholars explored the different aspects of MNEs' activities. For instance investigating capital movements, scholars such as Iversen (1935) put forward theories of portfolio capital movements, others including Southard (1931), Marshall et al. (1936), Barlow (1953), and Dunning (1958) explored the effect of country specific influences on the location of FDI, a third group of scholars including Lund (1944) considered the internationalisation and capital movements in the light of firms' competences, and finally authors such as Plummer (1934), Penrose (1956), and Bye (1958) explored the internalisation processes of vertical and horizontal activities undertaken by firms, as well as neoclassical theories of trade.

During and post 1960s, the emergence of the capital flows between the post-World War II developed countries, underlined the importance of theories that could explain the motivations, and reasons behind international production of many corporations (enterprises). The earliest theories on the subject putting forward some explanations in this regard, often came short of explaining the cross investments in the same sectors by/from countries that were at different stages of development, as well as cross investments between similar developed countries<sup>9</sup>. Amongst these works is the work of Bain (1956) who explained the competitive structure and ownership of a variety of U.S. industrial sectors according to market imperfections (a number of factors namely; entry barriers, proprietary rights, scale economies, privileged access to markets and absolute costs<sup>10</sup>) that provided firms in certain industrial sectors with competitive advantages. Other scholars such as Hymer and Vernon developed theories based on firm specific assets and ownership advantages, and developed models such as product life cycle to explain this phenomenon<sup>11</sup>.

Moreover, considering the organization theory of the firm, in 1960s and early 1970s IB literature generally adopted the neoclassical economics with the neoclassical definition of the firm provided by Yarborough and Yarborough (1988) as "a unitary profit-maximising entity defined by a technologically determined production function" (p.2). This view focuses on two main points: the quasi-contractual arrangements claimed to rationalise the

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<sup>9</sup> developed countries with the similar level of development

<sup>10</sup>Oxford Hand Book of International Business (2001, Chapter2, p.38)

<sup>11</sup> Firms investing abroad in a manner that had not been observed before

existence and operation of the firm, and the separation of ownership and pursuit of alternative 'realistic' goals, referred to as 'managerial theories of the firm'. Thus the general neo classical approach of the IB literature during 1960s and early 1970s, considers firms, as profit maximizing entities and place them as the main building block of the economy, aspired by the works on neoclassical theory of the firm and modern organization view put forward by Coase (1937), Hayek (1945), and Arrow (1969). The early European researches on FDI from Dunning (1958), and those of American business schools, assume firms as the profit or asset growth maximising entities and the institutional component of managerial decision making, and motivations and behavioural issues, are rather omitted from the most scholarly works including the Vernon's (1966) product life cycle model (with the exception of Aharoni (1966) with brief behavioural considerations). In 1970s, when the focal of attention was deviated more towards MNEs, a number of scholars [i.e. Behrman (1974), Buckley and Casson (1976), Johanson and Vahlne (1977)] adopted organization perspectives in their scholarly works on the subject, however in this period the behavioural component of the entities were the subject of attention and the term 'institutions' was not explicitly used, and certainly not developed to great length that is has to this date. The overview of the developments made in 1960s-1970s in IB literature, comparative capitalism and organization theory were discussed above. The following section reviews the earliest IB theories on FDI.

### **2.3.1. Theories of FDI (1960-70s)**

As discussed in previous chapter, two influential theories of FDI were developed by Hymer and Vernon in 1960s and early 1970s with the intention to explain why firms invest abroad. In this subsection, these theories are reviewed and their contribution to the FDI literature is discussed.

#### **2.3.1. A. Hymer (1960/1976) & Market Power Approach**

Hymer a PhD student at MIT in 1960 under the supervision of Kindelberger was searching for an explanation for the engagement of the enterprises (corporations) in international production (going overseas). Building on the theory of the firm, Hymer argued that firms at their early stages grow (as firm's market power, profits, and concentration increases) in size as well as complexity within their national boundaries, and that this growth continues up to the point where the concentration of a number of firms

within the national boundaries results in an environment where firms have no possibility of, or gain no profitability from, increasing the concentration within their national boundaries. It is at this stage that firms become interested in investing abroad as a way of extending their operations, markets and networks.

In his view FDI was undertaken not as a result of the difference in interest rates in foreign markets relative to the home market, but rather, in order to finance the international operations of the firms. Therefore he considered that in order to explain FDI, it was essential to understand the reasons why the firms found it “profitable” to control other firms/assets across border in coordinating their international operations. Consequently, he argued that in order to explain FDI, it is necessary to explain the international operation of the firms rather than other aspects of MNEs i.e. the growth of MNEs. In terms of the costs of international operations of the national firms, he considered two types of costs: first, the fixed costs (i.e. different language, market, political and economic environment, etc.) and second, recurring costs (i.e. exchange rate risks, discrimination by governments, consumers, etc.). Given the higher costs of operating abroad, he argued that the firms undertake FDI to operate in foreign markets for two main reasons: first, removal of conflict, and second, possession of advantages. On the latter (possession of advantages), Hymer, being influenced by the ideas of Bain (1956), he noted that firms have different types of advantages, that they might use in order to operate internationally, however, he does not specifically focus on the types of advantageous.

In contrast to his earlier work (Hymer 1968), Hymer (1972) adopts a different approach in explaining international production by adopting the Coase’s theory of firm, and explores mainly the boundaries of the firm, rather than the organization of the MNE and the organizational aspect of MNE as a distinctive organization form (Yamin and Forsgren 2006, pp.168). Coase (1937) introduced firm as the building block of analysis which has been a popular organizational view adopted by many studies throughout the years. Hymer (1972) basing his arguments mainly on the view point previously developed by Coase (1937), explores the reasons why firms engage in vertical expansion and integration (vertical and horizontal integration of firms) and acknowledges that MNEs’ activities might lead into a better allocation of resources in an international level, by circumventing market failures. However he pays little attention to the strategic and managerial related

issues.<sup>12</sup> The latter did contribute immensely to the internationalisation theories which were developed in next decades.

In general Hymer's work for the most part (Hymer 1968; Hymer 1972) focuses on Multinational corporation (MNE) as an institution that engages into international production rather than engaging mainly in international exchange, by doing so he constructs his arguments in a way that allows him to explore MNEs' behaviour, based on their industrial organization (in the context of industrial organization theory) and ask questions regarding "how can a foreign company compete successfully in an unfamiliar market, where it must be at disadvantage compared to local firms". In order to answer the latter he argues that "for firms to own and control foreign value-adding activities, they must possess some kind of innovatory, cost, financial or marketing advantages- specific to their ownership – which is sufficient to outweigh the disadvantages they face in competing with indigenous firms in the country of production". (Dunning and Lundan, 2008, p.84)

The works of Hymer (1960; 1968; 1970; 1972; 1976) on the explanations of the foreign value added activities of firms using the theory of indirect capital provided four main contributions for the literature on FDI. These contributions are: first, FDI is a result of market imperfections. Therefore, the explanations provided on FDI activity based on the predictions of classical portfolio theory incorporating factors such as risk, uncertainty, exchange rate volatility, transaction costs and the costs related to obtaining information, became generally invalid. Second, was that FDI involves the transfer of more than funds (finance capital) as the portfolio theories of Iverson (1935) subscribed it to. He argued that FDI involves the transfer of not only monetary resources, but also the managerial skills and human capital, entrepreneurship, technology and in a sense a package of resources. The third contribution of Hymer's work, is the way the 'international firm' is viewed as the firm that 'internalises or supersedes the market' boundaries. "The latter provided a useful prologue to the theory of internationalization as a means for transferring knowledge, business techniques and skilled personnel". (Dunning and Lundan 2008, pp.82-84)

The fourth contribution of Hymer's work<sup>13</sup> is the introduction of the concept of **firm specific assets**. Hymer noted that firms' international operations in foreign countries are expensive for the MNE relative to costs local firms bear in coordinating their activities due

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<sup>12</sup> Oxford Hand Book of International Business (2001, Chapter2, p.38)

<sup>13</sup> 1960s dissertation published in 1976



to the existence of market imperfections and added costs of coordinating their activities abroad as a result of barriers to language, culture, higher costs of communication and governance, etc.). He demonstrated that the firms have to possess certain propriety advantages that help them to compensate for the disadvantages that they face in foreign markets.<sup>14</sup> In other words MNEs need to possess inherent advantages in order to be able to compete in host markets whilst bearing higher costs relative to the local firms. Noting the importance of firm specific assets for MNEs, he introduced and emphasised on the Ownership advantages of MNEs.

Kindelberger (1969) interpreted the Hymer's explanation of international operations which was more based on the theory of the firm, in an industrial organization theoretical context in which the MNE was viewed as a result of the monopolistic competition in differentiated products in contrast to the more theory of the firm view of the MNE, which viewed it as an agent involved in oligopolistic interaction with other firms. A number of works by Hymer (1976), Kindelberger (1969) and Caves (1971) have used the market imperfections in explaining the international production activities of the firms.

### **2.3.2. B. Vernon (1966) & PCM**

Vernon (1966) building on the works of Linder (1961) and Posner (1961) introduced the Product Life Cycle Model (PCM)<sup>15</sup> in order to explain foreign activities of US MNEs<sup>16</sup> after the Second World War, by proposing that apart from the human resources and natural endowments, a country's propensity to engage in trade is mainly depending upon its firms' capability in upgrading these assets as well as provision of the new ones (mainly technological capacity). Vernon's (1966) main idea is as follows: in the first stage the products are produced for domestic consumption in the proximity to the innovatory activities and markets. At a second stage in product life cycle when the combination of the innovation and production advantages of the U.S. firm is favourable, the firm starts to export to other countries. In the third stage of product life cycle, the product matures and its competitive advantages which were once of uniqueness and innovation, change into minimisation of the costs of value adding activities as well as their marketing expertise. At this stage due to the higher pressure on the firm to compete with its imitators, the increases

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<sup>14</sup> Kotha, S., Rindova, V.P. and Rothaermel, F.T. (2001)

<sup>15</sup> a microeconomic concept

<sup>16</sup> a concept that has a macroeconomic nature

in price elasticity, and increase in the cost of labour results in choosing a location for production or value added activities across borders, rather than domestic. Thus, Vernon (1966) argues that “if the conditions in the host country were ‘right’, the affiliate might replace exports from the parent company or even export back to it.” (Dunning and Lundan, 2008, p.85)

The setting developed by Vernon (1966) has the firm as the unit of analysis and explains the foreign production using an extension of neo-classical theory of spatial distribution of factor endowment with intermediate products. However Vernon (1966) assumes the factor endowments as country specific, and therefore does not consider other factors that might be benefiting firms such as the ones suggested by internationalisation theory. Therefore the product life cycle model introduced by Vernon (1966) refers to efficiency seeking production of the firms, where the firms are benefiting from certain ownership advantages<sup>17</sup>.

The efficiency seeking activities of firms are a product of the Efficiency Seeking (ES)<sup>18</sup> motivations of firms. These motives as Dunning and Lundan (2008, p.78) describe are to “rationalise the structure of established resource based or market seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities”. Therefore based on Vernon (1966) it is possible to view the relocation of the firms into foreign markets which is mainly with the main objective of sharpening the cost efficiency of the operations, a result of the ES motivations of the firm that result in turn to ES FDI. Therefore firms undertake such investments (and as a result become MNEs) in order to enhance/defend their competitiveness in (usually higher-income) markets where they are already well established [Dunning (1993), Hood and Young, (1979), Caves (1971)]. Vernon (1966) considers such strategies to be considered at later stages of the product life cycle, when the product matures and its competitive advantages which were once of uniqueness and innovation, change into minimisation of the costs of value adding activities as well as their marketing expertise, therefore, the firm would have undergone through the two first stages of innovation and production for domestic market, and exports to foreign markets. As Vernon (1966) and later on Dunning and Lundan (2008) note firms that undertake ES FDI are usually

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<sup>17</sup> Ownership advantages in the view of Vernon (1966) are country specific and therefore, in this case for the U.S. firms, this could be interpreted as a certain combination of innovation and production advantages enjoyed by these firms.

<sup>18</sup> ES states that production of specific existing goods is relocated to a particular country with the main objective of sharpening the cost-efficiency of operations.

experienced, diversified and large firms that have undertaken other forms of FDI such as Resource based and market seeking FDI, and are at a certain stage where they have become sufficiently large, and therefore undertake ES FDI in order to sustain their activities in a competitive manner.

Efficiency Seeking FDI is mainly undertaken by firms either in order to take advantage of differences between the availability and relative cost of traditional factor endowments in different countries<sup>19</sup>, or is in order to take advantage of economies of scale and differences in consumer tastes and supply capabilities. The former is the case where the MNE operates both in developed and developing countries, while the latter is the case where the MNE is operating in countries with similar economic structure and income levels. In this type of ES FDI, competencies and capabilities of the MNE, incentive structures and availability and quality of supporting institutions, characteristics of local competition and the nature of consumer demand as well as macro and micro policies of the governments are of greater weight in influencing the decision of MNEs, in contrast to the less significant factors such as factor endowment.

Vernon similar to Hymer explores the foreign activities of U.S. firms. However, in contrast to Hymer is more trade and macro oriented. He emphasises on country specific factors. In fact he argues that the advantages of the U.S. firm relative to their rivals are the country's (United States') factor endowment, market structure and patterns of demand, and relates these country specific factors to both the origin of the competitive advantage of the firms and the location of their value added activities. Therefore Vernon's analytical framework shies away from three main factors: first, he pays minor attention to the "organizational structure of firms"<sup>20</sup>; second he only considers the case where firms engage into FDI as a mean to access the means of production in a pro-active manner and shies away from other types of FDI production such as licensing; third, he does not consider the implications or gains that result from the organizational form of the firm as MNE. In contrast Vernon (1983) considers the organization institutional risks as one of the factors influencing outward FDI of the firms.<sup>21</sup>

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<sup>19</sup> The example of the latter is the type of MNEs that conducts its production in both developed and developing countries, where it concentrates its capital intensive, technology and information intensive value added activities in developed country and the labour and natural resource intensive activity in the developing country.

<sup>20</sup> Oxford Hand Book of International Business (2001, Chapter2, p.38)

<sup>21</sup> Oxford Hand Book of International Business (2001, Chapter2, p.38)

Therefore in comparison, Hymer adopts a micro view to analyse a macro phenomenon, considering firm as the unit of analysis, and arguing that the ownership advantages of the firms are the drivers of the firm in its investment abroad. He considers the issues of control and ownership visibly in his analysis. Vernon, adopts a more macro view and considers the country specific factors as the comparative advantage of a firm relative to its counterpart in other countries, and considering the case of United States post WWII, discusses that firms in U.S. start with a comparative advantage but in time as the product matures this advantage erodes as a result of imitators and therefore firms have to relocate abroad to maintain the competitive advantage (take advantage of cheaper labour and higher volumes). Thus, he refers to **efficiency seeking motives** of the multinational firms.

Our research similar to Hymer's, adopts a micro view and places firm at the centre of analysis and explores the effect of civil and political liberties on FDI activity by considering the micro drivers (firms' incentives and motives) that inform firms' FDI activity. In contrast to the work of Hymer, however, our study does not emphasis on the ownership advantageous and instead considers the motivations of the firm as the drivers of their FDI activity. Amongst these motivations we consider the efficiency seeking motives introduced by Vernon, and consider the firms to be profit maximising entities that are sensitive to costs, and view the effect of civil and political liberties on FDI activity of the firms mainly thorough a transaction cost view. In particular in our theoretical model the ES motives are modelled through cost of production (mainly wages). In our empirical model the ES motives are similarly accounted for by provision of wages per hour and employee compensation indices that reflect the cost of production in a host country.

#### **2.4. Overview of the developments made in 1970s to the early 1980s**

In 1970s and early 1980s, the concept of market failures seemed to be exhausted in an economic sense as the idea put forward by Coase (1936) had been well extended and the works of scholars such as Williamson (1976) were interpreting such concepts in the behavioural context.

Since early 1960s the works of a number of heretic economists such as Simon (1959), Cyert and March (1963) and other behaviouralists who were questioning the main assumptions of neo-classical economics were at one extreme, and the works of more conventional economists who were trying to internalize the criticism of these heretics into

the traditional structure of the neo-classical economics were at the other extreme. A number of economists of this area, including Alchian and Demsetz (1972); and Williamson (1973, 1976) diverted from these extremes and either focused on industrial organization tradition, others including Akerlof (1970), Spence (1976) explored of the realm of information and uncertainty, or similar to Furbotn and Pejovich (1972) explored the institutional structures and property rights. The general aspect of the works of these scholars is internalization of the market activities, and their emphasis on the role of 'institutions'.

Due to such contributions in terms of the way firms and markets were perceived, in the context of organization theory and transaction costs economics as well as neo-classical economy as a whole, the institutional view of the firm as MNE became increasingly popular. In contrast to the view that emphasises on the ownership aspect of the firms, which views MNEs as firms who own foreign production facilities that are used and controlled in producing internationally, and considers their role as one of the 'producers', the institutional view of the firm as MNE which was adopted by McManus (1972), Buckley and Casson (1976), Hennart (1977, 1982), and Swedenborg (1979), considers MNEs as an institutions that coordinate the use of intermediate assets produced in one or several foreign locations and therefore view the MNEs' role as one of 'transactors',

These developments therefore led to the view of MNEs as transactors in comparison to producers, and the adoption of the neo-corporatism view of comparative capitalism which viewed the capacity of the states in the light of their capability in negotiating durable bargains with employers and trade unions, on wages, working conditions, and other social and economic policies, raised two main questions: first, what is the process through which firms internationalize their activities; and the second, why do firms invest abroad rather than engaging in the contractual transactions or arms' length . The exploration of the first question led to development of Uppsala School of thought that mainly focus on the processes through which the firms internationalize their activities, by Johanson and Vahlne (1977), and Luostarinen (1979) of Helsinki School of Economics and the introduction of market seeking activities. The exploration of the second question led to emergence of the internationalization theory and consequently internationalization advantageous, that were introduced by Buckley and Casson (1976) and further developed in the works of Nelson and Winter (1982), Kogut and Zander (1993), and Dunning (2000), building on the

previous works of Penrose's (1958), Bye (1958) and later on Hymer (1968)<sup>22</sup>. The next section reviews the main IB theories that were developed in 1970-80s, namely the Uppsala School of thought and internationalization theory.

#### **2.4.1. Theories of FDI (1970-80s)**

This section reviews the theories developed by Uppsala School of thought developed by Johanson and Vahlne (1977), and Luostarinen (1979) of Helsinki School of Economics and the introduction of market seeking activities, and Buckley and Casson (1976) and others who worked on internationalization theory and Internationalization (I) advantages. Moreover, since this research build on the work of Coase (1937), we place the firm at the centre of our analyses and attempt to explain the FDI activity through exploration of the firms' motivations of FDI as well as other factors. Consequently, we introduce the taxonomy of firms' motivations of FDI introduced by Behrman (1974), at the end of this section.

##### **2.4.1. A. Uppsala school of thought**

During the 1970s and 1980s, a more international business oriented group of scholars viewed the firms undertaking FDI, as the institutions investing abroad and explored the reasons of such value added activities undertaken by these institutions and shifted away from the earlier views of FDI. Two main strands of literature are developed in this era. First is of the Scandinavian Researchers known as the Uppsala school of thought mainly developed by Johanson and Vahlne (1977), and Luostarinen (1979) of Helsinki School of Economics. This group of researchers mainly focus on the processes through which the firms internationalized their activities, by adopting a sequential approach through which the firms learn about the foreign markets (their market structure, supply and demand behaviour, etc.) and commit to them by investing in those markets. The main idea of Uppsala school of thought is that the firms first enter the foreign markets which they are familiar with (though exporting to these foreign markets or investing in them); second, capitalize on their knowledge of the foreign markets gained from the learning process that occurs through exporting to/or investing in the foreign markets; and third, move onto other unknown territories. Therefore the Uppsala school of thought mainly explores the market

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<sup>22</sup> Hymer (1968) in Casson (1990)

seeking activities of the MNEs and provides a number of models of entry into foreign markets.

Uppsala model contributes to the literature by underlying the role of the level of knowledge and learning capacity that exists within firms in their behaviour and decisions on investment abroad. It considers that firms commit to the market by investing in them rather than other types of investment such as investing as means of diversification of the portfolio. It provides an incremental exploration in the analysis of FDI and considers the market characteristics in the heart of analysis. However, it can be argued that it has the following short comings: first, considers the small firms and countries, i.e. Sweden; second, focuses mainly on the businesses rather than direct investment; third, does not consider the factors such as risk, and distance; finally it does not provide any considerations on the firm's first step abroad nor provides extended discussions on opportunity seeking behaviour or development of the firms.

Another significant contribution of the Uppsala model remains the introduction and exploration of the Market Seeking (MS) activities of MNE. The MS motives of the MNEs refer to the motives that lead to undertaking MS FDI and activities by MNEs. It is possible to categorise such motives into seven categories; first is that of market size; second is the market growth; third is the case when the suppliers of customers of a firm establish foreign production facilities and the firm follows them into those markets in order to retain their business; fourth is increasing the exposure to the foreign market in order to provide more frequently adapted, and better products and services, more adequate for the tastes and needs of the host market; fifth is the increase in the exposure to the foreign market in order to learn about the foreign market, and therefore through the learning process decrease the disadvantages that the firm has relative to its domestic counterparts in the host market; sixth is that producing from a plant adjacent to the consumer market is far less costly than supplying it from a distance. Although the latter is very product/service, and country specific, for the types of goods and services that are highly costly to be transported to the target markets, there is a higher probability of MS FDI for the enterprise than others; Finally, MNEs as a part of their global production and marketing consider it necessary to have a physical presence in the leading markets served by their competitors and hence view MS FDI as a strategic activity through which they maintain their global market position relative to their competitors. Although the strategic element of competition is of

immense importance to the MS motivations of FDI, however it is possible to regard the actions of host governments as one of the most important reasons of MS FDI. Behrman (1974) includes MS motives into taxonomy of firms' motivations of FDI. In this research as discussed before we mainly emphasise on the motivations of FDI rather than Ownership, Location and Internationalization advantageous that later on were incorporated into Dunning's OLI paradigm. Consequently we have provided a detailed discussion of MS motives, and MS FDI in section 2.4.2.

Before proceeding to the pioneers of internationalization theory, Buckley and Casson (1976), perhaps it is beneficial to organize the main advances that provided new platforms upon which many scholars based on their main assumptions. The first in the twentieth century would be Coase (1937) who contributed to the literature in two ways: first, was his view of the firm as the unit of analysis in organizational theory context; second was his criticisms of neo-classical theory based on market imperfections that later on influenced the works of Hymer and others. This line of thought led to literature that mainly considered the market imperfections and their influences on the way firms behave.

The second influential progress was the consideration of the international operations of the firms by Hymer. Hymer (1960) using the market imperfections, and the firm as the unit of, following Coase (1937) and Bain (1956), explained the competitive structure and ownership of a variety of U.S. industrial sectors according to market imperfections. This line of thought led to the literature that mainly considered the international operations of the firms. Finally the third influential progress is the internationalization theory put forward by the Buckley and Casson (1976), which will be discussed in the next section.

#### **2.4.2. B. Internalisation Theory - An introduction to firm and industry level analysis**

The second strand of literature developed in this era, 1970s-80s, was the one proposed by international economists<sup>23</sup>. The works in this strand of literature mainly explore the reasons why the firms invest abroad rather than engaging in the contractual transactions or arms' length. The idea put forward by the internationalization economists such as Buckley and Casson (1976), Nelson and Winter (1982), Kogut and Zander (1993), and Dunning

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<sup>23</sup> These authors were mainly from Canada, Sweden, UK, and US.



(2000) was mainly developed from the earlier works of the Penrose (1956), Bye (1958) and later on Hymer (1968)<sup>24</sup>.

Buckley and Casson (1976) were the first of the international economists who introduced the transaction costs into international operations of the firms, and argued that MNEs coordinate their activities in the way that helps them to develop and exploit firm specific advantages in intermediate products as well as knowledge. Taking advantage of the arguments on ownership, they extend the latter by demonstrating that under the propriety ownership, knowledge is no longer a public good, as it is costly to obtain it, and thus the ownership of knowledge serves as ownership of a firm specific asset that can be developed and exploited. In presence of market failures, firms internationalize their activities in order to gain, develop and exploit firm specific assets (i.e. knowledge), as an alternative to obtaining them indirectly from the external markets.

The main idea of international economists is that the investment activity undertaken by the firms is a function of their comparative cost benefit analysis of organization of the transactions of their intermediate services and goods in their home market relative to the foreign markets. The main difference between this idea and the one put forward by Hymer is that internationalization economists assume firm specific assets as exogenous. The origin of such arguments could be traced to the failure of arm's length transactions in that they either were not providing firms with benefits or did not do so as efficient as the firms could do, and hence referring to Internationalization (I) advantages of firms as MNEs. The internationalization advantages are reviewed in section 2.6.1, as one of the pillars of the OLI paradigm introduced by Dunning (1980).

One of the contributions of the work of Buckley and Casson (1976) is that they consider the industry-level, and firm level analysis, as well as the mostly covered country specific analysis, and thereby shifted the focus of the International Business (IB) literature to firm and industry level analysis. Their novel theory is developed on three main assumptions: first, firms are profit maximising entities in imperfect markets; second, the imperfection of the markets of intermediate products and knowledge, provides motivations and incentives for the firms to bypass them by internalizing markets which in turn means creating common ownership and governance structure for firms in markets in order to coordinate

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<sup>24</sup> Hymer (1968) in Casson (1990)

their activities; third, “internationalization of markets across national boundaries generates MNEs”. (Buckley and Casson, 1967, pp.33)

In spite of the fact that Buckley and Casson (1976) introduce the transaction cost to the international operation of the MNEs, their internationalization theory is not based on the transaction cost economics of Williamson (1975). Instead their work mainly builds on the firm specific assets concept introduced by Hymer (1960, 1976) as they argue that the capacity of the firm to innovate (ability to innovate) is the main firm specific advantage of the firm that leads to internationalization. In more general terms, they argue that the firms with high capacity for innovation (firm specific asset) have a higher propensity to internationalize as they have the ability to develop and exploit their firm specific assets in order to overcome the disadvantages they face in foreign markets. Subsequent research including the works of (Buckley and Casson (1976; 1998), Dunning (1977), Hennart (1982), Zaheer (1995), Caves (1996), Dunbar and Kotha (2000) has focused on identifying those sources of advantage that compensate for the “liability of foreignness”.

Whilst our research design mainly develops on the motivations of FDI, rather than Ownership, Location and Internationalization advantageous, our study is considerably influenced by international economists such as Buckley and Casson (1976), in that they are the first to consider the industry-level, and firm level analysis, as well as the mostly covered country specific analysis, and thereby shifted the focus of the International Business (IB) literature to firm and industry level analysis. This research similarly considers the industry and sectoral level of analysis, as well as country specific analysis in order to explore the FDI activity of the firms (a macro concept) through the micro drivers of firms’ coordination of their FDI activities. Furthermore, our set of assumptions to some extent are inspired by the authors’ work, in that we also assume firms to be profit maximising entities functioning in imperfect markets, where the imperfection of the markets of intermediate products and knowledge, provides motivations and incentives for the firms to bypass them by internal markets which in turn means creating common ownership and governance structure for the firm in markets in order to coordinate its activities. Finally, our research has a number of fundamental similarities with Internationalization theory of Buckley and Casson (1976), in that while we adopt a transaction cost view to explain the international operation of the MNEs. However, in contrast, our main set of arguments throughout the thesis are not chiefly based on the

transaction cost economics of Williamson (1975), and rather rely on the works of Hymer, as we develop on the firm specific assets concept of Hymer.

The next sub-section introduces the taxonomy of firms' FDI motivations provided by Behrman (1974). This research building on the works of Coase (1937) considers the motivations of firms' FDI to act as micro drivers that influence firms' FDI behaviour, and consequently the macro FDI activity.

#### **2.4.2. FDI Motivations**

In this subsection we discuss the motivations of FDI activity drawn from the works of Jack Behrman (1972) and Dunning and Lundan (2008). The general taxonomy of the motivation of FDI is as follows: Resource Seeking motives (RS); Market Seeking Motives (MS); Efficiency Seeking Motives (ES); and finally Strategic Asset Seeking Motives (SAS). As discussed in the previous section, the motivations of firms from their investment abroad are drawn from the earlier works reviewed in the previous sections namely the work of Uppsala School of Thought on Market Seeking motives, work of Internationalisation theorists such as Buckley and Casson (1981) on strategic asset seeking motives, and Vernon's (1966) efficiency seeking concept that was further developed by Williamson (1973, 1976).

##### **2.4.2. A. Resource Seeking (RS) Motives and Resource seeking FDI**

Firms' with resource seeking motives are classified as resource seeking firms or resource seekers. These firms broadly speaking invest abroad to obtain specific resources of higher quality at a lower price or cost in comparison to their home country. Thus their motivations inherently follow a profit maximising nature. The acquiring of the resources with lower costs also promotes their position in a competitive market with respect to their rivals. We<sup>25</sup> classify the resource seekers into four main categories. First, are those driven by the incentive to minimise their costs and secure their supply through acquiring physical resources of a certain type. The physical resources include minerals (fuel minerals as well as industrial minerals), agricultural products and metals. Specifically, these resources<sup>26</sup> are the ones, for whose production demands a particular kind of "complementary capabilities

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<sup>25</sup> Dunning and Lundan (2008) classify the resource seekers into three main categories. Namely the first three types of resource seekers provided in this section.

<sup>26</sup> These resources include: Gas, Coal, Oil (Fossil Fuels), Diamonds, Zinc, Copper, Tobacco, Rubber, Sugar, Pineapples, Bananas, Palm Oil, Coffee, Tea.

and markets that MNEs are especially well equipped to provide” (Dunning and Lundan 2008, pp.67-69). In general the resource intensive FDI of this type demands a high level of expenditure. The location based and location bound resource seeking also entails FDI in service sectors such as construction, education, tourism, and oil drilling. This type of RS motives is observable in firms from both developed and developing countries. The example of this type of RS investments is the Chinese and Indian firms’ recent investments in Africa. (Dunning and Lundan 2008, p.68)

The second type of RS FDI entails firms that are interested in rich supply of cheap labour. Since labour force is one of the factors determining the profitability and cost structure of the firms, it naturally follows that firms mainly in manufacturing and service sector would be interested in obtaining plentiful unskilled or semi-skilled labour for lower cost. The distinction between the levels of skill is made based on the idea that the high skilled labour force has the propensity to be more sensitive to wage differentials than their low or semi-skilled counterparts. This type of RS motives is observable frequently in the firms from more advanced and industrialized countries. The example of this type of labour-seeking investment is the USA and EU firms’ investment into South East Asian countries such as Taiwan, and Malaysia. (Dunning and Lundan 2008, p.69)

The third type of RS motives includes firms that aim to acquire management expertise, organizational skills, or technological capability through collaborative alliances. Example of this type of FDI is observable from Korean and Indian firms’ collaborative alliances with firms from EU and USA. (Dunning and Lundan 2008, p.69)

The fourth type of RS motives includes firms that aim to acquire specific type of resources that exist only in certain regions. These types of RS motives are not considered in the context of this research, since their consideration would be case specific and in contrast to the aim of this research. Our empirical model takes into account all three types of resource seeking motives by provision of two main models. In our first model we take into account the resource seeking motive that is stimulated by abundance of resources and labour. However, the cost comparison are not made, due to the fact that RS motives are included as explanatory variables that would explain the FDI activity in the way that they provide the opportunity for our empirical model to explore the effect of civil and political liberties on FDI. Similarly the abundance of human capital (management expertise, organizational skills, or technological capability) is explored through consideration of

research and development index in the second model, in the presence of the other two RS motives' variables, allowing us to capture RS motives in full extent.

It is also possible to distinguish between firms who place emphasis a certain type of FDI activity. For instance firms that mainly undertake RS activities include those who populate the commodity sector, as well as those in manufacturing sector. The contrast would be on the type of RS FDI undertaken. Thus a sectoral consideration would possibly provide a greater view of the type of activities that firms in the sector undertake, as well as the types of FDI that are normally considered in the sectors.

#### **2.4.2. B. Market Seeking (MS) Motives and Market Seeking FDI**

Firms with MS motives generally invest in a particular country with the intention of supplying goods and services to the country itself or its adjacent countries. In most cases these regions have been supplied through exports by the firm and the undertaking of FDI is mainly to reduce the cost of export, other related costs or in many cases the changes in tariffs and import policies of the designated countries. Therefore, since the aim of firms is to supply the local or adjacent markets, the market size and the prospects of market growth are of importance for firms motivated by MS motives. Dunning and Lundan (2008, pp.70-72) classify the MS motives into five subclasses. First, is the type of MS FDI that takes place due to changes in the location of firms' suppliers or buyers. For instance if the buyers of a firm set up a foreign production plant, firm would be interested in following them through MS FDI in order to supply the demand of a currently engaged buyer. The example of this type of MS motives is the MS FDI of many Japanese auto-component manufacturers in U.S. through establishment of subsidiaries or joint ventures with the intention of supplying the U.S. auto manufacturers (Dunning and Lundan 2008, p.71). The second type of MS motives that leads to MS FDI is that firms need to adapt their products and services frequently in order to meet the local expectations in terms of "cultural mores", "indigenous resources and capabilities" as well as local tastes. Therefore it is imperative for firm to familiarise themselves with the language, legal requirements, business customs and marketing procedures of the local markets. Otherwise they would be in disadvantage vis-à-vis local firms.

The third type of MS motives that leads to MS FDI is that in many cases where a certain government policy in terms of export, import, or trade policy limits the activity of the firms

from a certain country, MS FDI is undertaken in order to circumvent such laws and ensure the supply of the designated market. The example is that of Canadian Telecom MS FDI into U.S. in late 1980s with the intention of securing Japanese contracts in an era where Japan due to political reasons favoured U.S. telecommunication industry for its source of telecom equipment (Dunning and Lundan 2008, p.73).

The fourth type of MS motives that leads to MS FDI is that in many cases the production and transaction cost of supplying a market through exports are generally higher than supplying the market within.<sup>27</sup> This type of motivation is highly case specific since the production and transaction costs are industry and country specific. In general this type of motivation leads to MS FDI in case of the countries that are geographically removed from their markets. For instance the MS FDI is commonly used by U.S. firms when investing in Germany and rarely undertaken by their French and Dutch counterparts (Dunning and Lundan 2008, p.73).

The fifth type of MS motives is that of a strategic nature; where an MNE undertakes MS FDI in order to ensure its presence in markets where its competitors have established their physical presence. Many of the “leader and follower”, and “bandwagon” type of investments are driven by strategic MS motivations and are implemented through MS FDI. Our empirical model only considers the type of ES motives that are stimulated through market size (first type of MS motives). Our proxy for market size is Gross Domestic Product (GDP), which is chiefly considered as a reliable proxy for market size of the host countries in the literature. By doing so, we try to avoid multicollinearity between our measures, since the other types of MS motives explored above have commonalities with other motivations such as ES motives and SAS motives.

#### **2.4.2. C. Efficiency Seeking (ES) Motives and ES FDI**

The ES motives are those concerning governance structure of the dispersed activities of MNEs’ resource based or MS based investments. Firms conduct ES FDI in order to adopt a certain coordination structure between their entities via ‘economies of scale’ and ‘risk diversification activities’ in order to take advantage of different factor endowments, institutional agreements, and demand patterns in a way that leads to higher return on investment. There are two main types of ES motives. First, are the ES motives that lead to

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<sup>27</sup> This type of motives is viewed as MS motives by Dunning and Lundan (2008).

ES FDI in countries with similar income levels and in general economic structures with the intention to take advantage of 'economies of scale'. The second type of ES motivations leads to ES FDI with the aim of taking advantage of differences in relative cost of traditional factors endowments in various countries. For instance an MNE in electronic equipment sector would undertake an ES FDI in U.S.A or EU with the aim of production of the high tech designs of the product, while it would undertake another ES FDI in India or China with the intention of manufacturing the equipment in a much more cost efficient manner.

Furthermore in many cases, the distinction between the motivations is not transparent, due to the general taxonomy of motivations provided by Behrman (1974), or in other cases due to the fact that firms' motivations overlap, leaving the determination of the type of motives up for interpretation. For instance in the previous section (MS motives) we explained the type of MS motives that leads to MS FDI in cases where the production and transaction cost of supplying a market through exports are generally higher than supplying the market within. This type of motives can easily be interpreted as ES motives, due to the fact that the incentive of the firm from their investment is mainly based on their intention to reduce their costs in supplying the host country's market or adjacent markets. Thus it is possible to argue that the main intention of the firm from their FDI activity is increasing the efficiency of their activities and lowering their costs in supplying foreign market(s), and thereby to review these types of motives as ES motives.

A similar line of reasoning can be applied to the first three types of RS motives discussed in section 2.4.2. A, namely: the RS motives that intend to acquire resources at a lower cost; RS motives that intend to take advantage of wage differentials and aims at acquiring cheap labour; and finally the type of RS motives that aim to acquire management expertise, organizational skills, or technological capability through collaborative alliances. These types of motives can easily be interpreted as ES motives due to the fact that the main incentive of the firm from the investment is lowering their costs by acquiring cheaper resources through FDI. Finally, considering the sectoral analysis in our research, it is possible to view the firms' motives in acquiring cheap labour in sectors with high level of human capital (i.e. services) and lower level of human capital (i.e. manufacturing), as ES motives of the firms, since the main incentive of the firm in these cases is lowering their costs through FDI. The latter indicates that provision of a distinction between the firms

investment into high knowledge intensive and lower knowledge intensive sectors requires further considerations in order to determine the boundary conditions of the wage setting in various sectors.

In our analysis, while allowing for the presence of reservation wage and unemployment in the market, we argue that the wage setting process between foreign firm and labour representatives in most cases bounded by a range that revolves around the average wage paid for labour in certain sector. Furthermore, we consider the effect of repression of wages on labour productivity in a conceptual manner, arguing that in sectors in which the labour share of production supersedes the capital share of production, and the nature of labour contribution to the production is knowledge intensive the ES motives would be more in line with lower the cost of production whilst the strategies that are undertaken in this regard are more in line with provision of higher wages in comparison to the average sectoral wage in the host country in order to ensure higher productivity of labour. In contrast we argue that in sectors in which the production is mainly capital intensive and the labour contribution to the production is not knowledge intensive (and due to less knowledge intensive nature of labourer's input to production, they are easier to replace), the ES incentives generally tend to be followed through strategies that ensure that the cost of labour is sufficiently low in comparison to home market and other possible host locations in which FDI could take place, in order to provide firm with higher return on investment and thus contribute to the firms' financial competencies in comparison to its competitors.

Moreover, in this study, the variables that are considered to proxy for ES motives include employee compensation and wages per hour that ES motives explained above. Since our research is founded on a transaction cost premise that explores the effect of civil liberties and political rights on FDI through examination of their effect on the wage setting process, and taxes, respectively, our theoretical exploration mainly focuses on firms that are stimulated by ES motives and considers the distinction between low and high knowledge intensive sectors by exploring labour share of production. However, our empirical analysis provides a number of explanatory variables that proxy for all motives, and by doing so affords us the possibility of exploration of the effect of civil and political liberties on FDI in a less restricted manner, by allowing the investigation of the effect of civil and political liberties in the presence of explanatory variables that proxy for RS, MS,



ES and SAS motives of the firm. The distinction between high and low knowledge intensive sectors in our empirical setting is made through provision of a variable that indicates the investment in research and development in the host country and thus provides the opportunity to provide a cross country comparison between the same sectors in various host locations. Therefore, our theoretical model explores the effect of the level of human capital on ES FDI through examination of the differences within sectors, whilst our empirical model explore the effect of the level of human capital on ES FDI through examination across country differences in the same sectors.

#### **2.4.2. D. Strategic Asset Seeking (SAS) Motives and SAS FDI**

SAS motives are those relating to acquiring assets of foreign entities, with the intention of pursuing MNEs' long-term strategic objectives, specifically objectives that are related to issues of sustainability and advancement of MNEs' competitiveness. Therefore the SAS motives are more related to the type of FDI that leads to obtaining firm specific assets that lead to a greater competency of the MNE in contrast to its competitors. Therefore the motives of SAS FDI are in general in line with strengthening the firms' competency by acquiring firm specific assets in comparison to its competitors, rather than exploiting market advantageous of specific costs. Considering the definition and properties of SAS motives, their classification is heavily reliant on the Hymer (1960) work on firm specific assets, where the firm specific assets are acquired with the intention of ownership specific advantageous and/or weakening competitors' competences. Therefore, in the case of SAS FDI, similar to ES FDI, firms tend to aim to take advantage of common ownership of their diversified assets, with the distinction that the former tends to follow strategic incentives and hence strengthening firms' competency in comparison to its competitors, while the latter mainly focuses on lowering the costs and achieving higher returns on investment, and therefore strengthening the financial position of the firm.

In general the SAS FDI is conducted through mergers, and acquisitions, and joint ventures that are aimed to contribute to the core competency of the firm. In this sense SAS FDI is undertaken using one of the three methods just mentioned in order to elevate the core competency of the firm in comparison to its rivals. A few examples that indicate the dominant strategic incentives of FDI include: first, SAS FDI that is undertaken by firm in order to forge a collaborative alliance with another firm, with the intention of diminishing the chances of the competitors to do so; Second, SAS FDI that undertaken in the form of

merger with a foreign competitor in order to elevate the core competences of both entities vis-à-vis more powerful competitors; third, SAS FDI that is undertaken to procure a number of suppliers with the intention to corner firms' competitor; fourth, SAS FDI that is undertaken to procure a number of distributions outlets in order to gain a better distributional capability in comparison to its rivals; fifth, SAS FDI that is undertaken in order to acquire a host market entity in order to be able to obtain government contracts that are not accessible to the foreign firms; and six, is the SAS FDI that is undertaken in order to procure a firm that produces complementary goods and services with the intention to offer its customers a more diversified range of products (Dunning and Lundan 2008, p.73).

Finally, as discussed earlier in many cases it is difficult to separate between SAS, ES, and other types of FDI. In most cases the taxonomy of the motivations provided allows interpretation of overlapping motives in various ways. However, empirical IB literature has provided a series of explanatory variables that are conceptually related to each of the motives discussed. For instance variables such as GDP and GDP per capita have been extensively used to indicate the market size and MS motives of FDI. ES motives have been mainly represented by labour related variables such as wages, employee compensation, and other variables including taxes and cost of export and import. The RS motives have been generally represented by variables that indicate the level of resources in a host location, which include: estimate of natural resources' reserves (i.e. crude oil, oil, natural gas, etc.) and production of natural resources. Finally, SAS motives have been mainly represented by research and development related indices (i.e. expenditure on R&D, number of R&D researchers, etc.), high technology exports, export and import platform indicators including quality of transport system variables (i.e. air freight transport, rail lines, paved roads, etc.), and logistics performance. The discussion on the variable selection will be provided in chapter 6.

#### **2.2.3.4. E. Overview**

The four main types of motivations covered in this section are one of the corner stones of our empirical analysis as we consider the MS, RS, ES, and SAS motivations as the micro drivers of FDI activity. In post 2000s era, three motivations are added to the discussed set of motivations which include: escape investments, support investments, and passive investments. These motivations are not discussed due to the fact that our theoretical and empirical investigation chiefly builds on the four established motivations

provided by Behrman (1974). The next section reviews the developments made in literature on FDI, during 1980-1990s.

## **2.5. Overview of the developments made in 1980-90s**

During 1980-90s, due to the globalization and technological advances that have widened the options for behaviour of firms as well as governments, and the increases in the uncertainty complexity and volatility of the environment in which MNEs operate, the institutional factors and institutions started to become an integral part of the explanations provided for determinants of FDI activity. A number of scholars in this era did incorporate the institutional issues in their works, however did not distinctly labelled them as such or either have not considered them as the main objective of their research. At national level works of a number of scholars including Eden and Potter (1993) working on the international political economy, international relations, and business history have been amongst those taking into account the institutional factors. At firm level, works of Kogut (1992), Kogut and Zander (1993) and Westney (1993; 2001) on the role of culture, and sociological analysis of culturally related patterns have helped to introduce the institutional considerations into mainstream theorizing<sup>28</sup>.

Moreover, in this era a number of approaches were incorporated by Dunning (1980, 1981) into a holistic approach that embodies all the seemingly separate theories of why firms' undertake FDI activity (i.e. Ownership advantageous, Location advantageous and Internationalization Advantageous). Dunning (1981) building on the previous theories of FDI, provided an eclectic framework of FDI (O-L-I), in order to provide an explanation for the international investment position of a country. The eclectic nature of the OLI paradigm has allowed the continuous revisions and enhancements in the framework, consequently OLI framework has been one of the main IB theories that can be adopted to explain the FDI activity to date. However, our research does not adopt the OLI paradigm in order to explore the effect of civil and political liberties on FDI. Therefore in this section the original OLI framework and in section 2.8 the recent revision of OLI paradigm will be briefly reviewed in order to familiarize the reader with the framework. The next section provides a review of the main theories of FDI developed in 1980-90s.

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<sup>28</sup> A number of studies on culture, such as the ones building on the works of Hofstede (1980; 2001) as reviewed by Graham (2001) Graham, J. L. (2001). Culture and human resources management. The hand Book of International Business. A. M. rugman and T. L. Brewer, (Eds.). Oxford Oxford University Press: 503–36.  
can be added to the latter.

### **2.5.1. Theories of FDI developed in 1980-90s**

#### **2.5.1. A. Dunning (1980) – incorporates the Internationalization advantages (I) to the Eclectic framework (O & L) -**

Dunning (1980) incorporates the approaches of Hirsch (1976) and Buckley and Dunning (1976) on the effect of ownership and location on both the composition and level of FDI, in order to explore the issues that studies such as internationalization considered previously in Buckley and Casson (1976), in a greater context and provides some empirical contribution in this regard. He argues that the ownership and location endowment approach, by themselves, fall short of providing explanations for all forms of trade, and that while using one of these approaches leads to provision of successful explanations for particular types of trade (Hirsch 1976), they do not provide explanation for all international production. He continues by stating that while the “ownership endowment approach is necessary, it is not a sufficient condition for explaining international production”. By exploring the motives of internationalizing ownership endowments of MNEs (avoiding disadvantages or capitalizing on imperfections of either “market or price system and the public authority fiat”) he discusses that a MNEs’ international involvement is a product of ownership, location, and internationalization advantages and therefore incorporates internationalization advantages into eclectic theory. He shows the latter by the empirical examination of US MNEs in fourteen manufacturing industries in seven countries.

#### **2.5.2. B. Dunning’s Eclectic Paradigm – A synthesis of prior theories of International Investments**

The origins of the eclectic paradigm of Dunning can be traced back to Dunning (1958). Dunning’s notions of ownership and location advantages of the firms were built on the role of MNEs as the organizing entity, and were inconsistent with the general neoclassical international production theories provided by others such as Leontief (1953), Hymer (1960), and Posner (1961). The emphasis of Dunning is on the view of MNEs as the organizing entities as well as the consideration of mobile factor endowments of firms that only existed in imperfect form, is inconsistent with the general views of the scholars of the time such as Vernon (1966; Vernon 1971; Vernon 1979) whose work emphasises on MNEs life cycle, the works of Keessing (1966), Magee (1977) and Johnson (1970) that emphasises more on the role of trade, production and investment in knowledge, the works of

Hufbauer and Adler (1968) and Hufbauer (1970) that emphasises on the role of technical lags, and the works of other such as those of Baldwin (1970) and Knickerbocker (1973) on the role of structural factors and McManus (1972) on managerial aspects of MNEs. However, the main difference between the works of Dunning with the other theories put forward on the subject [i.e. works on international trade and investment Caves (1971; 1980), and other works on industrial organization theories and Bain type advantages]<sup>29</sup> is the emphasis that he puts on the imperfect transferability of ownership advantages of firms.

Dunning (1979; 1980; 1981) builds on the previous works on International Business toward a more holistic approach that can provide the most extensive set of explanations for various types of investment activity undertaken by firms as MNEs. The ingredients of eclectic paradigm are the Ownership advantages drawn from the works of Hymer (1960/1976), Kindelberger (1969), Caves (1971), the Internationalization advantages drawn from the works of Buckley and Casson (1976), and the Location advantages drawn from the works of Vernon (1966), Dunning (1974), and Thrift and Taylor (1982) were introduced by a number of scholars prior to Dunning.

According to the eclectic paradigm of international production, three main factors of Ownership, Internationalization and Location can be used to explain the investment activity of MNEs. The first factor, the ownership-specific advantages in general relate to the ownership of intangible, or tangible assets that provide a firm (an entity) the comparative advantage over its competitors. Such advantages can be categorised in three main types. The second, Location specific advantages (L), relates to the locational characteristics of regions and countries i.e. well-developed infrastructure, presence of skilled and productive labour force, innovatory capacities, investment capacities, low input prices, and how these advantages might provide locational advantages for the firms from these regions and those investing in such regions. The third factor is the internationalization (I) specific advantages which are best visible under the light of market failures. The I advantages consist of a number components which include lower negotiation costs, lower search costs, and those that compensate for the absence of future markets and those that lead to control for market imperfections. Dunning (2000) discusses that the eclectic paradigm is “an envelope for complementary theories of MNE activity”, and thus emphasises that the not only these factors on their own, but also their combination

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<sup>29</sup> Dunning and Rugman (1985)

is of importance in explaining the MNEs international production activities. We refrain from extensive explanation of OLI paradigm in this section and leave the provision of a more extensive review to the section 2.6.1.

Another approach by Jack Behrman (1974) provided the taxonomy based on which the international investment activity of firms are categorised according to their motivations, namely; market seeking, efficiency seeking, resource seeking and strategic asset seeking motives. Our research follows this taxonomy, namely firms' motivations in exploring the firms' FDI activity. It is imperative to note that Behrman (1974) taxonomy specifically considers the firms' incentives and motivations from FDI in a rather micro manner, in contrast to eclectic paradigm that provides a macro framework in which FDI is viewed with to host countries' Location, Internationalization behaviour of the firm and the Ownership advantageous first introduced by Hymer (1960, 1968). Therefore, our research that follows the organization theory of Coase (1937) by placing firm at the centre of analysis, chiefly uses Behrman's taxonomy of the motivations in explaining FDI activity. Consequently, our intention is to use the micro drivers of FDI in order to explain FDI activity rather than the macro based approach of Dunning's OLI. The next sections review the developments made in the post 2000s era, which mainly include the revisited OLI paradigm, provide the review of the view of institutional factors and their effect on FDI activity, and the discuss the Varieties of Capitalism (VoC) framework of Hall and Soskice (2001) that is chiefly used by this research in provision of theoretical and empirical analysis. Subsequently the incorporation of the VoC framework into IB literature is discussed in detail.

## **2.6. Theories of FDI post 2000s**

The recent IB and economics literature has shifted its attention towards institutional factors both in empirical (Filippaios, Kottaridi et al. 2004) as well as theoretical (Mudambi and Navarra 2002) context. In macro context, a number of studies including the works of Henisz (2003), Mudambi and Navarra (2002), and Mudambi, Navarra et al. (2003) have explored the effect of institutional factors on the behaviour of domestic and foreign firms and therefore their FDI behaviour, while in micro level studies such as Kostova (1999), and Xu and Shenkar (2002) have explored the effect of elements such as institutional distance on FDI. The micro and macro level analyses being drawn from conceptually different traditions, and institutional traditions, take into account different views of

institutions and as a result different types of institutions. Dunning and Lundan (2008) argue that consideration of institutional influences inside the firm and those between the firm and the external environment simultaneously provides a greater standing point from which one can observe the determinants of MNE activity and its effects (Dunning and Lundan 2008, pp.128). In the spirit of adopting a unified framework that considers both firm and country specific considerations Dunning and Lundan (2008) use and extend the framework put forward by North (1990; 1994; 2005).

IB literature exploring the way affiliates communicate and function in the context of a foreign host country as well as dealing with the parents, includes the works of authors such as Kostova (1999) who have mostly started to frame the institutional distance in order to reveal the influence of institutions on the 'incentive structure' and 'enforcement mechanisms'. Others such as Kostova and Zaheer (1999), and Kostova and Roth (2002) consider the effect of location, motivations and conduct of MNEs' affiliates in foreign markets in the light of institutional distance between the home and host countries. Other studies that consider the effect of institutional factors on FDI activity include the works of authors such as Guler, et al. (2002) who consider the transfer of Organization Specific advantages from parent to the affiliate; those who similar to Xu and Shenkar (2002) consider the interaction between the entry mode and locational choice; and those who similar to Davis, et al. (2000), Chang and Rosenzweig (2001), Lu (2002), and Guillén (2003) consider the effects that of the imitation of MNEs entry choice on FDI activity using the firm-level institutional variables. The resurgence of the institutional factors in analysis of the determinants of FDI has led to their inclusion in the studies of Dunning (2002) and Dunning (2004) that consider the exploration of the 'relational' capital of the firm in order to incorporate the institutional variables into OLI framework. Consequently noting the importance of institutional factors in explaining FDI activity, Dunning (2005; 2006) attempts to incorporate the institutional variables with OLI paradigm by arguing that FDI activity is majorly influenced by the analysis of national level institutions. Subsequently authors such as Rondinelli (2005) have explored the institutional characteristics of seven types of national institutions.

In business and management literature most of the works on firm-level institutional analysis have been drawn from either Scott (1995; 1998; 2001) who identifies three types of institutions namely; normative, regulative and cultural-cognitive, that rely on different

understandings of the role of institutions in different disciplines, or based on the typology put forward by DiMaggio and Powell (1983)<sup>30</sup> who identifies three mechanisms of institutional diffusion namely; coercive, normative and mimetic that can be mapped to the types of institutions put forward by Scott (1995; 1998; 2001). Acknowledging the importance of firm level analysis in provision of more detailed information with regard to FDI activity, a number of studies including Meyer (2001), Yiu and Makino (2002), Delios and Henisz (2000), and Delios and Henisz (2003) have taken into account the effect of both firm and national level institutions on MNE's entry mode as well as its behaviour.

Furthermore, the recent developments in the comparative capitalism arena which mainly develops on the institutional characteristics of the economies in exploring the similarities and differences between the ways firms coordinate their activities have become increasingly relevant to the recent IB literature that incorporates the institutional factors at the heart of the analysis of FDI activity. The recent theory of comparative capitalism provided by Hall and Soskice (2001) puts forward the Varieties of Capitalism framework (VoC) which is developed on the previous works of scholars including Due et al. (1991), Gold (1993), Hall (2004). The VoC framework is introduced, discussed in section 2.6.3, and incorporated into IB literature in section 2.7. By doing so we provide in a sense a base for further arguments that connect the theories on Organization theory, and Varieties of Capitalism (VoC) framework into the IB literature. This in turn allows this research to bridge these traditions and incorporate the organization theory and VoC framework into IB literature, and in doing so provide a holistic framework that should help explaining the FDI activity of the firms. The reviews here thus are the backbone of the further arguments developed in chapter four, which in turn enables us to provide a theoretical model of FDI by considering not only country level factors, but also the market structure, difference between the way firms coordinate their activities in different types of market economies, and finally allows us to extend the existing frameworks further by bringing the ideas with regard to sectoral analysis of firms in different market economies.

As discussed earlier in this chapter we do not provide the review of literature that is mainly on the institutional factors, civil liberties and political rights. Instead the purpose of this chapter is to review the main IB theories that have been developed to explain FDI activity, comment on their characteristics, structure, and to provide information with regard

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<sup>30</sup> The typology put forward for institutional diffusion is mainly used by the scholars in management science.



to the IB theories that are used as foundations for our research. In this respect, our research mainly builds on the motivations of firms, develops theoretical and empirical models that take into account both sectoral and country level analysis in order to provide both disaggregated and aggregated analysis of the FDI activity. As noted above, the investigation of FDI activity using lower levels of analysis can provide detailed information of the way various factors affect FDI activity. Furthermore, our consideration of institutions will be further discussed and the arguments based on which the adoption of civil liberties, political rights, and ICRG institutional variables will be provided accordingly in the following chapters. The following section provides some information on the developments made in IB theory in post 2000 era, mainly the revisited OLI paradigm that incorporates the institutional aspects of FDI into Ownership, Location and Internationalization advantageous. However, as discussed earlier this research chiefly builds on motivations of the firm in explaining FDI activity, therefore, the review of the revisited OLI paradigm is kept to minimum under the considerations of the length of the research and provision of information that is most relevant to our research.

### **2.6.1. The Eclectic Paradigm (OLI) Revisited (2008)**

As a result of the recent focus on institutional factors affecting FDI activity, Dunning and Lundan (2008) revisit the OLI paradigm and provide an extended version of the OLI holistic approach that includes the institutional factors. The revisited OLI paradigm considers further breakdown of the once aggregate category of incentives. The Ownership advantages are consequently considered to be consist of; first, the intangible assets advantages or ownership of property rights (Oa) that includes production innovations, production management, organizational and marketing systems, innovatory capacity, ‘non-codifiable knowledge’(accumulated experience in finance, marketing, etc.). Second, ownership of specific advantages that are resulted from common governance (Ot) which refers to both advantages enjoyed by the branches plants of an enterprise, and those advantages enjoyed as a result of multinationality. Third, ownership specific advantages that are related to owning firm specific institutional assets (Oi), (formal and informal institutions that govern the coordination activity of the firm in internal and external environment). Examples of the latter are the codes of conduct, norms and corporate culture, incentive systems, leadership and management system, etc.

The Location (L) specific factors relate to locational characteristics of regions and countries (i.e. well-developed infrastructure, presence of skilled and productive labour force, innovatory capacities, investment capacities, low input prices), and how these advantages might provide locational advantages for the firms from these regions and those investing in such regions. Similar to ‘Oi’ (institutionally related ownership advantageous), the ‘Li’ (institutionally related location advantages) of countries are influential on FDI activity. Dunning and Lundan (2008) consider the institutionally related location advantageous to be considerably different between developed and developing countries and among developing countries, due to differences between the institutional aspects of these countries.

The Internationalization (I) advantageous relate to “firms’ propensity to internalise market failure” (Dunning and Lundan 2008, pp.140-141). The learning process and the knowledge acquired through the Internationalization incentives of the firms’ are institutionalized within firm, and will be influential on firms’ behaviour. The latter is mainly due to the fact that the internationalization process influences the process of understanding and assessing the benefits and costs of alternative modes of exploiting O and L specific advantageous. The revisited OLI paradigm considers that the type of internalization process that is adopted is mainly determined through the Oa and Oi of the firm, in contrast to the view that equates ownership with internationalization, the revisited OLI paradigm then considers MNE “as a collection of activities, both internal and external to the ownership boundary of the firm, that are controlled and coordinated by it” Therefore the revisited paradigm considers that the “costs of motivating agents within the firm, even if lower than the costs of transacting in the marketplace, are dependent on the incentive structures and enforcement mechanisms devised and implemented by the firm, and thus the formal and informal institutions therein”(Dunning and Lundan 2008, pp.140-141). Therefore the revisited paradigm relates the internationalization activity of the firms to their incentive structures and institutions of both MNE and the foreign market.

### **2.6.2. Varieties of Capitalism (VoC)**

In this section, we introduce Varieties of Capitalism (VoC) framework introduced by Hall and Soskice (2001) in order to lay the ground work for the incorporation of VoC framework into IB theory both in a theoretical and empirical manner, in the following chapters. The incorporation of VoC into IB theory is carried out in a theoretical model of

chapter four by provision of arguments that leads to distinction between the way types of market economies influence the wage bargaining process between foreign firms and labour representatives and thus affect FDI activity. Moreover, in the empirical context, we use the VoC framework in distinguishing between the FDI activities of firms from various types of economies investing abroad. This section starts by introducing the VoC framework from the previous theories of comparative capitalism and then distinguishes the VoC framework from other theories by discussing the framework under the light of institutional economics, organization theory and transaction cost theories. Furthermore, we discuss the properties of VoC framework and its approach in distinguishing between firms based on the types of market economies they are affiliated to. The characteristics of firms from Liberal Market Economies (LMEs) and Coordinated Market Economies (CMEs) are discussed, and subsequently, the way the VoC framework is incorporated into IB theory is reviewed.

### **2.6.2. A. Varieties of Capitalism; introduction and a critic of previous theories**

Hall and Soskice (2001) provide a new framework for understanding the institutional differences and similarities amongst developed economies in order to bridge the business studies and political economy. VoC (Varieties of Capitalism) is an actor based approach in which multiple actors (such as producers, firms, unions, governments, etc.) are those populating the greater environment of political economy. In other words political economy is viewed as a “terrain populated by multiple actors, each of whom seeks to advance his interests in a **rational** way in **strategic interaction** with others” (Scharpf 1997).

Adopting a relational view of the firm, Hall and Soskice (2001) argue that the success of the firm is significantly related to its ability to coordinate with a range of actors that it is involved with (such as employees, clients, suppliers, other businesses, shareholders, etc.). In order to distinguish between the types of relationships that a firm generally coordinates to function, we follow Hall and Soskice (2001, p.6) by providing a five spheres classification in which the relationships that a firm has to develop in order to resolve its coordination problems<sup>31</sup> are divided into; industrial relations, vocational training and education relationships, corporate governance, inter-firm relations, and finally the sphere of employees.

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<sup>31</sup> which are related directly to its core competencies

The industrial relations sphere relates to the coordination problems related to the bargaining processes with employees, unions and organizations that represent labour force, over wages, working hours, and working conditions. The second sphere, vocational training and education, relates to set of skills and the level of human capital. In this sphere the workers have the problem of deciding on the type and level of skills that they have to invest on, while the firms have the problems of securing the labour force with suitable set of skills. The third sphere relates to corporate governance, in which the coordination of the relationships with investors, financiers and other sources of finance are considered. The fourth sphere relates to the inter-firm relations, which accounts for the relationships with the other enterprises such as suppliers and clients. The fifth sphere relates to the relationships with the firm's own employees which includes the problems of adverse selection, moral hazard, and other problems of information flow and information sharing in an organization.

It is worthy to mention that the theoretical model of chapter four mainly focuses on the industrial relations sphere by exploring the effect of civil liberties on the bargaining processes between foreign firms and labour representatives (unions) in the host country, over wages and employment. Moreover, our theoretical consideration of the effect of political rights on FDI is captured through the taxes applied to foreign firms in the host markets. The latter indicates that the influence of the political rights on FDI activity through taxes would be considered in the corporate governance sphere (in particular its subset corporate finance).

Based on the VoC framework economies can be categorized into a number of more homogenous clusters of economies where each cluster shares more similar characteristics with the others in the cluster. In order to expand on the different types of economies, and the way their characteristics influence the structure and characteristics of their institutional systems, we refer to the basic framework provided by Hall and Soskice (2001) on types of economies, namely Liberal and Coordinated Market economies. Moreover, the national political economies can be categorized based on the way they address the coordination problems that they face with their relationships in each of the five spheres<sup>32</sup>. In this perspective, Two types of political economies are introduced which are at the poles of the

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<sup>32</sup> Reminder: Hall and Soskice (2001, p.6) provide a five spheres classification in which the relationships that a firm has to develop in order to resolve its coordination problems<sup>32</sup> are divided into; industrial relations, vocational training and education relationships, corporate governance, inter-firm relations, and finally the sphere of employees.

main spectrum where all nations can be arrayed. The first of these political economies is the Liberal Market Economies (LMEs).

Liberal Market Economies (LMEs) are the ones in which firms coordinate their relationships and activities through competitive market arrangements and hierarchies. In LMEs, market relationships are coordinated under a context of competition and formal contracting while the relationships are characterised as arms' length exchange of goods and services.<sup>33</sup> In such markets supply and demand is adjusted by the actors, mostly in a neo-classical economics fashion, in response to price signals generated by markets.

Coordinated Market Economies (CMEs) are the ones in which the firms depend more heavily on non-market modes of coordination that generally entail extensive relational, incomplete contracting, more reliance on collaborative as opposed to competitive relationships, and network monitoring based on the exchange of the private information inside the networks. CMEs therefore tend to use a more extensive set of organizations in coordinating their activities relative to LMEs.

The contribution of VoC into our empirical investigation is the provision of the ability to distinguish between the way firms from LMEs and CMEs coordinate their activities and relating their behaviour to their types of economies. The latter allows one to group the countries with similar types of economies, and investigate whether there are significant differences between the ways firms from different types of economies coordinate their FDI activity. Furthermore, our sectoral investigation of the FDI activity of the firms from LMEs, and CMEs allows us to investigate whether the affiliation to the specific type of economy has any effect on the way firms in similar sectors coordinate their FDI activity.

In order to expand more on the ways in which firms from LMEs and CMEs coordinate their relationships, we explore types of activities that firms generally undertake in each of the five spheres.

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<sup>33</sup> Williamson (1985) provides a great discussion of the characteristics of such markets.

## **2.6.2. B. Liberal Market Economies, and Coordinated Market Economies coordination activities in relational spheres**

In LMEs, firms emphasis more on the current profitability as a result of the markets for corporate governance (financial systems). In financing firm's activities, the valuation of the firm is of vast importance, in case of financing through equity, in forms of bonds and shares as well as bank lending. In such competitive markets the investors speculate their investment based on semi-publicly<sup>34</sup> available data and information to value a company, and thus, in LMEs firms generally are encouraged to attend to the semi-publicly available dimensions of their performance that influence their share price.<sup>35</sup>In contrast, CMEs' firms do not rely on publicly available data and valuations for their financing and instead coordinated market economies generally provide them with access to finance. The latter in turn leads to a main difference between the activities that firms in CMEs and LMEs persuade in their development and growth as well as the coordination of their activities. CMEs having access to 'patient capital' generally tend to invest and undertake projects that have a more long-run view on generating returns and thus, having access to capital they tend to retain workforce with more specialized set of skills. Therefore, we expect firms from CMEs to be less sensitive to the host countries' lending interest rate, in contrast to their LME counterparts.

On the other hand the independent financing activity that is not based on the balance sheet and quarterly performance of the firms, leads to a different monitoring system in these markets. In order to evaluate the performance of the firms to safeguard the investments of the investors in CMEs, investors have access to more 'private' and 'inside' information on the operation of the companies through the networks that link managers and technical personnel inside the companies to their counterparts in other firms in the way that it provides them with the possibility of sharing reliable information on the progress of the firms in these economies. Also in some cases firms share their information with a third party (such as business associations in which the officials have extensive knowledge of the industry) that is in the position to monitor the firms' activities and sanction them if there is any misleading on their part. A third element that is also often used for monitoring of firms, is the 'reputation' of the firms which is an influential factor for firms as it facilitates

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<sup>34</sup> We refer to publicly available data as semi publicly available data due to existence of the of information asymmetries

<sup>35</sup> For this reason in LMEs to provide finance more independently on quarterly balance sheet and publicly available data, the networks that could provide the investors with inside information about the firm's progress are heavily undermined and next to non-existent.

the access to finance by validating their membership in different networks<sup>36</sup> that are valuable to them in many respects. Therefore, in order to avoid bad reputation, most of the firms try to provide the right information on their progress and performance. Consequently firms from CMEs are less concerned with the quarterly performances as the access to capital is determined through networks that project the performance of the firms. In CMEs firms have close relationships with their suppliers and clients. Consequently, firms' information is available in a secure form from the networks of cross-sharing and joint membership in active associations with other companies that gather and provide information on the companies in order to secure a better coordination in terms of standard setting, vocational training and technology transfer amongst the companies. (Hall and Soskice 2001, pp.23)

Considering the differences between LMEs and CMEs, we expect the firms from LMEs to be more sensitive to host countries' lending interest rate in financing their project in comparison to CMEs. Since the foreign market financing would improve the financial position of the firm in short run and lead to better evaluation and other sources of financing in short run. In contrast, we expect the firms from CMEs to be less sensitive to foreign market interest rate lending since their investments are generally funded internally and in most cases the evaluations are not the sole determinant of the financial health of the organizations, since the investors have access to 'private' and 'inside' information on the operation of the companies through the networks that link managers and technical personnel inside the companies to their counterparts in other firms in the way that it provides them with the possibility of sharing reliable information on the progress of the firms in these economies. In our empirical section we investigate the effect of interest rate lending, as a proxy for host country financing available for MNEs in financing their FDI activity, on their FDI behaviour.

Furthermore, since the evaluation of the firms in LMEs and CMEs vary significantly, it is possible to investigate whether firms from LMEs are more sensitive to foreign market taxations. As mentioned earlier our theoretical model considers the effect of political rights on FDI activity chiefly through taxes applied to foreign firms in the host country. This indirect effect of political rights on FDI activity is investigated in our empirical model by

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<sup>36</sup> This type of CME monitoring systems, is referred to as 'network reputational monitoring' Vitols, S., C. Steven, et al. (1997). Corporate Governance in Large British and German Companies: Comparative Institutional Advantage or Competing for Best Practice. London, Anglo German Foundation.

provision of 'taxes on income and profit' as one of our explanatory variables, allowing us to explore the effect of taxes on firms from LMEs in comparison to their CME counterparts.

In terms of industrial relations, firms in LMEs generally rely on market relationship between the top manager<sup>37</sup> and the individual employee (labour force). Therefore, the firms wither and lack an established representative body for employees or the representative bodies of employees are generally less powerful than the ones observed in CMEs. Due to the less cohesive relationship between trade unions and employer association, the coordination of economy-wide wage is very difficult and thus, LMEs rely on macroeconomic policy as well as market competition to control the inflation as well as wages (Hall and Franzese 1998).

In contrast to LMEs, managers in CMEs rarely have the capacity for unilateral actions and mostly secure the agreements for decisions through supervisory boards that include other managers, shareholders and representatives of the employees. The internal structure of the firms in CMEs reinforces the network monitoring systems, and structural bias towards the consensus decision making leads to greater information sharing as well as development of reputations which in part contribute to the provision of reliable information to facilitate network monitoring. In such systems the incentives of the managers are more in line with the operation of business networks (rather than profitability), and long term performance of the firm as well as maintenance of their reputation in order to be able to secure consensus for the projects. The specialized employees are recruited via provision of long-term contracts and consequently, as Sorge and Warner (1986) and Dore (1986) discuss, the firms in CMEs tend to employ production strategies that demand highly skilled and specialized labour force which is expected to share the information it acquires to generate continuous improvements in product lines and processes. While firms are vulnerable to problems of 'hold up' by labour force, and 'poaching' of the employees, in many cases the complementary effect of the industrial relations in such economies seems to suffice such potential problems. For instance in Germany the industry level bargaining between the trade unions and employers' associations leads to types of settlements that ensure employees receive a good deal. On the other hand the existence of employers' association bodies that bind their members to a number of agreements, and the equal wage system for the certain set of skills in an industry reduces the probability of poaching to a

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<sup>37</sup> Top Management generally has the unilateral control over the firm and a substantial freedom to hire and fire employees. (Hall and Soskice 2001, p.29)



very low degree. Therefore the complementary effects of institutions and formal and informal constraints in CMEs ensures that the firms are functioning well and by applying coordination bargaining across industries and in the economy as the whole, limit the inflationary effects of wage settlements and poaching.

In order to investigate the effect of the differences that exists between the way firms from LMEs and CMEs coordinate their activities in industrial relations sphere, on their FDI, we explore whether the provision of higher level of civil liberties that affords the employees to establish labour representative entities, would influence the FDI activity of the firms from LMEs in a more significant manner, in comparison to their CME counterparts.

Firms in LMEs, relying heavily on a fluid labour market, benefit from a complementary education and training systems that mainly focus on offering general skills to labour force. The latter is beneficial for the firms as they do not intend to invest on a number of programmes to gain employees with special set of skills, in a highly fluid labour force economy where there is no guarantee of keeping the employees. On the other hand a greater set of skills means the greater bargaining power for the employees, and also that employees themselves prefer to be generally marketable in such economy and therefore the provision of the general set of skills by vocational training is complementary to the structure of the economy. In contrast to LMEs' firms, their CME counterparts generally use skilled and specialized work force. The provision of such labour force requires investment on both employers, by provision of higher salaries and long-term contracts, and employees who have to invest heavily on their skills both in terms of time and bearing the risk of un-employability in many other sectors that demand other sets of skills. The industry wide employer associations and trade associations in CMEs contribute to the provision and recruiting the highly skilled workforce by supervising more or less publicly subsidized training systems as well as pressuring the major companies to take apprentices and monitoring their participation in such schemes. Such associations in turn limit free-riding on the training efforts of other, as well as ensure that the training fits the firms' needs and that there will be external demand for graduates that have been apprenticed and are unemployed, by negotiating industry wide skill categories and training protocols with firms in each sector.

The effect of vocational training and education relationships sphere of each type of economies on FDI activity can be investigated through consideration of the influence of level of education on level and composition of FDI activity of firms from LMEs and CMEs. In our empirical exploration, ‘investment in research and development’ has been considered as the variable that would capture the effect of educational disparity in the host countries on the FDI activity of the firms from LMEs and CMEs.

As for inter-company relations, in LMEs, firms rely on standard market relationships and enforceable formal contracts. The formal contracting and law system tends to provide a support for markets and hierarchies in such economies. In some extreme cases of LMEs, relationships are mediated by antitrust regulations designed to prevent firms collaborating in order to control, market power, or prices, which in a sense is in line with the idea that these markets as competitive markets are robust and other characteristics of the markets such as corporate governance that renders firms sensitive to profitability hinders the informal contracts and non-market coordination. By provision of long term contracts and a more secure employment, CMEs do not rely on the work force mobility for the transfer of technology as the firms in LMEs do. Instead they tend to facilitate technology transfer by inter-company relations that are supported by a number of networks through which the business associations with public officials determines where firm competencies can be improved and by orchestrating publicly subsidized programs do so. This sphere of firms’ coordination activity is not considered in this research, due to the fact that it is out of the scope of our research question, which is to investigate the effect of civil liberties and political rights on FDI activity.

## **2.7. Incorporation of VoC into IB Literature**

This research builds on the organization theory of Coase (1937) and by doing so places firm at the centre of analysis. This allows us to incorporate the VoC framework into IB literature by adopting a relational view of the firm. The latter in turn affords us the possibility of distinguishing between the coordination activities of firms based on their types of economies.

Establishing the basic foundations of our research we consider the institutional factors (external and internal) to affect the FDI activity of the firms. Furthermore, we consider the motivations of the firm, namely; MS; RS; ES; and SAS, motivations to be the drivers of

the FDI decision of the firms. Our theoretical model mainly develops on ES FDI by considering the FDI decision of the firm in the light of labour costs in various host markets and sectors. In this respect our disposition is similar to the transaction cost terminology, in that we chiefly consider the monetary analysis of FDI decision to provide informative information with regard to FDI activity of the firms.

Therefore, considering VoC taxonomy of the spheres of firms' coordination activity, this research incorporates VoC framework into IB literature by drawing on the differences between the ways in which firms from different market economies coordinate their activities. The spheres of firms coordination activity that have been considered in explaining FDI activity are industrial relations, vocational training and education relationships, and the corporate governance, leaving incorporation of the sphere of employees and inter-firm relations sphere to future research.

The emphasis of our theoretical model is on the industrial relations by investigating the effect of civil liberties through wage bargaining processes between foreign firms and labour representatives. The incorporation of industrial relations sphere of VoC is carried out in our theoretical model by distinguishing between different types of labour law that in turn translate to various types of labour representation. In particular we develop on the works of Due et al. (1991), Gold (1993), Hall (2004), and Hall and Soskice (2001) in distinguishing four main types of unions, namely: (1) LME type unions; (2) CME type unions; (3) Northern unions; and (4) other unions. These distinctions allow us to explore the effect of the firms' internal and external institutional influences on their FDI decision, by exploring the behaviour of firms when bargaining over wages and employment.

In our empirical investigation we incorporate the analysis of industrial relations sphere through analysis of the effect of level of civil liberties, and its indirect effects through wages, and employee compensation on FDI from LMEs and CMEs. The analysis of vocational training and education sphere is considered by examining the effect of the level of investment on research and development on FDI activity. Furthermore we explore the corporate governance by considering the effect of taxes and host country's interest rate lending on FDI activity of firms from different types of market economies.

Furthermore, the VoC is incorporated in our empirical investigation by considering the firms from LMEs, CMEs and Northern countries as firms affiliated with considerably

different market economies. This aggregate consideration of the firms from various types of economies in turn allows us to distinguish between the various factors that affect firms from a certain types of economy and thus, allows us to provide comparison between the ways various factors affect the FDI decision of MNEs affiliated with different types of economies.

Therefore, our research contributes to the current knowledge by incorporating the VoC framework into IB literature in both theoretical and empirical manner, and thus allows us to explain FDI activity of the firms in the light of not only their external institutional factors (i.e. home or host countries institutional properties) but also in the light of the firms' institutional characteristics. The next section provides concluding remarks to this chapter, leaving the specific literature review of the effect of institutional factors, civil liberties and political rights to the following chapter.

## **2.8. Concluding Remarks**

In this chapter, in a chronological manner, the literature on FDI is reviewed. This is accomplished by provision of the information with regard to developments made in comparative capitalism as well as literature on foreign direct investment. The comparative capitalism arguments are nested in older traditions of economics and political science and in a way provide information with regard to the paradigms that affect the scholarly thinking and movements throughout the life of the rather newer tradition of International Business.

The chronological setting is designed with the intention to provide the reader with the information about the constructs that existed at each period of time and how the scholars have developed the literature given the knowledge at any given decade. The chapter has strived to provide parallel contextual narratives on the developments of both comparative capitalism and IB literature with the intention to underscore the effect of the philosophical views of the firm and the effect of consideration of different designs in the line of scientific inquiry. For instance we find that the organization theory of the firm and markets influences the level at which scientific inquiry is conducted and results in different constructs. Furthermore, the chapter, in a timely manner, reviews the developments on the IB theories with regard to FDI, from the earliest theories on the reasons why firms invest abroad (Hymer 1960) up to date.

In the first section the theories of Hymer (1960; 1968; 1970; 1972; 1976) on firm specific assets and ownership advantages, Kindelberger's interpretation of Hymer's work under the industrial organization context, and the works of Vernon (1966; 1971; 1979; 1983) on product life Cycle were discussed. The second section reviewed the theories of Uppsala School of thought based on works of Johanson and Vahlne (1977) and Luostarinen (1979), theory of internationalization based on the works of Buckley and Casson (1981; 1988), and the motivations of FDI based on the work of Behrman (1974). The third section introduced Dunning's (1980) Eclectic theory and IDP theory. The fourth section reviewed the post 2000s theories of FDI by provision of a brief review of the revisited OLI paradigm and subsequently introduced and discussed the Varieties of Capitalism (VoC) framework in order to provide the platform for its incorporation into IB literature.

Finally, the last section explained the way that varieties of Capitalism approach is incorporated into IB literature both in terms of theoretical and empirical contexts, building on the earlier works of neoclassical theory of the firm and modern organization view put forward by Coase (1937), Hayek (1945), and Arrow (1969) and the institutional view put forward by North (1990; 1994). This construct will be used in the chapter four, in order to act as the corner stone of our theoretical model. Moreover, the VoC is considered in explaining the FDI activity of firms from LMEs and their counterparts from CMEs. The latter in turn allows us to make comparison between the FDI activities of firms from different market economies, as a whole, and also affords us the possibility of comparing the FDI behaviour of firms from different market economies investing in the same sectors. The latter provides us with a great set of tools in explaining the FDI activity of the firms and their affiliated countries based on the way in which firms coordinate their activities in various types of market economies. The next chapter provides a detailed review of the literature on the studies that have explored the effect of institutional factors, civil liberties and political rights and FDI.

## **Chapter 3 : Literature Review and Meta-Analysis**

### **3.1. Introduction**

The determinants of Foreign Direct Investment (FDI), both in terms of the level of FDI as well as its composition have been of great debate over the past seventy years. Examples of such works are Root and Ahmed (1978) and Asiedu (2006) that mainly focus of the level of FDI, and the works of Javorcik (2004) and Gwenhamo and Fedderke (2010) who take into account the composition of FDI. The first traces of argument can be traced back to the post World War II in the works of Hymer (1960) and Aliber (1971). Since then determinants of FDI have been explored in a number of disciplines, mainly; Economics, International Business, Finance, Business and Management, and Political Economy. Consequently, one can approach the topic from a variety of angles. This section focuses on the effect of political and civil liberties (factors forming the general democratic environment of nations) on FDI and sets out to investigate the literature that examines the effect of political and civil liberties on FDI activity.

This research investigates the effect of civil liberties and political rights (liberties) on FDI activity. Therefore, after having reviewed the main IB theories on FDI activity in the previous chapter, this chapter aims to provide a focused review of the literature that have explored the effect of institutions, democracy, and civil and political liberties on FDI activity. For instance, authors such as Huntington & Dominguez (1975), Wintrobe (1998), Greider (1998) provide discussions and evidence in favour of the idea that multinational enterprises (MNEs) tend to invest in countries with low level of liberties (countries with high levels of repression) while others such as Olson (1993); McGuire & Olson (1996); Ursprung & Harms (2001) provide discussions and evidence contrary to the later arguing that MNEs invest more in countries where democratic rights of people are respected. Others such as Przeworski, Limongi and Voigt (2003) argue that none of the two arguments are convincing. Recent studies including Li and Resnick (2003) , Adam and Filippaios (2007), Asiedu and Lien (2011) tend to provide evidence in favour of existence of non-linear relationships between the two. The studies mentioned above, amongst many indicate that literature on political and civil liberties as determinants of FDI is far from being conclusive.

Since the literature is providing mixed results<sup>38</sup>, we use a meta-analysis methodology to trace the similarities and differences in terms of study properties (both with regard to data used and methodology followed) in the existing literature with our key aim being to identify the key factors that influence the direction of results. We follow the methodological approach of Gorg and Strobl (2001), and Meyer and Sinani (2009) to examine whether there are systemic biases introduced in the literature through the common choices made in terms of scale and study properties (i.e. the choice of country level analysis, data range and decade influences; etc.). This chapter contributes in the current debate in two main ways. First, we introduce the firm's investment motivations as one of the elements that have been considered in the design of the papers examined. Second, following the arguments put forward by Busse (2004) we examine the decades included in the samples investigated as one of the factors determining the types of relationships reported.

The rest of the chapter is structured as follows: Next section provides a review of the existing literature. In section 3.3 we develop a conceptual framework and derive hypotheses for the relationship between political and civil liberties and foreign direct investment. Section 3.4 presents the methodological approach and the empirical findings. Finally, section 3.5 concludes the paper by offering research implications.

## **3.2. Literature Review**

The older literature on economics have often adopted a Schumpeterian [introduced by Schumpeter (1942)] view of democracy that conceives democracy as a one dimensional concept that is mainly related to the existence of political rights that allow for free elections. A recent example of such works is that of Acemoglu and Robinson (2006) who consider democracy to be “the institutional arrangement for arriving at political decisions in which individuals acquire the power to decide by means of a competitive struggle for the people's vote” (Acemoglu and Robinson , 2006, p. 48). Adopting this view political economy literature has explored effects of democracy on investment (see Barro, 1997, for surveys) and often shown that political institutions influence the investment and growth. Examples of studies that mainly explore the effect of democracy and democratic institutions on FDI

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<sup>38</sup> A brief classification of the literature on the effects civil and political liberties and democracy on FDI is provided in Appendix 1.

activity include the works of Busse (2003), Jensen (2003), Li and Resnick (2003), and Choi and Samy (2008) amongst others.

The political scientists have generally viewed this one dimensional view of democracy, with a certain degree of scepticism, and have often provided alternative views of democracy that deviate from the latter. For instance Plattner (2002) views democracy as “a more ample degree of protection of political and civil liberties”. In this research a view of democracy is adopted that is in line with work of Tilly (2007), by considering a regime to be democratic “to the degree that political relations between the state and its citizens feature broad, equal, protected and mutually binding consultations” (Tilly 2007, p. 14), and that “political rights correspond to broad, equal, mutually binding consultations, whereas civil liberties refer especially to protection” (Tilly 2007, p.45). Following this view we consider the political rights and civil liberties to be two dependent dimensions of democracy, the presence of which “generates in principle a wide variety of possible patterns in the evolution of democracies by themselves or in combination with other factors” (Ariel BenYishay & Roger Betancourt, 2013).

In recent years, the institutional aspects of host countries as a group of factors that affect FDI activity have gained popularity. Consequently some of IB scholars have turned to political science in provision of their conceptual distinction between different aspects of institutional environment of the host countries. These studies in contrast to the older tradition of economics that commonly views democracy as a one dimensional concept, view it as a multi dimensional concept that is influenced through a number of contributing factors such as civil liberties, political rights, and institutional characteristics of the host countries. The examples are the studies of Li and Resnick (2003), Busse (2004), Busse and Hefeker (2005), Adam and Filippaios (2007), and Asiedu and Lien (2011) who consider the effect of both civil and political liberties on FDI activity, the studies of Méon and Sekkat (2004), Pournarakis and Varsakelis (2004), Ahlquist (2006), Daude and Stein (2007), Aizenman and Spiegel (2006), Ali et al. (2008), Mottaleb and Kalirajan,(2010) and Aleksynska and Havrylchuk (2012) amongst others, who consider the effect of institutions on FDI activity, and finally a third group of studies including the works of Wheeler and Mody (1992), Asiedu (2001), Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Li and Resnick (2003), Click (2005), Chen and Funke (2007), Coates et al. (2010), and Baek and Qian (2011) who mainly consider the effect of political factors on FDI



activity. Finally the fourth group of studies that have mainly focused on the effect of civil liberties on FDI activity includes the works of Coughlin, et al. (1991), Pournarakis and Varsakelis (2004), Blanton and Blanton (2007), and Coates et al. (2010).

This research in line with the new generation of studies on FDI activity considers civil and political liberties to be two dependent sub-components of democracy that influence the patterns in which democracy evolves. Furthermore, we consider the institutions to be the formal and informal rules of the societies. Therefore, in this study we mainly regard civil and political liberties, along with institutional environment of the societies as the factors comprising democratic processes of nations and consequently set to explore the extent to which civil and political liberties affect the FDI activity.

North (1990) is one of the first scholars who establishes a link between institutions and investment, while mainly considering the influence of institutions on the economic activity and investment. The literature has been greatly neglecting the influence of institutional factors on FDI up until recently. Before proceeding to provision of the brief literature review it is fruitful to provide some definitions. The definition of institution adopted by Dunning and Lundan (2008) is in the same wave length with the one adopted by Hall and Soskice (2001) and the one that is mainly is drawn from the works of North (1990; 1994; 2005). Hall and Soskice (2001, p.9) following North (1990; 1994; 2005) define institutions as “a set of rules, formal and informal, that actors generally follow, whether for normative, cognitive, or material reasons, and organizations as durable entities with formally recognized members, whose rules also contribute to the institutions of the political economy”. Adopting this view of institutions, we consider ‘Democracy’ to be a product of well-functioning high quality institutions that provide an environment in which there exists high level of political and civil liberties. Therefore our proposition similar to those of Adam and Filippaios (2007) is that it is possible to view the level of democracy as a composition of the level of political and civil liberties in a state, where all these elements are products of institutions in that state. Finally, we consider corruption as institutional deficiencies or ill functioning institutions. Having established the way democracy, institutions, civil and political liberties are reviewed in this research, we turn into the way effects of these factors on FDI activity are structured and reviewed in this chapter in the following paragraph.

The literature that is reviewed in this chapter as mentioned earlier is mainly focused on the studies that have considered the institutional factors, democracy, and civil and political liberties in explaining FDI activity. It is worthy to note that most of the studies that have been considered in this chapter share a common characteristic, that is, they have undertaken empirical analysis of the effect of the aforementioned factors on FDI activity. These studies are categorised into two main categories: first, are the studies that have exclusively considered the effect of these factors in explaining the FDI; second, are the studies that have included these factors as auxiliary explanatory variables in their analysis while mainly exploring the effect of economic factors on FDI activity. Therefore, based on this classification it is possible to argue that the first group of studies explore the effect of institutional factors, democracy, civil and political liberties on FDI activity in a direct manner, while the second group of studies constitute the literature that have considered the indirect effect of these factors on FDI activity by providing them as auxiliary explanatory variables in exploring the effect of economic factors on FDI activity.

Based on this proposition, it is possible to review the findings of the literature in a spherical manner in which papers considering the influence on quality of institutions (in a general sense), those considering mainly political aspects of institutions, those mainly considering civil aspects of institutions, and finally those studies that only include institutional factors as a side independent variable, are reviewed in different groups.

### **3.2.1. FDI and Institutions**

A number of scholars adopt a rather general view of institutions in their analysis and explore the influence of different aspects of institutional environment of host and home countries on FDI activity. These studies that include the works of Lipsey (1999), Pournarakis and Varsakelis (2004), Ali et al. (2008), Méon and Sekkat (2004), Mottaleb and Kalirajan (2010) generally find evidence supporting a significant positive relationship between FDI and institutions.

Pournarakis and Varsakelis (2004) in an empirical attempt using the sample of countries with transitional economics find a positive relationship between institutional factors and decision investment of foreign firms and add that existence of high quality institutions strengthens the location advantageous of host countries and leads to higher FDI. Méon and Sekkat (2004) examine the impact of “ill-functioning institutions” on participation of

MENA countries in the world economy and empirically<sup>39</sup> investigate the impact of the quality of institutions on FDI and find a significant positive relationship between the quality of institutions and FDI attractiveness. Similarly, Abdul Mottaleb and Kalirajan (2010) explore the determinants of FDI inflows to developing countries and find a positive significant relationship between quality of institutions and FDI. Lipsey (1999) investigates the determinants of FDI activity in ten Asian countries, from 1989 to 1994, considering factors such as market size, growth rate, per capita income, distance, export orientation, taxes and quality of institutions. He finds that countries with highest measures of institutional characteristics were those attracting most FDI. Thus, he considers that the low quality of institutions. However, he argues that the inference based on institutional measures (institutional characteristics of a country) seems to be problematic as they tend to be correlated with economic characteristics of the countries. Similarly, Ahlquist (2006) through empirical investigation of a data set on 90 developing countries from 1985 to 2002 finds that direct investors are sensitive to political institutions, and that stable and democratic institutions attract more FDI. Daude and Stein (2007) investigate the effect of institutional variables as determinants of the location of FDI using a sample of unilateral FDI stocks from 1990-2000, and find that higher quality of institutions has an overall positive and significant effect on FDI. Furthermore, authors add that some institutional aspects (in particular: unpredictability of laws, regulations and policies, excessive regulatory burden, government instability and lack of commitment) have a greater influence on FDI activity than other institutional factors.

Furthermore a number of scholars including Aizenman and Spiegel (2006) explore the effect of institutional efficiency on FDI flows through cross sectional analysis of a sample of 97 developed and developing countries from 1989 to 1999 and find that institutional efficiency is positively associated with the ratio of subsequent foreign direct investment flows. In an empirical attempt, Ali et al. (2008) investigate the impact of institutions on FDI using a panel of 107 countries from 1981 to 2005, and find that institutions are a robust predictor of FDI and that the most significant institutional aspects are linked to propriety rights, the rule of law and expropriation risk.

The more recent literature on the effect of institutional factors on FDI includes the work of authors such as Aleksynska and Havrylchyk (2012) who explore different aspects of

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<sup>39</sup> using panel data from 1990-1999, covering a number of countries (34 to 107 countries)

host countries' institutions such as the institutional distance between the home and host countries. Aleksynska and Havrylchyk (2012) exploring the role of institutional distance on the FDI show that institutional distance has an asymmetric effect on FDI depending on whether investors choose countries with better or worse institutions. Authors add that while institutional distance dampens FDI, the discouraging effect is diminished in case of host countries with substantial resources.

The overall view of the studies<sup>40</sup> exploring the effect of institutional environment on FDI activity indicates that most studies have found evidence supporting a significant positive relationship between FDI and institutions. In line with the way institutional aspects of host countries are viewed in this chapter, we further explore the studies that consider the direct effect of the civil and political aspects of institutional environments of the countries on FDI activity in subsections 3.2.3, 3.2.4 and 3.2.5.

### **3.2.2. FDI and Democracy**

The findings of the strand of literature that explores the influence of the level of democracy in host countries on FDI varies from studies such as Rodrik (1996), Harms and Ursprung (2001), and Busse (2004) who have reported a positive significant relationship, to the works of authors such as Huntington & Dominguez (1975), Wintrobe (1998), Greider (1998) who find a negative relationship, to a non-linear effect reported by Li and Resnick (2003), Adam and Filippaios (2007), and Asiedu and Lien (2010).

For instance Harms and Ursprung (2001) explore the relationship between democracy and FDI with the main intention of examining whether the popular view that “political repression boosts FDI” holds. They consider the panel data of 62 developing and transitional economies for 1989-1997 and find that in contrary to the mentioned view, MNEs tend to be attracted by the countries in which civil and political liberties are respected.<sup>41</sup> Using both aggregated and disaggregated measures of democracy and civil and political liberties, Busse (2004) investigates the impact of the level of civil and political

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<sup>40</sup> [i.e. Fathi, A. Norbert, F. and MacDonald, R. (2008); Pierre-Guillaume Méon and Khalid Sekkat (2004); Abdul Mottaleb, K. and Kalirajan, K. (2010)]. Others considering the influence of the level of democracy in host countries on IFDI have found either a positive significant relationship [i.e. Harms, P. and Ursprung, E. H. (2001)] or a negative relationship [Huntington, S. P., & Dominguez, J. I. (1975); Wintrobe (1998); Greider, W. 1998].

<sup>41</sup> They find that indices of political rights and civil liberties (both extracted from Freedom House), and institutional factors (bureaucracy, rule of law, efficiency, corruption; average of measures extracted from ICRG) have a significant influence on foreign direct investment per capita and that this influence is positive. This result emerges both from a cross section and panel analysis. They add that “a greater unionization among workers seems to attract, rather than deter foreign investors”.

liberties, as well as the quality of institutions on FDI considering two main specifications, and different time spans. In a time series setting he finds evidence of a positive significant relationship between democracy and IFDI. Therefore his empirical findings support the findings of Rodrik (1996) and Harms and Ursprung (2002) that TNCs appeared to be attracted by countries where democratic rights are protected. However using cross section methodology for 1970s, he finds a negative and statistically significant relationship between democracy and FDI. Busse (2004) argues that in 1970s, TNCs were much more likely to invest in countries with repressive regimes, with significantly lower political rights and civil liberties for the population". Considering cross section analysis for 1980s, he finds positive insignificant effect of democracy on FDI. Finally, considering the cross section analysis for 1990s, he finds positive significant effect of democracy on FDI. Busse and Hefeker (2005) in a similar attempt explore the linkages between institutions, political and civil rights and FDI inflows (IFDI) using a panel of 83 developing countries from 1984 to 2003 and finds that "government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government, and quality of bureaucracy are highly significant determinants of foreign investment inflows".<sup>42</sup>

Other studies including Asiedu and Lien (2010); Adam and Filippaios (2007), and Li and Resnick (2003), investigating the effect of the level of democracy in host countries on FDI generally find non-linear relationships where the non-linearity is generally introduced through different factors. For instance Asiedu and Lien (2010) examine the relationship between democracy and FDI under the light of the share of natural resources in exports of the countries and find that democracy's effect on FDI is conditional to the host countries' share of natural resources in total exports.<sup>43</sup> Including institutional factors; corruption, law, and bureaucratic quality of the host country, in their specification, they find that corruption and bureaucracy influence FDI in a significant and negative manner while rule of law has a positive significant impact on FDI. Their measures of political instability however provide puzzling results as measures of political instability, conflict, and government stability appear significant in all specification but with opposite signs<sup>44</sup>. Their empirical investigation covers panel data of 112 developing countries for 1982-2007, and speculates

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<sup>42</sup> The indices of civil, political and institutional measures are extracted from ICRG provided by PRS (Political Risk Services) and are incorporated into the study as the twelve indicators provided by the institution capturing different aspects of institutional quality and political risk.

<sup>43</sup> Democracy has a significant positive influence on FDI in countries where the share of natural resources in total exports is low and a significant negative relationship in countries where the share of natural resources in total exports is high.

<sup>44</sup> 'Conflict' appears with a positive sign which is in contrast with the expected sign. 'Government stability' appears with a positive sign as expected.

that expansion of democracy in 90 countries may enhance FDI, while an increase in degree of democratization might have negative influence on FDI in the other 22 countries.

Another example of such non-linear relationships reported when democracy and FDI are considered is the work of Adam and Filippaios (2007) that explores the effect of the level of democracy on FDI by decomposing democracy into two main elements of civil and political liberties<sup>45</sup>. Using panel data of 105 developed and developing countries for 1987-1997, they find that there is a negative relationship between civil liberties and FDI, which is hump shaped (there is a threshold level below which repression of civil liberties is associated with more FDI). With respect to political liberties, they find that there is a positive significant relationship between political liberties and FDI. Therefore, they conclude that MNEs tend to invest in countries with low civil but with high political liberties. The final example of the studies that have found a non-linear effect between democracy and FDI is the study of Li and Resnick (2003). In an empirical<sup>46</sup> attempt to investigate the influences of existence of democratic institutions on IFDI, Li and Resnick (2003) find that both property rights protection and democracy-related property rights protection encourage FDI inflows, and that democratic institutions improve private property rights protection. On the other hand they find that democratic institutions reduce FDI through other channels, i.e. provision of capital controls.

### **3.2.3. FDI and Civil & Political Liberties**

In this section we consider the handful of studies that have considered the effect of both civil and political liberties on FDI. These studies differ from the group of studies reviewed in the previous section in that they consider the effect of sub components of democracy on FDI. Therefore the effect of each of these factors is separately investigated on FDI while the overall model has covered both components that influence the evolution of democratic processes in the countries.

Studies that have considered both civil and political liberties fall into two groups. First group including the studies of Busse (2004) and Busse and Hefeker (2005) generally have found a positive relationship between civil and political liberties and FDI. The second group including the works of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and

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<sup>45</sup> Indices of civil and political liberties are extracted from Freedom House.

<sup>46</sup> using panel data (TSCS) of fifty three developing countries

Resnick (2003) have found a non-linear relationship where the non-linearity is introduced through different factors<sup>47</sup>, or by the consideration of different aspects of democracy<sup>48</sup> or institutional elements.

#### **3.2.4. FDI and influence of Political aspect of institutional Environment**

Scholars exploring the political influences of the institutional environment on FDI generally have found results supporting four main perspectives. These perspectives range from studies that include the works of Jensen (2003), Addison and Heshmati (2003) who have found a significant positive relationship between FDI and institutions. The second perspective is provided by the studies such as Wheeler and Mody (1992) and Sethi, et al. (2003) who have found an insignificant positive relationship. The third perspective is the one provided by studies such as Asiedu (2001) and Coates et al. (2010) who have found an insignificant negative relationship. Finally a fourth perspective is resulted by the works of Li and Resnick (2003) who have reported both positive and negative influences.

For instance Jensen (2003) empirically explores the effect of political condition of a country on the FDI inflows (FDI attracted) using both cross section and panel analysis for 114 countries<sup>49</sup> and finds that democratic governments attract higher levels of FDI (Democratic institutions have a large positive effect on FDI inflows). Others such as Addison and Heshmati (2003) investigate the determinants of FDI inflows to developing countries (72 developing countries), using the data from 1970-1999 and find that democratization leads to increase in FDI inflows to developing countries. Asiedu (2005) empirically investigates the influence of political risk, institutional framework and government policy on FDI using a sample of 22 countries in Sub-Saharan Africa from 1984 to 2000 and finds that an efficient legal system and a good investment regulatory framework promote FDI, whereas, political instability discourage FDI.

Sethi, et al. (2003) explore the trends of U.S. FDI and the factors influencing it, using the data on U.S. FDI into western Europe and Asian countries for the period 1981-2000, authors find a positive insignificant relationship between political and economic stability

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<sup>47</sup> i.e. the level of natural resources in the host country.

<sup>48</sup> i.e. Based on arguments put forward by Li and Resnick (2003), democratic governments have a positive effect on FDI by strengthening property rights and have negative effects on FDI through provision of democratic constraints on elected politicians; reducing the host government's ability in providing the MNEs with generous financial and fiscal incentives; and finally provision of protection for the indigenous business through provision of wide access to elected officials and political participation.

<sup>49</sup> The cross section analysis considers data from 79 countries, while panel analysis considers the data from 114 countries.

and U.S. FDI in case of Western European countries, and a negative insignificant relationship between political and economic stability between U.S. FDI in case of Asian countries. Similarly Wheeler and Mody (2002) focus on manufacturing U.S. MNEs in 42 foreign countries for the period of 1982-1988, and empirically show that the socio political risk has a positive insignificant impact on U.S. MNEs' manufacturing FDI, while geo-political risk has a significant positive impact on U.S. MNEs' FDI.

Asiedu (2001) explores whether the factors that affect FDI inflows in developing countries affect Sub-Saharan Africa (SSA) differently. Using panel data from 1988 to 1997 covering 71 countries and considering number of assassinations and revolutions measure of Barro and Lee (1993) as measure of political risk, she finds that political risk has an insignificant negative effect on FDI. Demirhan and Masca (2008) explore the determinants of FDI inflows using a sample of 28 developing countries over the period of 2000 to 2004, in a cross sectional setting and find that political risk has an insignificant negative impact on IFDI. Click (2005) empirically investigate the sample of 59 countries over the period of 1982 to 1998 and finds that political risk has a deteriorating effect on FDI unless the return on investment for direct investors is sufficiently high. Other scholars such as Bandelj (2002) adopt a more holistic approach and consider not only the political risk but also the effect of social relations on FDI and finds that "while political alliances, cultural ties, and the presence of networks between countries shape FDI flows", political risk<sup>50</sup> is only a significant influential host characteristic in the absence of relational factors and insignificant when relational predictors are added to the model. Finally Baek and Qian (2011) investigating the effect of political risk on FDI using a sample of 116 countries over the period of 1984 to 2008 finds that political risk is a significant determinant of FDI in both industrialized and developing nations. Furthermore authors add that in recent era political risks have become more important and significant determinants of FDI flows, especially in industrialized nations.

Finally, a number of scholars have considered the effect of political rights on FDI activity through its effects, such as existence of interest groups, in host countries. Coates, et al. (2010) investigating the effect of existence of interest groups on FDI activity using an unbalanced sample of 128 countries from 1985 to 2004, over three time periods finds that

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<sup>50</sup> Measure of political risk is extracted from Ernst & Young (Dunning & Rojec 1993)



higher political liberties that leads to existence of interest groups is negatively related to investment.

### **3.2.5. FDI and influence of civil aspect of institutional Environment**

A number of papers have also focused on the influence of civil aspects of institutional environment. These studies have found results supporting a range of outcomes on the relationship between the civil aspect of the quality of institutions and FDI. These outcomes range from studies who similar to Coughlin, et al. (1991) and Pournarakis and Varsakelis (2004) have found a positive relationship between the level of civil liberties and FDI, to those who similar to Blanton and Blanton have found a positive insignificant relationship, and a third group of studies including Coates, et al. (2010) who have found a negative relationship.

Pournarakis and Varsakelis (2004) investigate the factors leading to uneven allocation of FDI in economies of transition. Considering the period of 1997 to 2001, they find that the higher level of civil rights in a country, and the better the quality of institutions have an indirect positive effect on FDI.<sup>51</sup> In a more detailed study Coughlin, et al. (1991) investigate the factors influencing the location decision of foreign investors when investing in various states of United States, using data from 1981-1983, and find that higher unionization rates are associated with increased FDI.

Blanton and Blanton (2007) examine the impact of human rights on FDI inflows (both direct and indirect), and empirically<sup>52</sup> show that human rights has both direct and indirect effects on FDI, with repression negatively related to FDI inflows. They find “human rights significantly related to human capital”, and that through human capital, human rights have a significant indirect effect upon FDI. In regard to the influence of democracy, and democratic institutions on IFDI, they find a positive insignificant relationship. In contrast, Coates, et al. (2010) investigate the effect of interest groups and their activities on FDI by considering panel data of 126 countries for 1985-2004, and report their findings that are

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<sup>51</sup> The reasoning is that the higher the level of civil liberties and institutional factors contributes to the location advantages and also help a country to become a more attractive location for FDI. “Countries that are distinguished by a more equitable system of rule of law, lower corruption and more freedom in economic activity, achieve much better performance than countries that are characterized by significant deficiencies. Countries that suffer from limitations in economic activity either by governmental institutions or non-governmental agencies (that is, the mafia, armed groups) exhibit the worst performance in attracting FDI.” Their instruments in measuring the level of civil liberty (index of civil rights) and the quality of institutions (Freedom of press, corruption perception index and index of political rights) are extracted from Freedom House and Transparency International (TI).

<sup>52</sup> using panel data for 1980-1997 of a number of countries

consistent with Olson's hypothesis; “the number of interest groups in a nation is negatively correlated with investment, consistent with a sclerotic effect due to rent-seeking by interest groups.

### **3.2.6. FDI and indirect effect of institutions**

The studies that have explored the direct effects of institutional factors on FDI were reviewed in the previous section. The section reviews the studies that investigate the indirect effects of institutional factors on FDI. The indirect effect of institutions are the effects found by the studies that mainly explore the effect of economic factors in explaining FDI activity and have institutional factors as inexplicit determining factors of FDI activity. The examples of such studies include: Mauro (1995), Mody and Srinivasan (1998), Globerman and Shapiro (2002), Noorbakhsh, et al. (2001); Kaufman, et al. (1999).

For instance Noorbakhsh, Paloni and Youssef (2001) explore the effect of the level of human capital in host countries on geographical distribution of FDI. In their specification they have included the indices reflecting the quality of institutions<sup>53</sup> and factors reflecting the level of host country risk (this factor is extracted from Euromoney) which in a way reflect the effect of political instability on FDI. Their empirical analysis covers 36 developing countries over the period of 1980-94, and does not find a significant relationship between political instability and FDI; however they did find evidence supporting an inverted U-shaped relationship between FDI and democracy similar to Barro (1996; 2000). In contrast Noy and Vu (2007) investigate the effect of capital account policies on FDI inflows (IFDI) using annual panel data for the period of 1984 to 2000 from a set of developed and developing countries and find that level of political risk have a significant negative influence on the IFDI.<sup>54</sup> They conclude that liberalizing capital account is not sufficient to lead to an increase in IFDI unless there is a decrease in the level of political risk. Campos and Kinoshita (2003) explore the effect of “agglomeration economies and institutions vis-à-vis initial conditions and factor endowments in explaining the locational choice of foreign investors”, using a panel data set of 25 transition

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<sup>53</sup> indices were extracted from Freedom House

<sup>54</sup> Their measure of corruption, financial risk rating and political risk rating are extracted from PRS group's International Country Risk Guide (ICRG).

economies for the period 1990-1998, and find that institutional factors have a positive significant effect on FDI.

Click (2005) investigates the impact of the perceived risk of FDI for U.S. FDI and the allocation of FDI for the period 1982-1998 in 59 countries and finds that some cross country differences in terms of FDI are explained by the reported level of financial risk (i.e. Euromoney country risk, institutional investor risk) and that the unexplained country risks are related to unobserved political risk. He also finds that ICRG ratings on financial/economic risk and political risk, influences the return on investment both in short and long run, but a change in the political rating has no effect. Brunetti, et al. (1997) and Lambsdorff (2003) find that the predictability of corruption has an impact on inward capital flows that is distinct from the impact of the level of corruption. Institutional deficiencies may also have an indirect effect on FDI flows through their impact on other variables. A similar observation was made by Campos, Lien & Pradhan (1999) reports that the predictability of corruption is a significant determinant of the investment ratio. Bellak, et al. (2008) explore the determinants of FDI in Central Eastern European Countries (CEECs) specifically the effect of labour costs on FDI. They consider bilateral FDI net-flows from 1995-2003, between seven home, and eight host countries and find that “higher unit labour costs as well as higher total labour costs affect FDI negatively, whereas higher labour productivity impacts positively on FDI”. In their specification they take into account the political risk of the countries extracted from EUROMONEY, and find a negative insignificant relationship between political risk and FDI.

### **3.3. Conceptual argumentation**

The previous sections provided the review of literature that has explored the effect of institutions, democracy, and its sub components civil and political liberties on FDI. Furthermore, in our review we distinguished between the studies that have exclusively considered the effect of these factors on FDI from those who have used these factors as axillary explanatory variables in exploring the effect of economics factors on FDI. The overall view of the findings indicates that the literature on the effect of each of these factors on FDI remains inconclusive. Considering our research question that aims at exploring the effect of civil and political liberties on FDI, this section provides the argumentation for the meta-analysis and provides a number of hypotheses to be tested in the following sections.

### **3.3.1. Meta-Analysis – Motivations & Hypotheses**

In the context of FDI literature, the determinants of FDI have been the subject of investigation for a long time encompassing a variety of studies from its earlier origins in the works of Hymer (1960) to the recent times. The general methods of analysis either have considered sole host or home country factors that push or pull FDI (level of growth, exchange rates, taxes, institutions, policies, legal systems, cultural distances, etc.), both host and home country factors (type of countries, the host country factors, the home country factors, the difference between endowment or other country level characteristics picked up by interaction terms of other means), and in some cases not only the country level factors but also the global movements of capital, and other external influences on the flow of capital and its elasticity.

In this context, the inclusion of firms' investment motivations and the use of firm and sectoral level data have been generally scarce. This is primarily due to two reasons. First the lack of integration between the international economics and international business literatures and second the scarcity, until very recently, of data that could capture firms' investment motivations and foreign direct investment at the sectoral level. Building on international business literature arguments we therefore consider not only the host country factors (locational characteristics) but also the motivations of firms investing in those host countries. We argue that firms invest in different locations following a number of motivations and that the effect of civil and political liberties on FDI is moderated by these motivations.

The motivations of FDI are covered in the previous chapter in section 2.5.2, thus we refrain from reviewing them here. RS, MS and ES represent ways in which MNEs seek to enhance the benefits they can secure from their mature competitive technologies, as embodied in successful established products. By contrast the fourth motivation, strategic asset seeking (SAS), relates to the internationalisation of the ways in which these companies pursue the medium- and long-term regeneration of their competitive scope. This reflects a second development (alongside freer trade) that has conditioned the strategic evolution of globally-competing enterprises, i.e. the greatly increased dispersion of the sources from which they can acquire key inputs into their creative/learning processes, market heterogeneity and technological heterogeneity (Papanastassiou and Pearce 1999). In the existence of this motivation a high repression of civil liberties is

expected to exert a negative effect on the productivity of the workforce. In such an environment workers are not accustomed to taking initiatives, cannot co-operate effectively, and have lower incentives to be productive. This could hinder the strategic asset seeking motivation.

Based on the arguments above we develop the following set of hypotheses:

*H1: The effect of civil and political liberties on FDI decision and behaviour is moderated by the firms' motivations.*

Following from the above arguments, there have, also, been a number of changes in the way businesses coordinate their activities in different decades and there has, also, been significant changes in market structures. These changes lead to shifts in the composition of firms undertaking FDI as well as changes in the motivations of firms. Therefore, different FDI behaviour can be observed in different decades. We consider changes in FDI decisions as indicating patterns in the strategic expansion of MNEs' operations, as they approach globalised competition through organisational structures configured as 'dynamic differentiated networks' (Filippaios, Kottaridi et al. 2004). Thus, at a point in time, an MNE's competitive posture is activated through a range of different *types* of subsidiaries addressing different facets of its strategic needs. Across time this network is subject to continual expansion (new operations) and restructuring (changing roles of existing subsidiaries) as competitive needs alter and the potentials of different host countries develop (or are reinterpreted). Firms' behaviour is a result of their motives, therefore, the incorporation of firm level data, and a deeper understanding of the micro level processes that lead to MNEs behaviours are a detrimental part of the analysis in explaining the FDI activity. It is possible to argue that the consideration of sectoral level data could also be proved useful. Unfortunately, there is not enough information to base these arguments under empirical scrutiny since in our meta-analysis sample only four papers have considered sectoral analyses.

With this in mind we put forward our second hypothesis:

*H2: Due to changes in markets and industries over time, the investment incentives of the firms change over time and as a result the moderation effect of civil and political liberties on FDI is affected.*

A final argument on the relationship between civil, political liberties, democracy and FDI can be put forward relative to the construct of variables. Generally, democracy is disaggregated to its constructing elements which are commonly considered as civil and political liberties. An example of the latter is the way FREEDOM HOUSE constructs democracy indices based on civil and political indices. Since the results both on the effect of democracy on FDI, as well as its constructing sub-elements civil and political liberties are inconclusive<sup>55</sup>, this research aims to investigate the separate effect of civil and political liberties on FDI. Even though higher civil and political liberties of course imply better democratic institutions, there is no reason to expect that these two types of liberties affect the investment motives of the MNEs alike. Civil liberties refer to the workplace environment and the organization rights of the workers and to various economic rights. In contrast, political liberties refer to the decision-making process in the country and the way the government chooses which policies to implement. We therefore put forward our final hypothesis:

*H3: Civil and political liberties could moderate FDI in different ways.*

*H4: The overall level of democracy could moderate FDI, however this effect is less pronounced in contrast to civil and political liberties, and often provides mixed or counter intuitive results due to the aggregate nature of the measure.*

To empirically evaluate the above hypotheses we conduct a meta-analysis that includes the MNEs motivations, decades, and other study characteristics<sup>56</sup> (publication year, type of data used, frequency of the data used, etc.), in exploring the literature on FDI. This paper to the best of our knowledge is the first meta-analytical attempt to explore the factors influencing FDI considering both firm-level (micro) as well as the commonly explored country level factors (macro-level factors; both in partial or general equilibrium sense). The consideration of such elements is based on the proposition that firms' motivations have some bearing on the MNEs decisions, following earlier discussions by Hymer (1976), Dunning (1981) and Dunning (2008).

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<sup>55</sup> Examples of papers producing mixed results are provided in table.1.

<sup>56</sup> The full list of variables considered is provided in Appendix 3.2.

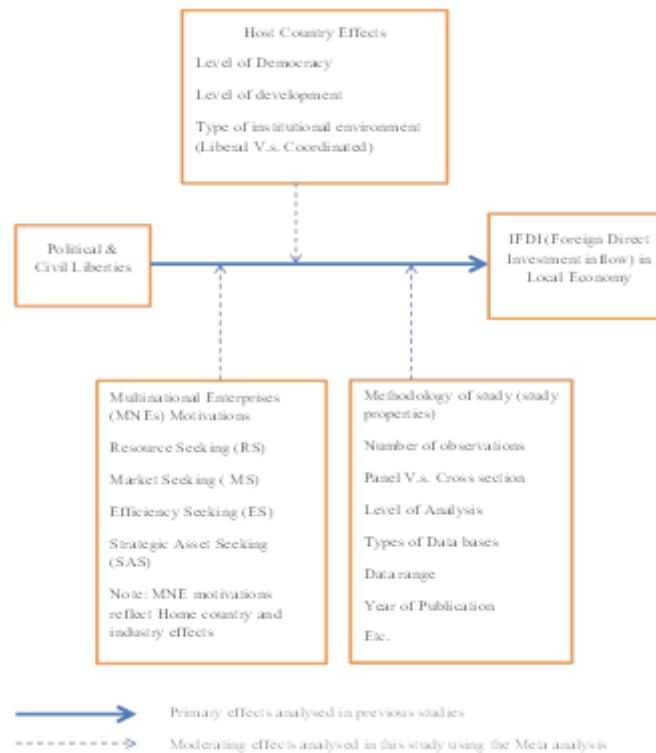


Figure 3-1: Overview of the conceptual framework

### 3.3.2. Research Design & Data

The sample of studies is collected by searching the ECONLIT, NBER, REPEC, ECON PAPERS and JSTOR databases, the Internet using keywords such as “FDI and civil liberties”, “FDI and political liberties”, “FDI and democracy”, “FDI and institutions” and “FDI”, and through review papers on determinants of FDI. The selection of these databases for extraction of the articles is mainly driven by the fact that they tend to provide the most extensive set of articles, with some concentrating more on the printed papers (i.e. JSTOR) and others more focused on the provision of working papers and white papers (i.e. REPEC, EconLit). Out of the thousands of articles briefly reviewed, the overall number of papers extracted for the analysis at the first stage was about 239 papers. Table 3-1 tabulates the data sources and number of articles that were extracted using the search engines.

This research based on the arguments provided above, considers the following search criteria in provision of its sample; (1) Dependent variable of the papers is FDI. (2) Papers have considered one or multiple of the factors (institutional, political, and civil) in their

analysis either exclusively or inclusively. (3) Papers examine the effect of one of the factors (Institutional, Political, Civil Liberties) on FDI. In the second review of these papers the sample was trimmed down to those papers that considered political and civil liberties either implicitly or explicitly and met the search criteria in greater detail. The second review therefore, resulted in provision of sample that consists of 69 empirical studies<sup>57</sup> instead of the initial 239 papers. The following section expands more on the data collection and treatment for the first part of the analysis.

**Table 3—1: Data sources and number of articles that were extracted using the search engines**

	ECONLIT		NBER	REPEC		ECON papers		EBSCO		JSTOR
FDI	Journal Articles	Working Papers	Working Papers	Journal Articles	Working Papers	Journal Articles	Working Papers	Journal Articles	Working Papers	Journal Articles
	2571	692	692	1439	2572	1600	2000	3907	28	2380
FDI + Political Liberty	All sources:1		Working Papers 102	12	5	All sources:39		All sources:5		60
FDI + Democracy	All sources:25		Working Papers 54	13	2	Journal Articles 11	Working Papers 18	All sources:0		478
FDI + Civil Liberty	All sources:2		Working Papers 57	3	7	All sources:12		All sources:2		47
FDI + Institutions	Journal Articles 31	Working Papers 17	All sources:630	All sources:359		All sources:100		All sources:9		1139

The overall number of papers identified and included in the analysis is 64 papers. Table 3-2 provides an indicative classification of the papers included in our analysis.

**Table 3—2: Indicative table of papers included and identified relationships**

Determinants of FDI	Positive	Negative	Insignificant	Nonlinear
Democracy	Fathi, A. Norbert, F. and MacDonal, R. (2008); Pierre-Guillaume Méon and Khalid Sekkat (2004); Abdul Mottaleb, K. and Kalirajan, K.	Huntington, S. P., & Dominguez, J. I. (1975); Wintrobe (1998); Greider, W. 1998		

<sup>57</sup> Five of the empirical papers have been dropped in the second part of the Meta analysis due lack of provision of number of observations for the estimations. Therefore the final sample covers 64 papers.



	(2010); Harms, P. and Ursprung, E. H. (2001)			
Civil and political liberties	Busse, M.(2004); Busse M., Hefeker C., (2005)			Asiedu, E. and D. Lien (2010); Adam, A. and F. Filippaios (2007); Li, Q. and A. Resnick (2003)
Political liberty & political aspects of institutions	Jensen, M., N., (2003); T. and Heshmati, A. (2003); Sethi, D., Guisinger, S. E., Phelan, S. E. & D. M. Berg (2003)		Sethi, D., Guisinger, S. E., Phelan, S. E. & D. M. Berg (2003) ; Wheeler, D. and Mody, A. (2002); Asiedu, E. (2001)	
Civil liberties	Coughlin, C. C., J. V. Terza and V. Arromdee (1991)	Coates, D., J. C. Heckelman, et al. (2010)	Blanton, R. G. and Blanton, S. L.(2005)	

### 3.4. Methodology

In this section we have carried out two sets of analysis. The first analysis assumes that the effect sizes are all equal (and dichotomous) and therefore captures the difference in results in terms of direction and type of the relationships reported. This fixed effect approach helps one to find whether there is an effect reported and if so what type of the relationship it is.

The analysis of fixed effect sizes is provided in Appendix 3.3. The main findings of the fixed effects analysis are as follows: (1) we find that civil and political liberties provide more information about the FDI activity in comparison to aggregate measures of institutions and democracy, underscoring the arguments of Blonigen (2005) that advocate the use of disaggregated measures, in order to allow the researcher to pick up the influences on FDI activity; (2) Investigating the direct versus indirect relationship reported, we find that for institutional context, the decade of analysis (decade from which the data is extracted), is a significant factor. The latter is in line with the argument provided by Busse (2004) on the effect of the decades on the results and the time line shifts in the way MNE’s conduct their businesses. As for Political liberties, we find “number of years taken into account” is a significant factor, while we find no significant factors influencing the direct versus indirect relationship between civil liberties and FDI; (3) Investigating the factors that influence the results in terms of a significant versus insignificant relationship reported, we find that for Political liberties context, Number of Host Countries (No\_HC) is a significant factor. Whilst there are no significant factors reported for institutional and civil

liberties; (4) Investigating the Positive Versus Negative relationship reported, we find that three factors of firm Motivations (Motiv\_T), Type of Host Country (Type\_HC), and Journal Cluster (JCE), significantly influence the type of relationship reported (positive versus negative). However, we find no significant factor influencing the type of relationship (positive or negative) reported in political and civil liberties context. As it was discussed before, firms' motivation was expected to influence the decision theory of the firm in undertaking their FDI activity. Type of host country is also another factor that has been shown to be influencing the type of relationship, which is in line with the arguments put forward in the literature, examples of which is the study of Adam and Fillipaos (2007).

In general there are more evidence from the factors influencing the type of relationship reported between institutions and FDI, in contrast to the relationship between civil and political liberties and FDI. The latter might very well be the result of the number of studies that have considered institutional factors in comparison to those considering political and civil liberties. Since the investigation of political and civil liberties as elements comprising the general democratic quality of a society which are rather both an element that leads to better quality of institutions and also are a product of good institutions in a society, has only become fashionable in recent year, thereby the number of studies considering these elements are less than the more fashionable institutional factors. The same argument can be made for the number of factors found influencing the relationship between political liberties and FDI (two factors reported), and civil liberties and FDI (no factors reported).

The second analysis relaxes the assumption of equality of the effect sizes, and uses the regression coefficients of the studies (effect sizes) instead of dichotomous values reflecting the effects of the; Institutions, Democracy, Civil Liberties, and Political Liberties, has been reported. This random effect approach will provide the opportunity to relax the assumption that the true sizes of effects are similar across studies and thereby allows one to provide a more detailed analysis of the effect of different variables on the relationships reported. The analysis of the fixed effect sizes, and related discussions are provided in the following sections.

#### **3.4.1. Analysis using Actual effect sizes (random effects):**

In the this section the regression coefficients of the studies (effect sizes) are used instead of dichotomous values reflecting whether an effect from one of the factors;

Institutions, Democracy, Civil Liberties, and Political Liberties, has been reported. This random effect approach will provide the opportunity to relax the assumption that the true sizes of effects are similar across studies and thereby allows one to provide a more detailed analysis of the effect of different variables on the relationships reported.

#### **3.4.1.1. Data collection**

We build on an earlier data collection methods used in the Meta-analysis by Gorg and Strobl (2001), and Meyer and Sinani (2009). Our database encompasses all papers used in the first part of the analysis. However, in this part, according to the different models and specifications provided in papers, data for coefficients and number of observations of each of main following factors; Institutions, Political Liberties, Civil Liberties, from the regressions that considered the dependent variable FDI and had one or multiple of the mentioned factors as explanatory variables were extracted. Therefore, the main data set in this part does include three main columns for effect sizes (regression coefficients reported), and number of observations for each of the mentioned factors (Institutions, Political Liberties, Civil Liberties).

Other columns of data provide the information reflecting the study characteristics. The studies characteristics include information with regard to: type of data used for empirical analysis; the publication year; span of time that is analysed in the research; and a number of other factors (provided in Appendix 3.2) in order to allow investigation of possible effects of research design on the results reported. Furthermore, in cases where a study has adopted alternative analysis using different data types, ranges or different specification and/or alternative models, new observations are created and are treated as independent observations in the sample [similar to Meyer and Sinani (2009)], in contrast to the first part of the analysis that only provided one observation per paper, in this section we have about 289 observations based on studies covered in the first part of the analysis.

A number of points should be made about this sample. First, is that a number of observations are dropped as in some cases the number of observations used in regressions could not be retrieved. The latter has led to provision of the 289 number of observations from the 64 studies in contrast to the first part of the paper that had considered 69 studies overall. Second, as it was mentioned above, the number of observations does not

correspond to the number of paper as there are several observations created for different specifications and regressions provided in papers.

Third, in a number of occasions studies shy away from provision of information about a certain aspect of the paper implicitly or explicitly by default<sup>58</sup>. This is the case in some parts of the sample and therefore in some cases calculation is suffering from low number of observations. In this regard we have tried to report data that is produced based on a legitimate sample size, based on the estimation technique.

Fourth, overall, our sample is not extensive as the number of studies investigating the determinants of FDI considering the quality of institutions, political liberties and civil liberties are not numerous and this research has covered almost all the possible studies available from the resources mentioned.

### 3.4.1.2. Methodology: Schmidt and Hunter method

This section consists of three parts. First part provides the mean weighted average effect sizes reported for each of the factors considered. The second part provides the results of the split analysis as well as comments on them. Final part conducts a set of Ordinary Least Squares estimations and reports the results.

#### Calculation of mean weighed average effect sizes

The meta-analysis method used here is based on Hunter and Schmidt (1990). The effect sizes are calculated using the sample discussed above and the results are provided below in table 3-3 where; “ $\bar{r}$ ” is the sample weighted (by observations) mean effect size,  $N$  is the number of observations used, “ $S_r^2$ ” the variance of sample weighted mean effect size, the sampling error variance is reported as “ $S_e^2$ ” and the biased population variance is represented by “ $S_p^2$ ”.

$\bar{r} = \frac{\sum_{i=1}^k N_i \cdot r_i}{\bar{N}}$	<p>Average effect size. <math>N</math> is the number of observations and <math>\bar{N}</math> is the average of all <math>N</math> and <math>K</math></p>
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<sup>58</sup> For instance in case of investigation of the factors determining Inward FDI in certain states of United States, authors might only look at the state characteristics and shy away from provision of detailed information about the investors in which case this research would not have any information regarding the source countries investing in U.S. and thus, the sample in this regard may miss some observations.

	number of observations.
$S_r^2 = \frac{\sum_{i=1}^k N_i (r_i - \bar{r})^2}{\sum_{i=1}^k N_i}$	variance of sample weighted mean effect size
$S_e^2 = \frac{(1 - \bar{r})^2}{\bar{N} - 1}$	the sampling error variance
$S_p^2 = S_r^2 - S_e^2$	Variance in population effect (biased population variance)

The general insignificance of results reported for the regressions might be due to the existence of moderating effects. Taking the latter into account this research investigates regression analysis as well as ANOVA type analysis and split analysis to investigate all the possible effects that might otherwise not be taken into account. If the regression analysis would only be taken into account, the results would not be extensively informative and rather generally insignificant and discounted in the magnitude because of the existence of the moderating effects. The effect sizes are calculated using the sample discussed above and the results are provided below:

**Table 3—3: Results of the regular calculations**

Regular Calculations		
	$\bar{r}$	$N$
Institutions	0.1532	127
Democracy	0.6432	50
Political Liberty	0.1862	91
Civil Liberty	0.5199	51

The results show that as expected, the overall effect of institutions on the FDI is insignificant and positive. The effect of democracy on FDI seems to be positive and we also observe that it has the second largest magnitude. The effect reported for political liberties is positive, indicating that the higher the level of political liberty the higher the level of FDI reported. Although the magnitude is significantly lower than that reported for

civil liberty which also has a positive sign. Finally, considering the effect of Civil Liberties on FDI, we find a positive insignificant relationship reported, with the magnitude that is the second largest after democracy.

Overall, all the factors have reported expected intuitive signs. However, all the results are insignificant. The insignificance might be a by-product of the existence of moderating effects. Therefore, we will perform an ANOVA type split analysis in the following section to investigate existence of such relationships. In terms of magnitude of the effect sizes reported, Democracy, political liberties, institutions and civil liberties have the largest positive effects on FDI, respectively. The lower effect size reported for civil liberty might be an indication of the difficulty to pin down the effect of this measure compared to other factors such as political liberties, or the aggregate measures such as democracy which itself is a composition of other factors.

The overall insignificant and the magnitudes reported lead one to suspect the existence of moderating effects and thus they are investigated below. It's worthy to mention that calculation of the overall effect size considering the average effect sizes however provided results that suffered from low degrees of significance and magnitude and thus are not reported here.<sup>59</sup>

#### **3.4.1.2. A. Split analysis**

The results of the regular and average calculations were intuitive, however they were mainly insignificant. Therefore in order to investigate the influence of different elements on the relationships reported, we conduct split analysis. In the first part we use standardised mean differences in order to investigate the pair-wise contrasts using ANOVA type tests.

The “split analysis” is considering all the groups related to the same factor and takes the observations related to a certain sub group and finds the effect size and the probability assigned to such effect size. Conducting this task will help one to compare the effect sizes and probabilities across groups in order to examine whether there are some distinguishing patterns in the context and whether such patterns reflect an intuitive argument or else

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<sup>59</sup> The main idea in the average calculation method is that the average effect of all the observations related to the same study is calculated and then weighted by average number of observations. The results of average calculations are provided in Appendix 3.4.

project a new finding. The results of split analysis and the related discussions are available from appendix 3.5.

### **3.4.1.3. Analysis using OLS estimator**

Since collection of effect sizes has led to provision of continuous dependent variables, it is possible to conduct a linear regression analysis to explore the moderating effect of different study characteristics on the type of relationships reported between institutional, democratic, political and civil liberty factors considered in the studies. A second reason for conducting the linear regression analysis is that the results provided earlier on in this section, although generally intuitive, were largely insignificant. Thus this section aims to shed more light on the effect of political and civil liberties as individual measures, as well as their aggregate forms on FDI. Therefore this section reviews the results of the effect of institutional factors, democracy, political liberties, and civil liberties on FDI, respectively.

#### **3.4.1.3. A. Institutions and FDI – a linear regression analysis**

Considering the effect of institutions on FDI in different decades, we find that during 1980s, existence of sound institutional environment has had a negative and significant<sup>60</sup> effect on the inflow of FDI. This effect seems to have reversed during 1990s, where one observes a positive significant effect of institutions on FDI at a much higher level of significance. The latter might be the effect of the shift in industries from a more resource intensive set of motivations, perhaps the remainder of such effects from 1970s, to a more efficiency seeking motivation in late 1980s, and throughout 1990s.

Apart from the explanation provided above, there might be a number of other factors that have had effects on such shift (i.e. policies). For instance during 1980s (Reagan Administration) changes in tax laws mainly in United States as documented by Scholes and Wolfson (1989) led to a “first-order effect on merger and acquisition activity in United States”, increases on the reliance on the institutional arrangements in order to reduce the non tax costs of organizations, as well as changes in the composition of the American firms investing abroad<sup>61</sup>. Since U.S. FDI comprises a high proportion of overall FDI

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<sup>60</sup> Level of significance considered is 10%.

<sup>61</sup> Due to the Tax reform Act of 1986 and higher tax costs as a result of it, transaction between many U.S. firms and their subsidiaries became highly costly, and demand for merger and acquisition transactions increased. The latter also led to a change in the composition of U.S. FDI, as many of small firms investing outside of U.S. did not afford to do so afterwards.

documented, a shift in the composition of U.S. firms' conducting FDI might lead to observation of such effects.

**Table 3—4: Moderating factors affecting the relationship between institutions and FDI flows.**

Variables	Model1	Model2	Model3	Model4
Dec_70s	0.002 (0.305)			1.323 (1.091)
Dec_80s	-0.678* (0.381)		0.357*** (-0.053)	-2.108 (1.531)
Dec_90s	0.985*** (0.305)		-0.319** (-0.13)	2.110+ (1.32)
Dec_2000s	-0.226 (0.382)		-0.321*** (-0.052)	0.666 (0.912)
RS		3.301 (2.308)	-0.176*** (-0.048)	3.851+ (2.641)
MS		-0.264** (0.104)	0.343*** (-0.074)	1.121 (1.214)
ES		2.023+ (1.396)	-0.048+ (-0.032)	2.527+ (1.671)
SAS		-0.79 (0.59)	0.054 (-0.045)	-0.159 (0.461)
Type_of_Host_C				0.052 (-0.119)
_cons	-0.164 (0.382)	-0.793 (0.845)	0.079 (0.143)	-4.808+ (3.298)
N	126.000	126.000	284.000	125.000
F	.	.	7.717	.
Ll	-361.434	-354.946	-37.899	-351.098
aic	730.869	717.892	91.799	718.196

Asterisks remark the level of significance: 15%, \* 10%, \*\* 5% and \*\*\* at one percentile level of significance.

Considering model 2, the analysis of the effect of solely firm's motivations on the effect of institutions on FDI shows that market seeking motivations (MS) and efficiency seeking motivations are the only two motivations significantly affecting the relationship between institutions and FDI. Efficiency seeking motives show a positive significant effect on the relationship as expected. Therefore it appears that firms tend to invest more in host countries where good institutional environment and as a result a high level of civil and political liberties for the employees exists. This finding while similar to those of Fathi, et



al. (2008), Méon and Sekkat (2004), Mottaleb and Kalirajan (2010), who indicated the existence of a positive relationship between high institutional quality and FDI, is rather more specific as it underlines that such a significance positive effect is mainly specific to firms with efficiency motives.

On the other hand the significant negative effect of Market Seeking (MS) motives on the relationship between institutions and FDI is rather counter intuitive. We find no significant effect of resource seeking (RS) motives and Strategic Asset Seeking (SAS) motives on the relationship between institutions and FDI. The results indicate a positive insignificant effect of RS motives on the relationship and a negative effect of SAS motives on the relationship between institutions and FDI, which are rather counter intuitive as one would expect firms with RS motives would prefer the host countries with higher level of repression *ex ante*, or would lead to an increase in the level of repression in host countries *ad hoc*.

In an effort to provide a better fitted model, a number of regressions are performed and the most satisfying two models are model3 and 4. The model3 takes into account both decades of data considered in the studies as well as the motivation of the firms undertaking FDI. The results show a significant positive effect of consideration of data from 1990s, a significant positive effect of RS motives, and a significant positive effect of ES motives on the relationship between institutions and FDI.

#### **3.4.1.3. B. Democracy and FDI**

Considering the factors affecting the relationship between the existing level of democracy and FDI, we find that similar to the arguments provided by Busse (2004) there is effect of shifts in the way MNEs behave in different decades. As it is expected, the more resource seeking activities of firms in 1970s seems to have favoured the choice of host countries with lower level of democracy, as we observe a significant and negative effect of the data from 1970s on the relationship reported between democracy and FDI. On the other hand we observe a positive significant relationship between democracy and FDI when the data from 1980s is considered. The data from other decades seem to have had no significant effect on the relationship between democracy and FDI. Thus the main destination of the firms considered in the literature as the main proportion of FDI destination during 1970s seems to have been from developed to less developed or

developing countries, while it would have been mainly from developed to other developed countries in 1980s. A general example of such FDI is the Japanese FDI into U.S. in late 1980s which would count for a staggering amount of the capital flows considered.

Another perspective, through which the flow of FDI could be reviewed, would be from the composition of the firms (or their incentives) that have conducted FDI activity and have been considered in the literature. The results of model2 show that RS motives of firms have a positive and significant effect on the relationship between democracy and FDI, underlying the view that firms with RS motives prefer to invest in more democratic countries and support a certain level of democracy in host countries in order to assure their protection and reduce the level of uncertainty. On the other hand we find that MS motives have a significant negative effect on the relationship between democracy and FDI, underlying the idea that democratic markets are rather more carefully protected. Since firms with MS motives by nature would be aiming for some market share, more protection in their target markets would have a negative effect on their decisions toward FDI. While the effect of RS and ES motives of MNEs on the FDI activity and behaviour is extensively documented in the literature, the effect of MS motives on their behaviour is scarcely reviewed. Thus future researches are advised to review the latter more in length.

A similar argument can be made for the effect of ES motives on FDI. The observed negative significant effect of ES motives on the relationship between democracy and FDI results from the cost consideration activity of the firms with ES motives. Since in more democratic markets the level of civil and political liberties are higher (since the level of democracy is generally decomposed to the level of civil and political liberties in the literature, similar to this research), the costs would be higher in such markets and hence the relationship as expected would be negative and significant. Finally, we find a minor negative and non-significant effect of SAS motives on FDI.

**Table 3—5: Moderating factors affecting the relationship between democracy and FDI flows.**

Variables	Model1	Model2	Model3	Model4
Dec_70s	-1.911** (0.839)		0.115 (0.241)	0.226 (0.326)
Dec_80s	1.678* (0.855)		-0.402 (0.296)	-0.487 (0.384)
Dec_90s	-0.852 (0.92)		-0.861 (0.623)	-0.568 (0.695)

Dec_2000s	-1.231 (0.983)		0.993* (0.573)	1.050* (0.56)
RS		0.676* (0.366)	0.771** (0.319)	0.624** (0.298)
MS		-4.676*** (1.578)	-4.897*** (1.664)	-4.778*** (1.711)
ES		-0.915* (0.482)	-0.351 (0.394)	-0.006 (0.308)
SAS		-0.093 (0.212)	-0.704+ (0.447)	-1.099** (0.507)
Type_of_Host_C				-0.141+ (0.088)
_cons	1.481* (0.849)	5.734*** (1.649)	6.432*** (1.763)	6.583*** (1.794)
N	50.000	50.000	50.000	48.000
F	2.031	4.131	2.711	2.337
ll	-112.227	-100.149	-99.653	-96.466
aic	234.454	210.299	217.306	212.932

Asterisks remark the level of significance: 15%, \* 10%, \*\* 5% and \*\*\* at one percentile level of significance.

Considering model 3, that takes into account the combination of these factors leads to provision of a better fit and consistently shows that the data from post 2000 era and RS motives have a positive and significant effect on the relationship between democracy and FDI while the consideration of MS motives still carries a significant negative effect.

Examining all the variables including the effect of type of the host country on the relationship between democracy and FDI (model4), we find that the data from post 2000s and RS motives have a positive significant effect on the relationship, while MS and SAS motives along with type of host country, have a negative effect on the relationship. The “introduction of type of host country” variable to the model has led to a change in the level of significance in the SAS motives variable, which in turn underscores the effect of considering the type of host country on the relationships reported.

### 3.4.1.3. C. Political Liberties and FDI

Analysing the effect of decades on the relationship between political liberties and FDI, we find no significant effect (model1). On the other hand analysing the effect of firms’ motives on the relationship between political liberties and FDI shows a significant and negative effect of MS and SAS motives on the relationship (model2). As it was discussed before in previous section, higher level of political liberty generally leads to higher level of

protection in the market and since firms with MS motives would prefer to operate in markets with low level of protection this significant and negative effect is expected. Exploring model3 that includes both sets of variables (decades and motives) we find that the use of data from 1980s has a negative effect on the relationship between political liberties and FDI while a similar model taking into account democracy indicated a minor negative insignificant effect. The differences between the effects of sub measures of civil and political liberties and main measure, democracy can be traced back into interpretations of disaggregated measures versus aggregate measures.

Analysing different models based on the set of variables available lead to provision of the model4 that underscores the importance of the type of host countries taken into account in the studies. Type of host country taken into account shows a positive and significant effect on the relationship reported between political liberty and FDI. Considering the effect of motivations on the relationship we find that MS motives have a negative significant effect on the relationship between political liberties and FDI. Reviewing the result of the decade variables we find the significant negative effect of data from 1980s on relationship between political liberties and FDI. This finding is of great value since it indicates the importance of the type of host country taken into account.

In the previous sections, we discussed how various firms from different backgrounds (in the sense of the way they conduct and coordinate their activities- varieties of capitalism) differ in their decisions on FDI and their behaviour both ex ante and ex post, in host countries. It was also discussed that firms do behave differently in different types of host countries; namely their behaviour seems to be pro-democratic environment in developed countries, while it seems to vary in developing and less developed countries based on the types of the firms investing in those countries and the level of natural resources and market structure existing in them. The finding above underscores and confirms the previous claim that type of a host country and its level of political liberty have an effect on the level and composition of FDI.

**Table 3—6: Moderating factors affecting the relationship between political liberties and FDI flows.**

Variables	Model1	Model2	Model3	Model4
Dec_70s	0.549 (1.132)		1.727 (1.92)	2.107 (1.914)
Dec_80s	-1.605 (1.148)		-2.512* (1.503)	-2.087+ (1.293)

Dec_90s	0.944 (0.857)		2.164 (1.49)	-0.02 (1.024)
Dec_2000s	0.49 (1.086)		1.263 (1.579)	0.073 (1.331)
RS		-0.208 (0.449)	0.997 (1.294)	0.265 (1.145)
MS		-2.873** (1.339)	-4.463** (1.955)	-3.750** (1.828)
ES		0.018 (0.609)	1.874 (1.37)	0.799 (1.085)
SAS		-3.335+ (2.016)	-3.081* (1.738)	-2.394+ (1.541)
Type_of_Host_C				0.560*** (0.208)
_cons	-0.3 (0.874)	3.182** (1.451)	1.675 (1.909)	1.709 (1.8)
N	91.000	91.000	91.000	85.000
F	1.976	2.412	1.656	1.92
ll	-240.471	-234.955	-231.259	-215.19
aic	490.942	479.91	480.519	450.379

Asterisks remark the level of significance: 15%, \* 10%, \*\* 5% and \*\*\* at one percentile level of significance.

In general the models analysed in this section suffer from low power which is natural considering the cross sectional nature of the data and small sample, and is quite common in Meta-analysis literature.

#### 3.4.1.3. D. Civil Liberties and FDI

Analysing the effect of decades on the relationship between civil liberties and FDI (model1), we find that the data from 1990s and post 2000s have a significant effect on the relationship, with data from 1990s having a significant positive effect on the relationship while the data from post 2000s having a negative significant effect. The latter shows a shift in the last decade from a rather positive effect in 1990s to a negative one in this decade. Perhaps one would be able to refer to the changes in markets as the result of introduction of information systems and internet which has resulted in outsourcing many activities of MNEs to places where they would not have a comfortable or an efficient control over before.

Examining the effect of the firms' motivations on the relationship between civil liberties and FDI (model2), we find that ES motives as expected have a significant and negative effect on the relationship while SAS motives have a positive significant effect on it.

**Table 3—7: Moderating factors affecting the relationship between civil liberties and FDI flows.**

Variables	Model 1	Model 2	Model 3	Model 4
Dec_70s	0.158 (0.776)		0.544 (1.020)	0.883 (1.128)
Dec_80s	0.32 (0.568)		-0.176 (0.833)	-0.415 (0.870)
Dec_90s	1.204** (0.594)		0.819 (0.875)	0.480 (0.996)
Dec_2000s	-0.845* (0.447)		-0.769+ (0.472)	-0.729+ (0.488)
RS		-0.254 (0.211)	-0.369 (0.876)	-0.210 (0.925)
MS		-2.196 (1.734)	-2.081 (2.006)	-2.241 (2.049)
ES		-0.238*** (0.035)	-0.062 (0.834)	0.118 (0.857)
SAS		0.636*** (0.209)	0.345 (0.269)	0.445 (0.335)
Type_of_Host_C				0.060 (0.054)
_cons	-0.82 (0.568)	2.638+ (1.722)	1.819 (2.007)	1.918 (2.042)
N	50	51	50.000	50.000
F	.	.	.	.
ll	-89.192	-86.238	-83.440	-83.381
aic	186.383	180.477	180.880	182.763

Asterisks remark the level of significance: 15%, \* 10%, \*\* 5% and \*\*\* at one percentile level of significance.

The negative significant effect of ES motives on the relationship can be traced back into profit maximising behaviour of such firms with incentives to reduce costs by either investing in places with lower civil liberties or repress civil liberties at their current existing production locations. On the other hand the positive significant effect of SAS motives on the relationship between civil and political liberties can be traced back into the incentive of firms with such motives to maximise the innovative capability and motivation of their labour force.

Examining model 3, which tends to explore the effect of both sets of variables we find that data from post 2000s still has a negative significant effect on the relationship between civil liberties and FDI. We also observe the same effects of the motivations on the relationship reported, however the findings are insignificant. Exploring model 4, we find a change of sign in the value reported for ES motives, indicating the effect of host country on efficiency seeking behaviour of firms in the context of civil liberties and FDI.

### **3.5. Conclusion**

This chapter focuses on the effect of institutional factors as well as political and civil liberties (factors forming the general democratic environment of nations) on FDI and sets out to investigate the literature that have taken into account the effect of the Civil, political and institutional environment (of either host, home, or both host and home countries) on FDI flows. The aim is to provide a greater understanding of the existing knowledge in regard to the effects of the aforementioned factors on FDI as well as exploration of the gaps there may be in the literature. In doing so we adopt meta-analysis methods in our exploration in order to examine whether there are systemic biases introduced to the literature through the common choices made in terms of scale and study properties (i.e. the choice of country level analysis, data range and decade influences; etc.). The main contribution of this research is inclusion of all the elements of the studies that have considered the effect of civil and political liberties or some explicit or implicit measures of these concepts in determining the determinants of FDI, in order to investigate whether there are specific trends not only in the results produced, but also whether there are factors that contribute to production of certain set of results. A second contribution of this part of the research is that it takes into account the factors such as firms' motivation and the decades of analysis which in turn both have been generally neglected in the meta analysis conducted on the literature as well as FDI literature, with some exceptions including the works of Busse (2004), Dunning (1988), and Dunning and Lundan (2008).

In terms of study characteristics we find that the use of panel data has generally provided significant results when considering the relationship between institutional factors and FDI. In terms of the scale of measures used, our analysis on the literature exploring the effect of political, civil, democratic, or institutional factors on FDI activity shows that measures such as democracy that have a more aggregate construct, generally lead to provision of low magnitude and often insignificant results which in fact are manifestations

of combined mixed effects packaged together, since their (in this case democracy) sub measures (civil and political liberties) in most cases pick up contrasting effects. We also find that the use of data from various decades leads to provision of different sets of results in terms of both influences of different factors on FDI as well as the incentives of MNEs in their decision towards the types of investments undertaken. The latter as well documented by Busse (2004) is the product of the changes both in markets as well as firms' motives (incentives) which in a way shapes the way firms coordinate their activities. Therefore the consideration of aggregate data over a number of decades seems thoroughly hazardous.

Also as expected, we find that firms' motivations have influence on their behaviour and FDI activity. For instance examining the effect of the firms' motivations on the relationship between civil liberties and FDI, we find that ES motives as expected have a significant and negative effect on the relationship while SAS motives have a positive significant effect on it. The negative significant effect of ES motives on the relationship can be traced back into profit maximising behaviour of such firms with incentives to reduce costs by either investing in places with lower civil liberties or repress civil liberties at their current existing production locations. On the other hand the positive significant effect of SAS motives on the relationship between civil and political liberties can be traced back into the incentive of firms with such motives to maximise the innovative capability and motivation of their labour force. The motivations while conditional to the element of time and subject to change seem to provide good information about the micro processes that lead to progression of macro activities of sectors and firms within them. On the other hand since the literature is vastly populated with studies that use country level analysis it seems that consideration of firm level and sectoral level data would be fruitful.

Another finding is related to the choice of home and host countries taken into account in the analysis. We find that the choices of host country is important in the design of the research as it has generally been a significant factor on the relationship between FDI and factors considered here (institutional factors, democracy, civil and political liberties). Finally, we find a negative significant effect of Market seeking and Strategic Asset Seeking motivation of firms on the relationship between political liberties and FDI. The exploration of the latter and provision of some explanation for it would be of interest for the future research.



The overall view of the findings of the Meta-Analysis conducted in this chapter informs the formation of the theoretical framework of chapter 4, by validating the existence of the effect of motivations on the FDI, not only in a conceptual aspect but also, as set of factors that have consistently and significantly have shown to influence the relationship between civil and political liberties and FDI. In particular, our theoretical model builds on transaction cost theory by analysing the effect of the existing level of civil liberties and political rights on the cost structure of MNEs abroad and thereby their decision with respect to FDI. In our empirical investigation all FDI motivations as set forward by Behrman (1974) are considered as explanatory variables that help explaining FDI activity by drawing on micro drivers of FDI activity. Furthermore, the meta-analysis provided in this section, provides support for the view advocated by a few including Blonigen (2005), that, consideration of disaggregated data provides more detailed information with regard to specific effects of civil and political liberties on FDI activity in various sectors. The theoretical model of chapter four, distinguishes between industries based on their labour/capital share of production. The empirical investigation of chapter 7 undertakes the examination of the effect of civil and political liberties on FDI, both in an aggregated (total FDI) and disaggregated (sectoral) manner. The sectoral analysis of effect of civil and political liberties on FDI activity in various sectors is conducted by dividing industries into two main sectors of manufacturing and services.

The meta-analysis conducted in this chapter, also underscores the importance of: the choice of host countries; and the effect of time on the findings. Our sample of host countries is chosen in the way that it embodies an extensive number of countries that includes developed, developing and less developed countries, and thereby avoids selection bias, and allows the generalization of findings. Furthermore, one of the results of our Meta-analysis suggests that the time span of data influences the relationships reported. In order to avoid provision of results that are conditional to time, and by nature not generalizable, our empirical database spans from 1990 to 2009, providing data on FDI activity for two decades.

This chapter provided a review of the literature that have considered the effect of institutions, democracy, civil and political liberties on FDI, and showed that the literature remains inconclusive on the effect of civil and political liberties on FDI. The Meta-analysis provided useful information with regard to: the effect of firms' motivations on the

relationship between civil and political liberties and FDI; the importance of using disaggregated data in analysis of FDI activity; the effect of the window of time from which data is extracted, and other characteristics of research design on the empirical results, and by doing so informs the development of the theoretical model of chapter 4, and the empirical investigation of chapter 7.

## **Chapter 4 : Theoretical Model**

### **4.1. Introduction**

The previous chapter reviewed the literature on the effect of civil liberties and political rights on FDI activity, and showed that the literature on the effect of civil and political liberties on FDI continuous to be inconclusive due to the existence of mixed findings on the subject. This chapter builds upon: the IB theory, in particular the motivations of FDI introduced by Behrman (1974) and later on reviewed by Dunning and Lundan (2008); Comparative Capitalism, in particular Varieties of Capitalism framework introduced by Hall and Soskice (2001); and Organization Theory of Coase (1937) further developed by North (1990) with the intention to construct a theoretical framework that would allow examination of the effect of civil liberties and political rights on FDI in an explicit manner.

In this chapter we theoretically explore the effect of the civil liberties and political rights on the initial cost of FDI and thereby FDI activity. The models provided build upon the works of Grout (1984), Hart and Moutos (1995) and Adam and Filippaios (2007). It is assumed that the decision of FDI is influenced by the initial cost of investment into the designated host country. Therefore, firms are considered to bargain with employee representatives (labour unions) in the host country before deciding upon their investment abroad, in order to obtain full information with regard to the initial costs of investment. The incentive of the representatives of the MNE is to bargain over wages in order to reduce the initial and recurrent cost of production. The negotiation over the initial cost of production is undergone with the knowledge that the union representatives might have the incentive to revisit the bargaining process after the investment is made, with the intention to bargain over higher wages, thus a “non-binding contract” (Grout, 1984) is negotiated between the firm and entity. The incentive of unions, in the presence of unemployment in the market entails two main elements of negotiation over wages and employment. We theoretically show that in the presence of unemployment in the market, the utility function of national unions and sectoral unions would be similar. Therefore the utility function of unions (irrespective of their level) translates to a type of function that embodies both elements of wages and labour recruitment. Furthermore, incorporating the VoC framework we distinguish between different types of unions based on their market economies and other characteristics. The distinction provides four main types of unions, namely; Nordic,

Liberal, Coordinated, and other unions, relating to Northern, LME, CME, and other types of market economies.

Our view of the civil liberties is in line with that adopted by Freedom House in provision of data on the concept. Reviewing the subcomponents of the civil liberties concept from the questionnaire<sup>62</sup> used for collection of data on civil liberties by Freedom House, civil liberties embody a number of factors including: *Freedom of expression and belief, Association & organizational rights, rule of law, and personal autonomy & individual rights*. Therefore, the level of civil liberties is assumed to be directly related to the union power, granted by the institutional government in the host countries. It is considered that in the absence of civil liberties, the individuals do not have the ability to express their opinions, due to lack of *Freedom of expression and belief*. Furthermore, in the absence of civil liberties, employees do not have the right to form entities (i.e. labour representatives and unions) that would express their opinions and advocate their rights due to restrictions on *Association & organizational rights*. Therefore in the countries with high repression of civil liberties, firms are able to conduct their activities without worrying about renegotiation of wages or employment. In contrast in the presence of civil liberties employees are free to form unions, and express their rights and thus influence the activity of the firms. In the study of FDI activity we have considered the effect of civil liberties to be channelled through unions (labour representatives).

Our view of the political rights is in line with that adopted by Freedom House in provision of data on the concept. Reviewing the subcomponents of the political rights concept from the questionnaire<sup>63</sup> used for collection of data on civil liberties by Freedom House, political rights embody a number of factors including: *Electoral process and political pluralism & participation*. Therefore, it is considered that in countries with low level of political rights, the low quality of electoral process, and low degree of political pluralism and participation tends to result in the governing body that is not representative of the people. Consequently it is assumed that the low level of political rights is directly related to the radical changes in policies. The policies that affect the FDI activity vary from those relating to trade, to those relating to the access to capital and taxes. Since our design is mainly devoted to explore the effect of civil and political liberties on FDI activity through bargaining processes that would alternate the cost structure of the foreign firms

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<sup>62</sup> The questionnaire used for collection of data on civil liberties, by Freedom House is provided in Appendix 6.4.

<sup>63</sup> The questionnaire used for collection of data on civil liberties, by Freedom House is provided in Appendix 6.4.

abroad, the political rights are considered to be affecting FDI activity through taxes imposed on foreign firms. The low level of political rights in the host countries would allow the presence of governments with low degree of representativeness that is a product of low level of political pluralism and weak electoral process. In such countries, governments are able to adopt rent extraction strategies that assign higher taxes on foreign firms in order to extract rent from them. In line with arguments provided by Olson and McGuire (1995), it is assumed that the less democratic (lower level of political and civil liberties) governments, which are generally not representative, are more prone to imposition of policies and taxation systems that are in line rent extraction. Therefore, the effect of the level of political rights in the model is accounted for through taxes on the MNEs. Moreover, this chapter provides two models that account for taxes on income, as well as taxes on profits. The two models were discussed and elaborated and a number of theoretical findings were produced based on which a set of hypotheses are derived that are going to be empirically tested in chapter seven.

The theoretical model developed in this chapter is novel. However, it shares a number of similarities with the conceptual model provided by provided by Adam and Filippaios (2007). In order to distinguish between the models provided in this chapter and that provided by Adam and Filippaios (2007), the distinctions are noted as follows: First, the host markets are not assumed to be fully competitive markets and thus our model allows for presence of unemployment in the host markets. Second, since the assumption of full employment in the host markets is relaxed, a welfare wage is introduced to account for the effect of the level of welfare wage on the wage bargaining process. Third, the models provided take into consideration two types of taxation systems, namely: taxes on profit, and taxes on income. Fourth, the incorporation of the VoC into our framework allows us to draw comparisons between the way bargaining processes are conducted when various MNEs and host markets from different types of economies are considered. The integration of VoC framework into IB theory and its incorporation into a transaction cost based theoretical model is a novel contribution of our model. Fifth, it is assumed that non-union employees and union employees (both types of labour) are present in the market.

The rest of the chapter is structured as follows: Sections 4.2 and 4.3 introduce MNEs and Unions, their assumptions and profit functions. Section 4.4 provides a static game theoretical model that considers the effect of civil liberties and political rights on FDI

through wages, and taxes on income, respectively. The game theoretical model is then developed further to provide the minimum level of capital that has to be invested by MNE for the FDI to take the place. The sensitivity of FDI, based on cost of investment, to the level of civil liberties and political rights are explored and the comparative statistics and testable hypothesis are derived and discussed.

In order to explore the effect of political rights on FDI, we consider an alternative game theoretical model that considers taxes to be applied to profit rather than income. Subsequently the Nash equilibrium, comparative statistics and testable hypothesis, are provided and discussed. Due to limitations in terms of space, we refrain from providing the material related to this model in the core text, and instead provide them in the appendix 4.4.a. Section 4.6 discusses the limitations of the theoretical model, and proposes a number of avenues for further research. Finally, section 4.8 provides some concluding remarks on the theoretical investigation.

## **4.2. Static Game between the Firm and the labour (trade) Union**

This research considers that in most cases, before an MNE undertakes FDI, it performs a set of activities in order to obtain a set of information in regards to the host country's market. This set of information would entail the taxes imposed on MNEs in the product market, the general product market environment (in terms of competition, number of producers, the composition of producers, etc.), information with regard to the cost of labour which is obtained through a number of channels (in many cases there are standard wages set in sectors and industries), and a information on a number of other factors that might affect the production and profit of the firm in the host market.

It is assumed that after obtaining the preliminary set of information, if the investment opportunity is comparatively attractive, MNEs proceed to communicate with different parties affecting their prospective investment in host country, namely, they discuss their tax structure, initial cost of investment, and their bargain over their labour costs with unions in the target market. The attractiveness of the opportunity to invest is related to the firms' motivation of investment. As discussed in chapter 2 and 3, we consider firms to be motivated by four main motives of Resource Seeking (RS); Market Seeking (MS); Efficiency Seeking (ES); and Strategic Asset Seeking (SAS). Our theoretical model in this chapter mainly focuses on ES motives by considering the wage bargaining process

between firm and labour representatives, and thereby the wage setting to be the determinant of the FDI activity. Consequently the effect of civil liberties on FDI activity is considered through the influence of civil liberties on the unions' bargaining power, and the effect of political rights on FDI is considered through the effect of taxes applied to MNE in the foreign market.

#### **4.2.1. Assumption with regards to Nature:**

Markets are assumed to be imperfect. The flow of information is assumed to be symmetric. The employment is assumed to be relative, and the assumption of full employment is relaxed. Wages are assumed to have a range of  $wage \in [w_a, W]$  where  $w_a$  is the minimum wage earned by those not working, and  $W$  is the maximum wage earned in the market. It is assumed that there exists an average wage in the market denoted by ( $W_{Av}$ ). The bargained wage is considered to be  $w_B > w_a$ , and the average wage paid in the market is  $w_a < W_{Av} \leq W$ . It is assumed that MNE bargains with National Union  $U_N$  and autonomous union  $U_A$  separately. It is assumed that there is no flow of information between the unions, and the market is considered to be neutral with regards to entry of the MNE. Finally, firm and unions are considered to be risk neutral.

#### **4.2.2. MNEs' Assumptions and Considerations**

Before embarking upon our discussions on the MNEs, it is necessary to review the definitions<sup>64</sup> of FDI, and MNE. The widely accepted definition of Foreign Direct Investment (FDI) is provided in appendix 1.1. According to the U.S. Department of Commerce, FDI occurs whenever a U.S. citizen, organization, or affiliated group takes an interest of 10 percent or more in a foreign business entity.<sup>65</sup> IMF (1993)<sup>66</sup> defines FDI as "investment that involves a long-term relationship reflecting a lasting interest of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of investor. The investors' purpose is to exert a significant degree of influence on the management of the enterprise resident in the other economy".<sup>67</sup>

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<sup>64</sup> Definition of Foreign Direct Investment and related concepts to FDI are all provided in Appendix 1.1.

<sup>65</sup> Charles W.L. Hill (International Business; competing in global market place, sixth ed., p.238)

<sup>66</sup> *Balance of Payments Manual*, 5<sup>th</sup> edition (BPM5)

<sup>67</sup> The OECD *Benchmark Definition of Foreign Direct Investment*, 3<sup>rd</sup> edition, is fully consistent with BPM5. Source: OECD (1995), *OECD Balance of Payments Manual*, 3<sup>rd</sup> ed., Paris: OECD.

Therefore once a firm undertakes FDI, it becomes a Multinational Enterprise<sup>68</sup> (MNE). It is imperative to note that it is FDI that transforms a domestic firm – irrespective of its size and other characteristics- into a multinational enterprise. Dunning et al (1993, p.3) defines a Multinational or Transnational enterprise as “an enterprise that engages in foreign direct investment (FDI) and owns or, in some way, controls value added activities in more than one country.” This is the main definition of a multinational enterprise (MNE), in the sense that it is widely accepted in academic and business circles, by data collecting agencies such as the Organization for Economic Co-operation and Development (OECD), UNCTAD’s Division on Investment, Technology and Enterprise Development (DITE), and by most national governments and supranational entities.

The first distinct characteristic of an MNE is that, in contrast to multi-activity or diversified firm, MNE access, organize and coordinate the value added activities through FDI, across national boundaries. Second is that, MNEs tend to internalize some of the foreign markets for the intermediate products arising from these activities.<sup>69</sup> Dunning & Lundan (2008) argue that these two characteristics- cross border transactions and production- are unique to MNEs and that no other institution engages in both of these activities.

Having discussed the definitions of FDI and MNE, we continue by providing the assumptions and properties of MNE in this research. It is assumed that MNEs’ (firms) objective is to maximise their utility at any given point in time, constrained to the amount of information available to them and their level of knowledge at the time. It is acknowledged that the utility function of the firm is defined as the summation of the monetary and non-monetary utility functions of the firm. In other words the utility function of the firm is not bounded to the traditional profit functional form of revenues after costs. It also considers the non-monetary gains such as strategic gains (i.e. market share, market positioning, comparative position with respect to competitors, etc.), or financial gains (i.e. access to capital, diversifying investment, diversifying institutional risk, reducing dependency, etc.) that can be gained by that can be obtained by FDI. However, this

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<sup>68</sup> The term Transnational was adopted by United Nations Centre on Transnational Corporations (UNCTC) in 1974 by the request of a number of South American countries in order to distinguish between the companies that are domiciled in a country in South America who invest in another country in the region (Transnational enterprises), and those companies that are originating from outside of the region (MNEs). However, as Dunning & Lundan (2008, p.765) discuss that over the years terminological differences between the two terms have become immensely obscure and as a result in recent literature these two terms are used interchangeably. In this volume the terms “Multinational” and “Transnational” are used interchangeably.

<sup>69</sup> Dunning & Lundan, p.6



research generally considers the monetary gains of firms as the representative measure of their utility, for two main reasons: first, providing tractable measures for non-monetary gains of firms through FDI might not be adequate considering the level of aggregation assumed (for the most part) and also the possibility of such measures leading to narrowing down the scope of research to specific number of countries and firms for which this data can be obtained, which is not in line with the Varieties of Capitalism view adopted earlier); second, there is no evidence that the complexity introduced through inclusion of such measures, significantly contributes to the model at this level of aggregation.

It is assumed that Firms' (MNEs') objective is to maximise its profit based on the amount of information available to it at the time. The firm produces homogenous goods, using labour (L), capital (K), and technology (A). 'K' is assumed to be the amount of capital that firm transfers to a host country in order to conduct FDI. Similarly 'A' is the firm specific technology that is transferred to the host country by the firm. 'L' is the number of labourers (employees) employed in the host country.

The firm's production function at this stage is considered to be Cobb-Douglas. It is also assumed that the production function is subject to diminishing returns to scale (therefore the first derivative of the production function is considered to be negative).<sup>70</sup> Furthermore, the productivity of labour is assumed to be constant and observable by the firm, therefore there are no issues of; governance, wage/productivity and conflict, are introduced into the discussion. Note that by assuming that productivity of work force is constant, and observable to the firm, we shy away from including the efficiency wage arguments into our theoretical model. The general consensus of the empirical literature on the efficiency wage premia is that foreign firms tend to pay higher wages to their employees in comparison to their local counterparts, due to their higher productivity, which in turn is the product of their "know-how and modern management practices that allows them to compete effectively in foreign markets and to offset the cost of coordinating activities across different countries"(OECD 2009). It is generally argued that market failures influence

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<sup>70</sup> Cobb-Douglas production function is a type of production function that model situations in which inputs can be substituted for each other to produce the same output, but can not be substituted at a constant rate. A Cobb-Douglas production function;  $F(K, L, A) = A \cdot K^\gamma \cdot L^\sigma$  is homogenous of degree  $\varepsilon = \gamma + \sigma$ , and if  $\varepsilon < 1$ , it is said that the production function is subject to diminishing return to scale. Subsequently  $\varepsilon > 1$  is the case where there is increasing return to scale while  $\varepsilon = 1$  is the case where there is constant return to scale.

MNEs to pay higher wages (or so called efficiency wages) in comparison to local firms for three possible reasons. First is that MNEs pay higher wages in order to reduce worker turnover and thereby minimise the risk of their productivity advantage spilling over to local firms, and also to motivate workforce as they may face higher monitoring costs related to informational problems. Second is that MNEs' productivity advantages give rise to rents that they share with their employees. Finally, the higher wages provided by MNEs in comparison to their local counterparts is considered to be the influence of institutional factors that give incentives for them to go beyond local labour practices. While introducing the efficiency wage considerations to our model could be useful, we refrain from doing so in order to keep our theoretical model simple and tractable, leaving the task for the future research.

It is assumed that monetary profits sum up the more tractable part of profit function, and that it is the main driver of the firm in its decision with regards to FDI. The main costs of firm are considered to be the cost of production, and sunk cost. The cost of production is assumed to involve, only the cost of labour. As for the latter, since this section is introducing the general static form of the model, the sunk costs are considered to be associated with the cost of exiting the market, and the costs associated with the operationalization of the project. The latter is mainly because we relax the assumption that the firm can start and stop the production without incurring any costs. Thus since the continuous production of the firm to the optimal level is a rather simplistic view, we consider that the firm takes the cost of start and stopping of production into account when considering their cost structure. Therefore the general utility function reduces to the form of profit function of the firm and is as follows:

$$P = \text{Revenue generated by the production and sales of goods or services} - \text{Costs} \quad (1)$$

Therefore the main costs of firm are considered to be the cost of production, and sunk cost. The former, the cost of production, is assumed to only involve the cost of labour. Sunk costs are generally considered as the investment costs that are not retrievable (or recovered one incurred) and by nature they differ from fixed and marginal costs. Here the sunk cost that firm bears is mainly the cost of not employing the capital somewhere else whilst making a decision (or cost of waiting for the time from the capital is held unallocated to the point when the decision is made regarding the investment). It is possible to assess the value of this cost in many different ways. Some of these ways are: assessing

the value of the investment based on the a comparative analysis of the possible investment opportunities that the capital can be invested in (in a specific sector or by a certain type of firm); assessing the value of the sunk cost based on the nominal rate of return in a specific market at a certain time window; and finally assessing the value of the sunk cost using U.S. T-bills as measures of interest free rate of return. Therefore it is possible to write the following:

$$P = Y(K, L, A) - w_B L - C_s \quad (2)$$

Where:	Y(.)	Cob-Douglas Production function
	K	Capital used for production of goods in host country
	L	Labour employed (from host country)
	A	The firm-specific technology used for production
	$w_B$	The wage paid to host country employees (Assumed all labourers)
	$C_s$	Sunk Cost

It is imperative to review the set of assumptions that are made here: First, it is assumed that the firm perceives two types of costs when deciding on the investment, the production costs and sunk costs. The production cost is assumed to be the cost of employing ‘L’ employees who will be paid wage of ‘ $w_B$ ’. The sunk cost as it was mentioned before is assumed to be the cost of ‘ $r$ ’ per unit capital or ‘ $r.K$ ’ (the interest rate itself is not important since the term diminishes in early stages). Second, it is assumed that firm does not perceive any cost related to entry and exit or any barriers to entry and exit for that matter. In other words, it is assumed that there are no barriers to entry and exit and that the entry and exit are costless. Third, the production function is assumed to be Cobb-Douglas, with diminishing rate or return to scale. Fourth, we are not distinguishing between the level at which the bargaining is conducted on MNE side. Consequently this research does not take into account the issues introduced through the consideration of the coordination of MNEs’ representatives in bargaining with unions. An example of these issues is the asymmetry in communication and coordination of entities at MNE side, which is explored by Buccella (2011) who take into account the games where both general management of the firm and the subsidiary have the option of bargaining with the unions and mainly focus

on the level of management of MNE that conducts the bargaining process with the unions. In the contrast, this chapter in a similar spirits to the work of Aidt and Tzannatos (2008) who consider the level of bargaining and coordination of unions on the bargaining process, considers the effect of the level of bargaining on union side on the bargaining process. The former will be covered explicitly in the next section.

In its most primitive form the investment costs in a static game where the bargaining is conducted in one period, the project is assumed fully reversible with no transaction costs, the set of information is assumed to be symmetric across the firm and other entities, and no cost of entry and exit are assumed, would reduce to the interest free rate return of the capital for the time when the capital is not invested anywhere else. In other words, the simplest form of the sunk cost is the cost of ‘ $r$ ’ per unit capital or ‘ $r.K$ ’. Thus, it is possible to view the production function of MNE as its simplest form as:

$$P = (1 - t).Y(K, L, A) - w_B L - r.K \quad (3)$$

Where:	Y(.)	Cob-Douglas Production function
	K	Capital used for production of goods in host country
	L	Labour employed (from host country)
	A	The firm-specific technology used for production
	$w_B$	The wage paid to host country employees (Assumed all labourers)
	$r.k$	Sunk Cost
	$t$	both taxes paid in host country and home country
	$r$	Zero coupon or interest free tax rate

Where ‘ $t$ ’ corresponds to both taxes paid in host country and home country. The taxation element in most cases reduces to taxes imposed on the MNE in host country. However in some cases MNEs are subject to taxes in home country as well (double taxation). The literature on the subject includes the works of Hartman (1985), Slemrod (1990), and Hines (1996, 1999) who have explored double taxation, and the works of Xiao (2004), and Prasad and Wei (2007) who have provided evidence of round tripping and other means of tax evasion. Since the consideration of bilateral taxes would introduce

further complexity into our model; focusing on bilateral taxes would in turn shift our attention away from the research question at hand; and that it is enormously difficult to find report of the amount of taxes MNEs pay to their home government in cases where double taxation is imposed. In this research we assume ‘ $t$ ’ to be the taxes paid to host country’s government. Later on we expand on taxes by considering two different systems of taxation: taxes on income and taxes on profits (provided in the appendix 4.4.a). Accordingly we explore the bargaining process under each of these taxation systems and offer testable hypotheses.

Omitting the technology factor (Cobb-Douglas production function) for the moment and considering that MNEs are subject to taxation in host countries, it is possible to write the former as follows:

$$P = (1 - t).Y(K, L) - wL - r.K = (1 - t)K^{\theta}L_{EMNE}^{\alpha} - w_B.L_{EMNE} - r.K \quad (4)$$

where ‘ $t$ ’ could correspond to both taxes paid in host country and home country. The taxation element is taxes imposed on the MNE in host country. Consequently, MNEs’ profit function in case of no FDI (bargaining reaches no agreement and FDI doesn’t take place) is:

$$P = \bar{P} = -r.K \quad (5)$$

However if an agreement is reached and FDI takes place, the profit function would be:

$$P - \bar{P} = (1 - t)Y(K.L_{EMNE}) - w_B L_{EMNE} - r.K - (-r.K) \quad (6)$$

Hence the main incentive of the firm from the investment is as follows:

$$P - \bar{P} = (1 - t)Y(K.L_{EMNE}) - w_B.L_{EMNE} \quad (7)$$

- Where  $Y(.)$  is the Cobb-Douglas production function  
 $t$  is the taxes imposed on MNE (is assumed to be only host country taxes)  
 $K$  is the capital needed for the investment considering the cost of FDI  
 $L_{EMNE}$  is the labour (employees) employed by MNE at host country  
 $w_B$  is the wage that is agreed upon by MNE and union if an agreement is reached  
 $\bar{P}$  is the average profit earned by MNE.  
 $r.k$  is the sunk cost of the project.

It is possible to write equation (7) as follows:

$$P - \bar{P} = (1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE} \quad (8)$$

Where  $g$  is the productivity share of capital  
 $d$  Is the productivity share of labour  
 $t$  is the taxes imposed on MNE (is assumed to be only host country taxes)  
 $K$  is the capital needed for the investment considering the cost of FDI  
 $L_{EMNE}$  is the labour (employees) employed by MNE at host country  
 $w_B$  is the wage that is agreed upon by MNE and union if an agreement is reached

Equation (8) is the profit function that MNE will strive to maximise through the bargaining process. Considering the dependency of production to labour, it is possible to consider the bargaining process to generally revolve around wage setting. In the next section we will discuss the trade unions, their characteristics, utility function and structure. Moreover we discuss the differences in the type of labour representations that exist across countries that belong to various types of market economies, building on varieties of capitalism.

#### 4.2.3. Labour (Trade) Union

This section provides a brief review of the literature on trade unions and puts forward the definition of the Labour (trade) union, considered in this research. Subsequently the objective of labour (trade) union is discussed in order to inform the construction of their utility function. The utility function of the trade unions is discussed, and the formulation is considered in case of National Unions, and Sectoral Unions. This distinction allows us to evaluate and compare incentive of unions that conduct their bargaining over the wages, employment and working conditions at the national level with those that conduct their bargaining processes at lower levels, in particular, sectoral and industry level labour representatives.

The motivation of the latter is in two folds: first, since our research aims to explore the effect of civil and political liberties on FDI, in both aggregated and disaggregated manner,

it is imperative to consider both national and sectoral level types of unions in order to distinguish between the bargaining processes at different levels. Second, based on the VoC approach we have discussed the differences between the ways firms from different market economies coordinate their activities. Furthermore, we extended our relational discussion over the coordination activity of firms to the market economies within which these firms function. Labour (trade) unions from different market economies, similar to firms, are considered to share the characteristics of social economic entities in their market economy, and thus are considered to differ from one another. Based on this proposition unions can be categorised into four main categories, namely; LME unions (Anglo-Saxon unions), CME unions (Continental European unions), 'Nordic unions' and 'Other unions'. Considering the characteristics of various types of unions which will be discussed in section 4.3., we distinguish between unions from various market economies by arguing that in case of LMEs, unions bargaining process is mainly kept on individual bases while in CMEs the bargaining processes tend to be conducted at industry or sectoral level, and finally in case of Nordic market economies the bargaining process is generally performed in a collective manner at national level between the national level labour unions and association of employers over issues such as: wages, employment and working conditions. Therefore the consideration of the effect of the level of analysis, on the incentive structure, and utility function of the labour representative is paramount to the structure of our analysis.

#### **4.2.3.1. A Background on the literature**

Surveying the literature on economic theory of trade unions Johnson (1975, p.23) wrote "... the absence of a solid theoretical foundation has handicapped the economic analysis of trade unions and has surely contributed to its decline in relative attention". However a general exponential growth in the theoretical economic literature on the subject is observed during 1970-1980s [refer to Oswald (1985) for a relevant survey]. The literature on trade unions, in general investigates the issues related to specifying the unions' constraints and preferences, commonly motivated by the idea that the micro-foundations of markets have some influence on their macroeconomic issues and hence macroeconomic analysis [i.e. Farber (1986)]. Following the progresses made, the post 1980s literature on the subject has been developed further by eliminating the barriers between labour economics and other sub-disciplines of economics such as international trade theory and industrial economics. Such advancements, mainly the establishment of a dialogue between labour and industrial

economics, in part led to increasing interests in the theoretical analysis of labour unions and thereby labour markets institutions and structures. The “shift away from the competitive paradigm as an organizing framework for the analysis of labour markets, together with a renewed emphasis on bargaining” (Addison and Schnabel 2003, p.45), as Pencavel (1991) discusses, resonates with much earlier works in labour economics, an example of which is the work of Commons (1934). It is important to note that the purely economic analysis of unions such as those put forward by Cole and Postgate (1963), and Pelling (1987), while useful, remain necessarily partial, as the analysis of unions would by no means be close to relative completeness unless the social, institutional, political and historical aspects of the markets are taken into account. However by nature, every research conducted on the subject would be constrained to elements of energy and time, thus in order to provide illuminating results through the scientific inquiry, one has to make decisions in regard to the way these factors are introduced and treated in the investigation. In part we discuss these<sup>71</sup> aspects through Varieties of Capitalism (VoC) view, where social, political, institutional, and other factors of markets are mapped out in an aggregate way, resulting in provision of a grand perspective in regard to markets and the way the actors coordinate in them.<sup>72</sup>

In determining the behaviour and decision of Multinational Enterprises (MNEs) in host markets, we argue that the objective of unions and the factors that influence their capacity and in a way influence the way they conduct their bargaining with MNEs, has some influence on the cost structure of the investment both in terms of level and composition. Therefore, in this section, markets are viewed based on the VoC perspective in order to capture an aggregate notion of the way the markets coordinate. Along with the latter (macro view), the micro foundation of the markets are introduced through an investigation of the constraints and coordination activities of Unions in markets, with the intention that such factors would provide some information on the way the bargaining processes are influenced and driven as a result of the institutions (formal and informal rules) of the markets.

Before proceeding further, it is useful to review the definition of union, as that is considered in this research. According to Webb and Webb (1920) a trade union is defined as “a continuous association of wage-earners for the purpose of maintaining or improving

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<sup>71</sup> social, institutional, political and historical

<sup>72</sup> A review of the Varieties of Capitalism Framework is provided in chapter 2.



the conditions of their working lives (of their employment).” More recent definitions are in the same wave length with the definition put forward above. Labour (Trade) Unions, emerge in most countries and in a collective manner, represent the interests of employees (labour), irrespective of the stage of unionization or the ideological orientation. (Addison and Schnabel 2003, p.172)

In the earliest theoretical works of Dunlop (1944), Leontief (1946), Fellner (1949) and Cartter (1959), that arguably established the theoretical economic foundation of the labour unions the general assumption was that unions similar to any other economic actor are profit maximising entities or optimizing agents that optimise their relative labour demand function constraints (through which they maximised their utility function)<sup>73</sup>. In contrast to the former, others such as Ross (1948) maintain that the “nature of unions militated against a simple precise representation of their objectives within a mathematical optimizing model” (Addison & Schnabel, 2003, pp.48). Other scholars including Pencavel (1991); Flanagan et al. (1993) and Booth (1995) further investigate the political models of unions and comment on the poor development of the literature on the subject.

In general labour (trade) unions are considered as organizations of workers that are formed to achieve common goals of the employees (labourers) in terms of wage, employment and employment conditions. In spite of their seemingly common incentive, it is imperative to note that the institutional channels and arrangements through which unions strive to improve the lives of their members vary widely across countries and types of markets that they are residing in (i.e. Liberal Markets, Coordinated Markets). Moreover the extent of their actions propagates differently in different countries and markets depending on the institutional environment. In some cases, the actions of unions are merely restricted to their members while in others they seem to affect the non-union members as well as union members through variety of channels and mechanisms (i.e. thread effects, legal extensions). The evidence on union effect varies from markets where they have minor impacts (i.e. American Unions), to markets where their impact alters the sectoral or overall market labour costs and prices of goods and hence influencing the welfare of consumers and in an extreme cases are capable of impacting the macroeconomic performance.

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<sup>73</sup> For instance Dunlop (1944) considers unions with;  $U=w.l$  form utility function, where “U” is the union’s utility, “w” is the wage per worker and “l” stands for labour. Thus the union is considered to be maximising its utility through their relative wage/employment constraints.

Considering the definitions put forward, union's goals are in a sense considered to be bargaining over the wages, employment and employment conditions of the labour. In an economic sense however, as Addison and Schnabel (2003) discuss that "labour (trade) union's incentives are similar to any other organization". In other words union's incentives similar to any other economic organization are in line with their economic performance. Based on this view, the unions and firms seem to have competing interests.

Considering the former, the economic literature used to investigate the effect of unions on firms (through productivity), by focusing on the adverse effects associated with 'featherbedding' and other efficiency damaging work. However, the progresses made, led to generation of a new view, mainly that the presence of unions to some extent is fruitful for the market and all its participants through their so called efficiency-enhancing role. In this view, the union and firm are considered to have complimentary interests and the analysis requires considering both shared as well as conflicting interests of firms and unions. The example of such frameworks is the 'Harvard School' (Freeman and Medoff 1984) framework that analyses the efficiency enhancing role of unions. Harvard school framework discusses four main channels through which unions act as efficiency enhancing actors. These channels are mainly; (a) a "shock effect which reduces managerial X-inefficiency; (b) morale effect; (c) better flow of information and coordination between the employees and managers; and finally (d) improved use of voice in the context of potentially sub-optimal exit"(Addison & Schnabel, 2003, p.46).

The main contribution of the Harvard School framework is the provision of the 'new view' of the unions as the efficiency enhancing actors that improve the efficiency of the firms by providing a better voice mechanism that enhances the flow of information and coordination in the firm. Therefore it is possible to view the unions as actors that enhance the efficiency of firms and thereby strengthen their productive capability. On the other hand they act as potential monopoly powers that extract rent through bargaining over wages, work conditions and working hours (factors that affect employee's lives).

In line with our previous arguments of section 4.2.2., regarding the possibility of extending this chapters' theoretical model by consideration of efficiency wages and productivity of workforce, future research can extend our theoretical discussion by examining the effect of civil liberties through unions extent and level of bargaining, as well as the way their structure affects the firms' coordination activity both with respect to

productivity and rent seeking. In this chapter, we largely focus on the bargaining processes between firms (MNEs) and labour (trade) unions by considering their efforts in terms of wage setting. This is mainly due to the fact that the wage setting plays an important role on the firm's cost structure and therefore influences the cost of investing in a host country (both in terms of initial investment as well as the sunk costs).

Considering the objective functions used for unions, in the literature, two main types of functions are generally considered. The first is the Stone-Geary utility function that takes the following form:

$$U = (w - \bar{w})^\alpha (l - \bar{l})^{1-\alpha} \quad (9)$$

Where  $w$  and  $l$ : present level of wages and labour respectively.  
 $\bar{w}$  and  $\bar{l}$ : reference level of wages and reference level of employment  
 $\alpha$  : relative weights that union gives to higher wages negotiated

Early works of Hersoug (1978), Oswald (1979), Corden (1981) and Stewart (1982) were among the first works that used the Stone-Geary utility function. Since then the specification has been popular due to its tractability and flexibility, while suffering from its ad hoc nature. Since the Stone-Geary utility function cannot be adapted to more microeconomic type analysis<sup>74</sup>, other utility functions such as utilitarian utility function became fashionable through their early uses in Sampson (1983), Oswald (1982), Calmfors (1982) and McDonald and Solow (1981). The general form of Utilitarian utility function is as follows:

$$U = l_E \cdot u(W_{Av}) + (L_T - l_E) \cdot u(w_a) \quad (10)$$

$u(.)$  : utility function of individual union member  
Where  $l_E$  : number of employed union members  
 $L_T$  : Total number of union members(employed and unemployed)  
 $W_{Av}$ : Average wage paid to employed union members

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<sup>74</sup> For instance the Stone-Geary utility function can not be adapted to account for the preferences of the individual union members.

$w_a$  : Alternative income level (wage) earned by unemployed union members

The utilitarian utility function is the sum of the utility earned by employed union members through their wages, and the utility earned by unemployed members through their income by other means (i.e. part time work, welfare payments, etc.).<sup>75</sup>

The similarity between the two is that they both provide special cases of rent maximization and wage maximisation depending on the way the variables are treated.<sup>76</sup> Another example of microeconomic type utility functions put forward for analysis of unions is that of expected utility. Since our objective in this section is to lay the groundwork for the theoretical framework in the next sections, and since our research considers the bargaining processes between firms and unions, we do not consider the micro type utility functions exclusively, in the context of our analysis. Therefore, we shy away from expanding further on different types of utility functions used in a microeconomic context.

The two general micro (utilitarian utility function and expected utility types functions) and macro (Stone-Geary utility function) utility functions are frequently used in the context of labour (trade) union literature. The proponents of micro type utility functions often regard macro type utility functions such as Stone-Geary as ad hoc, and argue that it does not derive from the preferences of the union members.

Those in favour of macro utility functions such as Addison and Schnabel (2003, pp.51) argue that the “union is more than simply the sum of its parts on account of its political nature”. Similarly Arrow’s Impossibility theorem, the discussions out forward by Olson (1965) that in general question the rationality of collective action as a representative measure of the sum of individual rational actors, the aggregation problems that arise when generating a collective utility function based on the summation of individual members’ utilities, and finally the very popular view of profit maximizing<sup>77</sup> nature of firms that is nested on rather macro foundations as opposed to micro ones, are a number of reasons why a Stone-Geary type utility function could be well justified, adopted and discussed in length,

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<sup>75</sup> Note that under the standard assumptions the utilitarian utility function represents the indifferent curves in (w,l)-space (which are convex and with downward slopes).

<sup>76</sup> For Stone-Geary  $\alpha=1/2$  and  $\bar{l}=1/2$  resembles rent maximization behaviour, while in Utilitarian utility function the assumption that employees are risk neutral will result in rent maximization. We will observe wage maximisation if in case of Stone-Geary utility function  $\bar{w}=0$ , and in case of Utilitarian utility function when  $L_{TU} = l_{UE}$  or (when membership equals employment).

<sup>77</sup> This assumption could be made implicit or explicit and can be either considered as a strong, semi-strong, or a weak assumption.

particularly in the context of labour (trade) union research. Therefore evidence from the literature suggests that the use of different types of utility functions is generally subjective to the research design (whether the author considers the macro view or the micro view) and research question. In this research we would like to draw on the institutional differences (the channels considered are the existing level of civil and political liberties) between different types of economies (VoC) and their influence on the bargaining processes between MNEs (firms) and unions in host countries. In order to expand on the latter, as mentioned before, Hall and Soskice (2001) provides the Varieties of Capitalism (VoC) view that clusters different types of economies based on their market structure and the coordination activities of the firms in those markets.

The level of civil liberties in a host market encapsulates a number of factors such as the *freedom of expression and belief, association and organizational rights, rule of law, and personal autonomy and individual rights*. Political rights generally encompass factors such as *electoral process, electoral pluralism and participation, and functioning of government*. These measures affect the level of foreign multinationals behaviour in different host countries. In the context of FDI, we argue that the level of civil liberties in host countries influences the bargaining processes between MNEs and unions (national or autonomous) and therefore affects the cost structure of investment as well as the level of initial investment that has to be made. Political liberties in host countries also influence the behaviour of MNEs. However, the channels through which the levels of political liberties affect the cost structure of investment and initial investment level are substantially different from civil liberties. The political liberties' influences can be traced through the bargaining processes between MNEs and the regional authorities, or in some cases governments, over taxes, security, and a number of other factors. Since such bargaining processes are generally held secret, and obtaining data for such analysis would not provide enough information to draw conclusions on the effect of political liberties on FDI<sup>78</sup>, this research focuses mainly on the influence of the level of civil liberties on FDI.

Therefore the consideration of different levels of coordination (VoC) and existing level of civil provides some information on the level of investment needed for FDI, as well as the cost structure of FDI for the MNEs, which in turns is expected to prove informative on the decisions made by MNEs in regard to FDI opportunities in different host countries.

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<sup>78</sup> Due to problems introduced through the complexity of political interactions in different parts of the world, this research focuses mainly on the effect of the level of civil liberties on FDI.

#### 4.2.3.2. Unions and the scope of Bargaining

The previous section reviewed the literature on the unions' incentives; the types of utility functions used to proxy for such incentives, and this research take on the views provided. In order to explore the bargaining process between the union and firm, in this section we provide an overview of the scope of bargaining, as well as bargaining structure. The scope of bargaining consists of the factors (i.e. wages, employment, etc.) that are included in the bargaining process between unions and firm. The structure of bargaining on the other hand pertains to the issues of product structure and bargaining which consists of two main building blocks of internal and external structure of bargaining.

In order to explore the scope of bargaining, we consider two main approaches often considered in the union-firm bargaining process. First, is the 'right to manage approach' that assumes that in the bargaining process, once wages are set, firms autonomously choose employment in order to maximise their profits. In other words, the scope of bargaining is mainly restricted to wage setting. In this setting depending on the power of union in the bargaining process the outcome could lie on the "labour demand curve where it is tangential to the union indifference curve"<sup>79</sup> in one extreme (the case where union has monopoly power), somewhere in the middle (depending on the relative bargaining power of union and firm) or could be competitive equilibrium (in case union has no power). In this approach the relative wage preference of union, parameters of labour demand function (for instance the slope of labour demand curve is influential in determining the wage-employment outcome), level of reference wage and relative bargaining power of union, on union side, and the elasticity of product demand and the extent of competition and type of competition on the firm side, are influential in determining the equilibrium outcome in terms of wages and employment. While this approach is generally popular, perhaps because it resembles the so called 'real-world' bargaining processes, it has been theoretically criticised due to the fact that the bargaining outcomes in terms of their place on demand curve resulted from adopting this approach are generally considered inefficient. This theoretical dissatisfaction with 'right to manage' approach has led to provision of 'efficient bargaining' approach where a so called Pareto optimal (a situation in which one of the parties is left better off, without leaving other worse off) is considered through

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<sup>79</sup> Addison & Schnabel (2003, pp.53)

finding a combination of wages and employment along the efficiency locus<sup>80</sup> or ‘contract curve’. In other words this approach considers that there is an efficient bargaining outcome (the outcome is placed on the efficiency locus curve) for the bargaining process between the firm and union. It is imperative to note that this so called ‘efficient’ outcome is by no means efficient for the society as a whole, but rather a subjective efficient solution for the bargaining game provided.

Considering the two approaches commonly used in the literature, one has to raise the question of “which of these approaches are more empirically valid?”. This question is discussed in length in Pencavel (1991) and Booth (1995). However the literature on the subject falls short of provision of any definitive answers. Following Addison and Schnabel (2003) we consider the bargaining structure to consist of ‘*internal bargaining structure*’ and ‘*external bargaining structure*’. The internal bargaining structure is generally referring to the conditions within an organization that affects the bargaining process namely factors such as number of unions, bargaining over wages with a firm, the power of any of these multiple unions in their bargaining process with the firm, presence of closed shop unions, etc. The external environment is on the other hand referring to “institutional conditions characterising the bargaining relationships across establishments”<sup>81</sup>. Therefore the external bargaining structure embodies the degree of centralization or decentralization of bargaining across firms/unions in a sector, industry, or in a more aggregate form in host country markets or in markets that belong to a certain type of economy in terms of their degree of coordination and their market structure (VoC; Liberal markets or coordinated markets). Factors such as the type of product market competition and industrial structure are among those leading to formation of type of external bargaining structures.

Since the question we are trying to address here is the effect of the existing level of civil liberties in host countries on the level and composition of FDI, we only consider the external structure of bargaining. The latter apart from reducing the complexity in modelling of such relationships, has a very simple economic justification. The idea is that since organizations are inherently profit maximising entities (to some respect), they understand the cost structure of bargaining processes. Therefore, an MNE bargaining over wages and employment would possibly try to deal with a single union, rather than a number of unions, in order to reduce the cost of coordinating with different representatives

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<sup>80</sup> The efficiency locus is the tangency points between firms’ iso-profit curves and union’s indifference curves.

<sup>81</sup> Addison and Schnabel (2003, pp. 62)

of different unions. It is possible to consider the opposing argument, stating that coordinating with different unions leads to provision of lesser power for each union, which in turn puts the firm in a greater bargaining position when bargaining over wages and employment. However, we argue that the wages are elastic to a certain level when considering labour markets, meaning that the extent of bargain over wages would provide the unions the ability to bargain over wages from a normative minimum wage to a maximum level of wage paid for a certain type of labour within the sector, industry or market. This range differs across types of economies, markets, industries and sectors. We consider this from the view point provided by varieties of capitalism, as well as the type of bargain structures that exist within different types of economies. In order to expand on the latter we provide some information on the types of unions and the level of bargaining processes that exist in a number of markets across different economies in order to establish the types of bargain generally considered in different types of economies, which are in a way part of the institutions that govern the social activities of the societies, and in thereby influence the type of economy in terms of coordination as well as structure of markets.

#### **4.2.3.3. Unions' Assumptions and considerations**

In this chapter, as discussed earlier, markets are assumed to be imperfect. Therefore, we relax the assumption of full employment and adopt a more realistic assumption that there exists a certain level of unemployment in the market. Consequently, union members are assumed to be consisting of a certain number of members that are employed and the other members that are unemployed. The employed union members are assumed to be earning a wage equal or higher than the average pay for labour in the labour market. For simplicity, it is assumed that the employed members are earning an average wage of ( $W_{Av}$ ). The average wage is assumed to be higher than the income that unemployed would obtain. That is to say that if an amount  $w_a$  is considered to be the income of an unemployed union member,  $W_{Av} > w_a$  is assumed to hold. In other words union members would not work unless they are paid more than they earn not working.

The general form of the utility function of the union considering the utilitarian utility function discussed in previous section is:

$$U = l_E \cdot u(W_{Av}) + (L_T - l_E) \cdot u(w_a) \quad (11)$$



$u(.)$  : utility function of individual union member

Where

$l_E$  : number of employed union members

$L_T$  : Total number of union members(employed and unemployed)

$W_{Av}$  : The average wage paid to employed union members

$w_a$  : Alternative (welfare) income earned by unemployed union members

Note that since the working conditions of employees are not considered here, the utility functional form could be interpreted in crude terms as profit function of the union. In this setting, it is considered that unions strive to maximise their profit similar to any other economic entity. The expected income of labour union (in case FDI occurs) in a general form would be a function of its income and costs as follows:

$$E(V) = L_E \cdot W_{Av} + (L_T - L_E) \cdot w_a \quad (12)$$

The union bargains over wages and employment with MNE. The wage that is bargained over would be ( $w_B$ ) which will be set if the parties reach an agreement through the process of bargaining. The bargained wage ( $w_B$ ) is assumed to be either equal or above the average wage paid. Therefore it is assumed that  $w_B \geq W_{Av}$ . The union has the option of bargaining with MNE over the wages to the extent that an agreement is reached, in which case the utility function of the union would be as follows:

$$V = L_E \cdot W_{Av} + L_{EMNE} \cdot w_B + [L_T - (L_E + L_{EMNE})] \cdot w_a \quad (13)$$

$L_{EMNE}$  : is the labour (employees) employed by MNE

Where

$l_E$  : number of employed union members

$L_T$  : Total number of union members(employed and unemployed)

$W_{Av}$  : The average wage paid to employed union members

$w_a$  : Alternative (welfare) income earned by unemployed union members

$w_B$  : The wage that is agreed upon by MNE and union if an agreement is reached

Otherwise union will have the following expected profit

$$V = \bar{V} = L_E \cdot W_{Av} + (L_T - L_E) \cdot w_a \quad (14)$$

Therefore

$$V - \bar{V} = L_E \cdot W_{AV} + L_{EMNE} \cdot w_B + [L_T - (L_E + L_{EMNE})] \cdot w_a - [L_E \cdot W_{AV} + (L_T - L_E) \cdot w_a] \quad (15)$$

$$V - \bar{V} = L_{EMNE} \cdot w_B - L_{EMNE} \cdot w_a = L_{EMNE}(w_B - w_a) \quad (16)$$

Where	$V$	The utility that union earns if an agreement is reached
	$\bar{V}$	The utility that union is earning on average (the utility earned by union if an agreement is not reached)
	$L_T$	The total labour force in the market
	$L_E$	The employed labour force
	$L_{EMNE}$	The labour force which would be employed by the MNE if an agreement is reached
	$W_{AV}$	The average wage earned by single employee in the market
	$w_B$	The wage that is agreed upon by MNE and union if an agreement is reached
	$w_a$	The alternative wage earned by a single union member if not unemployed – income of unemployed union members

In order to explore the union bargaining positions more in depth, we develop more on the types of unions discussed in previous section.

### 4.3. Varieties of Unions, Union structures, and Union bargain structures (in terms of level and extent)

In this section we explore the level of bargaining and other characteristics of unions in different types of economies in order to distinguish between the types of bargaining processes that are standard within different markets.

Gold (1993) and later on Hall (1994) following Due et al. (1991) identify a number of different traditions of legal regulations in EU member countries and distinguish three main systems, namely; (1) Roman-German system; (2) Anglo-Irish system; (3) Nordic system. The authors discuss that in Roman-German<sup>82</sup> tradition of legal regulation, constitution guarantees a “core of fundamental rights and freedoms, constituting the foundation of national industrial relations”<sup>83</sup> and state plays a central role in industrial relations. This legal system in part translates to provision of comprehensive labour market legislations

<sup>82</sup> Examples of countries that have this type of legal systems are Germany, France, Belgium, and Netherlands.

<sup>83</sup> Due et al. (1991, pp.90-91)

which are imposed by the state as the general labour market regulations which govern most aspect of labour markets, including the employee-employer relations. Author considers Anglo-Irish tradition of legal regulation to be a system in which there is little legislation conferring basic rights and state play a very limited role in governing industrial relations in general and labour markets as its subset. Therefore, the employee-employer relations are conducted in a liberal manner and the agreements are specific to different cases. Finally, authors consider the Nordic<sup>84</sup> tradition of legal regulation to have a limited role of state in industrial relations; however, in this system the labour market agreements are made across industries and thus there is a collective bargaining that is conducted between the employers and unions and the agreements are imposed in most sectors of the market.

Hall and Soskice (2001) following the works of Due et al (1991) and Gold (1993) explore the labour law policy amongst US, EU member states, and Northern countries, and argue that labour laws differ significantly across different countries, so does the functionality and coordination activities of employee representatives (unions) and employer (or employers' association). Building on a holistic approach authors provide classification of different industrial relations systems and categorize the labour law systems into four main categories; "Anglo-Saxon unions", "Continental European Unions", "Nordic Unions" and "Other Unions". Authors characterise the "Continental European System of labour market" in a setting that is later on referred to as "coordinated markets" by Hall and Soskice (2001). In this system of labour market, government intervenes in the employees (or employee representative entities) and employers (or employers' associations) interactions and issues by establishing "strong legislative core of employee human rights, which provides the basis for agreements as well as a framework for discord between unions on one side and employers or employers' association on the other".<sup>85</sup>

The Anglo-Saxon unions are generally unions that function in countries that are later on categorized by Hall and Soskice (2001) as "Liberal market economies". The examples of liberal market economies as it was discussed in chapter 2 are Ireland, United States of America, and United Kingdom.<sup>86</sup> The authors argue that generally in liberal market economies, Anglo-Saxon market regulations (mainly labour market regulation) has led to

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<sup>84</sup> Examples of such systems are Denmark, Finland, Norway and Sweden.

<sup>85</sup> "This model was said to be found in EU core countries such as Belgium, France, Germany, the Netherlands and Italy, and it is also mirrored and emulated to some extent in the institutions of the EU, due to the relative weight that these countries had in the EU until the EU expansion by the inclusion of 10 new Eastern European member states in 2004."

<sup>86</sup> "In contrast to other EU core countries, these countries first joined the EU in 1973."

provision of limited government legislative role and power in regard to labour (employee), and labour representative entities (i.e. labour unions), and employers (or employers' association) issues. Thus, government plays a minor part in interactions between employers and employees representative entities. Another characteristic of the "Anglo-Saxon system of labour market regulation" is that the agreements made between employers (i.e. employers' association) and employee representatives (i.e. unions) are not drawn in a collective manner whereby they apply to a number of industries and sectors.<sup>87</sup> Therefore in liberal markets the government role is minor and agreements between employees or their representatives (unions) are in general made between employer and employees' representatives (unions), there are not many cases of collective bargaining agreements across sectors. It is worth mentioning that this classification is made in an aggregate form, since the union membership level and labour market structures differ amongst these three countries to some extent<sup>88</sup>, it has been suggested that this grouping is made based on comparison of different types of labour markets in a spectral manner.

Nordic labour market regulation is the third type of labour market regulation discussed by Gold (1993) and later on Hall(1994). In this system of labour market regulation, government has limited legislative role in regard to employee (or employees' associations) and employers' issues and interactions. This aspect of Nordic labour system is similar to that of liberal markets' labour market regulations (or Anglo-Saxon labour market regulation). However, in contrast to Anglo-Saxon system (liberal markets' labour market regulation system), in Nordic system, there exists a network of widespread collective agreements that cover most sectors (including the industries within them) in the economy. Therefore, in Nordic system, whilst the government plays a minor role in regulating the interactions between employers (in this case it's generally the employers' association) and employees (in this case, it is mainly the employees' associations; or representative unions), through which unions bargain over wages and employment with employers and issue collective agreements that are respected in wide range of sectors and industries. This model is considered to encompass Norway, Denmark, Sweden and Finland.<sup>89</sup>

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<sup>87</sup> There are rare occasions of specific industries and sectors having the tradition of providing collective agreement specific to that industry or sector. However the overview of such collective agreements when whole economy is considered shows that in most cases collective agreements are not considered.

<sup>88</sup> With United States taking a more Laissez-Faire approach, in comparison to UK that has some boundary regulations, and Ireland that has symptoms of a European liberal labour market regulatory system.

<sup>89</sup> In this set of countries Denmark joined the EU first in 1973, later on Sweden and Finland joined EU in mid-1990s.

**Table 4—1: Classification of bargaining level based on types of economies - Source: Hall and Soskice (2001)**

Type of Economy	Bargain between	Extent of agreement	Government Role
Liberal	Employee & employer	Individually	Minor
Coordinated	National Union & employer	Sectoral	Major
Nordic	Employers' & Employees' Associations	Across sectors	Minor

Beyond the classification put forward by Gold (1993), and later on Hall (1994), the most recent contributions in economics literature in terms of classifying the markets based on their institutional characteristics, structures and socio-political environment, is the work of Hall and Soskice (2001) which does not exclusively discuss the differences in the way employees' are represented, but rather adapts a more holistic approach, in which they discuss the markets overall and classify them into varieties of capitalism as it was discussed in Chapter 2. Drawing on the market characteristics and the employer-employee representative interaction in these markets in the next few sections, we examine the wage/employment bargaining environment in these markets and provide some insightful theoretical findings.

Based on the view provided above, the degree and extent of bargain differs from a liberal to coordinated, to Nordic and hybrid types of economies and host countries with such characteristics. A second element that is observed is the existence of different types of unions in different types of economies. The literature on the unions which entails the works of Gold (1993), Hall (1994) and Hall and Soskice (2001), generally distinguishes between national level union, autonomous unions, and in most recent cases (i.e. literature on unions in EU) the transnational unions<sup>90</sup>.

In this research two main types of unions<sup>91</sup> are considered within the markets, namely the National Level Labour Unions (NU) and Autonomous Labour Unions (AU) which in

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<sup>90</sup> The literature on this type of unions is rather scarce and the effects reported are generally low in magnitude and insignificant.

<sup>91</sup> The transnational unions are not accounted for, since the literature generally discusses that they are not powerful enough in order to influence the labour market to the extent the other two influence.

turn proxy for other unions functioning within the labour market (i.e. sectoral unions, industry level unions, etc.). This generalization is made chiefly with the intention to reduce the complexity of introducing multiple players into game theoretic discussion and the issues that would have to be resolved by doing so (mainly introduction of different types of asymmetries, the timing of the bargaining processes, etc.), which possibly would have not contributed much to this study considering the level of aggregation used in the terminology (type of economies, types of union structures, etc.). The definition of labour union adopted in this research is in line with the definition provided by Webb and Webb (1920) is in the same wave length with the definitions considered in most of the literature on the subject and discussed above. Thus, we consider the labour unions goal to be improving the life of its members by bargaining over wages, employment and employment condition. Therefore this research considers the unions' incentives and activities are generally in order to; first, bargain over wages; two, bargain over the number of jobs that would be bargained for at the same time with wages. On another note, factors that entail considerable qualitative nature, such as employment condition are not quantitatively tractable. Since this research follows the quantitative tradition of social inquiry, such factors are not considered or discussed in this research. The next section outlines the labour unions' utility function, and extends the general form to more specific cases (for the case of different types of economies).

#### 4.3.1. The effect of the type of union on their bargaining preferences

It is assumed that the National Union ( $U_N$ ) puts more weight on the level of employment across sectors, and less weight on the bargained average wage since the size of MNE is in terms of a recruiting entity is minor compared to the whole market, and so is their capital. Thus, national union will be bargaining over  $L_E$  with the intention of reducing the general level of unemployment with average wage constraints. Therefore, the utility function of national union is considered to be as below:

$$V_N = L_E \cdot W_{Av} + L_{EMNE} \cdot W_B + [L_T - (L_E + L_{EMNE})] \cdot W_a \quad (17)$$

$$\overline{V}_N = L_E \cdot W_{Av} + [L_T - L_E] \cdot W_a \quad (18)$$

$$V_N - \overline{V}_N = L_E \cdot W_{Av} + L_{EMNE} \cdot W_B + [L_T - (L_E + L_{EMNE})] \cdot W_a - L_E \cdot W_{Av} - L_T \cdot W_a + L_{EMNE} \cdot W_a = L_{EMNE} \cdot W_B - L_{EMNE} \cdot W_a \quad (19)$$

Where	$V_N$	The utility that national union earns if an agreement is reached
	$\bar{V}_N$	The utility that national union is earning on average (the utility earned by union if an agreement is not reached)
	$L_T$	The total labour force in the market
	$L_E$	The employed labour force
	$L_{EMNE}$	The labour force which would be employed by the MNE if an agreement is reached
	$W_{AV}$	The average wage earned by single employee in the market
	$w_B$	The wage that is agreed upon by MNE and union if an agreement is reached
	$w_a$	The alternative wage earned by a single union member if not unemployed – income of unemployed union members

On the other hand, it is assumed that the Autonomous Unions ( $U_A$ ) is considered to put more weight on the bargained wage within the sector/industry and less weight on number of jobs created through the bargaining process (level of unemployment within the sector/industry). The autonomous union here considered as sectoral union <sup>92</sup>(in general a type of union whose contracts with foreign firms does not cover cross sectoral labour force). Considering the incentive of the autonomous union, its general utility function is as follows:

$$\bar{V}_A = L_S \cdot w_a \quad (20)$$

If an agreement is reached, the utility function would be as follows:

$$V_A = L_{EMNE} \cdot w_B + [L_S - L_{EMNE}] \cdot w_a \quad (21)$$

Therefore the payoff of reaching an agreement would be:

$$V_A - \bar{V}_A = L_{EMNE} \cdot w_B + [L_S - L_{EMNE}] \cdot w_a - L_S \cdot w_a = L_{EMNE} \cdot w_B - L_{EMNE} \cdot w_a \quad (22)$$

Where	$V_A$	The utility that autonomous union earns if an agreement is reached
	$\bar{V}_A$	The utility that autonomous union is earning on average (the utility earned by union if an agreement is not reached)

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<sup>92</sup> Note that the autonomous union could be any type of non-government union, with different sizes. The only assumption here is that the autonomous union does not govern labour union movements across sectors and industries (that it covers industry level or sectoral labour force). The latter is merely to distinguish the coverage of the contracts between MNE and Union.

$L_S$	Total labour force in the sector (or industry)
$L_E$	The employed labour force
$L_{EMNE}$	The labour force which would be employed by the MNE if an agreement is reached
$W_{AV}$	The average wage earned by single employee in the market
$w_B$	The wage that is agreed upon by MNE and union if an agreement is reached
$w_a$	The alternative wage earned by a single union member if not unemployed – income of unemployed union members

The former reduces to  $V_A - \bar{V}_A = L_{EMNE} \cdot (w_B - w_a)$ . Note that solving the model for national union, and autonomous union with their different preferences in terms of employment and wages, produces similar results. The latter has an intuitive reason. The reason is that under more realistic market conditions, market frictions, or specifically labour market frictions (in this case existence of unemployment in the labour market), unions' behaviour are not characterised by solely bargaining over wages, or employment. The bargaining therefore would be over both employment and wages in a manner that maximises unions' utility function. The solution of this theoretical maximisation considering the characteristics of each union under the assumption of existence of unemployment in the market shows that irrespective of the motivation of the union, they would behave in a similar manner. That is to maximise both employment and wages (wages are considered to be generally in the proximity of the average wage paid in the specific sector). Therefore the value of reaching an agreement for the union (irrespective of its type) would be the product of the difference between the utility earned if an agreement reached and otherwise as follows:

$$V - \bar{V} = L_{EMNE} \cdot W_B - L_{EMNE} \cdot w_a = L_{EMNE} \cdot (w_B - w_a) \quad (23)$$

Furthermore, our premise was that the level and extent of bargaining process differs across various market economies, considering the theoretical results of this subsection, it is possible to argue that the behaviour of labour representatives in the presence of unemployment would be similar, irrespective of their market economy. Thus in the presence of unemployment, US, Norwegian and French unions would have the same incentives in their bargaining processes, that is to bargain over both wages and employment. Considering the level and persistence of unemployment, future research will



be able to develop on the influence of the level of unemployment on the union membership and their incentive structure when bargaining with foreign firms.

The findings of this section limit the applicability of the VoC arguments only to the foreign firms. Since the profit function provided for the MNE has a singular general form, we proceed with provision of theoretical solutions to the bargaining process in a general case, in this chapter, and leave the distinction between the behaviour of firms from various market economies to the empirical investigation undertaken in chapter 7.

#### **4.4. Bargaining Process I (taxes applied to income)**

Since our approach adopts a transaction cost view of the FDI decision, our premise is that the firms' cost structure influences the firms' decision with regard to FDI. Furthermore, in the previous section we showed that in the imperfect markets (in the presence of unemployment), the incentive of all unions irrespective of their size and level of bargaining, is to obtain higher wages for employed members and obtain employment for the unemployed. Consequently we showed that the utility function of national level unions that arrange collective bargaining (i.e. Northern unions), is similar to the utility function of labour representatives bargaining at industry/sector level (i.e. CME unions) and those bargaining at lower levels (i.e. LMEs).

In this section we provide a theoretical exploration of the bargaining process between foreign firms that are interested in investing abroad, and the labour representatives of the host country. Firm (MNE) tries to maximise its profit function by bargaining over wages, since they generally are a significant part of the cost structure of firm. Similarly, union considers the average utility attained by its members and tries to maximise its utility function through employment and wages. Sections 4.2.1, 4.2.2, and 4.2.3 aimed that providing information with regard to the underlying assumptions of this sections' theoretical exploration.

The bargaining process is adopting the 'right to manage approach' and thus is mainly considering the negotiation over wages rather than employment. Therefore, considering the 'right to manage approach', it is assumed that wages are determined through the bargaining process, and firm unilaterally determines employment once wages are set. The right to manage approach is adopted in the scope of bargaining for three main reasons. A first

reason is that right to manage approach closely resembles the way the bargaining processes are generally conducted in the real world. The second reason is that right to manage approach provides an asymmetric Nash bargaining solution. A third reason for choosing the right to manage approach is that we assume that in most cases unions' wage demand would not be altered severely by the number of jobs that would be provided by MNE.

It is possible to explain the latter in two folds: First; since in most markets that were reviewed, the level of unemployment is generally low, unions probably would be bargaining over the certain number of employees that could be employed, and their position in the bargaining table would not be varying immensely by the number of jobs that could be attained. Second; on the firm side, there is a certain number of employees that could possibly be hired, the alteration of the wage based on increases in number of employment opportunities provided by the firm, since the number of jobs are limited, and that firm is assumed to prefer to bargain with only one union, is almost of no significant value for the firm. In the presence of unemployment, the bargaining process consequently reduces to:

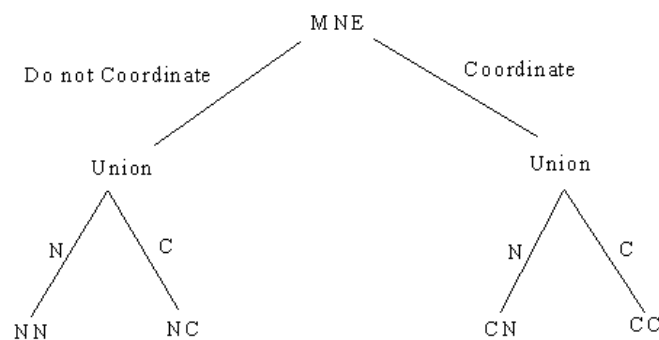


Figure 4-1: Schematic view of the Bargaining tree

Considering the assumption above, the bargaining is conducted in a way that wages will be set and then firm unilaterally decides on employment (right to manage approach). Therefore considering the table below, there is a Nash solution to the bargaining problem with the following form:

$$\mathit{Arg} \max_{w,L} [(V - \bar{V})^a (P - \bar{P})^{1-a}] \quad (24)$$

Union and MNE's options and pay offs		MNE	
		Accepts the wage (A)	Doesn't accept the wage (D)
Union	Accepts	$P = \bar{P} + (1 - t)Y(K \cdot L_{EMNE}) - w_B L_{EMNE}$ $V = \bar{V} + L_{EMNE} \cdot W_B - L_{EMNE} \cdot w_a$	$P = \bar{P}$ $\bar{V} = L_E \cdot W_{Av} + (L_T - L_E) \cdot w_a$
	Declines	$P = \bar{P}$ $\bar{V} = L_E \cdot W_{Av} + (L_T - L_E) \cdot w_a$	$P = \bar{P}$ $\bar{V} = L_E \cdot W_{Av} + (L_T - L_E) \cdot w_a$

The general form of the statement thus is as follows:

$$\{w^*, L^*\} = \underset{w, L}{\text{Arg max}} [[L_{EMNE}(w_B - w_a)]^a [(1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE}]^{1-a}] \quad (25)$$

For simplicity we refer to  $[L_{EMNE}(w_B - w_a)]^a [(1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE}]^{1-a}$  as  $W$ .

$$\text{Thus: } \{w^*, L^*\} = \underset{w, L}{\text{Arg max}} [W] \quad (26)$$

- Where
- $g$  is the productivity share of capital and  $g + d < 1$
  - $d$  Is the productivity share of labour and  $g + d < 1$
  - $t$  is the taxes imposed on MNE (is assumed to be only host country taxes)
  - $K$  is the capital needed for the investment considering the cost of FDI
  - $L_{EMNE}$  is the labour (employees) employed by MNE at host country
  - $w_B$  is the wage that is agreed upon by MNE and union if an agreement is reached
  - $w_a$  is the income of the unemployed (welfare)
  - $a$  is the bargaining power of the union and  $0 \leq a \leq 1$
  - $1 - a$  is the bargaining power of the foreign firm

For simplicity refer to  $(1 - t) \cdot K^g$  as  $M$  and for simplicity all  $L_{EMNE}$  are referred to as  $L$ .

$$\frac{dW}{dL_{EMNE}} = a(w_B - w_a) \cdot [L_{EMNE} \cdot (w_B - w_a)]^{a-1} \cdot (M \cdot L_{EMNE}^d - w_B \cdot L_{EMNE})^{1-a} + (1 - a) \cdot (M \cdot L_{EMNE}^{d-1} \cdot d - w_B) \cdot (M \cdot L_{EMNE}^d - w_B \cdot L_{EMNE})^{1-a-1} \cdot [L_{EMNE} \cdot (w_B - w_a)]^a \quad (27)$$

Considering  $\frac{dW}{dL_{EMNE}} = 0$ , and solving for  $w_B$ , gives

$$w_B = \left( \frac{a}{a-1} - d \right) \cdot \frac{1}{\frac{a}{a-1} - 1} \cdot M \cdot L_{EMNE}^{d-1} = a - d(a-1) \cdot (1-t)K^g \cdot L_{EMNE}^{d-1} \quad (28)$$

Similarly

$$\frac{dW}{dw_B} = a \cdot L_{EMNE} \cdot [L_{EMNE} \cdot (w_B - w_a)]^{a-1} \cdot (M \cdot L_{EMNE}^d - w_B \cdot L_{EMNE})^{1-a} + (1 - a) \cdot (-L_{EMNE}) \cdot (M \cdot L_{EMNE}^d - w_B \cdot L_{EMNE})^{1-a-1} \cdot [L_{EMNE}(w_B - w_a)]^a \quad (29)$$

Considering  $\frac{dW}{dw_B} = 0$ , and solving for  $w_B$ , gives

$$w_B = a \cdot M \cdot L_{EMNE}^{d-1} + w_a \cdot (1-a) = a \cdot (1-t)K^g \cdot L_{EMNE}^{d-1} + w_a \cdot (1-a) \quad (30)$$

Considering equation [28] and [30], it is possible to write:

$$a - d(a-1) \cdot (1-t)K^g = a \cdot (1-t)K^g \cdot L_{EMNE}^{d-1} + w_a \cdot (1-a) \quad (31)$$

$$L_{EMNE} = \left[ w_a \cdot (1-a) \cdot \frac{1}{(1-t)K^g \cdot d} \right]^{\frac{1}{d-1}} \quad (32)$$

Substituting [30] (11) into [27] (9) gives:

$$w_B = \left( \frac{a}{a-1} - d \right) \cdot \frac{1}{\frac{a}{a-1} - 1} \cdot (1-t)K^g \left( \left[ w_a \cdot (1-a) \cdot \frac{1}{(1-t)K^g \cdot d} \right]^{1/(d-1)} \right)^{d-1} \quad (33)$$

$$w_B = a \cdot w_a \cdot \frac{1-a-d}{d} + w_a \quad (34)$$

The two equations (32) and (34) are the first order Nash solutions to the bargaining problem provided earlier. However the main task in this section is finding out the minimum level of investment that is needed for a project to be set up. In the static model as it was mentioned before, the decision is a “now or never” type decision, with no future time horizon to provide the option to wait. Therefore, based on the static game, assuming no asymmetries, no barriers to entry, no cost of repatriating the capital (no transaction or other costs related to transferring the capital), the main elements that are so far discussed are the two main elements that the bargaining process is based on, namely; wages and number of jobs provided (employment). Equation (32) and (34) provide some measure of the Nash solution for the game. Note that since we assumed the “right to manage” approach, which generally refers to the situation where the main element of bargain is the wages and after the wage setting MNE will unilaterally decide on the number of jobs

offered. Although this might seem unrealistic and in contrary with some of the point made before, the underlying reasoning is that in most cases number of labour force recruited is generally related to the level of production that is desired by the firm. Therefore since level of employment has a high elasticity with respect to productivity of the MNE in the foreign market and their projected profit as a result, it is assumed that the employment is an element that of a lesser importance on the bargaining table. Therefore the wage setting is the main element that the parties would be arguing over. At this stage, in order to find the minimum capital needed for the project start, it is possible to use the bargained wage, first order condition available from equation (28), and substitute it into profit function of the MNE [equation (4)] and minimising it based on capital (K) as follows:

Substituting (28) into (4) gives:

$$P = (1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE} - r \cdot K \quad (35)$$

$$P = (1 - t)K^g \cdot L_{EMNE}^d - \left(\frac{a}{a-1} - d\right) \cdot \frac{1}{\frac{a}{a-1} - 1} \cdot M \cdot L_{EMNE}^{d-1} \cdot L_{EMNE} - r \cdot K \quad (36)$$

$$P = (1 - t)K^g \cdot L_{EMNE}^d \cdot (1 - a - d + ad) - r \cdot K \quad (37)$$

$$\frac{dP}{dK} = g \cdot (1 - t)K^{g-1} \cdot L_{EMNE}^d \cdot (1 - a - d + ad) - r \quad (38)$$

$$\frac{dP}{dK} = 0 \quad (39)$$

$$g \cdot (1 - t)K^{g-1} \cdot L_{EMNE}^d \cdot (1 - a - d + ad) - r = 0 \quad (40)$$

$$r = g \cdot (1 - t) \cdot (1 - a - d + ad) \cdot K^{g-1} \cdot L_{EMNE}^d \quad (41)$$

Substituting (32) into (41) gives:

$$r = g \cdot (1 - t) \cdot (1 - a - d + ad) \cdot K^{g-1} \cdot \left[ (w_a \cdot (1 - a) \cdot \frac{1}{(1-t) \cdot K^g \cdot d \cdot A})^{\frac{1}{d-1}} \right]^d \quad (42)$$

Solving the former gives the minimum level of capital that needs to be invested for the FDI to occur (project to start):

$$K = [g^{d-1} \cdot (1 - a - d + ad)^{d-1} \cdot w_a^d \cdot (1 - a)^d \cdot r^{1-d} \cdot (1 - t)^{-1} \cdot d^{-d}]^{1/(d+g-1)} \quad (43)$$

Constraints:  $0 \leq g < 1$ ;  $0 \leq d < 1$ ;  $g + d < 1$ ;  $r > 0$ ;  $t > 0$ ;  $(1 - t) > 0$ ;  $w_a \geq 0$ .

#### **4.4.1. Comparative Statistics – Testable Hypothesis**

In the previous section we mathematically explored the bargaining process between the firm and the union, in case where taxes apply to income, and using the optimal level of employment, and labour, worked out the minimum level of capital that has to be invested for FDI to occur. In other words, ‘ $K$ ’ in equation (14) is the initial cost of FDI. Furthermore, a simplistic review of the equation (14) indicates that the initial cost of FDI is related to factors such as: bargaining power (that is related to the level of civil liberty in the host country); sectoral/industry characteristics (in terms of labour/capital share of production in the sector/industry); taxes on income (that is considered to reflect the effect of the level of political rights in the host country); welfare (alternative wage); and interest rates.

In this section, we would like to investigate the effect of civil and political liberties on FDI (our main research question) by exploring the effect of the level of civil liberties and political rights on the initial cost of FDI. Therefore our argument builds on the firms’ motivations, and in particular the ES motives, in determining the theoretical relationship between civil and political liberties and FDI. In other words adopting a transaction cost approach, we consider the firm to be mainly motivated by ES motives, and thus sensitive to changes in the initial level of capital that has to be invested for FDI to occur. In this setting the sensitivity of ‘ $K$ ’ to civil and political liberties, channelled through bargaining power and taxes on income, respectively, determines the theoretical effect of civil and political liberties on the level of FDI.

Moreover, in order to theoretically explore the effect of industry/sector specific characteristics on FDI, we consider the effect of the labour and capital share of production in various sectors/industries on initial cost of FDI, and considering our transaction cost disposition, consequently on FDI. Therefore, our distinction between the industries/sectors is mainly driven by their production characteristics. These mathematical explorations help in formulation of a number of hypotheses that will be empirically tested in chapter 7.

#### 4.4.6. A. Effect of changes in union power on the bargaining process on the minimum capital that needs to be invested for the FDI to occur

The term ‘ $a$ ’ in the Nash solution:  $\text{Argmax}_{w,L} [W = (V - \bar{V})^a (P - \bar{P})^{1-a}]$ , represents the weight (power) given to union and foreign firm through ‘ $1 - a$ ’. However, in order to find out what exactly gives bargaining power to unions and firms in their bargaining over wages and employment (without providing the arguments that are sector or market specific), it is possible to review some of the elements that were discussed earlier in this section such as extent of the contracts, the level of unionization in the markets (i.e. market/sector union density), the institutional elements in the markets and the main factor under consideration here, the existing level of civil liberties in the markets. The level of civil liberties in a host market as it was discussed encapsulates a number of factors such as the freedom of expression and belief, association and organizational rights, rule of law, personal autonomy and individual rights. Therefore, the extent to which the civil liberties are upheld in the host countries considerably influences whether the labour force would have the possibility to voice their opinion and be represented in any form.

The institutional factors’ influences generally have more to do with how these rights are upheld, rather than whether they are represented or not. For instance the existence of high level of bureaucracy and the need to fill up lengthy documents and undertaking long processes to claim one’s right would have to do more with the “formal and informal rules” (institutions) in a specific market or society. Another factor that could be considered here is the level of unionization in a market. This factor along with the extent of bargaining agreements, are generally factors that could be considered as factors determining the power of union on the bargain table.

To determine the effect of changes in bargaining power ‘ $a$ ’ on the minimum level of capital that has to be invested for the FDI to occur, the derivative of equation (43) with respect to ‘ $a$ ’ has to be considered.

$$\frac{dK}{da} = g^{d-1} \cdot w_a^d [(d-1) \cdot (d-1) \cdot (1-a-d+ad)^{d-2}] \cdot (1-a)^d + g^{d-1} \cdot w_a^d \cdot [d(-1)(1-a)^{d-1} \cdot (1-a-d+ad)^{d-1}] \quad (44)$$

Considering the equation above, the rate of change of the minimum capital that has to be invested for FDI to occur with respect to the power of union in the bargaining process,

will depend on the sign of the equation. Considering that our constraints are:  $g + d < 1$ ,  $a \leq 1$  and  $w_a, g, d, a \geq 0$ , the sign of  $\frac{dK}{da}$ , will depend on the sign of  $(1 - a - d + ad)$ . In other words the rate of change of the minimum capital, that has to be invested for FDI to occur, to that of union power will be determined by the level of union power, and the productivity share of labour in the sector.

In order to determine the extrema (min and max) of the capital that has to be invested for FDI to occur with respect to union power we consider the following:

$$\frac{dK}{da} = 0 \xrightarrow{\text{gives}} 2ad^2 - 2d^2 - 3ad + 3d + a - 1 = 0 \quad (45)$$

Furthermore since the second derivative of capital with respect to union power is positive, we have the minimum level of capital that has to be invested for FDI to occur. Now, considering the option of union and firm in the context of bargaining with the following Nash solution

$$\{w^*, L^*\} = \underset{w, L}{\text{Arg max}} [(V - \bar{V})^a (P - \bar{P})^{1-a}] = \underset{w, L}{\text{Arg max}} [[L_{EMNE}(w_B - w_a)]^a [(1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE}]^{1-a}] \quad (25)$$

It is possible to find the effect of factors that influence the bargaining process on the minimum level of capital that has to be invested for FDI to occur with respect to level of union power. Considering the case where union has all the power, the productivity of labour plays no part in the bargaining process between union and MNE in their wage and employment setting, and could obtain any value in the given range  $d \in [0,1)$ .

As	$a \xrightarrow{\text{Converges to}} 1$	$\frac{dK}{da} = 0$	Union has all the power on the bargaining table
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Therefore, it is logical to argue that in cases where the level of civil liberties are very high, the union solely dictates the level of wages, and thus there is no bargaining process between firm and the host countries unions. In such cases it is expected that firms would not invest, since unions have all the bargaining power and are capable of determining the level of rent extraction (extraction of profits). The table below shows the effect of different level of union and MNE power on their bargaining behaviour.



**Table 4—2: The effect of different levels of union and MNE bargaining power, and sectoral characteristics on the cost of FDI**

	$a \xrightarrow{\text{Converges to}} 1$	$d \in [0.1)$	$\frac{dK}{da} = 0$	Union has all the power
If union has all the power in the bargaining process with MNE, the initial cost of FDI is not sensitive to bargaining power.				
		$\frac{1}{2} < d < 1$	$\frac{dK}{da} > 0$	
	$a \xrightarrow{\text{Converges to}} 3/4$	$d = \frac{1}{2}$	$\frac{dK}{da} = 0$	Union has a greater power on the bargaining process
		$d < \frac{1}{2}$	$\frac{dK}{da} > 0$	
If union has a greater power over the bargaining process in comparison to the MNE, the initial cost of investment is sensitive to the level of bargaining power of the union, and increases as the union power increases, irrespective of the labour/capital share of production.				
		$\frac{3 - 2\sqrt{2}}{2} < d < 1$	$\frac{dK}{da} > 0$	If the productivity share of labour is more than capital, rate of change of capital to that of union power increases.
As	$a \xrightarrow{\text{Converges to}} 1/2$	$d \xrightarrow{\text{Converges to}} \frac{3 - 2\sqrt{2}}{2}$	$\frac{dK}{da} = 0$	Union and MNE have equal power
		$0 < d < \frac{3 - 2\sqrt{2}}{2}$	$\frac{dK}{da} < 0$	If the productivity share of labour is less than capital, rate of change of capital to that of union power decreases.
If union and MNE have similar level of bargaining power over the process, the cost of FDI will be sensitive to the level of labour/capital share of production. In case of labour intensive sectors we find that cost of FDI will be higher as the demand for labour gives the union higher bargaining ability. In contrast, we find that in capital intensive sectors, MNEs tend to have a greater power of the bargaining due to the fact that the production is capital intensive, hence we observe a lower cost of FDI when investment in capital intensive sectors are considered.				

		$1/2 < d < 1$	$\frac{dK}{da} > 0$	If the productivity share of labour is more than capital, rate of change of capital to that of union power increases.
As	$a \xrightarrow{\text{Converges to}} 0$	$d \xrightarrow{\text{Converges to}} 1/2$	$\frac{dK}{da} = 0$	Union has no power on the bargaining table
		$0 < d < 1/2$	$\frac{dK}{da} < 0$	If the productivity share of labour is less than capital, rate of change of capital to that of union power decreases.
<p>If union has no power, the greater the labour/capital share production in the sector, the higher the cost of FDI will be. In contrast the results indicate that the greater the capital/labour share of production in the sector, the lower the cost of FDI will be.</p>				

The set of results provided in the table 4-3 are discussed and below, and a set of hypotheses are delivered accordingly.

First, as mentioned earlier, existence of very high level of civil liberties in the host countries, translates to considerable bargaining power in favour of unions in comparison to the firm, exposing firms' cost structure to potential alterations through labour costs. Therefore we anticipate that in such cases firms would not undertake FDI, since unions have all the bargaining power and are capable of determining the level of rent extraction (extraction of profits). However, in cases when re-investment of FDI activity is considered, the rate of change of capital to that of union power is zero ( $\frac{dK}{da} = 0$ ).

Second, in countries with moderately high level of civil liberties, where the unions have a higher bargaining power in comparison to the foreign firms, the minimum capital that has to be invested for FDI to occur, tends to have a positive relationship with the union power. In other words, the higher the level of union power over the bargaining process, the higher the wages set, and thus the costlier the FDI.

Hypothesis (1): Civil liberties have a negative effect on FDI through bargaining power of unions.

Firms motivated by efficiency seeking motives, are interested in lowering their comparative costs and raising their efficiency. While the repression of civil liberties leads to lower power of labour representatives, which in turn translates to lower wages and lower marginal costs, however, the repression of liberties in turn leads to lower productivity of the work force and return on investment. Therefore, a second effect of civil liberties on FDI flows that can be explored in the context of ES FDI is the effect of civil liberties on FDI through productivity. Previous scholars such as Adam and Filippaios (2007) have conceptually discussed both of these contradictory effects of civil liberties on FDI and empirically shown that civil liberties have a non-linear effect on FDI. In this study, we provide a theoretical model that relates the effect of civil liberties on FDI activity to union power. However, we in contrast to Adam and Filippaios (2007) who conceptually argue the existence of the indirect effect of civil liberties on FDI through productivity of the labour force, in this study we relate the wage setting and consequently the initial cost of FDI to the production share of labour, and sectoral characteristics. In particular we argue that the differences in the initial level of capital needed for FDI in labour intensive and capital intensive sectors, originate from the fact that MNEs implicitly consider continuity, quality and capacity of labour force in terms of production, when bargaining over wages. Such sector specific considerations lead to disparities between the wages in different industries/sectors. For instance in a capital intensive industry/sector (i.e. manufacturing) where the labour force is mobile, easily substitutable, with low level of knowledge, the MNEs representatives bargaining over wages would aim to lower the wages up to the average industry/sector level wages (or in some cases higher than the average wage) in order to enjoy the differential cost of production in comparison to other locations. In contrast in a labour intensive industry/sector (i.e. services) where the labour share of production is considerably high and the employees are less mobile, not as easily substitutable, and have a certain level of knowledge to be able to provide value adding services, the MNEs' representatives would be more flexible in setting the wages in a way that it would not dampen the productivity of the work force. The following arguments aim to set forward hypotheses raised from our theoretical findings in order to explore the effect of civil liberties on FDI activity.

Third, in countries with moderate level of civil liberties, the initial cost of FDI is not only determined by the level of civil liberties, that provides equal powers for both unions and foreign firms on the bargaining process, but also the sectoral characteristics of the foreign entity. In particular we find that in the presence of moderate level of civil liberties (equal bargaining power allocated to parties through civil liberties), it is the production share of labour and capital that influences the bargaining power of unions and foreign firms. Consequently we observe that in sectors where the labour share of production is higher than capital, the initial cost of FDI is higher, indicating that in sectors with higher dependency on human capital, the cost structure of the firms tend to be more sensitive to changes in the cost of labour. Therefore the higher effect of civil liberties on bargaining process stems from the higher share of labour costs in total costs, in labour intensive sectors. Consequently given the argument above, in countries with moderate level of civil liberties, we expect the unions to be able to impose a greater threat to the cost structure of MNEs through rent extraction in labour intensive sectors (in comparison to capital intensive sector), thus raising the initial cost of investment and reducing the overall FDI flows.

Hypothesis (2): The effect of civil liberties on labour intensive FDI (i.e. services FDI) is greater than that on capital intensive FDI (manufacturing FDI) in case of free and moderately free countries.

Fourth, in moderately repressed countries with low level of civil liberties, and thus limited union bargaining power, the labour representatives have higher power over bargaining process in the sectors where labour share of production is greater than that of capital. This is mainly due to the fact that higher wages would impose a higher influence on cost structure of firms in labour intensive sector (since wages account for higher share of cost of production in labour intensive sectors), in comparison to those in capital intensive sector. Furthermore, it is possible to interpret this effect through the cost effect of productivity level of workforce in sectors where labour share of production is higher than capital. However, since we have considered constant productivity, we will not elaborate further on the productivity aspect of wages.

Hypothesis (3): The effect of civil liberties on services FDI (labour intensive production) is greater than that on manufacturing FDI (capital intensive production), in

case of repressed and moderately repressed countries (since labour intensive sectors have higher share of labour costs).

There is a difference between countries with low level of civil liberty and low union representation and the ones with medium level of unionization and civil liberty. In cases with medium level of unionization and civil liberty, the intensity of the labour to that of capital was as follows:

**Table 4—3: The effect of the level of civil liberty and union representation on the capital needed for the investment to take place.**

Low civil lib and union rep	Medium civil lib and union rep	Cost of FDI
$0 < d < 1/2$	$0 < d < (\frac{3-2\sqrt{2}}{2} \cong 0.1)$	$\frac{dK}{da} < 0$
$1/2 < d < 1$	$(0.1 \cong \frac{3-2\sqrt{2}}{2}) < d < 1$	$\frac{dK}{da} > 0$

Note that in countries with medium level of civil liberties, the sectors' labour share of production threshold at which the sign of  $\frac{dK}{da}$  changes is lower than repressed countries. Indicating that in countries with higher level of civil liberties, a higher level of rent extraction is applicable, particularly in case of labour intensive sectors where the firms are more sensitive to the level of wages, due to their labour costs accounting for higher share of total costs, leaving the labour intensive industries more exposed to higher initial cost of FDI. Based on the latter, it is possible to investigate whether in labour intensive sector; the higher level of civil liberty discourages FDI. However, the empirical comparative analysis of the effect of the level of civil liberties on the FDI inflows of the countries with medium level of civil liberties, in two main groups of labour intensive, and capital intensive industries is left for future research.

This section explored the direct effect of civil liberties on FDI through comparative power of union and MNE on the bargaining process over wages. The indirect effect of civil liberties through productivity of work force is elaborated in industry/sector specific distinction based on the industry/sectors' specific labour and capital share of production. The latter allows theoretical exploration of the effect of civil liberties on FDI. The next section explores the effect of political rights on FDI activity through taxes on income.

#### 4.4.3. B. The effect of taxes on the minimum level of capital that has to be invested for FDI to occur

The term ‘ $t$ ’ in our general form of the bargaining problem below, refers to taxes which could be considered as an indirect measure of political rights.

$$\{w^*, L^*\} = \underset{w, L}{\text{Arg max}} [[L_{EMNE}(w_B - w_a)]^a [(1 - t)K^g L_{EMNE}^d - w_B \cdot L_{EMNE}]^{1-a}] \quad (25)$$

We consider political rights to embody a number of factors including: *Electoral process; political pluralism and participation; and functioning of the government.* The effect of political rights on FDI activity is considered through taxes on income. Our premise is that political regimes vary according to the taxes imposed by government, in that countries with lower level of political liberties tend to impose higher taxes on foreign firms, in comparison to those with higher level of political liberties. In countries with higher level of civil and political liberties (democracy), lower than average income median voter tends to vote for higher distribution than socially optimum (Persson and Tabellini, 2000), and thereby increasing the overall tax rates, while the level of taxes imposed on foreign firms remain relatively low. In contrast in countries with low level of civil and political liberties (non-democratic) higher taxes are commonly imposed on foreign firms due to predatory policies rather than pressures for redistribution. As Olson and McGuire (1995) argue, in non-democratic regimes (low level of civil and political liberties) the “ruler can act like a stationary bandit” with intention to maximise the amount of capital that he can extract from the economy.

Considering rather short life of autocratic rulers this type of predatory policies is commonly applied by the autocratic rulers to maximise government revenue in order to serve an elite society at the expense of the public. Therefore we assume that the tax rates imposed by government are “decreasing functions of political freedom” (Adam & Filippaios, 2007), and that countries with low level of political rights often impose higher taxes, particularly on MNEs.

In order to determine the effect of political rights on FDI activity therefore we explore the effect of changes in taxes on income applied to the MNEs in foreign country on the minimum level of capital that has to be invested for the FDI to occur. To do so we work out the derivative of (14) with respected to ‘ $t$ ’ as follows:

$$\frac{d}{dt}K = \frac{d}{dt}([g^{d-1} \cdot (1-a-d+ad)^{d-1} \cdot w_a^d \cdot (1-a)^d \cdot r^{1-d} \cdot (1-t)^{-1} \cdot d^{-d}]^{\frac{1}{d+g-1}}) \quad (46)$$

$$\frac{d}{dt}K = (-1) \cdot \left(-\frac{1}{d+g-1}\right) \cdot (1-t)^{\frac{-1}{d+g-1}-1} \cdot [g^{d-1} \cdot (1-a-d+ad)^{d-1} \cdot w_a^d \cdot (1-a)^d \cdot r^{1-d} \cdot d^{-d}]^{\frac{1}{d+g-1}} \quad (47)$$

$$\frac{d}{dt}K = \left(\frac{1}{d+g-1}\right) \cdot (1-t)^{\frac{d+g}{1-d-g}} \cdot [g^{d-1} \cdot (1-a-d+ad)^{d-1} \cdot w_a^d \cdot (1-a)^d \cdot r^{1-d} \cdot d^{-d}]^{\frac{1}{d+g-1}} \quad (48)$$

Constraints:  $0 \leq g < 1; 0 \leq d < 1; g + d < 1; r > 0; t > 0; (1-t) > 0; w_a \geq 0$ .

The sign of  $\frac{d}{dt}K$  would be determined by the signs of the following:

$$-(1-a-d+ad)^{d-1} \cdot (1-a)^d \quad (49)$$

If	$-(1-a-d+ad)^{d-1} \cdot (1-a)^d$ Will be:	Outcome
$a = 1$	0	$\frac{d}{dt}K = 0$
$0 < a < 1$	$-(1-d)^{d-1}$	$\frac{d}{dt}K < 0$
$a = 0$	$-(1-d)^{d-1}$	$\frac{d}{dt}K < 0$

The results show that changes in the taxes on income, in case of repressed, moderately repressed and moderately free countries in terms of civil liberties ( $0 \leq a < 1$ ), have a negative effect on the initial cost of FDI, and consequently a positive effect on FDI activity. Therefore, in host countries with low, medium and moderately high level of civil liberties, increase in the level of political rights leads to lower taxes and higher FDI.

In contrast to the latter FDI activity tends to be insensitive to the level of taxes on income in case of countries with high level of civil liberties. In other words increase in the level of political rights in the countries who enjoy higher level of civil liberties, have no effect on FDI activity. Therefore, the evidence suggests that the effect of an increase in the level of political rights (channelled through taxes) on FDI is positive for most countries, with the exception of those with higher level of civil liberties.

Hypothesis (4): Political rights have a positive effect on aggregate (total) net FDI flows through taxes applied on income and profit.

#### 4.4.6. C. The effect of Welfare on the Minimum level of capital that has to be invested for FDI to occur

The previous two sections theoretically explored the effect of civil and political liberties on FDI and provided a number of hypotheses that will be empirically examined in chapter 7. This section aims to provide a rather economic exploration of the effect of host countries characteristics on the wage setting process. In particular we investigate the effect of the host countries' welfare on the wage setting process. The premise is that the level of welfare in the host country influences the industry/sector wages and thereby indirectly influences the wage setting process between MNE and unions. Furthermore, since social insurance exists, mostly in developed nations with high level of civil and political liberties, it is possible to view the effect of welfare wage on the FDI as a by product of high level of civil and political liberties. In order to determine the effect of changes in alternative wages earned by unemployed (could be interpreted as welfare in some cases) ' $w_a$ ' on the minimum level of capital that has to be invested for the FDI to occur, the derivative of the (43) with respect to ' $w_a$ ' has to be considered.

$$\frac{d}{dw_a} K = \frac{d}{dw_a} ([g^{d-1} \cdot (1-a-d+ad)^{d-1} \cdot w_a^d \cdot (1-a)^d \cdot r^{1-d} \cdot (1-t)^{-1} \cdot d^{-d}]^{\frac{1}{d+g-1}}) \quad (50)$$

$$\frac{d}{dw_a} K = d \left( \frac{1}{d+g-1} \right) \cdot w_a^{\frac{d}{d+g-1}-1} \cdot [g^{d-1} \cdot (1-a-d+ad)^{d-1} \cdot (1-a)^d \cdot r^{1-d} \cdot (1-t)^{-1} \cdot d^{-d}]^{\frac{1}{d+g-1}} \quad (51)$$

Constraints:  $0 \leq g < 1; 0 \leq d < 1; g + d < 1; r > 0; t > 0; (1-t) > 0; w_a \geq 0$ .

Sign of  $\frac{d}{dw_a} K$ , is mainly related to the sing of:  $-(1-a-d+ad)^{d-1} \cdot (1-a)^d$  (52)

If	$-(1-a-d+ad)^{d-1} \cdot (1-a)^d$ Will be:	Outcome:
$a = 1$	0	$\frac{dK}{dw_a} = 0$
$0 < a < 1$	$-(1-d)^{d-1}$	$\frac{dK}{dt} < 0$



$a = 0$	$-(1 - d)^{d-1}$	$\frac{dK}{dw_a} < 0$
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Therefore, in countries with high level of civil liberties where the union has all the power in bargaining with MNEs over wages and employment, increase in the level of alternative wages does not affect the minimum level of capital that has to be invested for FDI to occur. Interestingly in case of countries with low level of civil liberties where the unions have little, or no power over the bargaining process with MNEs, the rate of change of the minimum capital that has to be invested for FDI to occur with respect to welfare paid to unemployed is negative. In other words, a rise in the level of alternative income earned by unemployed in markets with medium and low level of civil liberties, leads to a lower capital to be invested for FDI to occur, and thereby encouraging FDI inflows.

#### **4.5. Limitations, and Avenues for Further Research**

The static model provides some insights into the way the level of civil liberties influences the Inflow of Foreign Direct Investment (IFDI) through channels such as unions and labour representation entities. Recent game theory models considering FDI flows, generally adopt more time variant models that allow for viewing the decision making process in real time considering Real Option (RO), Net Present Value (NPV), and other methods available. The main reason why this research has considered a static analysis of the effect of civil liberties on IFDI, is that in contrast to other factors affecting FDI flows, civil liberties (and more specifically the aspects of civil liberty that we consider here which are more related to labour rights and labour voice which are reasonably influential in the productivity of the firms), are not very time variant by nature. For instance, the level of repression of work force of a certain market is not something that could be changed in a matter of a few quarters or even years. Changes in the level of civil liberties that are granted for citizens of a certain country similar to other institutional changes generally occur gradually in a long period of upheaval and unrest, which is observable by the foreign firms. Therefore we are suggesting that in contrast to more time variant models of FDI which consider the option to wait, issues of flexibility and etc., analysis of the effect of civil liberties on IFDI could be achieved by consideration of a static model. However, the examination of this claim will be left for the future research.

Considering the level of political liberty in countries, it is possible to provide similar arguments as provided above. However, it is possible to refer to issues of changes in the treatment of foreign firms and taxation of foreign firms, by the governing body in the host country as the effect of political stability or political certainty in host countries. The analysis of the effect of changes in taxes and treatment of foreign firms, therefore, in general could possibly gain significantly by adoption of time varying methods that could capture the real-time effect of the changes that occur commonly in the political environment of the countries and the way they affect foreign firms' and their investments abroad.

The models provided in this chapter, investigate the effect of civil and political liberties on FDI, by incorporating the VoC framework into IB theory. The incorporation of VoC framework has allowed distinction between various types of unions. This distinction following Hall and Soskice (2001) is mainly based on the level of bargaining processes undertaken by firms in various market economies. Section 4.3 theoretically explored whether there are any differences between the incentive structure of unions based on the level at which they bargain with foreign firms. However, since in the imperfect markets, in presence of unemployment, the incentive of national, and sectoral/industry level unions reduces to one, the distinction is not pronounced in the theoretical model. The profit function of MNEs is kept generic in order to allow generalization of the findings. Future research could possibly extend the arguments made here further by exploring the level of union density as well as level at which unions bargain with foreign firms.

Finally, the limitations of our theoretical explorations are as follows: first, we only consider the monetary justification of investment and shy away from non-monetary motives that might lead to FDI; second, our transaction cost based model would mainly view the FDI decision in light of efficiency seeking incentives; third, the theoretical model provided is static and considers the FDI decision at a given point in time; fourth, the consideration of the effect of civil liberties on taxes is mainly through game theoretical argumentation that provides mainly information with regard to extremities (extrema); fifth, the consideration of taxes as the only theoretical channel through which political rights affect FDI, and the consideration of unilateral taxes.

## 4.6. Concluding Remarks

In this chapter we theoretically explored the effect of civil liberties and political rights on the initial cost of FDI and thereby FDI activity. The models provided build upon the works of Grout (1984), Hart and Moutos (1995) and Adam and Filippaios (2007). It is assumed that the decision of FDI is influenced by the initial cost of investment into the designated host country. Therefore, firms are considered to bargain with employee representatives (labour unions) in the host country before deciding upon their investment abroad, in order to obtain full information with regard to the initial costs of investment. The incentive of the representatives of the MNE is to bargain over wages in order to reduce the initial and concurrent cost of production. The negotiation over the initial cost of production is undergone with the knowledge that the union representatives might have the incentive to revisit the bargaining process after the investment is made, with the intention to bargain over higher wages, thus a non-binding contract (Grout, 1985) is negotiated between the firm and entity. The incentive of unions, in the presence of unemployment in the market entails two main elements of negotiation over wages and employment.

By incorporating the VoC framework we distinguished between different types of unions based on their market economies and other characteristics. The distinction provided four main types of unions, namely; Nordic, Liberal, EU, and other unions, relating to Northern, LME, CME, and other types of market economies. The differences between unions from various types of market economies, were further elaborated into the level at which the bargaining process takes place in case of each group. It was discussed that Northern firms in general tend to adopt a nation wide negotiations (bargaining processes) that embodies all the sectors, while CME unions tend to adopt sector level negotiations. In contrast LMEs tend to prefer individual bargaining. Considering the level at which negotiations take place we explored the utility function of different types of unions in imperfect markets and found out that in the presence of unemployment the incentive and utility function of all unions are similar. Thus the VoC contribution in terms of union classification showed that in the imperfect markets there are no significant differences between the coordination activities of unions that would alter the bargaining process. The profit function of MNEs was not tailored to reflect the differences in the way firms from different market economies coordinate their activities in order to allow generalization of the results. Furthermore, we mentioned that the VoC framework will be used to

empirically explore the way in firms from various market economies coordinate their FDI activity.

Our view of the civil liberties is in line with that adopted by Freedom House in provision of data on the concept. Consequently we consider that in countries with low level of liberties, unions have low (if any) power in representing employees' voice. Based on the latter we explored the effect of civil liberties on FDI through union power. Moreover, we consider the level of civil liberties to influence FDI through productivity of work force, arguing that in countries' where civil liberties are repressed, the productivity of work force dampens, which in turn results in lower efficiency of production.

In our view the cost of FDI in the host market, influences the probability of MNEs' investment. Consequently we argue that while foreign firms bargain over lower wages in order to increase their return on investment, they tend to consider a sector specific threshold, when bargaining over wages, which leads to lower cost of production, as well as higher efficiency in terms of production. This is in line with Adam Filippaios (2007) who conceptually established a non-linear relationship between civil liberties and FDI and empirically showed the existence of such relationship. This research contributes to the literature by theoretically relating this non-linearity to the sectoral characteristics arguing that in sectors where labour share of production is higher than that of capital, since the products are more sensitive to labour input, the wage setting incentive of MNEs is more in line with increasing the productivity of work force rather than repressing wages. Furthermore, since in labour intensive industries/sectors, labour costs account for a larger share of total costs, we find that firms are more sensitive to changes in cost of labour (wages) in labour intensive sectors in comparison to capital intensive ones. In contrast we argued that in capital intensive sectors, since the production is less reliant on labour input, the incentive of MNEs with regard to wage setting is more in line with repressing wages in order to gain higher return on investment.

Our view of the political rights is in line with that adopted by Freedom House in provision of data on the concept. Consequently it is assumed that the low level of political rights is directly related to the radical changes in policies, in particular tax policies applied to MNEs. In particular building on the earlier works of Olson and McGuire (1995), and Adam and Filippaios (2007) we argued that tax rates imposed by government are "decreasing functions of political freedom"(Adam and Filippaios 2007), and that countries

with low level of political rights often impose higher taxes, particularly on MNEs. Consequently we consider taxes on income as the main channel through which political rights affect FDI decision. An alternative taxation policy, taxes on profit, is also explored and discussed in appendix 4.4., in order to provide a type of sensitivity analysis by providing room for comparison.

The main theoretical model considered in this chapter, therefore explores the effect of civil liberties on FDI through union power, whilst account for the effect of political rights on FDI through taxes on income. The theoretical exploration of this model investigated the sensitivity of FDI with respect to level of civil liberties (union power), political rights (taxes on profits), and welfare wages of the host countries. The findings indicate that the level of civil liberty affects FDI in a nonlinear manner. In case of countries with high level of civil liberties, we find that initial cost of FDI is insensitive to the level of civil liberties, while in case of moderately free and repressed countries; it is the dependency of the production on labour or capital that determines the level of initial cost of investment. In particular we find that in moderately free countries the threshold of the labour share of production that influences the cost of initial investment is much lower than repressed countries. In other words in moderately free countries, the initial cost of investment even in sectors that have a low level of dependency on labour is higher as the threshold is found at  $d = \frac{3-2\sqrt{2}}{2} \cong 1/5$ . In contrast the threshold of the level of labour intensity that affects the initial cost of investment is found at  $d = 1/2$ . Therefore, we find that the level of civil liberty (conceptualized by union power), and the labour share of capital affect the initial cost of investment and therefore FDI activity.

The effect of political rights channelled through taxes, indicate that an increase in political rights have a positive effect on FDI in the case of most countries with the exception of those with high level of civil liberties (in which case increase in the level of political rights has no effect on FDI).

Finally, the results of the analysis of the effect of welfare wage on the initial cost of FDI indicate that in case of countries with highest level of civil liberties – and union representation- the welfare wages do not influence initial cost of FDI activity and therefore, FDI activity. In contrast the lower union powers in countries with moderately high, low, very low, level of civil liberties, including the highly repressed countries, the

level of welfare wages negatively affects the initial cost of FDI, and thereby positively affect FDI. Our investigation of model (1) helped in providing a boundary to the level of investment that has to be made for FDI to occur subsequent to the decision made. For instance if there is going to be changes applied to taxes on income, or welfare rate in a host country, MNE could possibly take them into account priori and determine the minimum level of investment that has to be made for the FDI.

The second theoretical construct provided in appendix 4.4., models the bargaining process between MNE and unions by considering the taxes to be applied to profits of the foreign firms. The theoretical exploration of this model investigated the sensitivity of FDI with respect to level of civil liberties (union power), political rights (taxes on profits), and welfare wages of the host countries. The findings indicate that that if the level of civil liberty is high in the host country, the initial cost of FDI is insensitive to the union power. In contrast if the level of civil liberty is moderately high, or low, the initial cost of FDI is negatively affected by union power. In other words, the level of civil liberties in host countries with higher level of liberties does not affect the initial cost of FDI, while the level of civil liberties in countries with lower level of liberties tends to attract FDI through lower cost of investment that should be made for FDI to occur. Finally, the results indicate that the labour/capital share of production has no bearing on the effect of the level of civil liberties on initial cost of FDI. A similar pattern is observed when welfare income (alternative wages), and political rights are considered. The investigation of the effect of political rights through taxes on profits of the foreign firms indicate that in host countries with high level of civil liberties, political rights do not affect initial cost of FDI and thereby FDI activity. In contrast, in case of moderately free and repressed countries, an increase in the level of political right tends to affect the initial cost of FDI in a negative manner, and thereby positively influence FDI. Moreover, we find that the effect of political rights on initial cost of FDI is not sensitive to the sectoral composition and therefore dependency of production to labour. Similarly, the level of alternative wage in host countries with high level of civil liberties does not affect initial cost of FDI and FDI activity. However, when moderately free and repressed countries are considered, we find that the level of welfare wage of these host countries positively affect initial cost of FDI, and thereby influencing FDI in a negative manner. Furthermore, the effect of the level of welfare wages of host countries on initial cost of FDI is not sensitive to sectoral composition, as we find no evidence of the sensitivity of initial cost of FDI to labour/capital share of production.

The review of the findings of the two models indicates that when the effect of political rights (liberties) on FDI is modelled by taxes on income, in general we find that the labour share of production plays a significant role in the bargaining process between MNE and labour representatives in the host markets. This influences the minimum initial capital that has to be invested for FDI to occur, and in turn affects the FDI activity. In contrast when the effect of political rights (liberties) on FDI is modelled by taxes on profit, in general we find that labour/capital share of production does not influence the bargaining process, initial cost of investment and consequently FDI activity. In all cases we find that the effect of civil liberties and political rights on the FDI activity is non-linear as consistently observe differences between the way level of liberties affect the investment into countries with higher level of liberties, in comparison to those with lower level of liberties.

Overall, this chapter building on arguments provided in previous sections, driven by the scarcity and inconclusiveness of the literature, theoretically explored the effect of the effect of civil and political liberties on FDI. The theoretical findings have been illuminating on their own merit, and also inspired a number of hypotheses that will be empirically tested in chapter 7 in order to test the validity of the findings.

## **Chapter 5 : Methodology**

### **5.1. Introduction**

In the previous chapters we explored the Economics, Political Science, and International Business literature on the effect of civil and political liberties on FDI. We also incorporated VoC framework into IB literature and introduced a theoretical model – the theory building block of our research. Since the scientific method of inquiry obliges one to provide information on the methods used for the scientific inquiry, this chapter aims to inform the reader of the thought processes that have led to formation of ideas which in turn have become implemented using different research methods. It has been the incentive of the author to provide a clear outlook of the processes that have formed the philosophical and methodological considerations of the research conducted.

The theoretical and conceptual factors that have influenced the research design of our thesis are discussed in this chapter as follows: first, the set of research objectives are provided and their relevance to methodological philosophies are discussed; second, research sample is deliberated through provision of discussions on data collection and data handling; third, data analyses methods are reviewed; fourth, the legitimacy of the research, and its limitations are discussed; and finally a summary of our methodological choices are provided to inform the reader.

## **5.2. Research Objectives**

Research objectives enable us to clearly understand the purpose of our study and further assist in the direction we investigate research phenomena (Emory and Cooper 1991). The objectives of our research are as follows: Firstly, we intend to explore the effect of the level of civil liberties, and political rights in host countries on the level of aggregated (total) and disaggregated (sectoral) FDI flows into them. Secondly, we aim to explore the linearity of the effects of civil liberties and political rights on FDI flows. Thirdly, we would like to whether the consideration of the type of market economy from which MNEs originate provides some information with regard to their FDI activity.

These objectives are in general motivated by the recent (past 15 years) shift of the FDI scholars' attention, and consequently the literature toward institutional factors in explaining FDI flows. In particular this research is motivated by the works of scholars such as Adam and Filippaios (2007) that explore the effect of disaggregated elements of institutional environment of societies<sup>93</sup>, namely the effect of civil liberties and political rights on FDI activity. The research objectives arose from review of the relevant academic literature that revealed gaps in the context of institutional determinants of FDI, in particular civil and political liberties' effects on FDI. The review of the literature specifically showed that the literature on the effect of civil and political liberties on FDI is not only scarce, but also that the findings are in most part, inconclusive. Furthermore, we found that most of literature has adopted research designs that explore the determinants of FDI in a country level context. As reviewed earlier in chapter 1.3, this research aims to explore the effect of civil liberties and political rights on aggregated (total) and disaggregated (sectoral) FDI

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<sup>93</sup> A more detailed discussion is provided on chapter three.



flows, investigate whether the effects of civil and political liberties are linear across sectors, and finally to explore whether there are differences between the ways firms from LMEs and CMEs coordinate their FDI activity.

### **5.3. Philosophical Perspectives**

As Saunders, et al. (2000; 2007) discuss, the philosophical perspectives generally relate to the assumptions made with regard to the social world and consideration of how it can be investigated. The mentioned assumptions include epistemological and ontological assumptions that are presumed by the researcher, which in turn provide a number of methodological options that can be considered by the researcher in investigating the question at hand.

#### **5.3.1. Epistemological Considerations**

An epistemological consideration is one that “concerns the question of what is regarded as acceptable knowledge in a discipline” Bryman and Bell (2003). The epistemological choices vary from natural science epistemology, are ‘positivism’, its contrasting view ‘Interpretivism’ and ‘Realism’ which shares some characteristics of the former. Below we briefly discuss the two main epistemological positions; Positivism and Interpretivism.

Positivism is the “epistemological position that advocates application of methods of natural sciences to the study of social reality ...” (Bryman and Bell 2003, pp.16-17). It entails four main principles: First, principle of phenomenalism which dictates that the ‘phenomena’ and ‘knowledge’ confirmed by the senses can be chiefly justified as knowledge. Second, Principle of deductivism which advocates that the main goal of theory is to develop hypotheses that can be tested and thereby allow explanations of the laws to be assessed. Third, principle of inductivism, which considers that knowledge, is arrived at through the gathering of facts that provide the basis for laws. Fourth the objectivity principle, which advocates the view that science, must be conducted in a way that is value free and objective (Remenyi, Williams et al. 1998).

A contrasting epistemological position to positivism is the interpretivism. This view advocates that a “strategy is required that respects the differences between people and the objects of natural sciences and thus requires the social scientist to grasp the subjective meaning of social action” (Bryman and Bell 2003, pp. 18-19). The supporters of this

epistemological position maintain that since subject matter of social sciences is people and their institutions, and that it is different than the subject matter of natural sciences, it naturally requires a different logic of research which reflects the distinction between human beings and natural order.

Our research does not require certain proximity to the phenomenon we explore – since we consider the firm as the unit of analysis. Therefore we follow the view that organisations exist as concrete entities about which data can be collected (Pugh 1983). Following this view, we assume that the data collected reflects an external reality and that it can be used to test the hypotheses provided. We follow the deductive principle by gathering informative data which later on leads to provision of a theoretical framework which is presented in a mathematical manner to explore our research question. The frameworks in general contain analytical constructs that are applied to examine the collected data (Bryman and Bell 2003). Furthermore, our research empirically tests the hypotheses provided and puts forward results and conclusions that are generalizable knowledge (Saunders, Lewis et al. 2000).

### **5.3.2. Ontological Consideration**

Burrell and Morgan (1979) consider the ontological considerations to be concerned with the reality of the phenomenon that is being investigated. Authors along with Remenyi, et al. (1998) put forward two distinct contrasting ontological view points, namely; ‘Nominalism’ and ‘Realism’. The former, denies the existence of an essential independent external reality and thus denying all objectivity, actual or potential (Hacking 1999). The latter, Realism, is referred to the position that considers the existence of an external reality that is independent of the phenomenon and individual’s appreciation. Bryman and Bell (2003) add that realism inherently shares two features of positivism. First is that natural and social sciences can and should adopt the same types of approach to the collection of data as well as explanations. The second refers to the commitment to the belief that there is an “external reality to which scientists submit their attention” (Bryman and Bell 2003, pp.17-19).

A review of works on organization theory provides a number of options for researchers to consider different propositions and adopt their ontological assumptions according to the manner that best fits their research question. Following this line of thought and the works

of Coase (1937) and later on Hall and Hitch (1939), we adopt the view that the firm is the basic building block of our analysis and that it has an external reality which is independent of the observer. Furthermore we follow Hall and Soskice (2001) by adopting an actor based approach in which multiple actors (such as producers, firms, unions, governments, etc.) are those populating the greater environment of political economy. In other words political economy is viewed as a “terrain populated by multiple actors, each of whom seeks to advance his interests in a **rational** way in **strategic interaction** with others” [Scharpf (1997)]. Hence our ontological view point is based on realism, not nominalism.

A further breakdown on ontological considerations is possible through consideration of constructionism and objectivism. The former as Bryman and Bell (2003pp. 22-24) stress that “the social phenomena and their meaning are continually being accomplished by social actors. It implies that social phenomena and categories are not only produced through social interaction but that they are in a constant state of revision”. The latter, as authors argue, is in contrast to the former and refers to the position that social phenomena and their meanings have an independent existence that is independent of the actors themselves. This research favours the objectivism to constructionism, and adopts an objective approach in exploring the research question.

### **5.3.3. Theoretical consideration**

A general notion put forward for the term theory is “an explanation of observed regularities” (Bryman and Bell 2003, pp.7). Bryman and Bell (2003) provide a set of informative discussions on different types of theories that are provided with the intention to introduce the social science students to research philosophies. The theories include grand theories that operates at a higher level of abstraction and middle range theories [i.e. Merton (Merton 1967)] which operate at a lower level of abstraction. In this research our main consideration is the deductive theory. Deductive theory “represents the commonest view of the nature of the relationship between theory and research”(Bryman 2003). The deductive approach in particular refers to the theoretical foundation in which a question is opposed, the basis of what is known about the theoretical foundations of the research domain, as well as research domain itself are considered, and a number of hypotheses are proposed, the proposed hypotheses at a later stage are put into empirical scrutiny in order to provide objective, and valid knowledge. A contrasting theory is inductive theory involves ‘induction’, as the researcher infers the implications of his/her research findings

for the theory that prompted the whole exercise (Bryman 2003, p.12). The distinction is that in inductive stance the theory is the outcome of the research while deductive approach draws the findings out of theory.

In this research we follow the inductive theory in providing a mathematical model and a traditional deductive theory and approach, by consideration of the theoretical foundations of research domain (as mentioned before, we follows the organizational theory that considers firm as the building block of analysis, following Coase (1937) who have come from an economic tradition), as well as the research domain itself (the literature on the topic), in order to provide a theoretical framework, that provides a set of findings which are examined through an empirical investigation, and the final findings are treated as knowledge in compliance with positivist, objectivist, deductive, assumptions and considerations. In particular our research builds on: IB theory on motivations of FDI set forward by Behrman (1974); Organization theory of Coase (1937); VoC framework of Hall and Soskice (2001), in order to construct a theoretical framework (provided in chapter 4) whose explorations provides a set of findings and hypotheses that are examined through an empirical investigation in chapter 7. The final findings therefore are knowledge in compliance with positivist, objectivist, deductive, assumptions and considerations.

#### **5.3.4. Methodological considerations**

Jankowicz (1991), Bryman and Bell (2003), and Saunders et al. (2007) consider methodology as the systematic approach toward collection of data so that information can be obtained. Remenyi et al., (1988) refers to methodology as the means available to research the phenomenon being studied. Furthermore, the research methodological considerations, or in other words methodological approaches are determined in relation to epistemology and ontology and thereby denote an objective or subjective approach to research Burrell and Morgan (1979).

The first notion to be explored, in this section is the research strategy as a subset of methodological considerations. The research strategy is crudely polarised into two main strategies; quantitative and qualitative. The qualitative research strategy generally emphasizes on words rather than quantification in collection and analysis of data and has the following characteristics; first, emphasizes an inductive approach to the relationship between theory and research; second, rejects the norms and practices of natural sciences

and positivism and instead relies on the way in which individuals interpret their social world; third, considers reality to be constantly shifting emergent property of individuals' creation. In contrast quantitative research strategy can be construed as a research strategy that emphasizes quantification in collection and analysis of data and has the following characteristics; first, entails a deductive approach to the relationship between theory and research where the emphasis is placed on testing the theory; second, it has incorporated the norms and practices of natural sciences and positivism; third, embodies a view of social reality as an external, objective reality (Bryman and Bell 2003, p.28).

Given the set of assumptions and considerations provided above in terms of epistemology, ontology, theoretical and organization views, our research follows a deductive approach. The reasons while evident from discussions above are provided here. First, our research follows an objective, positivist approach, where the stress is put on the empirical testing of the theoretical findings, in order to view them as knowledge. The reality is assumed to exist in an external and independent manner from individuals. It is assumed that firm as the building block of analysis exists as an external and independent entity for which data can be collected in a quantitative manner, and that the data itself projects a fragment of the external reality of the firm. Finally, we believe that markets are accumulated with firms for which data can be collected, and hence the trends of FDI can be analysed as the proxy for a fraction of the external reality of the markets. Finally, as Punch (Punch 1998; 2005) discusses, the quantitative research approach is an efficient way of understanding and explaining large scale structural features of social life and it provides the stance to provide generalizable outcomes (Saunders, Lewis et al. 2000).

**Table 5—1: Key characteristics of Quantitative Research Methods - Source: Saunders et al. (2000)**

Characteristics	Quantitative
Approach	Objectivist
The role of theory in relation to research	Deductive (testing of theory)
Epistemological orientation	Positivism
Ontological orientation	Realism

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Collection	Numerical and standardized data
Method of analysis	Diagrams and statistics

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## 5.4. Sample Description

### 5.4.1. Home Countries

Following the ideology put forward by VoC, provided in section 4.3, we explore whether the aforementioned differences between the types of economics in terms of market structure, coordination activities of firms within markets and labour laws, reflect some information on the way, in broad term institutional factors, and in particular the level of civil and political liberties in these markets affect the flow of FDI from and into various market economies. In order to explore the effect of the level of civil liberties on FDI flows, we consider a wide range of home countries qualifying as LMEs, CMEs and Nordic countries which in an aggregate way are considered by Hall and Soskice (2003) to have common features in terms of their labour markets. The sample of home countries chosen is as follows:

**Table 5—2: Sample of home countries**

Type of Economy	Liberal Market Economy (LMEs)	Coordinated Market Economies (CMEs)		
		Nordic Countries	Other EU Countries	Other CMEs
	United States of America (USA)	Denmark	France	Japan
	United Kingdom (UK)	Finland	Germany	
	Ireland	Norway	Italy	
		Sweden	Netherlands	
			Spain	

Consequently thirteen home countries of: United States of America (USA), United Kingdom (UK), Ireland, Denmark, Finland, Norway, Sweden, France, Germany, Italy,

Netherlands, Spain, and Japan, are considered in this research, allowing for a good coverage.

#### **5.4.2. Host Countries**

Considering the choice of host countries, we have considered inclusion of developed, developing and less developing countries in order to view the level and composition of FDI in these countries considering their characteristics. The latter provides the opportunity to examine whether MNEs from certain countries with certain level of civil and political liberties at home, prefer to invest in a specific manner. Furthermore, it is possible to observe whether different levels of civil and political liberties in host countries have influence on the level and composition of investment from the home countries. Taxation on income and labour laws, are the main measures that are considered to reflect the effect of these factors on the FDI level and composition into these countries. The choice of host countries is initially determined by the set of countries for which data was available from three main institutional indices sources; Freedom House, ICRG, and Polity IV. Reviewing the set of countries for which data is available and omitting the ones for which data is not consistently reported in all sources we obtain 140 initial host countries. Appendices 6.1 and 6.2 contain the list of all home and host countries considered.

#### **5.4.3. Research Period: 1990-2009**

Since this research intends to find the effect of the level of civil and political liberties on the level and composition of FDI flows, the first consideration in terms of the span of the data is related to the span of data available for Outward FDI (OFDI). It is imperative to note that this research conducts its empirical analysis in two main levels. First, is investigation of the effect of civil and political liberties on an aggregate measure of OFDI, and the second is the investigation of effect of aforementioned factors on disaggregated measures of OFDI.

The reasoning behind the choice of both aggregated and disaggregated analysis of FDI, is that we are interested in finding the effect of civil liberties and political rights on FDI at a country level (aggregated FDI) as well as sectoral level (disaggregated FDI). In chapter 4, we related the strategy that MNE follows in wage setting to the labour/capital share of production, and therefore disaggregation of FDI data would allow us to explore the effect

of civil liberties on sectors with various levels of labour share of production. The second motivation for this choice is the criticism of the aggregated FDI analysis put forward by Blonigen (1997) and Kiyota and Urata (2004), who point out that each factor (in our case the level of civil and political liberties) has different effects on different industries and that using disaggregated FDI data provides a more clear evidence of how each factor impacts FDI flows in certain industry level. In other words the impact of the most factors considered in the literature on FDI flows are not the same on all industries<sup>94</sup> and therefore, their effects on different industries offset one another when it is assumed otherwise and therefore analyses based on aggregate data does not capture the effect of a certain or a number of factors on FDI flows in a thorough manner.

The meta-analysis of the literature on FDI, provided in chapter 3, supports this constructive criticism as we find that in case of the effect of civil and political aspects of institutional environment, the literature is populated with studies that report effects that vary in range, sign and magnitude. Thus in order to conduct an empirical investigation that truly investigates the effect of the level of civil and political liberties, this research considers the investigation of the lowest level of data available. The lowest level of data on FDI available that is presented based on a singular generalised scale (NACE 1.1) is at industry level. This data is provided for all home and host countries mentioned above. Considering both sets of data on FDI; aggregate (total OFDI), and disaggregated data on OFDI (industry level data), we find that it is possible to construct a sample that spans from 1990 to 2009. This is mainly based on the duration of time for which industry level data on OFDI is available for the set of home countries considered. It is worth mentioning that a larger span could be considered, but the due to large number of missing observations, consideration of a larger span would not contribute to the analysis. Therefore, the span of our sample is from 1990-2009.

Moreover, in the meta-analysis provided in chapter 3, we showed that the effects reported are influenced by the time frame from which the data for the analysis has been extracted for. In our meta-analysis we also showed that the effect of time on results is significant when decades are used as time frame. Therefore, in this research we have chosen a sample that covers 20 years of FDI activity and thus the results of the analysis of data over such sample would withstand the effect of time, and would reduce the biases that

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<sup>94</sup> The impact of exchange rates on FDI flows differs from one industry to another.



could be introduced by selection of a shorter period of time. A more detailed description of the data on variables considered is provided in the next chapter.

### 5.5. Data, Data Characteristics and Data Collection:

Based on our epistemological, ontological and deductive considerations, we adopt a method of data collection that is in line with the quantitative approach. In the quantitative research the quantitative data can be collected in a standardised way (Saunders, Lewis et al. 2000).

The first stage of data collection, apart from the choice of host countries and notions of the concepts, measures and variables that were considered in the conceptual model, is to review the data and data bases available. Considering the dependent variable, FDI, and the independent variables discussed in the previous chapters, our data set entails data on FDI, and a set of explanatory variables that proxy for FDI motivations (RS;MS;ES;SAS), variables that reflect the level of civil liberties and political rights, variables that proxy for macroeconomic characteristics of the host countries, and finally variables that reflect the institutional characteristics of the host countries (reflecting on the differences between countries in terms of VoC). A preliminary data source review was conducted in order to provide some information on the available data sources and their characteristics. The data sources include:

**Table 5—3: preliminary data sources**

Concepts\Level	Aggregated	Disaggregated
FDI	EUROSTAT	EUROSTAT; Bureau of Economic Analysis (BEA)
FDI motivations	World Bank (World Development Indices); GMID; EUROSTAT; OECD.STAT	
Macroeconomic factors	ILO; IMF; World Bank (World Development Indices)	
Institutional factors	ICRG; POLITY IV	
Civil Liberties and Political Rights	FREEDOM HOUSE	

Further considerations with regard to data sources include: time span of the data provided; level of aggregation (i.e. the sectoral information provided for FDI activity); units of data (exchange rate, scale, etc.) and a number of other factors that will be discussed further in the following sections.

The dependent variable considered is the net FDI flows. In the following section we review the FDI data sources, their characteristics and the collection method. A main feature of this study is the examination of the effect of civil and political liberties on FDI in a sectoral setting. Section 5.5 provides some information on the FDI data sources' sectoral provisions and the data available based on sectoral considerations. The independent variables, their characteristics, data sources and collection methods are explored in are reviewed in the chapter 6 subsection 6.2.3.

### **5.5.1. FDI data**

Before proceeding to practicalities it is necessary to review a number of key points that binds the following development to a scientific basis. Bryman and Bell (2003, pp.156-158) define a concept as a building block of theory that represent the points around which business research is conducted. Bulmer (1984, pp.42-44) refers to concepts as “categories for the organization of ideas and observations”. The basic definitions provided for the concept of Foreign Direct Investment (FDI) are provided by Fifth edition of *IMF's Balance of Payments Manual* (BPM5; IMF, 1993) and the third edition of the *OECD's Benchmark definition of Foreign Direct Investment* (Benchmark Definition; OECD, 1996). The definition is available from appendix 1.1. AS Bryman and Bell (2003, pp.157-159) discuss, “if a concept is to be employed in the quantitative research, it will have to be measured. Once they are measured, concepts can be in the form of dependent and independent variables”. The concept of FDI based on our positivistic approach is measured by central banks and a number of governmental dependent and independent organizations through a number of procedures and questionnaires. Since the measurements for the concepts are provided, it is possible to view FDI as our dependent variable.

The key factors in choosing the sources for FDI data are of threefold: first, the source from which FDI data is extracted must provide detailed information of FDI activity at industry level; second, the source from which FDI activity is extracted must provide information for all the home countries we have considered; three, the industrial classification provided by the source should comply with the other sources of data in order to provide the possibility of investigation of FDI flows at industrial level of disaggregation. Table below shows the sources of data for the independent variable FDI (flows) and the data characteristics:

**Table 5—4: sources of data for the independent variable FDI (flows)**

	BEA	EUROSTAT	OECD.STAT	World Bank	GMID
FDI Abroad (Flows)	Available	Available	Available	Available	Available
Countries	More than 140 countries	More than 140 Countries	Only OECD and a few other countries (less than 70 countries)	More than 140 Countries	More than 140
Sectoral Provisions:	NAICS <sup>95</sup>	NACE 1.1 <sup>96</sup> and NACE 1.2	NACE 1.1 and NACE 1.2.	ISIC <sup>97</sup>	Other classification <sup>98</sup>
Sectoral Levels:	All levels, however some indices are different than the NACE 1.1	All levels		only 3 aggregate levels	

The table 5.5 shows the data sources and their coverage in terms of countries as well as sectoral composition of data available. In order to determine which one of the data sources above is the suitable choice for the FDI data, it is necessary to explore the industrial classifications and their characteristics.

### 5.5.1. A. Sectoral Considerations

There are four main reasons that motivate an industrial exploration of the effect of civil and political liberties on FDI. The first two reasons are regarding the effect of host countries' institutional environment on FDI, while the next two provide some information about the effect of MNEs' home institutional environment on their FDI behaviour.

<sup>95</sup> North American Industry Classification system (NAICS) is the standard used by the Federal Statistical agencies in classifying business establishments for the purpose of collection, analysing, and publishing statistical data related to the U.S. business economy (U.S. Department of Commerce). Further information is available from [www.census.gov/eos/www/naics](http://www.census.gov/eos/www/naics)

<sup>96</sup> NACE is the acronym used to designate the various statistical classifications of economic activities developed since 1970 by the European Union; it is designed to categorise data relating to "statistical units", in this case a unit of activity, for example an individual plant or group of plants constituting an economic activity such as an enterprise. It provides the basis for preparing a large range of statistics (output, inputs to production process, capital formation and financial transactions) of such units (source: NACE Rev. 1 introductory note). Further information is available from [www.Eurostat.com](http://www.Eurostat.com)

<sup>97</sup> "International Standard Industrial classification or (ISIC)". For more information please refer to United Nations (UN) Industrial standard classification of all economic activities Revision 4.

<sup>98</sup> Does not comply with NACE, NAICS or World Bank industrial classification

We believe that it is essential to investigate the effect of factor(s) on FDI activity in various sectors of economy. The reasoning is in line the arguments put forward by articulated by Blonigen (1997; 2005) that underscore the importance of using disaggregated measures in investigation of determinants of FDI. Blonigen (1997; 2005) argues that the effects of factor(s) are not consistently similar in sign or magnitude, on FDI, across industries, and that the aggregate considerations would naturally report the combination of different and at times opposing effects reported, leaving the general outcome of the studies that investigate the effect of one or a number of factors on FDI in an aggregate manner (i.e. country level analyses that explore the effect of one of a number of factors on FDI considering the whole economy) rather insignificant or in many cases in contrast to the results reported from other studies<sup>99</sup>. In the light of the contrasting results reported in the literature, and considering the effect of using aggregate data in exploring FDI activity, a sectoral consideration of the effect of factor(s) is imperative to provide detailed information on the effects of civil and political liberties on various sectors. A second reason for consideration of sectoral analysis is that the effects of different factors (i.e. firms' motivations, level of civil and political liberties) on sectoral FDI are not linear across time or countries. In particular in chapter four through the theoretical exploration of the effect of civil liberties on FDI, we found that civil liberties tend to be influenced by the level of labour share of production in case of most countries (all countries except those with highest level of civil liberties). In other words we found that in sectors where labours' input is an essential part of production, labour unions tend to have higher power over bargaining process. In contrast we found that in sectors/industries where capital plays a greater role in production, unions tend to have less power over bargaining process. Therefore in order to empirically investigate the effect of labour/capital share of production on the FDI activity, we gather disaggregated FDI data.

A Third reason for consideration of sectoral analysis is that following Behrman's (1974) taxonomy of firms' motivations of FDI, we distinguish between different types of incentives that drives the FDI activities of firms, namely; Resource Seeking (RS), Market Seeking (MS), Strategic Asset Seeking (SAS), and Efficiency Seeking (ES). This distinction in a sectoral level analysis provides the opportunity to investigate the effect of

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<sup>99</sup> A review of the literature on the effect of institutional factors, civil and political liberties, as well as democracy on FDI shows that the results of the studies that constitute as the main body of the literature on the subject, are generally in contrast to one another and in many cases, insignificant.

the level of civil liberties and political rights on the decision of firms investing in various sectors (with different incentives with regards to their FDI activity). This in turn helps in finding patterns in the way the sectoral composition of countries affect their FDI flows from different types of firms from various market economies.

Finally, the fourth reason that motivates a sectoral investigation of the effect of the level of civil and political liberties on FDI is the very nature of these factors. As it was mentioned on chapter (4), we consider the effect of civil liberties on FDI through the bargaining process between labour representatives and foreign firms in terms of wage setting and labour recruitment. This inherently would lead to a focus on sectors in which firms' incentives are more in line with efficiency seeking motives. This would provide the opportunity to examine the effect of the level of civil liberties in the host countries on sectors that are more reliant on efficiency seeking activities, as well as the effect of the level of civil liberties on the investment patterns into sectors that are capital intensive in comparison to labour intensive sectors. In order to account for the other types of FDI activity it is essential to provide an extensive set of sectors/industries that accommodate different types of FDI investment, thus allowing the empirical model to explore the effect of civil and political liberties on the FDI activity of firm that coordinate their activities in various sectors following different types of motivations.

The effect of political liberty on FDI was considered to be channelled through tax setting on the MNEs' profit in host country, in the conceptual model. This would apply to all firms undertaking FDI. The effect of political liberties on FDI is further on explored in an empirical manner by consideration of factors such as the stability of laws and regulations, stability of government and other factors that will be reviewed in chapter 6. These factors are added with the intention to capture the effect of political liberties on FDI in an aggregate manner similar to those provided in the conceptual model. While the effect of these factors on different sectors might be different, and as a result might lead to different patterns of investment by the firms in various sectors, there has been no study to our knowledge to provide such observations. Therefore our investigation on the effect of political liberties on FDI in a sectoral manner would provide some information on the effect of taxation, and trade restrictions on foreign firms' FDI activity in various sectors.

Therefore, in order to investigate the effect of civil and political liberties on FDI, this research considers the effect of civil liberties and political rights on aggregated and

disaggregated FDI, in order to provide information with regard to the effect of these factors on total FDI flows as well as sectoral FDI flows. This should provide more detailed information on the way the level of civil and political liberties affect the level and composition of FDI in a sectoral setting, and thus avoid the problems that arise from the consideration of the effect of these factors on aggregated FDI flows.

Considering our sources for FDI data, it is possible to categorize the sources based on their sectoral classifications. First source is World Bank, which provides data based on *International Standard Industrial Classification* commonly referred to as ISIC classification. The second source of data is the Eurostat that provides FDI data based on *Statistical Classification of Economic Activities in the European Community* sectoral classification commonly known as NACE. The final source of data is the Bureau of Economic Analysis (BEA) that provides FDI data based on the *North American Industrial Classification* commonly known as NAICS. Furthermore, the data provided based on each of these classifications has been under revision. The latter means that a consideration of data from one source would not provide one with a full set of data covering an extended number of years. At least not without manipulation of indices using concordance tables provided for different revisions.

The information with regard to sources of sectoral FDI data, classifications and the considerations made with respect to concordance of the classification of data from different sources are provided in Appendix 5.1.

#### **5.5.1. B. FDI Data Collection**

Considering the discussions made on sectoral data sources (available from Appendix 5.1), the data on dependent variable (FDI) is extracted from EUROSTAT and BEA for the period of 1990-2009. The data from each of the sources is provided in different data set named after the original source of FDI data (Eurostat and BEA data sets).

Considering the Eurostat data set, the choice of home countries are namely: United States of America (USA), United Kingdom (UK), Ireland, Denmark, Finland, Norway, Sweden, France, Germany, Italy, Netherlands, Spain, and Japan, as discussed in subsection 5.4.1 and the choice of host countries are provided in appendix 6.2. The classification of the industrial sectors is in line with the NACE Rev.1.1, ISIC Rev.3.1 and NAICS 2002, and

is discussed in length and provided in appendix 5.1. The initial data set provides FDI net flows of the 13 countries abroad into the 140 host countries (list of the countries is available from appendix 6.2).

Regarding BEA data set, the choice of home country is only United States. The industrial classification system used is the one proposed in the previous section. The choice of host countries is in line with those of Eurostat data set, which are available from appendix 5.1. The BEA data set provided the data on U.S. FDI flows abroad and not U.S. FDI net flows. In order to calculate net flows we calculated the different across years to provide the U.S. FDI net flows in the data set.

### **5.5.2. Independent Variables**

In chapter (4) we used a set of concepts such as; average wage, alternative wage, tax on profit, bargained wage, in order to provide a theoretical model of a bargaining process between MNE and labour representatives in host countries. Considering our positivist approach, we believe that these concepts can be measured, their measurements are obtainable from a number of sources, and that the measurements proxy for the concepts we have considered. Since the concepts are measured, following Bryman and Bell (2003) we refer to them as dependent and independent variables. In this case, since our dependent variable is FDI, our independent variables are those reviewed in this section.

#### **5.5.2. A. Preliminary set of Independent variables**

As mentioned earlier in this chapter, our set of explanatory variables include variables that proxy for FDI motivations (RS, MS, ES, and SAS), variables that reflect the level of civil liberties and political rights, variables that proxy for macroeconomic characteristics of the host countries, and finally variables that reflect the institutional characteristics of the host countries. This is mainly due to the fact that our research considers firm as the unit of analysis and that firms motivations are considered to be drivers of their FDI activity. Therefore the first set of explanatory variables considered are those that proxy for FDI motivation. Since we consider the macroeconomic characteristics of the host countries to influence FDI activity, therefore the second set of variables considered are those related to the host countries' macro characteristics. The third set of variables that are essential ingredients of our research are civil liberties and political rights indices provided by

Freedom House. Finally, we consider the institutional characteristics of the host countries to affect their FDI activity, therefore a number of institutional factors are considered as explanatory variables. A detailed review of all the measures available for the subgroup variables are provided in the next chapter. The decision process in determining the relevant measures for the concepts, involves four main criteria which are provided based on their priority. First, the measure must reflect the concept in the essence that it is used in the literature and conceptual model. Therefore the measure must proxy for the concept. Second, source from which the measure is extracted from should cover all the home countries and the most extensive set of host countries. Third, the period for which the measures' data is provided for should comply with the period for which the research is conducting the empirical investigation for (1990-2009). Finally, the units of measures should be taken into account as to ensure consistency amongst measures.

## **5.6. Missing data & related considerations**

The set of missing data is left blank in the excel dataset which is later on transferred to STATA 10, for empirical investigation. The observations remarked by (c) indicators in the official datasets are the observations that are kept confidential due to the scarce number of MNEs in a certain region and sector, as a result, the announcement of the level of net FDI flows are kept from public. These values are considered as not reported, and hence are reported as blank cells (no values) in the dataset. It is imperative to note that the difference between the case where data is kept confidential, or is not reported is treated differently than the case where the net FDI flows is reported "0", and the blank cells are chosen to distinguish between the two.

## **5.7. Methodology of Data Analysis**

The combined data set is used in empirically testing the hypotheses provided in chapter four, using statistical regression analysis. The empirical methods are briefly introduced in the next sections.

### **5.7.1. Variable based approach**

The use of variable based approach is prevalent to the quantitative research arena. This seemingly fundamental part of quantitative research is referred to as "a unique notion to



the quantitative research” (Saunders, Lewis et al. 2000). As mentioned before our variables are the reflective measures of the concepts provided in the conceptual framework and provide the opportunity of empirically testing the set of hypotheses provided in chapter (4). The next section provides some information on the complete dataset used for the empirical investigation.

### **5.7.2. Dataset and its characteristics**

Our combined dataset includes the aggregate and disaggregate levels of FDI flows from thirteen home countries to 140 host countries, with a range that spans from 1990 to 2009. This extended span of data provides the opportunity to avoid the problems that are generally prone to small data sets. Furthermore the choice of our extensive set of explanatory variables that includes measures that proxy for various factors explaining the FDI activity, provides us with a dataset that provides a considerable number of observations which would lead to provision of statistically valid exercise under the assumptions of *ceteris paribus*.

Our empirical investigation has a longitudinal design, with the intention to investigate the existence of the possible patterns that we conceptually hypothesized in our conceptual model of chapter (4). Bryman and Bell (2003, pp.60-61) consider the longitudinal design to represent a “distinct form of research design that is typically used to map change in business and management research”. Furthermore, our longitudinal design as it is reflected by the dataset has a panel type format, in which a randomly selected sample from in this case national and international organizations is considered for the analysis. Another characteristic of our data is that it is cross sectional, and that it considers FDI flows from thirteen countries into 140 countries, making our data a cross-sectional data set that covers the measures for the period of 1990-2009. This type of data is generally referred to as panel data. We review the characteristics of the dataset more in depth in the next chapter.

### **5.7.3. Regression analysis**

The method of analysis is the regression analysis which according to Jankowicz (1991) offers more room for generalization of the examined phenomena. The types of regression analyses considered, conducted and their characteristics are covered thoroughly in Chapter 7.

## **5.8. Research legitimacy, Reliability, Validity and Replicability**

Research reliability, validity, causality, generalization and replicability is collectively referred to as research legitimacy (Bryman and Bell 2003). Furthermore, they are considered to be the traditional criteria for judging quantitative research (Blaxter, Hughes et al. 2001). These elements are discussed in relation with our research in the following subsections.

### **5.8.1. Reliability**

Reliability relates to the issues of consistency of measures, their stability, inter-reliability and inter-observer consistency (Saunders, Lewis et al. 2007). It is imperative that the measures chosen for the concepts are good proxies for their concepts, are consistent, and stable over time. The reliability of measures in some cases can be investigated using different sources of data to examine their reliability. This has been the case for some of the explanatory variables as well as dependent variable.<sup>100</sup> In other cases since our sources of data are reputable, international organizations (World Bank, International Labour Organization, EUROSTAT, etc.) whose data is chiefly used by most researchers, we assume that the data provided is reliable. According to Bryman and Bell (2003, p.40) the reliability refers to “the question of whether the results of a study are repeatable”. Given the sources of data and the standard replicable method of analysis, it is possible to repeat this research, as long as the set of assumptions are consistent with ones provided in this research both in a conceptual context as well as empirical exercise.

### **5.8.2. Validity**

Bryman and Bell (2003, pp.40-42) consider validity of the research to be “concerned with the integrity of the conclusions that are generated from a piece of research”. Furthermore, they argue that in the quantitative research the question of validity is generally related to whether measures chosen as proxies for concepts are good reflectors of the concepts. It is worth mentioning that while reliability is a necessary condition for validity, it is not sufficient. However, if a measure is considered valid, it is presupposed that it is reliable.

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<sup>100</sup> The assessment of reliability through checking other sources of data has been possible for the variables that have been reported by a number of sources. For instance the level of employment is provided by a number of sources that provide such opportunity.

A number of strategies have been recommended to ensure validity of quantitative research. Amongst which use of the multiple data sources (Blaxter, Hughes et al. 2001) and combining data from different sources (Remenyi, Williams et al. 1998) are worth mentioning. In the context of this research we have carefully chosen a set of measures that are chosen for the concepts, with the intention to provide valid measures for our concepts. Furthermore, we use a number of data sources, in order to ensure the validity of our empirical investigation.

### **5.8.2. A. Internal Validity**

Internal validity refers to issues regarding causality. Bryman and Bell (2003pp.168-169) discuss that quantitative researchers in general are concerned with describing how things are rather than discussing why things are the way they are. Thus they argue that it is imperative to discuss the causes of a phenomenon as well as description of the way it is. In the context of this research we explicitly emphasised on the reasons why a certain type of incentive and the general factors affecting the investment decisions do influence investment patterns and have provided a set of hypotheses in order to examine the validity of the idea in an empirical sense.

### **5.8.2. B. External Validity**

External validity refers to the issues concerning the generalizability of the findings. Bryman and Bell (2003pp.168-169) argue that in the context of quantitative research, “the researcher is usually concerned to be able to say that his or her findings can be generalized beyond the confines of the particular context in which the research was conducted”. Jankowicz (1991) refers to generalizability as the extent of applicability of research findings of a research to outside environment in which the research has been conducted. In this context we consider our sample representative of the population of firms’ investing abroad, at least amongst developed countries. The set of host countries considered also can be arguably considered as a representative sample for most countries of the world. Therefore, it is expected that considering the boundaries of this research<sup>101</sup>, we should not experience significant sample selection bias, or other issues that might undermine the external validity of our research.

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<sup>101</sup> Our selection of home countries provides a significant generalization boundary by exploring the investment pattern of mainly developed countries through FDI. However this investment pattern considers FDI in an extended set of host countries which makes the findings externally valid.

### **5.8.3. Replicability**

Saunders, Lewis et al. (2007) argues that it is imperative that the methods taken into account in generating a set of findings, in the context of quantitative research, are made explicit in order to provide the possibility of replicating a piece of research. The provision of explanations with regard to the thought process as well as the decisions made in the course of this research that are provided chiefly in this chapter, and frequently in every chapter of this thesis is in order to familiarize the reader of all the processes that have helped forming this research. It is expected that the replication of the steps undertaken in this research given that the set of assumptions put forward are assumed by the replicator, leads to generating the same set of results. Apart from these considerations this research provides all the datasets constructed as a “replication dataset” for the public in order to provide the opportunity to anyone who might wish to replicate the results provided.

### **5.8.4. Research legitimacy**

The collection of issues regarding research reliability, validity, causality, generalization and replicability are the determinants of research legitimacy (Bryman and Bell, 2003). Thus if a quantitative research is valid, and hence reliable, it is generalizable and replicable, and explain the causes as well as phenomenon, it is legitimate. Considering our research we provide a legitimate quantitative research that satisfies the aforementioned requirements within its boundaries.

### **5.8.5. Limitations of the research**

Inherently, research methods are exposed to criticisms and their adoption in conducting a scientific inquiry by nature imposes a number of limitations on the research, as well as exposing it to a number of weaknesses that should be considered by the researcher. Blaxter, et al.(2010) point out that the researchers should be aware of their research’s limitations.

In the case of this research, the quantitative approach in business studies and social sciences is criticised for a number of reasons. The first criticism is that a quantitative approach applies the methods for researching ‘the natural world’ to the research on human beings and the social institutions, and therefore, the quantitative researcher does not distinguish the differences between people and social institutions from the ‘the world of

nature (Bryman and Bell 2007). The second criticism is that the numerical way of describing is much more limited than the more informative narrative (Punch 2005) and that the connection between the concepts that are involved in the research and the measures developed to explore the subject are generally assumed, and therefore, the measurement process of quantitative research possesses “an artificial and spurious sense of precision and accuracy” (Bryman and Bell 2007). The third criticism according to Bryman(2003) is that the quantitative research facilitates the collection of a narrow and superficial data. Furthermore, Bryman and Bell (2007) argue that the quantitative approach provides a static view of life that is independent of the people, by analysis of the relationships between variables. According to (Saunders, Lewis et al. 2000) the quantitative approach is more appropriate for the macro level analysis rather than micro, since it requires to use large samples (Saunders, Lewis et al. 2000).

In order to account for possible biases, this research as discussed in the earlier sections of this chapter, takes advantage of using a large data set which covers the data over twenty years, and therefore, avoids small sample biases and explores the phenomenon in a continuous manner. The in order to provide a more informative narrative of the research, the next section will discuss the variable selection process which aims at choosing variables that are the appropriate indicators of the concepts which are developed in the previous chapter. Furthermore characteristics of the data are explored in length and a number of comparative statistics are provided with the intention to provide a rich narrative as well as diverse set of statistical examination in order to explore the relationship between variables. The regression analysis is conducted in chapter 7, in order to explore the relationship between FDI net flows and a number of variables. The regression analysis itself is undergone a number of robustness tests in order to reassure the robustness of the results provided and therefore eliminate the possibility of statistical biases and allow for generalisation and causality requirements discussed above.

## **5.9. Conclusion**

The choice of the philosophical standpoint and research approach affects the choice of methods in scientific inquiry and therefore are the cornerstones that this research is built upon. This chapter intended to explore the philosophical and methodological considerations, debate them, and provide discussions on the sampling and data collection. The process of data collection, were further developed by descriptive narrative that

provided information with regard to dataset construction, the set of variables, and the home and host countries that were considered. Furthermore, the data handling process, methods considered for data analysis, the issues related to legitimacy, validity, and reliability were discussed along with the limitations of the methods considered. The next chapter, reviews variable selection methods adopted, explores the data characteristics, and provides some information with regard to variables chosen to explain FDI activity, in length.

## **Chapter 6 : Data Characteristics & Empirical Investigation**

### **6.1. Introduction**

In the previous chapter, the epistemological, ontological, other philosophical assumptions and methodological considerations of the research were discussed. A brief overview of data collection process was put forward to inform the reader of the processes that have led to formation of our dataset. As it was mentioned in section (5.5.2.), the selection of independent variables will be discussed thoroughly in this chapter, along with some information on sample characteristics. Furthermore, we provide some information on the overall data and provide some preliminary statistics with the intention to familiarise the reader with the dataset and prepare the groundwork for the empirical investigation of dataset.

This research as discussed in chapter 4, considers the firm as the building block of the conceptual model, and hence views the concepts from a firm level point of view. Complying with this logic we discuss the factors that explain the FDI activity of the firm from an incentive point of view (mainly the established motivations of FDI, namely; Resource seeking, Market seeking, Strategic Asset Seeking and Efficiency Seeking motivations) in contrast to a purely macro-view which would mainly take into account country level factors. However, we include a set of country level variables in order to

proxy for the macro-economic factors affecting the investment environment of countries, in order to explain FDI activity. The second element that is worth mentioning is that our level of analysis is placed at macro level trying to draw on the observable general trends in the FDI activity of the firms in a number of countries using both country and sectoral considerations. The combination of the micro drivers of FDI activity (motivations of firms in investing abroad) as well as countries' macroeconomic characteristics, institutional quality (i.e. Bureaucratic quality), level of civil liberties and political rights provides an extensive set of information that would provide some explanations on the composition and level of FDI activity. The country specific considerations include institutional variables that affect firm's decision and FDI activity. This chapter is organized as follows: first section provides information with regard to data sources, time span of data and the number of host and home countries considered. Second section provides some information on the general characteristics of data on dependent and independent variables and discusses the process of selection of valid variables for empirical investigation. Third section explores the normality of the data in order to determine appropriate statistical methods to be used for the analysis of data. Consequently we explore FDI activity with regard to a number of factors using Anova type tests and by doing so provide some characteristic statistics on FDI activity through our preliminary empirical investigations.

## **6.2. Variables and their definitions**

### **6.2.1. General sample description**

The choices of home and host countries were discussed in chapter 5. We have two data sets: Eurostat and Bureau of Economic Analysis (BEA) data sets. The data sets differ in terms of dependent variables and number of economic sectors (14 sectors in Eurostat data set and 15 sectors in BEA data set). However, the independent variables are the same.

The set of home and host countries are provided in Appendix 6.1 and 6.2, respectively. In order to explore the data sets further we continue our description by exploring our data in a way that it is represented by variables. Before exploring our data sets however, it is possible to discuss the initial data considered for empirical analysis of chapter 7. The data includes the observations on FDI activity of 14 countries (U.S. is counted twice since the data on U.S. is provided from two sources) over a number of years, 1990-2009, into 140 host countries. Therefore our data set has the properties of cross sectional data as well as

time series data. This type of data is commonly referred to as Panel data.<sup>102</sup> The use of Panel data provides this research, the possibility of multi-level analysis (allowing for sectoral and country level analyses, as well as comparison between the FDI patterns from various types of economies). Furthermore, it allows the author to observe the changes in variables in time and across countries, which in turn warrants one with a certain level of heterogeneity within sample.

### 6.2.2. Dependent Variable

Following the discussion in chapter 5, in a variable based context our first set of variables are the thirteen dependent variables providing data on FDI net investment abroad from home countries into 140 host countries (provided in table 6-1).

**Table 6—1: Preliminary list of Home Countries considered from Eurostat**

Variable	Variable Code	Variable Type	Scale/Range	Source
U.S. FDI	USFDI	Continuous/Ratio		BEA
U.S. FDI	US_FDIO_L1_USD	Continuous/Ratio		Eurostat
UK FDI	UK_FDIO_USD_L1_USD	Continuous/Ratio		Eurostat
Sweden FDI	Sweden_FDIO_L1_USD	Continuous/Ratio		Eurostat
Spain FDI	Spain_FDIO_L1_USD	Continuous/Ratio		Eurostat
Norway FDI	Norway_FDIO_L1_USD	Continuous/Ratio		Eurostat
Netherlands FDI	Netherlands_FDIO_L1_USD	Continuous/Ratio		Eurostat
Japan FDI	Japan_FDIO_L1_USD	Continuous/Ratio		Eurostat
Italy FDI	Italy_FDIO_L1_USD	Continuous/Ratio		Eurostat
Ireland FDI	Ireland_FDIO_L1_USD	Continuous/Ratio		Eurostat
Germany FDI	Germany_FDIO_L1_USD	Continuous/Ratio		Eurostat
France FDI	France_FDIO_L1_USD	Continuous/Ratio		Eurostat
Finland FDI	Finland_FDIO_L1_USD	Continuous/Ratio		Eurostat
Denmark FDI	Denmark_FDIO_L1_USD	Continuous/Ratio		Eurostat

In order to explore the extent of FDI data provided for each of the home countries considered, table below tabulates the span of FDI data extracted from two main data sets of EUROSTAT and Bureau of Economic Analysis (BEA).

<sup>102</sup> For further discussion on Panel data please refer to Wooldridge (2002)



**Table 6—2: Preliminary list of Home countries and the span of their FDI data**

Home Country	Time Span of FDI data available	Home Country	Time Span of FDI data available	Home Country	Time Span of FDI data available
U.S. (BEA)	1990-2009	Germany	1990-2009	Finland	1992-2009
U.S. (Eurostat)	1992-2009	France	1997-2009	Denmark	1998-2009
U.K.	1992-2009	Netherlands	1993-2009	Norway	1994-2009
Ireland	2001-2009	Italy	1999-2009	Sweden	1998-2009
		Spain	1999-2009		
		Japan	1996-2009		

Considering table 6-2, we find that for a number of countries the sample size is about half of the desired time span for analysis. Therefore, it is necessary to drop the home countries for which the data is considerably limited. Our meta-analysis, provided in chapter 3, showed that time frame from which data is extracted influences the results of analysis in a significant manner, if the data collected is mainly related to one decade. The biases that would be introduced by choosing a limited dataset, and the evidence of significant effect in case of data that relates to a decade motivates us to drop the home countries for which data is far too limited (less than 13 years). The resulting set of home countries are as eight home countries.

Furthermore by reviewing the data provided by EUROSTAT on US FDI, we find that it only includes data on aggregated FDI (total FD). Therefore, in order to maintain consistency in our analysis we drop the consideration of US FDI data from EUROSTAT and instead use the aggregated and disaggregated US FDI data from BEA. The resulting sample of home countries considered is provided in table 6-3 (below).

**Table 6—3: List of selected Home countries and the span of their FDI data**

Home Country (LME)	Time Span of FDI data available	Home Country (CME)	Time Span of FDI data available	Home Country (Nordic)	Time Span of FDI data available
U.S. (BEA)	1990-2009	Germany	1990-2009	Finland	1992-2009
U.K.	1992-2009	France	1997-2009	Norway	1994-2009
		Netherlands	1993-2009		
		Japan	1996-2009		

Considering the coverage of our sample of home countries, we find that the sample still embodies a number of countries representing FDI from various market economies, thus

allowing empirical comparison between the FDI activities of firms from different market economies. In order to explore the characteristics of the FDI data of this sample of countries table 6-4 provides a brief summary of the aggregate FDI data provided on dependent variables which include number of observations, mean, standard deviation, minimum and maximum values reported.

**Table 6—4: List of Home countries considered**

Source	Variable	Obs	Mean	Std. Dev.	Min	Max
BEA	USFDI (total)	1068	2559.172	8541.792	-26702	132749
Eurostat	UKFDI (total)	1202	1274.58	7737.168	-25910	169686.4
Eurostat	Norway FDI(total)	548	244.7106	2054.302	-8261.43	36330
Eurostat	Netherlands FDI(total)	905	810.8281	4467.23	-23432.9	107462.5
Eurostat	Japan FDI (total)	523	1045.105	2780.916	-2632.5	41810
Eurostat	Germany FDI (total)	2653	519.9144	3309.911	-29527.3	87284.45
Eurostat	France FDI (total)	1228	992.6818	4389.329	-24587.1	61824.29
Eurostat	Finland FDI (total)	1212	84.39261	775.2117	-5257.5	14102.22

In terms of overall level of FDI flows, we find Germany, France, Finland, U.K., and U.S. have the most number of observations for the period of 1990-2009. Based on the arguments made in chapter 4, we categorised the types of economies into two main types of LMEs (i.e. U.S., UK, and Ireland) and CMEs (Japan and EU countries). We further on categorised the CMEs based on different types of labour regulations into two main parts of northern countries (Denmark, Finland, Sweden, Norway) and Japan along with other European Countries (Germany, France, Netherlands). It is possible to observe the mean and standard deviation of these countries' net FDI flows over 1990-2009. Considering the mean FDIO, we find that the U.S, U.K., Japan, and France respectively have higher mean FDIO in comparison to other countries for the period of 1990-2009. Similarly reviewing the summary of total FDI data from Eurostat we find that U.K., and U.S., the liberal market economies, tend to have highest standard deviation, while France, Germany, and Japan, CME countries, tend to show less standard deviation in their investment activity.

The data on industry level FDI data is collected from the two main sources of data (EUROSTAT and BEA), and the classification of the industry level data is extensively discussed on Appendix 5.1. The data on industry level FDI is classified based on a higher level of aggregation than the proposed industry level data provided by any of the two main

sources considered (BEA and Eurostat). This is mainly due to low number of observations provided in some sectors that would tend to provide an unbalanced panel sample that would only be illuminating with regard to a selective number of sectors, rendering the data collection and analysis of the other sectors fruitless. The detailed discussion of the categorization of the sectors is provided in appendix 5.1. Based on author's classification, the sectors are considered to belong to one of the three groups of sectors, namely: Agriculture; manufacturing and services. The classification of all sectors in to the mentioned groups allows this research to provide considerable number of observations that would allow greater level of statistical confidence in the results. Furthermore, considering the extensive span of the time for which the data is collected, the sectoral sample would allow the generalization of the results. Further discussion on the sectoral FDI data is provided in chapter 7, subsection 7.2.1.

### **6.2.3. Independent Variables**

#### **6.2.3. A. Selection of valid measures for the concepts**

As discussed in previous chapter, the provision of valid measures for the concepts is imperative for quantitative research mainly due to the fact that it establishes validity and consequently legitimacy of the research. In this section we provide some information on the selection process that is performed in order to ensure the validity of the measures. We also discuss the reasons why these measures are considered as good proxies for the concepts.

The set of home and host countries considered are available from appendices 6.1 and 6.2 respectively. In order to inform the reader of the independent variable selection process in chapter 5, subsection 5.5.2 we discussed a series of concepts for which independent variables should be provided in order to explain FDI activity, in a manner that corresponds to our conceptual arguments, and theoretical framework. Furthermore, the set of independent variables are to be used for empirical analysis of the set of hypotheses developed earlier. As a brief reminder, we restate that our research places firm at the centre of analysis and therefore view the FDI activity of the firm in the light of firms' motivations first introduced by Behrman (1974). Furthermore, our research aims to explore the effect of civil liberties and political rights on FDI activity, thus the relevant indices are to be extracted from appropriate sources. Macroeconomics characteristics of the host countries are also considered to affect the FDI activity of the firms. Finally, this research considers

the institutional factors to influence the FDI activity. The discussion on varieties of capitalism provided in chapter 2, and further on elaborated in chapter 4 in provision of the theoretical model, established the way institutional characteristics of the certain types of market economies affect the coordination activity of their firms and drew distinctions accordingly. Therefore, the final set of variables that are to be considered is institutional variables that reflect the institutional environment of the countries. Table below provides a crude indication of the measures that are considered:

**Table 6—5: Concepts and their related variable sets**

Concepts/Variables Group	Related Sub groups of measures available
Resource Seeking (RS)	Energy Production
	Energy Reserves
Market Seeking (MS)	Gross Domestic Product (GDP) and related measures
	GDP per Capita and related measures
Strategic Asset Seeking (SAS)	Patents and related measures
	Trademarks and related measures
	Tariffs and related measures
	R&D related measures
	Infrastructure and related measures
Efficiency Seeking (ES)	Employment
	Unemployment
	Cost of Labour
	Wages
	Economically Active Population
	Minimum wage
	Trade Union Members
	Strikes and Lockouts
	Labour Force by level of Education
	Labour tax contributions
	Labour Productivity
Macro-economic variables	Real Effective Exchange Rate
	Real Interest Rate
	Risk Premium
	PPP conversion Measures
	Interest rate related variables

	Taxes and related measures
Political Rights	Political rights index from Freedom House
Civil Liberties	Civil liberty index from Freedom House
Institutional Factors	A variety of indicators are available from various sources.

Considering the table 6-5, we continue by reviewing the initial set of variables that can potentially be considered as proxies for the concepts discussed. The decision process in determining the relevant variables for the concepts entails four main elements which are discussed based on their priority. First, the measure must reflect the concept in the essence that it is used in the literature and conceptual model. Therefore the measure must proxy for the concept. Second, source from which the measure is extracted from should cover all the home countries and the most extensive set of host countries. Third, the period for which the measures' data is provided for should comply with the period for which the research is conducting the empirical investigation for (1990-2009). Fourth, the units of measures should be taken into account as to insure consistency amongst measures.

Adopting the aforementioned decision criteria in selecting the independent variables, the valid independent variables are chosen from the preliminary set, discussed in the following sections, and provided in appendix 6.3.

### 6.2.3. B. Time & Level of Income related Variables

The first set of independent variables reflects the timing of FDI; years under observation (1990-2009); five year dummy, and a decade dummy. These variables are taken into account to explore whether there are time effects that influence the FDI level and composition, and to provide the possibility of reflecting on concentration of FDI activity with reference to various Host countries. In chapter 3, through our Meta-analysis we found that there has been a time effect on FDI, which is reflected in the literature, in order to provide the possibility of exploring such avenues further these variables are constructed and provided in table 6-6.

**Table 6—6: Time related variables**

Variable No.	Variable	Variable Code	Variable Type	Scale/Range	Source
1	Time variable	Years	Interval/Ratio	1990-2009	-
2	Five year indicator dummy	Dum-fiveyear	Categorical/Nominal	1=1990-95	-

				2=1995-2000 3=2000-04 4=2005-09	
3	Decade Indicator Dummy	Dum-decade	Categorical/Nominal	1=1990s 2=2000s	-

Since the properties of host countries affect the level of FDI attracted by them, we consider the host countries' level of income as one of the country specific variables that might influence their FDI activity. The dummy variable constructed, classifies the set of 140 host countries considered in this research using World Bank index on countries level of incomes and classifies all host countries into one of the five classes provided below.

**Table 6—7: Host Country groupings based on their level of income. The classification is based on World Bank's country classification based on income.**

Variable No.	Variable	Variable Code	Variable Type	Scale/Range	Source
4	Dummy variable based on countries' level of income	Dum_levelInc	Categorical/Nominal	Upper income (OECD) =5 Upper income (Non OECD) =4 Upper Middle income=3 Lower Middle income=2 Lower income=1	World Bank

### 6.2.3. C. Macro-economic Variables

In order to take into account the macro-economic factors that influence the FDI activity, we consider a number of variables that include real interest rate, real effective exchange rate (which is mainly used for the generation of a consistent data set, in terms of currency unit of analysis), taxes imposed on export and import, taxes on profits, taxes on international trade and a number of other measures reflecting taxation system of home and host countries.

The first macroeconomic variable considered is exchange rate. Studies that have considered the effect of exchange rates on FDI include Froot and Stein (1991), Blonigen

(1997), Buch and Kleinert (2006) and Buch and Kleinert (2008). The second set of macroeconomic variables considered is related to interest rates and include, real interest rates and interest rate lending. The effect of interest rates on FDI is explored in studies such as Gross and Trevino, (1996). The third set of macroeconomic variables considered is related to taxation. The literature on the effect of taxation of FDI is populated by an extended set of studies such as Hartman (1984), Boskin and Gale (1987), young (1989); Scholes and Wolfson (1990), Slemrod (1990), Cassou (1997), Billington (1999); Broekman and van Vliet (2000), Swenson (1994), Jun (1994), Devereux and Freeman (1995), Pain and Young (1996), Shang-Jin Wei (1997), Jun (1994), and Wei (1997).

A fourth set of macroeconomic variables considered are trade related variables. A number of studies including Lipsey and Weiss (1981, 1984), Grubert and Mutti (1991), Blonigen (2001), Head and Ries (2001), Swenson (2004) explore the effect of trade on FDI activity. Our reasoning for inclusion of trade as one of the determinants of FDI is in line with consideration of trade as one of the factors that directly affect macroeconomic status of the host countries. Furthermore, we consider trade and trade related variables to have an indirect effect on FDI in case of vertical and horizontal FDI where the production is accomplished with the intention to export the products to another location, or the production of product itself is undertaken through processing different parts of the product in different locations with the intention to provide the final products in a certain target market. In both case trade and trade related variables are considered to affect FDI activity. The macro-economic variables considered are provided in table below, and their definitions are available from Appendix 6.3; macro section.

**Table 6—8: Preliminary Macro variables**

Variable No.	Variable	Variable Code	Variable Type	Scale / Range	Source
5	Real effective exchange rate index (2005 = 100)	exchangerate_realeffective	Continuous/Ratio	-	WB
6	Real interest rate (%)	interest_rate_real	Continuous/Ratio	-	WB
7	Lending interest rate (%)	interest_rate_lending	Continuous/Ratio	-	WB
8	Stocks traded, total value (% of GDP)	stktrdtot	Continuous/Ratio	-	WB
9	Trade (% of GDP)	trade_percgdp	Continuous/Ratio	-	WB
10	Exports of goods and services (annual % growth)	exp_gdsservs_percanngr	Continuous/Ratio	-	WB

11	Other taxes (% of revenue)	tx_other_percrev	Continuous/Ratio	-	WB
12	Taxes on exports (% of tax revenue)	tx_on_export_perc	Continuous/Ratio	-	WB
13	Taxes on goods and services (% of revenue)	tx_goodservices_percrev	Continuous/Ratio	-	WB
14	Taxes on goods and services (% value added of industry and services)	tx_goodservices_percva	Continuous/Ratio	-	WB
15	Taxes on income, profits and capital gains (% of revenue)	tx_inc_prof_cg_percrev	Continuous/Ratio	-	WB
16	Taxes on income, profits and capital gains (% of total taxes)	tx_inc_prof_cg_pctottx	Continuous/Ratio	-	WB
17	Taxes on international trade (% of revenue)	tx_intrade_percrev	Continuous/Ratio	-	WB

Note that we have not considered the effect of bilateral tax treaties, or complacency of taxation systems on FDI flows. This is mainly due to case specific nature of these factors. For a review of the taxation and its effect on FDI, please refer to Blonigen (2005).

### 6.2.3. D. Market Seeking (MS) Variables

Market seeking incentives includes the motivation of firms to invest in the markets where market size is considerable, and the economic growth allows a certain level of purchasing power of the population to consume the products produced by the firms' manufacturing or service entity. Thus these MS variables are a measure of market size and economic growth of the host markets, reflecting a demand factor for production. A number of variables are generally used as measures of market size in the literature. The most commonly used measures are Gross Domestic Product (GDP) and its related measures such as Purchasing Power Parity measure of GDP. The MS variables that are considered for empirical investigation in this research are provided in table 6-9, below.

**Table 6—9: Preliminary Market Seeking (MS) variables considered**

Variable No.	Variable	Variable Code	Scale / Range	Source
18	GDP (constant 2000 US\$)	GDPUSDCons	Continuous/Ratio	WB



19	GDP growth (annual %)	GDPPerAnnGrwth	Continuous/Ratio	WB
20	GDP per capita (constant 2000 US\$)	GDPPrCapitaUSDCons	Continuous/Ratio	WB
21	GDP per capita growth (annual %)	GDPPrCapitaPercAnnGrwth	Continuous/Ratio	WB
22	GDP per capita, PPP (constant 2005 international \$)	GDPPrCapitappIntlUSDCons	Continuous/Ratio	WB
23	GDP, PPP (constant 2005 international \$)	GDPpppIntlUSDCons	Continuous/Ratio	WB

### 6.2.3. G. Resource seeking (RS) variables

Resource seeking<sup>103</sup> investors broadly speaking invest abroad to obtain specific resources of higher quality at a lower price or cost in comparison to their home country. This in a sense relates to firms that chiefly populate energy, mineral, and other resource based sectors of the industry. Our preliminary review of the databases<sup>104</sup> mentioned in chapter (5), provides a number of choices with regards to measures that could proxy for the resource seeking motives of the firms, and hence account for the population of firms that mainly operate in resource based industries. The preliminary choices and their sources are tabulated in the table below. Considering our decision criteria, we review the available data and subsequently make a decision regarding appropriate variables that could proxy for resource seeking motivation of firms. These factors naturally provide some explanatory information in regard to the FDI activity of the firms, in aggregate and disaggregate manner.

**Table 6—10: Preliminary Consideration of possible proxies for Resource Seeking motives of MNEs**

Concepts/Sources	GMID
Energy Production	Annual Refinery Output
	Production of Natural Gas
	Electricity Production
	Production of Crude Oil per Day
	Production of Crude Oil
	Production of Coal
	Production of Biofuels
Energy Reserves	Coal Reserves

<sup>103</sup> A review of Resource Seeking (RS) motivations, is provided in chapter 2, subsection; 2.2.3.4.A.

<sup>104</sup>These sources include: World Bank, GMID, EUROSTAT, OECD.STAT, BEA and IMF, the other sources IFS , ICRG, POLITY IV, ILO, and Freedom House, do not cover related indices.

	Oil Reserves
	Natural Gas Reserves

From these measures, the related data on energy reserves were estimations made on some base years and the information was generally provided through reports in a less quantitative manner. The remainder is the data from GMID on energy production. Table below, provides information on the data.<sup>105</sup>

**Table 6—11: Preliminary Consideration of Resource Seeking variables and their sources of data**

Concepts/Sources		GMID	Period	Unit
Resource Seeking Motives	Energy Production	Production of Natural Gas	1977-2011	Millions (mn) of tonnes of oil equivalent
		Electricity Production	1977-2011	KWh
		Production of Crude Oil per Day	1977-2011	thousand barrels per day
		Production of Crude Oil	1977-2011	mn tonnes of oil equivalent
		Production of Coal	1981-2011	mn tonnes of oil equivalent
		Production of Biofuels	2005-2011	mn tonnes of oil equivalent

Most of the variables provided above cover the target time span (1990-2009) with the exception of Biofuel. Thus the RS variables are as follows:

**Table 6—12: Preliminary Resource Seeking (RS) variables considered**

Variable No.	Variable	Variable Code	Variable Type	Scale / Range	Source
24	Production of Crude Oil; Volume (million tonnes of oil equivalent)	Prod_CrudeOil	Continuous/ Ratio		GMID
25	Production of Natural Gas; Volume (million tonnes of oil equivalent)	Prod_Gas	Continuous/ Ratio		GMID
26	Production of Coal; Volume (million tonnes of	Prod_Coal	Continuous/		GMID

<sup>105</sup> Appendix B provides the overview of all variables, their range, unit and definition.

	oil equivalent)		Ratio		
27	Production of Electricity; Volume (KWH)	Prod_Elec	Continuous/ Ratio		GMID

### 6.2.3. E. Efficiency Seeking (ES) Variables

Efficiency seeking motives relate to investment activities that are mainly undertaken in order to reduce the costs of production. The reader is advised to refer to chapter 2 (subsection 2.4. 2) for further reading on ES motives. In these sectors, the motivation of firm from investing would mainly be due to lower costs of production. The latter would potentially be a product of lower wages, easier access to capital, easier access to natural resources (reducing the shipping costs), and a number of other factors that would lead to lower cost of operating the business. In our conceptual framework we have explicitly taken into account the wage bargaining process and the effect of wage structure of host countries. The following variables are considered to provide explanatory power in terms of explaining FDI activity based on ES motives of firms.

**Table 6—13: Preliminary Efficiency Seeking (ES) variables considered**

Variable No.	Variable	Variable Code	Scale / Range	Source
28	Cost to export (US\$ per container)	cost_exp_usd_percont	Continuous/Ratio	WB
29	Cost to import (US\$ per container)	cost_impert_usd_percont	Continuous/Ratio	WB
30	Customs and other import duties (% of tax revenue)	custom_duti_percatotrev	Continuous/Ratio	WB
31	Compensation of employees (% of expense)	emp_comp_percexpense	Continuous/Ratio	WB
32	Employment in agriculture (% of total employment)	emp_agri_percatotemp	Continuous/Ratio	WB
33	Employment in industry (% of total employment)	emp_indus_percatotemp	Continuous/Ratio	WB
34	Employment in services (% of total employment)	emp_serv_percatotemp	Continuous/Ratio	WB
35	Firing cost (weeks of wages)	firing_cost	Continuous/Ratio	WB
36	Labor force, total	lbrforce_t	Continuous/Ratio	WB
37	Labor force with primary education (% of total)	lbr_primeduc_perc_tot	Continuous/Ratio	WB
38	Labor force with secondary education (% of total)	lbr_sndeduc_perc_tot	Continuous/Ratio	WB
39	Labor force with tertiary education (%)	lbr_terteduc_perc_tot	Continuous/Ratio	WB

	of total)			
40	Labor participation rate, total (% of total population ages 15+)	lbr_particip_rate_tot	Continuous/Ratio	WB
41	Literacy rate, adult total (% of people ages 15 and above)	adult_lit_rate_tot	Continuous/Ratio	WB
42	Part time employment, total (% of total employment)	emp_pt_percemp_t	Continuous/Ratio	WB
43	Wage and salaried workers, total (% of total employed)	emp_wgnsale_perc_t	Continuous/Ratio	GMID
44	Wage Per Hour in Manufacturing (Local Currency; Constant Prices-Real Value)	wageperhour_manu_usd_fixed	Continuous/Ratio	ILO
45	Minimum Wage (Constant 2011 Prices) [GMID]	wageperhour_usd_fixed	Continuous/Ratio	OECD
46	Productivity per person employed (USD)	productivity_pperson	Continuous/Ratio	OECD
47	Days Not Worked by economic activity: Total	days_not_worked	Continuous/Ratio	ILO
48	Union Members (administrative data); Annual	un_members_admind	Continuous/Ratio	OECD
49	Total Employees (administrative data); Annual	employees_tot_admind	Continuous/Ratio	OECD
50	Trade Union Density (OECD.Stat)	trade_un_dens	Continuous/Ratio	OECD

### 6.2.3. F. Strategic Asset Seeking (SAS) Variables

The strategic asset seeking variables are intended to proxy for the SAS motivations<sup>106</sup> of FDI which generally are related to a number of factors such as quality of infrastructure (in terms of roads paved, quality of logistics, etc.), R&D investment, and trade export and import platforms of the host countries. In this research we review a number of measures available for SAS motives, which are available from Appendix 6.3, SAS section, and subsequently choose the following variables provided in table 6-14.

**Table 6—14: Preliminary Strategic Asset Seeking (SAS) variables considered**

Variable No.	Variable	Variable Code	Variable Type	Scale / Range	Source
51	Air transport, freight (million ton-km)	airtranspfreight	Continuous/Ratio		WB
52	High-technology exports (% of manufactured exports)	hitech_exp_perc_t	Continuous/Ratio		WB

<sup>106</sup> For further reading on SAS motives please refer to Chapter 2 (subsection 2.3.4.D).

53	Fixed broadband Internet subscribers	internet_subs_fbrdbnd	Continuous/Ratio		WB
54	Internet users	internet_users	Continuous/Ratio		WB
55	Patent applications, non-residents	patent_app_nonres	Continuous/Ratio		WB
56	Patent applications, residents	patent_app_res	Continuous/Ratio		WB
57	Rail lines (total route-km)	infra_raillines_t	Continuous/Ratio		WB
58	Railways, goods transported (million ton-km)	infra_railwgdstransp	Continuous/Ratio		WB
59	Railways, passengers carried (million passenger-km)	infra_railwpasscarried	Continuous/Ratio		WB
60	Roads, paved (% of total roads)	rdspvdperc_t	Continuous/Ratio		WB
61	Roads, total network (km)	rds_network_t	Continuous/Ratio		WB
62	Research and development expenditure (% of GDP)	rnd_expend_percgdp	Continuous/Ratio		WB
63	Researchers in R&D (per million people)	rnd_resemp1	Continuous/Ratio		WB

Note that not all variables considered above are used in the empirical analysis. The discussion on choosing the right regressors to explain FDI activity via regression analysis is provided in 7.2.2. The next section provides information with regard to the data on civil and political liberties and institutional environment.

### 6.2.3. H. Institutional variables

In chapter 3, through our met analysis, we extensively explored the literature on the institutional<sup>107</sup> determinants of FDI. The review of the 62 empirical studies from the literature informs the reader of a number of institutional data bases that are commonly used the frequency of their usage, in the context of institutional determinants of FDI, as shown on the table below:

**Table 6—15: Sources used for institutional variables in the literature**

Institutional Data Bases	Number of Studies <sup>108</sup>
Freedom House	9
ICRG	18

<sup>107</sup> The definition of institutions that is considered in this research is provided in appendix 1.1.

<sup>108</sup> The studies and their other characteristics are available upon request.

Political Risk Service Group (PRS)	2
POLITY	7
TI	10
Business International (Economist Intelligence Unit)	1
Kaufmann (1999)	6
WBES (world business environment survey)	1
World Bank (World Development Report corruption Index)	1
German Exporters Corruption index	1
(GG)World Bank Good governance Index	1
(PITF) Political Instability Task Force	1
World Bank	5
Euromoney	3
UNCTAD Investment Treaty Database	2
Economic Freedom Network <sup>109</sup> - legal system	1
Institutional Investor rating	1
Association for Investment Management and Research (Research, 1996)	1
GCR (global competitiveness report) - Corruption index	1
U.S. State Department Country Reports (Political Terror Scale)	1
GCR (Global corporate reporting)	1
ISTAT (the National Institute of Statistics of Italy) - POLITICAL DATA	1

Departing from a rather observatory perspective, we review the characteristics of the data bases and their data characteristics. In other words we explore the way the concepts are defined, measures are constructed, and their relevance with regard to real-world concepts they proxy for. Furthermore, we provide some information on the methods of data collection and generation, used in the process of construction of the indices. Finally the validity and span of data, and their applicability to our research is discussed. Since our question is regarding the effect of civil and political liberties on the level of composition of FDI, our construction inherently takes into account these factors. Therefore, naturally, we review the sources of data that provide quantitative data on the level of civil and political liberties for our sample. The methodology and ranking of the level of civil and political liberties are provided in order to provide a greater understanding of the reasons behind the consideration of the mentioned sources. Furthermore, we consider the institutional quality of host markets to affect their FDI. Therefore variables that provide information on the institutional environment of the countries are considered. Freedom House provides direct disaggregated measures of civil liberties and political rights for extensive number of years. ICRG provides data on disaggregated measures of institutional environment of the countries. Next sub-sections provide information on two main data sources of Freedom

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<sup>109</sup> See Gwartney et al. (1996, 2000) and Gwartney and Lawson (2003)

House, and ICRG. The characteristics of the data provided by these sources and the variables chosen for statistical exercises are discussed consequently.

### 6.2.3. H.1. Freedom House

The main source of data on civil liberties and political rights is *Freedom House* (FH). Freedom Houses' *Freedom in the World* annual survey evaluates the level of civil and political liberties in 195 countries and 14 related and disputed territories. The time coverage of data is from 1972 to present. While the FH provides both analytical reports and numerical ratings on two main categories of Political Liberty (PL) and Civil Liberty (CL), our research mainly uses the numerical ratings on these concepts provided by FH.<sup>110</sup> The methodology of the surveys based on which the numerical and analytical reports are constructed are available from the institutions' website.<sup>111</sup> Before exploring the survey and the ranking system based on which the Freedom House's indices are constructed we consider the view of freedom that is adopted by Freedom House and question the integrity of the questions with regard to the concepts of civil and political liberties. Political Rights ratings are based on the evaluation of three subcategories of electoral process, political pluralism and participation, and functioning of government (Freedom House 2011).

Civil Liberty (CL) ratings are based on the annual surveys conducted by the institution on four main categories; freedom of expression, and belief; Association and organizational rights; rule of law; and personal autonomy and individual rights.<sup>112</sup> These factors are derived in large measure from the Universal Declaration of Human Rights<sup>113</sup> and thus ground the methodology in the standard political rights and civil liberties ideas put forward by the declaration as well as their further interpretations in length by Gastil (1982) whose definitions of Civil and Political Rights (Liberties) are provided in appendix 1.1. In terms of coverage according to the Freedom House the same standards which are derived from the Universal declaration of Human Rights and are the sub-constructors of the measures

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<sup>110</sup> Freedom House provides three main indices; first, is the Political rights index, second civil liberty index and third is the Freedom House index (FHI), which is the average of the two indices. The FHI is frequently used as a measure of democracy. Since 2006 every edition of *Freedom in the World* also includes data for the component variables used to construct the political rights and civil liberties indices.

Source: <http://www.nsd.uib.no/macrodatabguide/set.html?id=17&sub=1>

<sup>111</sup> Review <http://www.freedomhouse.org/report/freedom-world-2011/methodology> for more notes on methodology.

<sup>112</sup> FH provides explanatory notes on the methodological consideration regarding the construction of the indices on these two measures.

<sup>113</sup> Available from: <http://www.un.org/en/documents/udhr/>

are applicable to “all countries and territories, irrespective of geographical location ethnic or religious composition, or level of economic development”. (Freedom House 2013, p.33)

We acknowledge that a plethora of work exist on the definition of freedom that vary in different aspects [both in terms of the light in which freedom is viewed (i.e. political, civil, etc.) as well as the scientific lenses (political science, law, economics, etc.) through which it is viewed. However, due to scarcity of consistent measures available to the researchers that provide ranking of the level of civil liberties and political rights (liberties) over a considerable number of countries; the popularity and the common usage of Freedom House data on Civil liberties and Political rights; third, the examination of the data sets and the criticisms applied by external users over the years that tend to provide some information on the strengths and weaknesses of the data set and assures one that the data sets have gone under some type of scrutiny over the years; and finally Freedom Houses’ OECD world paradigm view of freedom that is close to the view points based on which Hall and Soskice (2001) put forward the Varieties of Capitalism, this research has used Freedom House as its chosen database from which the data on civil liberties and political rights are extracted. These reasons are as follow: In the next section we explore the ranking system adopted by Freedom House in constructing the PR and CL indices.

### **6.2.3. H.1.1. Ranking**

Political Rights (PR) ratings is based on the evaluation of the annual surveys that consider three main subcategories of electoral process, political pluralism and participation, and functioning of government [Freedom In the World, 2011]. Civil Liberty (CL) ratings are based on the annual surveys conducted by the institution on four main categories; freedom of expression, and belief; Association and organizational rights; rule of law; and personal autonomy and individual rights.<sup>114</sup>The process involves consideration of the survey result of the questions provided in each subcategory for each of the two concepts. The questionnaire consists of 15 questions on civil liberties, and 10 questions on political rights. Each question has a ranking schematic from 0 to 4, where 0 represents the smallest degree of freedom and 4 the highest. Please refer to Appendix 6.4 for a review of the questions provided in Freedom Houses’ questionnaires in construction of the Political rights and civil liberties indices.

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<sup>114</sup> FH provides explanatory notes on the methodological consideration regarding the construction of the indices on these two measures.



For each concept respondents assign a score from 1(low level of freedom) to 4 (high level of freedom), to the questions provided. The overall score of the subcategory is calculated by summation of these score for each category, leading to provision of subcategory score range of 0 to  $4n$ , where  $n$  corresponds to the number of questions provided for each subcategory. <sup>115</sup>Since there are three questions regarding political rights and four questions regarding civil liberty, seven subcategory scores are available. In order to create the seven point scale, Freedom House then uses the sub-indicators in constructing Political rights and civil liberty scales, ranging from 0 to 40, and 0 to 60, respectively. In other words the scaling is conducted through the summation of the rankings of subcategory scores; for civil liberty it ranges from 0 or  $(0 \times 15 = 0)$  to 60 or  $(4 \times 15 = 60)$  and for political rights 0 or  $(0 \times 10 = 0)$  to 40 or  $(4 \times 10 = 40)$ . Appendix 6.5 provides some information with regard to Freedom House numerical ranking and their meanings.

### **6.2.3. H.1.2. Criticisms of Freedom House Data & Related Notes**

The first criticism of Freedom House and its data is related to lack of provision of the listing of the sources and detailed explanation of the coding process and rules in sufficient detail. However, Freedom house in its recent revisions (post 2006 datasets) has provided detailed information on the methodological considerations taken into account in construction of the indices, the coding process, and sub component variable scores that are used for construction of indices (which are publicly available). The recent versions also provide information on particular circumstances <sup>116</sup>(i.e. revolutions).

A second criticism of the data provided by Freedom House data is provided by Armstrong II, D. A. (2011) who investigates the measurement properties of Freedom House data scales using Bayesian measurement models (factor analysis and latent class analysis). While he finds the sub-indicators reliable indicators of the level of civil liberty and political rights, he argues that there is significant “variation hiding in the seven point political rights and civil liberties classification”. He continues by adding that the seven point scaling system used by Freedom House does not provide significantly reflective measures of the concepts. For instance author discusses that some of the countries that are

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<sup>115</sup> For instance Association and Organizational Rights has 3 questions, thus the overall subcategory score ranges from 0 to 12  $(4 \times 3)$ .

<sup>116</sup> Generally provided in the downloaded files

coded in different categories (are considered to enjoy different levels of freedom) are not statistically very different and in contrast some countries that are considered to have the same level of liberty and classified with similar scores, in fact vary considerably in terms of their level of liberties. Therefore, author concludes that such differences can be statistically consequential if the comparisons are made based on Freedom House data over time or across space and questions the validity of the data for usage in the predictive statistical modelling.

In order to expand on the latter, we have to refer back to the scaling process used by FH. The criticism is mainly due to the way FH uses sub-indicators in generating PL and CL scales. It is apparent that this scoring mechanism is carried forward with the intention of provision of a smooth data set, where insignificant changes are reduced. However, this smoothing mechanism leads to omission of the information with regard to differences between various PR and CL category memberships across countries, or over time. For instance the PR ranking of a country with score of 30 is two, similar to the PL ranking of a country with overall score ranking of 34. Note that the latter (second country) is 10% of scale more free than the former (country with the score of 30). On the other hand we observe that if the overall score of the same country is scored 29 (2.5% of scale range different than the one with overall score of 30), its ranking would be three. Therefore the changes in the summed score are not reflected consistently in the reported ranking and hence, are not very precise measures of CL and PR (or in a general terms, political liberty) concepts.

In order to reduce this systematic inconsistency in the provided measures, “Freedom House assigns upward or downward trend arrows to countries which saw general positive or negative trends during the year that were not significant enough to result in a ratings change” (Freedom House; Freedom In the World, 2013, pp.33). This is in line with the idea that the level of civil and political liberties are not prone to drastic shifts in an annual window of time, and that the changes in terms of civil liberties and political rights emerge across time. Therefore the provision of the signs of upward or downward trend arrows is intended to reduce the systematic bias of the scale. However, this systematic bias remains considerable in quantitative analysis where the values are considered (and the upward or downward trend arrows are discarded). Therefore, when using the Freedom House indices on civil and political liberties in a quantitative manner, the researchers should be aware of

the aforementioned systematic biases. A proposed remedy is using the sub-indicators themselves. The authors of this research have requested for the data on sub-indicators. However, the data on sub-indicators is available only for the period of 2006-2013.

### 6.2.3. H.1.3. Variables from Freedom House

As mentioned in the previous section the consideration of subcomponents of civil and political liberties, would provide more detailed and less biased information, however due to limited span of time for which the data on sub-indicators are provided for (2006-2013), we use the data on civil liberties and political rights acknowledging their short comings. The list of variables considered is as follows:

**Table 6—16: Preliminary institutional variables considered from Freedom House**

Variable No.	Variable	Variable Code	Variable Type	Scale	Source
64	Political Rights	FHPR	Categorical/Nominal	1 (Most Free) - 7 (Least Free)	FH
	Electoral Process (Sec A)	FHPRA		0 (Most Free) – 12 (Least Free)	FH
	Political Pluralism and Participation (Sec B)	FHPRB		0 (Most Free) – 16 (Least Free)	FH
	Functioning of Government (Sec C)	FHPRC		0 (Most Free) – 12 (Least Free)	FH
65	Civil Liberties	FHCL	Categorical/Nominal	1 (Most Free) - 7 (Least Free)	FH
	Freedom of Expression and Belief (Sec D)	FHCLD		0 (Most Free) – 16 (Least Free)	FH
	Associational and Organizational Rights (Sec E)	FHCLE		0 (Most Free) – 12 (Least Free)	FH
	Rule of Law (Sec F)	FHCLF		0 (Most Free) – 16 (Least Free)	FH
	Personal Autonomy and Individual Rights (Sec G)	FHCLG		0 (Most Free) – 16 (Least Free)	FH

The unnumbered variables in the table (6-16) correspond to the sub-indicators that are used for construction of Political rights (FHPR) and Civil liberty (FHCL). The consideration of these sub-indicators would be very useful since they do not suffer from smoothing and scale problems mentioned earlier and consequently would provide the opportunity of capturing minor country differences in the sample. However, the data corresponding to sub-indicators are only available from 2006 onward. Since our sample spans over 1990-2009, inclusion of sub-indicators would lead to provision of results over only three years (2006-2009) which would be very short time span and consequently result in a considerable reduction in number of observations (since our sample carry annual data for dependent variables). Therefore we have not considered the sub-indicators as

explanatory variables in our estimations due to two main reasons. First, low number of observations and short time span are generally not desirable in statistical analysis due to questions in regard to generalization and other problems that small samples generally suffer from. Second reason is related to two main considerations in our research; first, our analysis provided in chapter 3 suggested existence of a time effect on the flow and composition of FDI<sup>117</sup>, for which an extensive span of time is needed to empirically investigate the effect of time on FDI activity; second, is related to the elasticity of the level of civil liberty and political rights. A review of the data provided on the indicators and sub-indicators provided by Freedom House, shows that there exists a level of elasticity between the levels of freedom in each year and its subsequent years. This is discussed in detail in the end of chapter 4, where we discuss the choice of static versus a dynamic setting in modelling the effect of civil liberties and political rights on the level and composition of FDI. Considering this elasticity and minor changes in the level of indicators in time, it is possible to argue that consideration of a three year period sample with annual frequency would provide very limited if any information on the changes in the level and composition of FDI in time. Next section provides information on the ICRG institutional variables that are considered in this research.

### **6.2.3. H.2. International Country Risk Guide (ICRG)**

In order to take into account the effect of the institutional quality of host countries on FDI activity, it is essential to take into account valid measures that can proxy for the institutional characteristics of countries. One of the most extensive datasets on institutional quality is Political Risk Services' (PRS) *International Country Risk Guide (ICRG)*. The data set provides ratings on various institutional indicators of 140 countries on a monthly basis, and for an additional 26 countries on an annual basis under a different title (ICRG methodology is available from PRS website)<sup>118</sup>. In order to account for the institutional quality of the host countries we consider the data provided by *ICRG* on variables tabulated in table 6-17.

The first three variables considered are Government Stability, socioeconomic condition and investment profile indices provided by ICRG, with the range that covers these

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<sup>117</sup> In chapter 3, through our meta-analysis we found that there seems to be a time effect in FDI movement and composition. We considered that in line with the idea that there are changes in global market that result in shifts in level and composition of FDI into host countries.

<sup>118</sup> <http://www.prsgroup.com/PDFS/icrgmethodology.pdf>

concepts in a 0-6 number based ranking system (where 0 refers to highest level of risk and the progression to 6 indicates lower risk). The Government stability index measures government's strength, popular support and unity. Socioeconomic condition index measure is a measure based on three main sub components, namely; unemployment, poverty and consumer confidence. This measure reflects the socioeconomic pressures at work that could constrain government action or fuel social dissatisfaction (PRS Group 2011, p.4). Investment profile index provides an assessment of factors affecting the risk to investment (three main subcomponents are considered; contract viability, profits repatriation, payment delays) that are not covered by other political, economic and financial risk components.

The four remaining variables; corruption, law and order, democratic accountability and bureaucratic quality are using a different scale ranging from 0 (highest level of risk) to 6 (lowest level of risk). Corruption index provides an assessment of the level of corruption within political system of a country. ICRG's corruption index considers financial corruption (in the form of demands for special payments and bribes connected with import and export licenses, exchange controls, tax assessments, police protection, or loans), as well as other types of actual and/or potential "corruption in the form of excessive patronage, nepotism, job reservations, secret party funding, and suspiciously close ties between politics and business" (ICRG, Political Risk ranking methodology, 2011, pp. 5). "Law and Order" index, is a single component measure constructed using two subcomponents 'Law' and 'Order' which are each measured separately and scaled from 0 (high quality) to 3 (low quality). The 'law' element reflects the level of strength and impartiality of the legal system and 'Order' element assesses the popular observance of the law.

The Democratic accountability index measures the level of responsiveness of a government to its people. This index is constructed by identification of five main types of governance (i.e. democracy, dominated democracy, de facto one-party state, the jury one-party state, autarchy) and subsequently assigning the higher scores (scores close to 6 which reflect higher quality of democratic accountability and lowest level of risk) to dominated democracy and the alternating democracies, and lower scores (rankings close to zero) to countries that are considered to have an autocratic governance structure. The last variable used from ICRG, is the Bureaucracy quality index that reflects the strength of the

bureaucratic system of the countries. It is assumed that in the event of an economic shock countries with higher quality of bureaucratic system, will adopt policies that minimise the impact of the shocks without implementing drastic policy changes and government services interruptions. This index thus ranks the quality of bureaucratic system of countries from 0 (high quality and low risk) to 6 (low quality and high risk). Table below tabulates the variables that are used from ICRG data based in order to explore the effect of the institutional factors on FDI.

**Table 6—17: Institutional (Political Risk) variables available from ICRG; Source ICRG (2011)**

Variable No.	Variable	Variable Code	Variable Type	Scale	Source
66	Government Stability	gov_stab	Categorical/Nominal	0 (High Risk; Low Quality) 12 (Low Risk; High Quality)	ICRG
67	Socioeconomic Condition	socioecon_cond	Categorical/Nominal	0 (High Risk; Low Quality) 12 (Low Risk; High Quality)	ICRG
68	Investment Profile	invest_prof	Categorical/Nominal	0 (High Risk; Low Quality) 12 (Low Risk /High Quality)	ICRG
69	Internal Conflict	inter_conf	Categorical/Nominal	0 (High Risk; Low Quality) 12 (Low Risk; High Quality)	ICRG
70	External Conflict	exter_conf	Categorical/Nominal	0 (High Risk; Low Quality) 12 (Low Risk; High Quality)	ICRG
71	Corruption	corrup	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk; High Quality)	ICRG
72	Military in Politics	milit_in_polit	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG
73	Religion in politics	rel_in_polit	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG
74	Ethnic Tensions	ethnic_tens	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG
75	Law and Order	law_order	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG

76	Democratic Accountability	democ_account	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG
77	Bureaucratic Quality	bureauc_qual	Categorical/Nominal	0 (High Risk; Low Quality) 6 (Low Risk High Quality)	ICRG

#### 6.2.4. Variable selection

In order to choose appropriate explanatory variables from the set of independent variables provided in appendix 6.3, we consider the correlation of the variables in relating to each concept, to avoid inclusion of multiple variables that relate to the same concept and thus problems of multicollinearity. Furthermore, exploration of the available independent variables helps in choosing a limited number of covariates to explain the variations in the dependent variable and thus enables us to avoid high degrees of freedom and over specification. The tables of correlations are provided in appendix 6.6. Consequently the final set of independent variables is chosen for empirical investigation based on their level of representativeness of their related concepts. The decision criteria on choosing the independent variables are based on three main factors: first, one or two independent variables are chosen from each factor considered based on the degree to which they represent other variables from the same class. In particular the variables correlations with one another are considered to find the regressors that represent most information with regard to the concept that they proxy for. Second, the chosen variables must entail the most number of observations in order to provide a better level of confidence in our statistical analysis. Therefore in case where two or more variables show high correlations with other variables that proxy for the same concept the variable with highest number of observations is chosen as explanatory variable for FDI activity. We continue the discussion on the selection of appropriate independent variables, to the next chapter.

The next section provides some information on the sample characteristics and properties. These include the organization of data, range, type, frequency, and the number of observations available for the analysis.

### 6.3. Preliminary Analysis of Data

As mentioned earlier, the choice of specific independent variable section will be left to the next chapter, where empirical models are constructed based on the theoretical

foundations laid, in order to explore the set of hypotheses that have been developed through our Meta analysis, as well as theoretical investigation. The remainder of this chapter explores the characteristics of the data by exploring the distribution of data on dependent variables, and provides some elementary empirical analyses using Anova type tests.

In this section we specifically explore: the distribution of the dependent variable in order to determine our choice of statistical analysis; and also test the empirical validity of a number of findings, reported in chapter 3, in our Meta analysis section. As mentioned in chapter 3, our Meta analysis used the data extracted from literature that investigated the effect of civil liberties, political rights, institutions and democracy on FDI activity. The data mainly embodied study characteristics such as: data type; the span of data used; the effects reported (studies' regression coefficients were used in the random effect sections); and a number of other factors that proxy for characteristics of the studies.

### **6.3.1. Normality of distribution of the dependent Variables**

Since most of the parametric methods in statistics consider a certain degree of normality in the data, it is important to test the FDI data (dependent variable) in order to make sure our statistical exercise is valid. In other words we examine the distribution of the dependent variables in order to determine their properties and decide on the estimation methods accordingly.

The datasets are consisting of net FDI flows from 8 countries into 140 countries for the period of 1990-2009. Since the observations are available annually for all the countries, we have a panel data set (longitudinal data set) for the data span 1990-2009. "Panel data set consists of a time series for each cross-sectional member in the data set" [Wooldridge (2006)]. Since panel data sets have the characteristic of time series to report the changes in time of unit under observation, and also have the characteristic of cross sectional data to observe the data from a number of units at a moment in time, they are more prone to non-normality. There are a number of ways to examine the normality of the dependent variables. This section assesses the normality of the indices based on the graphical representation of the probability distribution of the observations (i.e. histograms) as well as standard tests (i.e. Shapiro-Wilk). The testing on non-normality is conducted using both graphical inferences of the histograms of the FDI data, as well as application of Shapiro-



Wilk test of normality. The process is explained in detail in appendix 6.7. The overall judgement is that FDI data is considerably non-linear. Therefore we use logarithmic transformation of the data in order to reduce the non-linearity. However, the testing of the log linear panel data on FDI still indicates a high level of non-linearity. Therefore we consider using non-parametric statistical tools that provide robust statistical results even when non-linear data is used.

#### **6.4. Nonparametric statistics**

In this section we introduce the empirical analysis method used to examine the effect of time, host country characteristic (level of income), civil and political liberties, and institutional factors on FDI. The motivation of this undertaking lies within a number of findings of the Meta analysis of chapter 3, that indicated that time and host country characteristics affect the findings of the empirical research exploring the effect of civil liberties, political rights and institutional factors on FDI. Furthermore, in line with our research question that explores the effect of civil liberties and political rights on FDI, we conduct the analysis of the significance of existence of different levels of liberties in host countries on FDI. Similarly we consider the effect of various institutional characteristics of the host countries on FDI in order to determine whether the proposed source of institutional data reflects the effect of institutional differences on FDI activity.

With this introduction in mind we proceed to introduction of non-parametric Anova type test that is used for the preliminary analysis of data. The reasoning behind the choice of non-parametric method for analysing the data is that parametric statistics and hypothesis testing in general assumes more restrictive set of assumptions than its nonparametric counterpart. In particular parametric statistics relies mainly on the distribution of the variables in its inference and thus, it is imperative for the researcher to test whether these assumptions are met prior to employing parametric statistical methods and tests. The nonparametric statistics and hypothesis testing in comparison entails less restrictive set of assumptions. In particular, when using nonparametric methods (or distribution free methods) inference is made based on a test statistic whose sampling distribution does not depend on the specific distribution from which the sample is drawn. For instance parametric variance test, ANOVA, assumes that mutually independent random samples are drawn from normal distributions, if and only if, the assumptions are met then a meaningful statistical inference of the null hypothesis of equal variances versus the alternative

hypothesis is meaningful. The nonparametric test of variance, Kruskal Wallis, does not assume the normality of the data and mainly assumes that the samples come from identical continuous distributions. The next section provides a brief explanation of the Kruskal Wallis test. The assumptions, process, and inference of the Kruskal-Wallis test is provided in detail in appendix 6.8.

### **6.5. Preliminary Empirical examination using K-Wallis Test – Eurostat**

In this section we empirically investigate the empirical validity of the Meta analysis findings using our data set. In order to do so, we recall some of the findings reported in chapter 3, subsection 3.5. First, the Meta analysis revealed that the use of data from various decades leads to provision of different sets of results in terms of influences of institutional factors, democracy, civil liberties and political rights on FDI as well as the incentives of MNEs in their decision towards the types of investments undertaken. The latter, as well documented by Busse (2004), is the product of the changes both in markets as well as firms' motives (incentives) which in a way shapes the way firms coordinate their activities. In this section we explore whether there are any significant effects of time frame on FDI flows. In particular we explore the effect of the window of time on FDI by considering two windows of: annual, five-year and ten-year intervals. This investigation would allow us to explore whether there are significant changes in the way firms conduct their FDI activity in each time frame (i.e. FDI in 1990s in comparison to 2000s).

Second, in chapter 3 we showed that the choice of host country has a significant effect on the relationship between FDI and institutional factors, democracy, civil liberties and political rights. In this section we examine whether the choice of host country influences FDI activity. In particular we distinguish between host countries based on their level of income, using World Banks' data, and explore whether the pattern of FDI investment varies significantly across groups of countries with different levels of income.

Third, in order to explore whether there are statistically significant differences in the flow of FDI over countries with different level of institutional characteristics, we use ICRG index on with various institutional measures, and explore whether there are significant differences in FDI flows over categorical variables adopting tests of variance (i.e. ANOVA and Kruskal-Wallis rank test). Finally, with the purpose of exploring whether there are

significant differences in the flow over FDI over various sectors, we conduct Kruskal-Wallis test using sectoral FDI data.

The examination of the effect of: time frame; choice of host countries; consideration of aggregated measure of democracy in contrast to its disaggregated measures; institutional factors; and sectoral characteristics, would enable us to make credible decisions with regard to our empirical investigation, and in turn reduce the possible biases that could be introduced otherwise. The following subsection provide the results and discussions on these preliminary analyses conducted using Kruskal-Wallis test.

### 6.5.1. Effect of Time on the net FDI flows

In chapter 3, we found that the literature on FDI supports the hypothesis of existence of a type of time effect on FDI flows. If such time effects exist, it is necessary to choose a sample that would be extensive enough to include several time frames, in order to investigate the effect of civil and political liberties on FDI. The reasoning is that if the sample used for empirical analysis is long enough, the results would not be biased by time specific effect, and therefore the results would be generalizable, leaving the findings unconditional to changes with respect to time. In order to explore the effect of time on FDI activity further we have conducted the K-Wallis test on the annual FDI flows data. Results are shown in the table 16-18, below.

**Table 6—18: The results of K-Wallis test for time effects**

	Country								
	US (BEA)	US	UK	France	Japan	Germany	Netherlands	Finland	Norway
Years	Mean FDI	Mean FDI	Mean FDI		Mean FDI	Mean FDI	Mean FDI		
1990	129.2596					346.9664			
1991	89.67442					294.3714			
1992	186.8212	622.4755	346.9643			250.8907	352.9167	-33.6719	
1993	132.8187	1038.867	518.1975			191.2411	204.3182	25.73644	
1994	333.8635	1286.731	525.9259			288.2764	178.2629	108.4	99.375
1995	287.557	1472.875	258.7186			514.731	132.5815	54.91936	98.30357
1996	247.0492	1265.648	178.4073		919.8148	658.8624	227.4239	83.19444	278.6875
1997	394.8812	1540.967	391.0724	620.587	912.0165	584.2553	210.6724	146.2113	334.2593
1998	338.7533	2072.202	641.3306	624.8218	667.7778	1378.523	294.3039	595.6121	54.92063
1999	281.4381	3175.556	1284.506	1710.077	714.5268	837.9506	732.101	157.3684	293.7037
2000	263.7714	1063.2	1660.981	2714.028	1002.694	369.8872	997.9256	509.2798	432.6263
2001	342.5997	941.8982	269.62	1504.751	1273.838	509.6609	671.6281	252.0875	44.09091

2002	876.3291	992.1162	232.7773	383.7081	962.6959	66.63095	242.0661	15.7197	525.6818
2003	916.3487	1030.179	214.1797	341.1053	879.1482	17.1269	497.7472	-9.09596	154.2857
2004	295.3703	1607.946	192.3523	127.3788	917.1121	11.34034	83.86224	-0.86107	83.28125
2005	614.8772	205.8581	367.1277	291.1209	1336.75	144.9289	482.7147	10.21116	290.2344
2006	1078.662	1639.37	213.7421	326.9861	1501.5	331.6632	1130.625	18.57651	242.5352
2007	585.7771	3359.936	928.643	493.9145	731.9271	497.2529	167.9732	13.57379	106.583
2008	636.1576	2246.036	533.4611	443.3636	1454.762	180.9847	164.7588	43.32707	432.8791
2009	591.6366	2096.348	187.4164	277.9127	435.2478	167.3603	56.75545	8.158574	247.1837
Total	440.05382	1520.696	444.8243	388.8163	895.524	258.6489	247.5662	33.1208	239.7094
chi-squared =	178.330 with 19 d.f.	86.159 with 17 d.f.	84.337 with 17 d.f.	201.466 with 12 d.f.	86.397 with 13 d.f.	286.560 with 19 d.f.	307.321 with 17 d.f.	293.275 with 17 d.f.	36.150 with 15 d.f.
probability =	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0017
chi-squared with ties =	178.513 with 19 d.f.	86.188 with 17 d.f.	87.248 with 17 d.f.	205.541 with 12 d.f.	86.416 with 13 d.f.	293.826 with 19 d.f.	317.584 with 17 d.f.	408.637 with 17 d.f.	38.908 with 15 d.f.
probability =	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0001	0.0007

In determining whether there is a time effect we consider the null hypothesis provided in the previous section. The results of K-Wallis test then is determined by the value of chi squared given the degrees of freedom. The alternative is to look at the  $p$ -value provided and if the value is less than  $p < 0.05$  (for 95% level of confidence), the null is rejected and hence a significant time effect in this case is observed. Note that there are two sets  $p$ -values and chi squared values are reported. This is due to the fact that in cases where there are ties (repeated values in the rank orders), the stated  $p$ -value and chi squared value reported for the last two rows (chi\_square with ties and probability) are the adjusted estimations of K-Wallis test estimated by STATA in order to provide a robust estimation. Therefore in cases where the last two rows'  $p$ -value and chi squared value reported are different than the ordinary values reported we consider the values that are adjusted for ties. The review of the results show that in all cases the time effect has a significant influence on overall FDI flows. Therefore, we reconsider the span of FDI data that is used for empirical analysis and argue that since our sample spans for 20 years, the time effects would have negligible influence on empirical inference of the results (the factors that have a significant effect on FDI, over a the sample that embodies a lengthy time frame, ensures us that the effects reported are not conditional to time, *ceteris paribus*).

**Table 6—19: Results of K-Wallis test for a time effect with five year window**

	Country							
	US (BEA)	UK	France	Japan	Germany	Netherlands	Finland	Norway

years								
1=1990-95	175.2638	470.1517			274.3902	208.6726	54.39445	99.375
2=1995-2000	309.44925	517.802	1007.263	803.534	801.8392	281.296	201.4525	189.754
3=2000-05	537.48519	329.4774	378.3319	1002.502	83.8525	309.9964	26.94705	254.9517
4=2005-09	703.98332	506.7839	364.6329	883.9725	250.8962	217.6066	18.61783	257.0652
Total	440.05382	444.8243	388.8163	895.524	258.6489	247.5662	33.1208	239.7094
chi-squared =	9.217 with 3 d.f.	66.950 with 3 d.f.	82.250 with 2 d.f.	11.190 with 2 d.f.	179.252 with 3 d.f.	171.864 with 3 d.f.	180.458 with 3 d.f.	21.932 with 3 d.f.
probability =	0.0265	0.0001	0.0001	0.0037	0.0001	0.0001	0.0001	0.0001
chi-squared with ties =	9.226 with 3 d.f.	69.261 with 3 d.f.	83.914 with 2 d.f.	11.192 with 2 d.f.	183.798 with 3 d.f.	177.604 with 3 d.f.	251.442 with 3 d.f.	23.605 with 3 d.f.
probability =	0.0264	0.0001	0.0001	0.0037	0.0001	0.0001	0.0001	0.0001

In the Meta analysis of chapter 3, we also considered the effect of time frame using a five year period, on FDI flows. Considering five year time windows, the five year dummy variable shows that the time effect still exists in a five-year window. Similarly reviewing the results of the effect of time on FDI activity considering ten year time windows indicate the presence of time effect for most countries with exception of United States and Japan.

**Table 6—20: Results of K-Wallis test for a time effect with ten year window**

	Country							
	US (BEA)	UK	France	Japan	Germany	Netherlands	Finland	Norway
years								
1990s		513.219	1007.263	803.534	540.1279	266.9354	154.6187	168.1957
2000s		420.2792	368.2307	912.1654	180.7677	242.1415	22.02414	256.879
Total	440.05382	444.8243	388.8163	895.524	258.6489	247.5662	33.1208	239.7094
chi-squared =	0.983 with 1 d.f.	13.096 with 1 d.f.	82.108 with 1 d.f.	3.631 with 1 d.f.	151.280 with 1 d.f.	152.230 with 1 d.f.	176.639 with 1 d.f.	18.652 with 1 d.f.
probability =	0.3215	0.0003	0.0001	0.0567	0.0001	0.0001	0.0001	0.0001
chi-squared with ties =	0.984 with 1 d.f.	13.548 with 1 d.f.	83.769 with 1 d.f.	3.632 with 1 d.f.	155.115 with 1 d.f.	157.314 with 1 d.f.	246.122 with 1 d.f.	20.075 with 1 d.f.
probability =	0.3213	0.0002	0.0001	0.0567	0.0001	0.0001	0.0001	0.0001

Therefore, the overall review of the results of the examination of the effect of time on FDI activity indicates that time has an effect on FDI activity in all cases where annual, five-year or ten-year time windows are considered. Considering the latter our sample that spans for 20 years will be long enough to withstand the biases that would be introduced

through the effect of time, and thereby would allow us to generalise our empirical findings as they would not be influenced by time specific drivers of FDI.

### 6.5.2. The effect of Host countries' level of Income on net FDI flows

In chapter 3 we showed that the choice of host country has a significant effect on the relationship between FDI and institutional factors, democracy, civil liberties and political rights. In this section we examine whether the choice of host country influences FDI activity. In particular we distinguish between host countries based on their level of income, using World Banks' data, and explore whether the pattern of FDI investment varies significantly across groups of countries with different levels of income. The dummy variable constructed to proxy for groups of countries with various levels of income is employed in the K-Wallis test using the net FDI flows of the eight home countries investing in 140 host countries to provide some information with regard to whether there is a significant effect of the level of income on net FDI flows. The results provided in table 6.-21 indicate that for most countries the level of income has a significant effect on the level of FDI with the exception of UK and Netherlands. Furthermore we find that upper income OECD countries attract the highest level of FDI in contrast to low income countries that attract the lowest level of FDI. The Upper Middle income countries attract the medium level of FDI in most cases with the exceptions of France, Japan and Finland investing more heavily in upper middle income countries in comparison to upper income non-OECD countries. Finally, the difference between the level of net FDI flows attracted by upper income OCED countries and upper income non-OECD countries is quite pronounced.

Table 6—21: The effect of level of Income (based on World Bank classification) on FDI flows

Host Countries based on level of Income	Country								
	US (BEA)	US	UK	France	Japan	Germany	Netherlands	Finland	Norway
Low income		2.04610	27.41751	6.888686	4.82142	0.68543		-0.11255	-4.91410
Lower Middle Income	69.01509	167.32720	62.52354	71.49488	427.25110	33.31074	35.37055	3.38183	-11.15080
Upper Middle Income	138.52846	720.71290	145.96780	99.48329	661.04880	94.23711	79.58113	7.92275	63.87942
Upper Income (Non OECD)	225.19630	1126.52000	181.29310	81.07522	422.07730	99.98877	150.74400	3.59440	501.61400

Upper Income (OECD)	772.17762	3753.20600	645.0009	726.42950	1378.29300	492.74680	340.54760	61.96473	469.53110
chi-squared =	49.854 with 3 d.f.	281.836 with 4 d.f.	8.775 with 4 d.f.	60.009 with 4 d.f.	21.904 with 4 d.f.	81.391 with 4 d.f.	4.502 with 3 d.f.	60.009 with 4 d.f.	41.085 with 4 d.f.
probability =	0.0001	0.0001	0.067	0.0001	0.0002	0.0001	0.2121	0.0001	0.0001
chi-squared with ties =	49.907 with 3 d.f.	281.935 with 4 d.f.	9.078 with 4 d.f.	61.171 with 4 d.f.	21.909 with 4 d.f.	83.448 with 4 d.f.	4.650 with 3 d.f.	61.171 with 4 d.f.	44.169 with 4 d.f.
probability =	0.0001	0.0001	0.0592	0.0001	0.0002	0.0001	0.1993	0.0001	0.0001

### 6.5.3. Civil and Political Liberties, Democracy, and Institutional Factors

In this section the effect of: the existing level of civil and political liberties as measured by Freedom House; and the institutional quality as measured by ICRG on FDI flows are examined. The statistics are provided based on K-Wallis test ran across the set of home countries, and the null hypothesis (the null hypothesis is that medians are equal) is examined.

#### 6.5.3. A. The effect of the level of Political Rights and Civil liberties (Freedom House index) on FDI

In order to explore whether existence of various levels of political rights affects FDI activity in a significant manner, the data on political rights from Freedom House is examined using Kruskal-Wallis test. The effect of the political liberties on net FDI flows is significant, as indicated by the table 6-22. Appendix 6.5 provides a brief review of the rankings' of Freedom house and their meaning. In essence all the host countries are ranked in a 1-7 scale where the lower the number (closer to one) indicates higher level of liberties and in contrast a higher rank (closer to 7) indicates very low level of (or the absence of) political freedom. In table 6-22, three main groups of countries are interesting to look at. First, is the group of countries that enjoy the highest level of political rights (indicated by 1). These countries attract the most level of FDI activity as is observable by the mean FDI values reported. The second group of countries are those who enjoy a middle range level of political freedom (indicated by 3 and 4). Considering this set of countries we find that LMEs tend to invest in more repressed countries (countries with ranking of 4). However this pattern does not extend across the sample since we find that LMEs invest more heavily in countries with a ranking of 4 than 5. In contrast, CMEs in general tend to invest in countries with higher level of political rights. Third group of countries are those who enjoy a very low level of political rights (indicated by rank 7). These countries attract a higher

than expected (higher than countries with ranking of 4 or 5) in case of LMEs. In other LMEs once again show the tendency to invest more heavily in more repressed nations. CMEs (with the exception of Germany, Japan and Finland) seem to invest more heavily in more politically free countries however the patterns are not linear. The further examination of the panel data using regression analysis is provided in chapter seven with the intention to investigate the effect of political rights on FDI.

**Table 6—22: The effect of Political Rights (Freedom House index) on FDI flows**

Level of Host Countries' Political Rights (FH)	Country								
	US (BEA)	US	UK	France	Japan	Germany	Netherlands	Finland	Norway
1	694.55443	3268.111	598.4153	606.5559	1265.364	424.4189	320.5568	51.19762	431.787
2	199.68493	812.2922	107.6909	87.92126	569.5488	62.84652	12.69603	3.768374	7.409251
3	77.22471	509.4263	59.91743	102.4858	387.9039	87.59684	225.5729	5.397531	111.1193
4	175.84033	426.1281	75.17266	38.86785	293.3308	33.03779	104.254	2.814569	150.6494
5	53.81519	107.2668	76.43016	66.2385	198.6027	3.621948	29.20735	0.880433	-8.09524
6	57.380744	227.0024	177.7773	170.8316	143.8061	110.7665	114.7524	14.07039	116.0833
7	260.52632	545.7169	195.3262	134.0357	1770.858	140.1073	112.286	31.96276	2.702703
chi-squared =	48.175 with 6 d.f.	180.075 with 6 d.f.	16.832 with 6 d.f.	50.981 with 6 d.f.	55.977 with 6 d.f.	26.800 with 6 d.f.	10.302 with 6 d.f.	13.175 with 6 d.f.	28.279 with 6 d.f.
probability =	0.0001	0.0001	0.0099	0.0001	0.0001	0.0002	0.1125	0.0403	0.0001
chi-squared with ties =	48.226 with 6 d.f.	180.139 with 6 d.f.	17.426 with 6 d.f.	52.030 with 6 d.f.	55.991 with 6 d.f.	27.470 with 6 d.f.	10.643 with 6 d.f.	18.340 with 6 d.f.	30.474 with 6 d.f.
probability =	0.0001	0.0001	0.0078	0.0001	0.0001	0.0001	0.1001	0.0054	0.0001

In order to explore whether existence of various levels of civil liberties affect FDI activity in a significant manner, the data on civil liberties from Freedom House is examined using Kruskal-Wallis test. The effect of the civil liberties on net FDI flows is as indicated by the table 6-23, significant. Appendix 6.5 provides a brief review of the rankings' of Freedom house and their meaning.

**Table 6—23: The effect of Civil Liberties (Freedom House index) on FDI flows**

Level of Host Countries' Civil Liberties (FH)	Country								
	US (BEA)	US	UK	France	Japan	Germany	Netherlands	Finland	Norway
1	902.4825	3958.451	693.9429	620.6591	1428.639	437.3681	358.5025	54.46584	517.7324
2	307.53793	1599.454	284.2523	322.5229	524.6977	245.4815	139.7795	23.96733	54.43678



3	121.83444	604.2106	70.59816	57.61652	545.7315	51.90529	83.05007	6.156188	174.4439
4	116.79665	415.4223	79.63234	56.58716	388.6936	36.12198	99.47847	0.137742	-9.7449
5	122.63369	328.8046	160.7454	197.7966	179.4991	107.4508	142.4757	14.27991	101.9976
6	324.24464	473.0619	153.9276	134.7327	1873.013	156.1434	106.4683	36.32603	3.842364
7	78.358744	111.8665	55.29752	23.20006	449.0653	39.94291	64.26587	1.252395	3.214286
chi-squared =	45.702 with 6 d.f.	149.642 with 6 d.f.	5.004 with 6 d.f.	52.420 with 6 d.f.	27.982 with 6 d.f.	19.921 with 6 d.f.	16.369 with 6 d.f.	15.981 with 6 d.f.	24.661 with 6 d.f.
probability =	0.0001	0.0001	0.5433	0.0001	0.0001	0.0029	0.0119	0.0139	0.0004
chi-squared with ties =	45.750 with 6 d.f.	149.694 with 6 d.f.	5.180 with 6 d.f.	53.498 with 6 d.f.	27.988 with 6 d.f.	20.419 with 6 d.f.	16.911 with 6 d.f.	22.246 with 6 d.f.	26.575 with 6 d.f.
probability =	0.0001	0.0001	0.5209	0.0001	0.0001	0.0023	0.0096	0.0011	0.0002

Considering the effect of civil liberties on FDI flows we find a significant effect that in an overall manner indicates that countries with higher level of civil liberties tend to attract more FDI. However, similar to the previous paragraph we find a nonlinear pattern in the FDI investment across countries with different levels of freedom (i.e. the countries that are ranked 6 seem to attract more FDI than those with a ranking of 5 for a number of countries). In order to explore the later in length we will explore the observed pattern and nonlinearity by conducting regression analyses in chapter 7. The next subsection examines whether the existence of various levels of democracy in the host countries significantly affects FDI. The results will be discussed in the light of the results provided for civil and political liberties.

### 6.5.3. B. The effect of ICRG indicators on net FDI flows

In this section we consider the effect of institutional factors using ICRG indicators on net FDI flows from 8 home countries into the 140 host countries, in order to examine whether there is a significant effect of institutional quality variables of the ICRG variables on the net FDI flows. These considerations as well as other preliminary tests conducted in section 6.5 are provided in order to help in choosing the appropriate regressors in our regression analysis, and familiarising one with the data set and its properties. The results of K-Wallis tests are available from Appendix 6.9. The results of K-Wallis tests indicate that in general all ICRG indicators have a significant effect on net FDI flows in case of most countries<sup>119</sup> with the exception of Norway (for which all indicators are insignificant with the exception of socioeconomic condition indicator).

<sup>119</sup> The exceptions include insignificant effects reported for: Democratic accountability in case of Germany; Ethnic tensions and law and order in case of Japan; and Government Stability in case of US (Eurostat).

### **6.5.3. C. Effect of sectoral composition of FDI on the net FDI flows**

Apart from the time and country specific effects, we would like to examine whether there is a sectoral effect on the net FDI flows of the home countries. Appendix 6.10 provides the results of the K-Wallis tests. The results of K-Wallis test of the effect of economic activity on FDI indicate that there is a significant effect of sectoral environment of the countries' on FDI in all cases with the exception of Norway. In other words we find that the sectoral composition has a significant effect on the net FDI flows and that level of FDI differs from a sector to the other in case of each of the home countries with the exception of Norway. In order to explore the latter further, in chapter 7 through regression analysis we explore the propensity of different types of economies, and in a more disaggregated manner the home countries, to invest in certain sectors via FDI.

The sectoral consideration affords one the opportunity to model the investment pattern of the home countries based on a priori knowledge of sectors in which they invest in and thus provides one with more detailed information of the variables that would affect the incentive of firms in the certain types of industries based on their characteristics. For instance Germany has the highest level of net FDI flows in real estate and renting and business activity, financial intermediation, and manufacturing. Firms in each of these sectors have a certain types of motives in investing abroad. The manufacturing firms' incentives based on the IB literature would be more related to efficiency seeking, resources seeking, or strategic asset seeking incentives which could be stimulated by the proximity to cheap labour, easier access to resources, or the proximity to target markets. Thus when considering a certain sector it is possible to construct a model that theoretically embodies these factors and examine whether such models fit the data better than the popular country level models generally used in the literature. Furthermore, in a more aggregate level it is possible to categorise sectors in three main classes of agriculture, manufacturing, and other business activities (which includes financial intermediation), in order to explore the possibility of constructing models for each of these sub-sectoral compositions. The latter similar to the sectoral consideration allows one to produce more theoretically specific models that could provide better empirical results and therefore produce better fit.

## 6.6. Concluding Remarks

In this chapter a number of measures that could be used as proxies for the concepts discussed in chapter 4 (theoretical model) and 3 (Meta analysis), were considered. Appropriate variables related to these measures were considered, discussed and organized. As for dependent variables they were discussed in length and the final set of variables were chosen and presented. The independent variables similarly were explored and a number of explanatory variables were chosen and were discussed. Further discussions on explanatory variables are provided in the next chapter, before the empirical analysis of FDI activity.

Later on we discussed the characteristics of the data on dependent variables. This has been mainly driven by the statistical properties of the empirical instruments that can be used for the analysis. We found that the data on dependent variables were not distributed normally. Thus we discussed and chose the appropriate non-parametric Anova-type test called Kruskal Wallis test in order to provide a number of preliminary estimations. These estimations entailed using the K-Wallis test on dependent variables and a number of moderating factors that were considered<sup>120</sup> to have an influence on the dependent variables.

The main motivation from the empirical analysis of the effect of time, country's level of income, civil and political liberties and institutions on FDI, are based on the findings of the Meta analysis of chapter 3. Therefore in order to avoid introduction of biases (i.e. time effect) into our empirical analysis of our panel data in chapter 7, we explored the effect of these factors on FDI to examine the presence of significant effects. The latter in turn informs our choices in terms of span of data, time, host countries and other factors that might affect our empirical results. This helps us to avoid the influence of the biases on the statistical inference, and results, and allows our empirical results to be generalizable through out time.

The preliminary empirical analyses conducted in this chapter indicated that in most cases time, host countries' level of income, level of civil liberties and political rights (based on Freedom House), and quality of institutions (based on ICRG) have significant effect on net FDI activity of the home countries considered. The investigation of the effect of macroeconomic variables on FDI is omitted from the discussion due to two main reasons: first, the macroeconomic variables are not provided in a categorical manner that

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<sup>120</sup> Please refer to chapter 3 and 4 for more explanation on some of these factors (i.e. time).

would allow the use of Kruskal Wallis test; second, the macroeconomic variables are commonly used in the literature as variables that reflect host countries characteristics, and therefore building on the literature we leave the analysis of these explanatory variables to the next chapter in order to be able to explore them in a panel setting that would allow a greater understanding of their effect on FDI flows. In the next chapter we discuss the regression analysis method adopted and the empirical results related to a number of empirical models considered, the theoretical considerations involved and the findings.

## **Chapter 7 : Empirical Investigation**

### **7.1. Introduction**

The purpose of regression analysis is to explore the relationship between dependent variable and the explanatory variables. In reality the dependent variable cannot be fully predicted by explanatory variables, instead the response for a fixed value of each explanatory variable is a random variable that summarizes the behaviour of the dependent variable for the fixed values of the explanatory variables using a measure of central tendency. The measures of central tendency typically vary from those that consider the measure of central tendency to the mean or average value of the population; those that consider the measure of central tendency to the median or the middle value of the sample; and a third group that consider the measure of central tendency to mode or the most frequent or likely value in the sample. Traditional regression analysis generally considers the measure of central tendency to the mean of the sample and summarizes the relationship between the dependent variable and the explanatory variables by describing the mean of the response for each fixed value of the predictors using a function that is generally referred to as the conditional mean of the response. (Hao and Naiman 2007)

The underlying processes of many regression models including; linear, non-linear and multiple regression models is based on modelling and fitting the conditional-mean function is used models. Furthermore, the use of conditional mean models has contributed to the provision of least squares and maximum likelihood estimators. In ideal conditions the conditional mean models have a number of attractive properties that have made them popular in the past. These include the capability of these models in providing complete and “parsimonious description between the covariates and response distribution”, their straight

forward calculations and interpretation. The consideration of mean as the measure of central tendency however introduces some inherent limitations for the conditional mean models and regressions. The first limitation of conditional mean models is that since mean is considered as the measure of central tendency, the non-central locations cannot be readily explored by these models. These non-central locations are often, in the context of social sciences, the very points where the interest of the research resides, and since the central-mean models poorly accommodate the possibility of exploring the more non-central locations, they are not the best instruments to explore the research question in depth. The second limitation of the conditional-mean models is related to their assumptions. The assumptions of normality and homoscedasticity are often violated in the real world context. Considering the former, the existence of Skewness and Kurtosis in the empirical data is all too prevalent to be ignored. In many cases, social scientists apply a number of data manipulation techniques (smoothing, filtering, erasing the outliers, etc.) to normalise the data. These techniques in some cases lead to provision of normalised data which in essence has lost a considerable amount of information which are in reality related to the research question at hand, which in turn provides researcher with data that is less informative, and in some cases non-informative with regard to the research question. Similarly considering the homoscedasticity assumption, in many cases the assumption is violated in which case the adoption of conditional mean models with mean as their measure of central tendency leads to failure in “capturing informative trends in response distribution”. The third limitation is related to way the consideration of mean as measure of central tendency (using central mean models) shifts the attention away from the observation of the properties of the whole distribution. The consideration of conditional mean models does not allow the researcher to go beyond the location and scale effects of the explanatory variables on the dependent (response) variable and thereby limits the ability of researcher in exploring the way changes in explanatory variables affect the dependent variable’s shape of distribution. Therefore the adoption of central mean models limits the exploration of the researcher by focusing the attention on the central location and consequently the other properties of distribution and the effect of the covariates on the distribution of the response variable remain unexplored to a great extent.

An alternative to the central mean regression models is the central median regression model. The median regression models has all the abilities of the conditional mean regression models, with the added benefit of using median instead of the mean which

enables the median regression models to be capable of performing well in cases where the data is highly skewed, in contrast to the conditional mean regression models. This is mainly the product of the choice of the measure of central tendency. In essence the median is the quantile that refers to the central location of distribution. Hao and Naiman (2007) refer to the “ $p$ th quantile as the value of the response below which the proportion of the population is  $p$ ”. Following this consideration, it is possible to view the median regression model as a “special case of quantile regression model where the conditional .5<sup>th</sup> quantile<sup>121</sup> is modelled as a function” of explanatory variables.

The Quantile Regression Model (QRM), first introduced by Koenker and Basset (1978), considers the changes in the conditional quantile of the dependent variable associated with the changes in the explanatory variables, in contrast to the conditional mean regression model that considers the change in the mean of the dependent variable associated with the changes in the explanatory variables. Therefore in the context of QRM conditional quantiles are functions of explanatory variables.

QRMs have a number of advantages over the traditional conditional mean models. First, they provide the possibility of exploring the full distribution of dependent variable, and the effect of the changes in the covariates on the response variable through the whole distribution by provision of a set of equally sized quantiles that not only characterize the central location of distribution, but also the shape of the conditional distribution. Furthermore, by minimization of a generalized measure of distance using algorithms based on linear programming, QRMs offer easy and good fit. The third advantage is related to the possibility of application of QRMs to data without applying major data manipulation techniques, which is a by-product of the underlying assumptions of QRMs. In order to expand on the latter and inform the reader of the assumptions and processes that entail the quantile regression models, appendices 7.2, 7.3 and 7.4 provides a brief overview of quantiles, quantile functions, and their properties.

## **7.2. Practical Notes on the regression analysis**

In this section we discuss the choice of software used for the empirical analysis, the transformation conducted on dependent and independent variables, and the process of

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<sup>121</sup> Quantile is the generalized term used to generalize the terms such as percentile, decile, quintile, and quartile. (Hao and Naiman, 2007)

choosing regressors. The software used is STATA which is commonly used in economics and IB literature for carrying the empirical analysis. The relevant commands in STATA are “qreg” for quantile regression and “bsqreg” for bootstrap quantile regression. The hypothesis testing follows the standard process as in each case a hypothesis is put forward and empirically tested. The standard measure of goodness of fit in our case is the pseudo R-square produced by the software.

### 7.2.1. Dependent Variables

In this section we review the dependent variables considered for empirical investigation. As discussed in Appendix 5.1, subsections 5.1.C and 5.1.E, due to lack of industry level data on independent variables, we refrain from analysis of industry level analysis, instead the analysis of aggregate sectors is considered. The aggregation of sectors is in line with classification of World Bank in dividing sectors based on the type of products and services production activities carried out in each sector. Based on the classification provided in appendix 5.1.C and 5.1.E, all sectors are combined into three main sectors of manufacturing, services and agriculture. In order to explore the theoretical propositions of chapter 4, the following dependent variables are constructed and used.

**Table 7—1: Dependent Variables Summary**

Sector	Source	Variable	STATA	Obs
Total	BEA	log(US FDI)	IUSFDItot	801
Total	Eurostat	log(UK FDI)	lukfditot	925
Total	Eurostat	log(Germany FDI)	lgermanyfditot	1648
Total	Eurostat	log(Netherlands FDI)	lnetherlandsfditot	704
Total	Eurostat	log(France FDI)	lfrancefditot	938
Total	Eurostat	log(Japan FDI)	ljapanfditot	442
Total	Eurostat	log(Finland FDI)	lfinlandfditot	480
Total	Eurostat	log(Norway FDI)	lnorwayfditot	206
Manufacturing	BEA	log(US manufacturing FDI)	IUSFDImanu	2803
Manufacturing	Eurostat	log(UK manufacturing FDI)	lukfdimanu	586
Manufacturing	Eurostat	log(Germany manufacturing FDI)	lgermanyfdimanu	622
Manufacturing	Eurostat	log(Netherlands manufacturing FDI)	lnetherlandsfdimanu	422
Manufacturing	Eurostat	log(France manufacturing FDI)	lfrancefdimanu	582
Manufacturing	Eurostat	log(Japan manufacturing FDI)	ljapanfdimanu	129
Manufacturing	Eurostat	log(Finland manufacturing FDI)	lfinlandfdimanu	293
Manufacturing	Eurostat	log(Norway manufacturing FDI)	lnorwayfdimanu	3
Services	BEA	log(US services FDI)	IUSFDIserv	2395
Services	Eurostat	log(UK services FDI)	lukfdiserv	1410

Services	Eurostat	log(Germany services FDI)	lgermanyfdiserv	1491
Services	Eurostat	log(Netherlands services FDI)	lnetherlandsfdiserv	1101
Services	Eurostat	log(France services FDI)	lfrancefdiserv	1355
Services	Eurostat	log(Japan services FDI)	ljapanfdiserv	0
Services	Eurostat	log(Finland services FDI)	lfinlandfdiserv	431
Services	Eurostat	log(Norway services FDI)	lnorwayfdiserv	8

Considering the low number of observations provided for sectoral FDI in case of Japan, and Norway, we refrain from sectoral analysis of FDI on these two countries. Furthermore, in view of the minor differences between Eurostat data classification and BEA data classification, and with intention to provide a sectoral analysis we have constructed a more aggregated classification that would rectify the difference between the data bases. Our classification classifies all sectors into four main classes as follows: Total FDI, Manufacturing FDI, Services FDI, and Agriculture. This classification is provided for two main reasons: first, the data for singular sectors is not extended enough to allow meaningful statistical regression analysis; second, the provision of aggregate measures of industries dissolves the minor differences that exist between the two classification systems of NAICS and NACE used in classifying the FDI activity of firms in United States and Europe. The classification scheme is as follows:

**Table 7—2: Sectoral aggregation layout**

Data source: Eurostat Classification: NACE 1.1	Aggregate Sectoral Measure	Data source: BEA Classification: NAICS	Aggregate Sectoral Measure
Total	Total	All Industries	Total
Agriculture and Fishing	Agriculture	Mining & Utilities	Manufacturing
Mining and Quarrying	Manufacturing	Total Manufacturing	Manufacturing
Manufacturing	Manufacturing	Food	Manufacturing
Electricity, Gas and Water	Manufacturing	Primary & Fabricated metals	Manufacturing
Construction	Manufacturing	Chemicals	Manufacturing
Trade and Repairs	Services	Industrial Machinery	Manufacturing
Hotels and Restaurants	Services	Electrical Equipment	Manufacturing
Transports, Storage & Communication	Services	Transportation Equipment	Manufacturing
Financial Intermediation	Services	Other Manufacturing	Manufacturing



Real Estate, Renting & Business Activity	Services	Wholesale	Services
Computer & Related Activities	Services	Depository Institutions	Services
Research & Development	Services	Finance	Services
Other Business Activities	Services	Services	Services
		Other Industries	Services

Using the classification system above we have combined the data from different sectors to build two levels of analyses. First is the analyses of Total (aggregated FDI), and the second is the analyses of sectoral FDI using two main sectors of Manufacturing and Services. The choice of the two main sectoral groups is due to the fact that the low number of observations for agriculture sector did not allow an empirical investigation of this singular sector. Therefore we only provide the results of the sectoral empirical analyses using manufacturing and services sectors in section 7.3.2.

An overview of data shows a shift from the manufacturing industry into services in post 2000s. Furthermore we have omitted Norway and Japan from our sectoral empirical investigation, due to low number of observations provided and the limited time span for which the data is provided. The number of observations for each country in the two considered sectors of manufacturing and services (given our adoption of logarithmic dependent variable which on its own led to reducing the number of observations to half) is tabulated.

**Table 7—3: Mean net FDI flows of 8 home countries into 140 host countries from 1990 to 2009 in two sectors of manufacturing and services**

Home Countries	Manufacturing	Services
	Mean Net FDI Flows 1990-2009 (millions USD)	Mean Net FDI Flows 1990-2009 (Millions USD)
USA (BEA)	4.139964	4.932041
USA (Eurostat)	N/A	N/A
UK	4.76659	3.91193
Germany	3.760392	3.849769
Netherlands	4.402011	3.741129
France	3.314165	3.812426

Japan	4.132935	0
Finland	4.097883	2.368999
Norway	4.213492	3.556921

The exploration of the results provided in section 7.3 and Appendices 7.6-7.12, affords us the opportunity to investigate the effect of motivations of foreign firms, along with consideration of country factors including macroeconomic characteristics, civil liberties, political rights, and institutional quality on FDI activity of MNEs from our set of home countries (USA, UK, Germany, Netherlands, France, and Finland) into the sample of 140 countries from 1990 to 2009. By doing so we explore the effect of variables on manufacturing and services FDI and investigate whether any of the variables affect the sectoral FDI in a different manner. Furthermore, we compare the effects reported for sectoral FDI with those reported for aggregate (total) FDI flows in order to determine the effect of the level of aggregation used for FDI flows on the results.

Following the latter, we review the behaviour of the firms, considering the firms' home countries' type of economy and try to find patterns in the way firms from liberal market, and coordinated market economies conduct their FDI activity, and comment on similarities and differences in a sectoral context. This helps us to explore the effect of market structure of MNEs on their sectoral FDI activity in manufacturing and services sector. Furthermore, we consider the way different variables affect net FDI flows considering the sectoral properties of firms. The behaviour of the firms in manufacturing, and services sectors are explored and the findings are compared with the behaviours observed when aggregate FDI flows are investigated in order to determine the effect of the level of aggregation used for FDI flows on the results. Therefore our sectoral analysis uses the data on FDI flows from six home countries into 140 countries from 1990 to 2009. The sample on total FDI flows however includes the aforementioned eight home countries data for the span of 1990-2009. The next section reviews the explanatory variables and their data.

### **7.2.2. Independent variables**

In order to choose between the set of explanatory variables for our regression analysis, we have conducted pairwise correlation tests (available from appendix 6.6), and reviewed the summary of variables, that include information on the number of observations. This in turn will help in choosing variables from each group of explanatory variables that: have

considerable level of correlation with other variables in their associated group that proxy for a certain concept; and also entail the most number of observations. Therefore pairwise correlation of the explanatory variables discussed in each section of 6.2.3, provided in appendix 6.6, which entail MS, ES, RS, SAS motives and Institutional variables are conducted in order to provide some information regarding the best proxy for certain set of regressors. For instance, considering Resource seeking motives, we have estimated the pairwise correlation of the production of crude oil, natural gas, electricity and biofuel. This provides some information on the correlation between these variables and helps in choosing one of the variables in a way that the chosen variable is the best representative of the concept, and carries the information for the RS motives with a considerable number of observations. The final set of independent variables that is used in the empirical investigation of this chapter is provided in appendix 7.1. Furthermore a closer review of the independent variables selected, provided in appendix 7.1, indicates that some of the covariates are highly correlated with others. In order to reduce the degree of linear dependence of the independent variables we have orthogonalized the variables that are highly correlated. While the Quantile Regression Analysis (QRM) does not apply rigid set of assumptions with regard to independent variables, we have strived to use independent variables that have a considerably low level of correlation with one another in order to produce robust results. The orthogonal variables are a special case of linearly independent variables (Rodgers, Nicewander et al. 1984). A review of the Appendix 7.1 shows that variables such as total stock traded as a percentage of GDP (lstktrdtot); investment in research and development (lrnd); and infrastructure indicator the airfreight transport (lairfreight) are highly correlated with Gross Domestic Product (lgdp). In order to reduce the linear dependence of these variables we have orthogonalized them with respect to GDP variable. The orthogonalized variables' (indicated by provision of 'O' before the variable name) correlations with other independent variables considered in the empirical models, are provided in appendix 7.1. The next section provides information with regard to the set of hypotheses that are considered in this chapter, and the relevant empirical models devised to analyse the credibility of the models made.

### 7.2.3. Review of the claims and hypotheses

This section intends to provide a brief reminder of the theoretical findings of chapter four, along with the hypotheses developed. The hypotheses will be further elaborated in order to provide the specific set of hypotheses that will be tested in this chapter.

The theoretical model provided in chapter 4, explored the effect of civil liberties and political rights on FDI. The effect of civil liberties on FDI was considered to be channelled through the power of labour representatives on bargaining power, and consequently wage setting. The evidence suggested existence of an overall non-linear effect of civil liberties on FDI in most cases (exceptions include countries with very high level of civil liberties, and those with highest repression of civil liberties). Therefore, a non-linear effect of civil liberties on FDI is reported. The theoretical model of chapter 4 set forward the following set of hypotheses:

Hypothesis (1): Civil liberties have a negative effect on aggregate (total) net FDI flows through bargaining power of unions.

The effect of political rights on FDI was considered through taxes. The results indicated that in host countries with low, medium and moderately high level of civil liberties, increase in the level of political rights leads to lower taxes and higher FDI. In contrast to the latter FDI activity tends to be insensitive to the level of political rights (taxes on income) in case of countries with high level of civil liberties. Therefore, the overall effect of political rights on FDI flows is considered to be positive.<sup>122</sup>

Hypothesis (2): Political rights have a positive effect on aggregate (total) net FDI flows through taxes applied on income and profit.

Moreover, our theoretical framework showed that considering the sectoral characteristics tend to provide more information with regard to the way the bargaining power of unions and firms are distributed. In particular we showed that in sectors where the labour share of production is larger than capital, firms tend to be more sensitive to

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<sup>122</sup> We refrain from investigating the insensitivity of FDI flows into Free Countries to the level of political rights channelled through taxes. This is mainly due to limited number of observations available on FDI flows from our set of home countries, the further break down of which would render low number of observations rendering statistical inquiry unreliable. Therefore, the investigation of the latter is left for further researches on the topic.

wages because they account for a higher share of cost of production, therefore unions tend to have a greater power over the bargaining process in comparison to their counterparts in capital intensive sectors. The overall evidence indicated that in the presence of civil liberties that allow labour representation, the sectoral characteristics, namely the ratio of labour to capital share of production, in most cases influence the bargaining power of the unions, and thereby affects the cost of investment abroad and consequently FDI flows.

Hypothesis (3): The effect of civil liberties on labour intensive FDI (i.e. services FDI) is greater than that on capital intensive FDI (manufacturing FDI) in case of free and moderately free countries.

Fourth, in moderately repressed countries with low level of civil liberties labour representatives have lower power over bargaining process, however, due to higher sensitivity of the firms' cost structure to the cost of labour in labour intensive sectors (wages account for a greater share of cost of production) labour representatives tend to have higher bargaining power when negotiating for wages in labour intensive sector, in comparison to their counterparts in capital intensive sector. Therefore an increase in the level of civil liberties would affect the bargaining processes in the labour intensive sector in a more noticeable way than in capital intensive sectors.

Hypothesis (4): The effect of civil liberties on services FDI (labour intensive production) is greater than that on manufacturing FDI (capital intensive production), in case of repressed and moderately repressed countries.

After the review of the set of hypotheses set forward by theoretical model of chapter 4, we discuss a few details that have influenced our empirical research and findings. First, the intermediating effect of labour /capital share of production on the influence of civil and political liberties on FDI is mainly observable in case of countries with medium or low level of civil liberties; we distinguish between the countries with different levels of liberties in our sample. In fact the review of the seven scale ranking system used by Freedom House in provision of the results indicates that the case of medium level of civil liberties ( $a \xrightarrow{\text{converges to}} \frac{1}{2}$ ), is not quite distinct. Therefore in order to consider the countries with medium and low level of civil liberties we categorize countries based on their level of civil liberties, using Freedom House rankings.

The original categorization of countries based on their level of civil liberties is inspired by the original work of Adam and Filippaios (2007) who categorize host countries with ranking or 3 and lower for free and moderately free countries, and those with ranking of 4 and higher as moderately repressed and repressed countries. However, due to low level of observations the results of the regressions using Adam and Filippaios (2007) categorization suffer from lack of statistical credibility.

Therefore, a second categorization is undertaken by categorizing the countries with ranking of less than 3 as free and moderately free countries, and those with ranking of 3 and higher as moderately repressed and repressed countries. Table below shows the two categorizations discussed. Further discussions on the latter will be provided in section 7.3.3 and 7.3.4.

**Table 7—4: The outlook of the way host countries are categorized based on their level of civil liberties using Freedom House rankings**

Host countries categorization based on their level of Civil Liberties using Freedom House ranking	Adam and Filippaios (2007)	Author's categorization
Free and Moderately Free	$FHCL \leq 3$	$FHCL < 3$
Moderately Repressed and Repressed	$FHCL \geq 4$	$FHCL > 3$

Second, we consider the aggregate of services sector to proxy for the type of sector whose production is more reliant on labour input (labour share of production is higher than capital;  $d > g$ ). Similarly aggregate of manufacturing sector is assumed to proxy for the type of sector whose production is more reliant on capital (capital share of production is higher than labour;  $g > d$ ). Based on this assumption we view the effect of civil liberties on these sectors in order to evaluate hypotheses 4 and 5.

Third, building on VoC framework, we argue that the differences in the ways in which firms from various market economies coordinate their FDI activity affects their behaviour in terms of FDI investment. Therefore we investigate whether the FDI activity of the firms from LMEs differ significantly from those of CMEs and Northern countries. This investigation is carried out for total FDI flows, by consideration of the factors that affect the FDI from the firms that originate from the groups of countries that account for LMEs (UK and US); CMEs (Germany; Netherlands; France; Japan); and finally Northern countries (Norway and Finland). The sectoral FDI flows in comparison considers only six

of the eight countries represented above by dropping Japan and Norway due to low number of observations reported for these countries.

Finally, considering the VoC framework we consider the macroeconomic and institutional characteristics of the host countries to affect the FDI activity of the firms from various market economies in a different manner. The investigation of the effect of the relevant independent variables are expected to provide some detailed information on the effect of these factors on the FDI investment from various market economies both in case of total FDI flows, as well as sectoral FDI.

In general the overview of the next section is as follows: first, the hypotheses related to total FDI flows are examined by consideration of the following models:

**Table 7—5: Regression models considered for the empirical investigation**

Model 1.1	Model 1.2	Model 1.3	Model 2.1	Model 2.2	Model 2.3
Log(GDP)	Log(GDP)	Log(GDP)	Log(GDP)	Log(GDP)	Log(GDP)
OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)
Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)
OLog(Wage per Hour)	OLog(Wage per Hour)	OLog(Wage per Hour)	OLog(Wage per Hour)	OLog(Wage per Hour)	OLog(Wage per Hour)
OLog(tax on income total)	OLog(tax on income total)	OLog(tax on income total)	OLog(tax on income total)	OLog(tax on income total)	OLog(tax on income total)
OLog(Airfreight)	OLog(Airfreight)	OLog(Airfreight)	OLog(Airfreight)	OLog(Airfreight)	OLog(Airfreight)
Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)
OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)
	Civil Liberties	Civil Liberties	Log(R&D_exp)	Log(R&D_exp)	Log(R&D_exp)
	Political Rights	Political Rights		Civil Liberties	Civil Liberties
		bureauc_qual		Political Rights	Political Rights
		gov_stab			bureauc_qual
		law_order			gov_stab
					law_order

As it is observable from the table, two main basic models are considered in this section. Both of the basic models considered, embody independent variables that reflect firms' motivations, and macroeconomic factors, with the difference that the second model (model 2.1) takes into account investment on research and development as one of the variables that take into account SAS FDI. Whilst the number of observations on research and development is fairly low in contrast to other independent variables, this research considers this factor to affect SAS FDI. Consequently both models are provided to allow comparisons and relevant discussions.

In general our empirical investigation starts with a model that embodies independent variables that reflect firms' motivations, as well as macroeconomic factors (model 1.1 & 2.1), then we add civil liberties and political rights to the basic model (model 1.2 & 2.2), and finally institutional variables (model 1.3 & 2.3). This is carried out by providing the results and relevant discussions of the regressions for LMEs, CMEs and Northern Countries, respectively. Moreover, the empirical investigation of sectoral FDI is carried out by consideration of the full models (model 1.3 and 2.3). Due to limited word count applied to the PhD doctoral thesis, we refrain from providing the results and discussion of the results of models 2.1-2.3 in the text. Consequently the results of these models are provided in appendices 7.5 and 7.6. Furthermore, in order to provide a sensitivity analyses where we only control for civil liberties, and not the channel through which its effects are passed on to the bargaining processes (wages), we consider models 1.3 and 2.3 without including wage covariate. The results of sensitivity analyses where we are controlling for civil liberties and omitting wages, in order to pin down the effect of civil liberties on FDI through wages, is provided in appendix 7.10. The results are in line with those reported for the full model including both variables.

The examination of the effect of the level of civil liberties on FDI flows however is conducted only on model 1.3 due to low number of observations that results from splitting our sample into different groups based on the level of civil liberties. Furthermore, due to low number of observations of ES related variable, wage per hour, it is omitted from the empirical results provided in sections 7.3.3 and 7.3.4. However, the results of sensitivity analysis using the original model 1.3 using both Adam and Filippaios (2007) and the authors' categorization of the countries based on their levels of civil liberties are provided



in appendices 7.11-7.13. The overall results reported in these cases with regard to the effect of civil and political liberties on FDI are in line with the results reported.

### 7.3. Empirical exercise

This section empirically investigates hypotheses 1 and 2, provided in the previous section. In order to do so we explore the net (total) FDI flows from 8 home countries into 140 host countries from 1990 to 2009 using six basic models (available from table 7-5) entailing variables that reflect firms' motivations, host countries' level of civil liberties, political rights, institutional quality, and macroeconomic characteristics.

#### 7.3.1. Total net FDI flows

The three regressions provided in table 7-7, cover the LMEs (US and UK) total FDI flows from 1990-2009. Of firms' motives, the effect of Market seeking motives reflected by market size (GDP) shows a positive significant effect on both LMEs' FDI flows for the period, across all models. This suggests Market Seeking (MS) behaviour of firms from LMEs. Considering the effect of Resource seeking motives reflected by production of electricity we find a negative effect reported for US in all models while the effect is reported to be significant in model (1.2) and (1.3) therefore, we consider the existence of resource production entities in the host country to have a negative effect on US FDI, indicating the competitive nature of US firms in terms of market entry, when resource seeking motivations exists. Therefore, we argue that US firms behave based in such a significant resource seeking behaviour that existence of resource production entities in the host markets has a negative effect on US FDI. Furthermore, considering the effect of Resource seeking motives reflected by production of electricity we find an insignificant positive effect on UK FDI, which following the same logic translates to lower resource seeking activity undertaken by British firms. In fact a review of the sectoral composition of UK FDI (provided in table below) shows that the RS FDI accounts for only a minor part of countries' FDI abroad.

**Table 7—6: Breakdown of British net FDI flows in to our set of 140 countries for the period of 1990-2009, based on economic activity.**

Economic Activity	Variable	Obs	Mean	Std. Dev.	Min	Max
Total	UK FDI	925	5.276535	2.230783	0.105361	12.04171

Agriculture and Fishing	UK FDI	15	1.340285	1.352896	0.105361	4.174387
Mining and Quarrying	UK FDI	108	4.59397	2.157265	0.105361	9.078441
Manufacturing	UK FDI	366	5.330245	1.875845	0.223144	10.67848
Electricity, Gas and Water	UK FDI	26	3.653169	2.639661	0.105361	8.909235
Construction	UK FDI	86	2.921178	1.647139	0.105361	7.682482
Trade and Repairs	UK FDI	263	4.142224	1.990675	0.105361	9.77835
Hotels and Restaurants	UK FDI	55	3.19701	2.17111	0.105361	7.715347
Transports, Storage & Communication	UK FDI	184	3.951259	2.096689	0.105361	11.3183
Financial Intermediation	UK FDI	240	4.962819	2.290362	0.223144	10.72119
Real Estate, Renting & Business Activity	UK FDI	266	3.825616	1.970179	0.105361	8.884988
Computer & Related Activities	UK FDI	94	3.032279	1.746777	0.105361	6.648749
Research & Development	UK FDI	17	2.08333	2.272083	0.223144	6.907755
Other Business Activities	UK FDI	291	3.417212	1.944044	0.105361	8.252251

The effect of efficiency seeking motives on FDI activity is captured through ‘wage per hour’. *Wage per hour* has a positive and significant effect on UK FDI in all models. This suggests that higher wages tend to affect UK FDI investment abroad in a positive and significant manner. The effect of *wage per hour* on US FDI however indicate a negative insignificant effect with the exception of model 1.1, suggesting that US firms are more sensitive to wages than their British counterparts, and thus show a greater ES behaviour in their FDI activity.

The effect of Strategic Asset Seeking (SAS) motives on FDI activity is captured through the consideration of the effect of the *quality of transportation* in the host countries (*airfreight*) on total FDI activity. The results indicate presence of a positive effect of SAS motives on LMEs’ FDI in all the models with significant results reported only in case of UK FDI. The latter indicates that the quality of transportation and in general the host countries’ infrastructure has a significant and positive effect on UK firms’ FDI, while the effect is reported to be weaker in case of US FDI.

The effect of macroeconomic environment of host countries on FDI is considered using the *interest rate lending* variable and the trade related variables (trade percentage of GDP and Stock traded as a percentage of GDP). Interest rate lending shows an overall insignificant effect on LMEs' FDI, with positive effect reported in case of US and a negative effect reported in case of UK FDI. The overall effect of *taxes on income and profit* on FDI flows is positive and significant on LMEs' FDI across models. The overall effect of the first trade related independent variable, *trade as a percentage of GDP* is a positive and significant effect on LMEs' FDI flows. Therefore we consider trade to have a significant affect on LMEs' FDI. The consideration of the second trade related variable, *stock traded as a percentage of GDP*, similarly shows an overall significant and positive effect on LMEs' FDI.

The effect of the host countries' level of *civil liberties* on LMEs FDI is negative and significant in all cases. This is in line with the hypothesis (1) provided in section 7.2.3. Since the higher level of civil liberties translates to higher costs through labour rights and bargaining processes as discussed in chapter 4<sup>123</sup>, the higher level of civil liberties appears to have a negative effect on net FDI flows of all home countries considered. Therefore considering the effect of the level of civil liberty in the sample of 140 host countries on the net FDI flows from LMEs, we find evidence supporting the view of Coates et al. and in contrast to studies that have found a positive relationship between the level of civil liberties and FDI including Coughlin et al.(1991) and those who have found a positive insignificant relationship such as Blanton and Blanton .

The effect of the host countries' level of *political rights* on LMEs' FDI is positive and significant in most cases. This is in line with hypothesis (2) provided in section 7.2.3. Therefore we find that higher political rights in the host countries positively affect LMEs' net FDI flows. Our finding supports the view of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007) who reported a positive relationship between the level of political liberties of the host countries on the FDI, and in contrast to the findings of Asiedu (2001) and Li and Resnick (2003).

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<sup>123</sup> Considering the criterion provided by Freedom House available from Appendix 6.4, civil liberties components which entail the rights to associate, which translates to representation of labour and bargain over the wages, among other civil related factors provided.

The effect of the host countries' institutional environment on FDI activity is considered through consideration of independent variables on government stability; law and order; and bureaucratic quality. The results indicate that *government stability* has a positive and significant effect on total FDI flows from LMEs, at 1%. *Bureaucratic quality* tends to have a positive effect on LMEs FDI with significant effect reported only in case of UK FDI. Finally, considering the effect of *law and order* on LMEs FDI we find a positive and significant effect of law and order on US FDI, while the effect reported for UK FDI is negative and insignificant. Therefore, the overall evidence on institutional quality suggests that better institutional environment of host countries positively affect FDI from LMEs, in support of the evidence provided by Lipsey (1999), Campos and Kinoshita (2003) and in contrast to findings of others such as Click (2005).

**Table 7—7: Estimation of determinants of LMEs' aggregated FDI**

Table 7-7		Estimation of Determinants of LMEs' FDI (Total FDI)					
		Model 1.1		Model 1.2		Model 1.3	
Variable name	STATA label	US	UK	US	UK	US	UK
GDP	lgdp	1.093***	0.804***	1.182***	0.965***	1.006***	0.841***
		(0.104)	(0.123)	(0.107)	(0.095)	(0.083)	(0.108)
Production of Electricity	Olprod_elec	-0.389	0.009	-0.496**	-0.057	-0.834***	-0.014
		(0.308)	(0.198)	(0.238)	(0.217)	(0.264)	(0.202)
Interest rate lending	lintrstRL	-0.208	-0.065	-0.015	0.313*	0.273*	0.248
		(0.372)	(0.216)	(0.149)	(0.180)	(0.153)	(0.174)
Wage per hour	Olwageph	0.099	0.301***	-0.080	0.152*	-0.112	0.160*
		(0.155)	(0.105)	(0.149)	(0.082)	(0.171)	(0.092)
Taxes on income (total)	ltxinctot	0.928***	0.784***	0.514	0.401	0.716**	0.424*
		(0.316)	(0.298)	(0.376)	(0.261)	(0.309)	(0.254)
Air freight	Olairfreight	0.191	0.322*	0.268	0.610***	0.132	0.406***
		(0.138)	(0.171)	(0.199)	(0.133)	(0.129)	(0.122)
Trade percentage of GDP	ltradepgdp	0.489	0.367	0.657***	0.578***	0.468***	0.477*
		(0.311)	(0.281)	(0.232)	(0.199)	(0.152)	(0.255)
Stock traded (total)	Olstktrdtot	0.693**	0.697***	0.645**	0.646***	0.267	0.387***
		(0.306)	(0.112)	(0.310)	(0.182)	(0.184)	(0.120)

Political Rights	FHPR			0.474**	0.248	0.448***	0.244***
				(0.216)	(0.198)	(0.138)	(0.084)
Civil Liberties	FHCL			-0.726***	-0.590***	-0.653***	-0.533***
				(0.255)	(0.226)	(0.183)	(0.126)
Government Stability	gov_stab					0.129*	0.198***
						(0.077)	(0.058)
Law & Order	law_order					0.375***	-0.087
						(0.094)	(0.127)
Bureaucratic Quality	bureauc_qual					0.109	0.446**
						(0.190)	(0.186)
Constant	_cons	-27.283***	-19.353***	-28.435***	-17.476***	-27.258***	-22.455***
		(4.262)	(4.327)	(3.819)	(4.840)	(2.875)	(3.336)
N		287.000	318.000	283	314.000	314.000	351.000
Pseudo R2		0.3031	0.2744	0.3328	0.3088	0.3588	0.4219

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10. Source: Author's estimations in STATA

The three regressions provided in table 7-8, cover the CMEs (Germany; Netherlands; France; and Japan) total FDI flows from 1990-2009. Of firms' motives, the effect of Market seeking motives reflected by market size (*GDP*) shows a positive significant effect on all CMEs' FDI flows for the period, across all models. Thus the evidence suggests a significant Market Seeking (MS) behaviour in CMEs' FDI activity. Considering the effect of Resource seeking motives reflected by *production of electricity* we find a negative and significant effect on CMEs' FDI across all models. Therefore, we find that existence of resource production entities in the host markets affects the FDI from CMEs in a significant manner, suggesting a strong Resource Seeking behaviour in CMEs FDI.

Of ES independent variables, the results of the basic model (model 1.1) show that '*wage per hour*' has an overall positive on FDI flows in all cases. Furthermore, the results suggest that wages have a positive and significant effect on Dutch FDI in models 1.1 and 1.3. Therefore, it is possible to argue that wages have a positive effect on most CMEs' FDI. The intuitive reason behind this effect is the type of ES motive that targets productivity rather than cost cutting by provision of higher wages in comparison to local wages, for employees in the host countries in order to ensure a greater level of productivity. Thus, it is possible to argue that overall, CMEs' FDI behaviour is influenced by ES motives.

The SAS independent variable that reflects the quality of transportation, *air freight* (lairfrieght), shows an overall negative and significant effect on German and French FDI. The effect of quality of transportation on Dutch FDI is similarly negative but insignificant in most cases (models 1.1 and 1.3). However quality of transportation has a significant and positive effect on Japanese FDI in all cases. Since the host countries quality of transportation affects the production activity of the affiliates, a possible explanation lies on the differences between the coordination activity of the German and French affiliates (and in a weaker level in case of Dutch firms) with those of Japanese firms. It is possible to relate this effect to the types of activities that CME firms undertake in their foreign affiliates. The activities of firms from Japan appear to be more production based as the research and development is mainly centralised in the home countries, the production of goods and services is outsourced to other locations where firms take advantage of lower costs. In contrast the firms from Germany and France show a rather decentralised structure in which the research and development can be conducted in locations other than the home country and thus they favour the expenditure on research and development as well as production in host countries. Since the quality of infrastructure of the host countries does not affect the research and development activities of the firms, and that countries with better infrastructure and potential for investment are generally dominated by the firms from Japan for the production of goods and services, the quality of infrastructure of the host countries appears to have a negative effect on net FDI flows of the firms from Germany and France. This proposition will be further examined in models 2.1-2.3 where host countries' *investment in R&D* is added to the empirical model as an independent variable.

Of the macroeconomic variables, the effect of host countries' *interest rate lending* on French and Japanese FDI is positive and insignificant. The effect of *interest rate lending* on Dutch FDI is positive and significant, while an overall negative effect is reported in case of German FDI. The second macroeconomic variable, *taxes on income and profit and capital gains (percentage of total taxes)*, has an overall insignificant negative effect on most of CMEs' firms except Japanese firms for which an insignificant positive effect reported. Finally, the last group of macroeconomic variables are the trade related variables. The first trade related variable, *trade as a percentage of GDP*, is reported to have an overall positive and significant effect on all CMEs' FDI. The second trade related variable, *stock traded as a percentage of GDP*, has a positive and significant effect on Dutch and French FDI in models 1.2 and 1.3, indicating an overall positive and significant effect on

FDI from these countries. The effect of *stock traded as a percentage of GDP* on German FDI is continuously positive and insignificant across models. Similarly the effect of *stock traded as a percentage of GDP* on Japanese FDI is positive and insignificant in models 1.1 and 1.2, indicating an overall positive insignificant effect on Japanese FDI.

The overall effect of *civil liberties* on CMEs' FDI flows is negative and significant in most cases, similar to the effects observed in case of LMEs, and in line with hypothesis (1) provided in section 7.2.3. Therefore our findings support the view of Coates et al. and in contrast to studies that have found a positive relationship between the level of civil liberties and FDI including Coughlin et al.(1991) and those who have found a positive insignificant relationship such as Blanton and Blanton .

The results of the empirical investigation of the effect of *political rights* on CMEs' FDI, is positive in case of Dutch, French and Japanese FDI, with significant effect reported for Japanese FDI at 1%. Furthermore, the effect of the level of political rights in the host countries on German FDI is reported to be negative and insignificant. Therefore the overall evidence suggests a positive effect of political rights on CMEs' FDI with the exception of German FDI. This overall positive effect is in line with hypothesis (2) provided in section 7.2.3. Our findings thus are in support of the view of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007) who reported a positive relationship between the level of political liberties of the host countries on the FDI, and in contrast to the findings of Asiedu (2001) and Li and Resnick (2003).

Of the institutional variables, the results of model 1.3 shows that *government stability* has a positive effect on German and Dutch FDI net flows, while the effect reported for France and Japan is negative with significant effects reported for Japan at 10%. The effect of *bureaucratic quality* of the host countries is reported to be insignificant and positive on all CMEs with the exception of French. Furthermore, the effect of *law and order* on CMEs' FDI tends to be positive with significant results reported only for German and French FDI at 1%. Therefore, the overall effect of institutional variables on FDI flows indicates presence of an asymmetric effect that is in line with the findings of Aleksynska and Havrylchyk (2012) who exploring the role of institutional distance on the FDI show that institutional distance has an asymmetric effect on FDI depending on whether investors choose countries with better or worse institutions.

Table 7—8: Estimation of determinants of CMEs' aggregated FDI

Table 7-8		Estimation of Determinants of CMEs' FDI (Total FDI)											
		Model 1.1				Model 1.2				Model 1.3			
Variable name	STATA label	Germany	Netherlands	France	Japan	Germany	Netherlands	France	Japan	Germany	Netherlands	France	Japan
GDP	lgdp	1.093***	0.971***	1.156***	1.251***	1.351***	1.276***	1.301***	1.008***	1.334***	1.265***	1.183***	1.050***
		(0.056)	(0.198)	(0.116)	(0.164)	(0.073)	(0.117)	(0.125)	(0.136)	(0.083)	(0.108)	(0.117)	(0.114)
Production of Electricity	Olprod_elec	-0.450***	-0.626***	-0.768***	-0.449*	-0.405***	-0.774***	-0.671***	-0.754***	-0.506***	-0.812***	-0.802***	-0.546*
		(0.112)	(0.216)	(0.216)	(0.237)	(0.128)	(0.121)	(0.186)	(0.205)	(0.167)	(0.191)	(0.246)	(0.328)
Interest rate lending	lintrstRL	-0.381***	-0.101	0.003	0.193	-0.050	0.390**	0.220	0.215	0.194	0.583***	0.356**	0.397
		(0.092)	(0.455)	(0.298)	(0.171)	(0.135)	(0.186)	(0.267)	(0.263)	(0.191)	(0.182)	(0.169)	(0.277)
Wage per hour	Olwageph	0.329***	0.394**	0.419***	0.245	0.153	0.194	0.176	0.091	-0.001	0.206*	0.156	-0.021
		(0.102)	(0.168)	(0.134)	(0.167)	(0.116)	(0.144)	(0.116)	(0.110)	(0.103)	(0.124)	(0.127)	(0.152)
Taxes on income (total)	ltxinctot	0.620***	0.260	0.240	0.497**	-0.270	-0.695*	-0.316	1.083***	-0.314	-0.460	-0.018	0.648
		(0.196)	(0.647)	(0.241)	(0.210)	(0.171)	(0.359)	(0.286)	(0.354)	(0.205)	(0.301)	(0.283)	(0.402)
Air freight	Olairfreight	-0.676***	-0.142	-0.420***	0.406***	-0.267***	0.167*	-0.177**	0.505**	-0.342***	-0.022	-0.242**	0.529**
		(0.086)	(0.149)	(0.090)	(0.156)	(0.103)	(0.085)	(0.090)	(0.222)	(0.090)	(0.191)	(0.121)	(0.246)
Trade percentage of GDP	ltradepgdp	1.296***	0.695*	0.976***	0.954***	1.562***	1.400***	1.166***	0.700***	1.279***	1.324***	0.834***	0.630**
		(0.215)	(0.388)	(0.194)	(0.256)	(0.164)	(0.228)	(0.305)	(0.251)	(0.198)	(0.228)	(0.276)	(0.246)
Stock traded	Olstktrdtot	0.123	0.325*	0.566***	0.130	0.099	0.412***	0.501***	0.114	0.026	0.346***	0.543***	0.126



(total)		(0.132)	(0.185)	(0.194)	(0.180)	(0.138)	(0.131)	(0.176)	(0.191)	(0.097)	(0.113)	(0.210)	(0.186)
Political Rights	FHPR					-0.164	0.015	0.197	0.462***	-0.046	0.036	0.285	0.460***
						(0.123)	(0.072)	(0.137)	(0.124)	(0.071)	(0.129)	(0.185)	(0.156)
Civil Liberties	FHCL					-0.327**	-0.573***	-0.706***	-0.296*	-0.385***	-0.546***	-0.679***	-0.248
						(0.142)	(0.090)	(0.208)	(0.155)	(0.079)	(0.147)	(0.176)	(0.202)
Government Stability	gov_stab									0.095*	0.097	-0.085	-0.091*
										(0.050)	(0.060)	(0.063)	(0.054)
Law & Order	law_order									0.389***	0.163	0.358***	0.030
										(0.098)	(0.112)	(0.119)	(0.148)
Bureaucratic Quality	bureauc_qual									0.164	0.139	-0.194	0.345
										(0.167)	(0.209)	(0.165)	(0.509)
Constant	_cons	-29.844***	-23.733***	-30.064***	-34.344***	-34.142***	-31.386***	-32.067***	-29.166***	-36.041***	-34.147***	-29.362***	-29.312***
		(1.739)	(6.591)	(3.874)	(5.573)	(2.154)	(3.347)	(4.776)	(4.775)	(3.273)	(3.499)	(3.887)	(3.730)
N		445	481	352	418	240	474	346	410	233	457	341	407
Pseudo R2		0.4593	0.4161	0.2899	0.4132	0.3391	0.4718	0.3824	0.4572	0.3743	0.5028	0.3858	0.4671

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10

Source: Author's estimations in STATA

The three regressions provided in table 7-9, cover the Northern countries (Norway and Finland) total FDI flows from 1990-2009. Of firms' motives, the effect of Market seeking motives reflected by market size (*GDP*) shows a positive significant effect on all Northern Countries' FDI flows for the period, with the exception of Norway in model (1.1) for which the effect is reported to be positive and insignificant. Thus the evidence suggests a significant Market Seeking (MS) behaviour in Northern countries' FDI activity.

The effect of Resource seeking motives reflected by *production of electricity* show a negative and insignificant effect on Northern countries' FDI across all models. Therefore, we find that existence of resource production entities in the host markets affects the FDI from Northern countries in a negative and insignificant manner, suggesting a weaker Resource Seeking behaviour in Northern countries' FDI in comparison to CMEs.

Of ES independent variables, *wage per hour* has a positive and insignificant effect on Finish FDI while a negative insignificant effect reported in case of Norwegian FDI. Similar to the evidence observed in case of CMEs, we find that Finish FDI is affected in a positive and insignificant manner by *wage per hour*, while the effect of wages on Norwegian FDI is more in line with the observed effect in case of United States, indicating that Northern firms' adopt different strategies when wages are considered.

The effect of SAS variable, reflecting the quality of transportation, *air freight*, has a negative significant effect on Finish FDI across models while an overall positive insignificant effect of the host countries' quality of institutions is reported in case of Norwegian FDI. Therefore, based on the arguments made earlier, we consider the Finish firms to have a more decentralised structure through which they outsource some of their R&D activity to their foreign affiliates, whilst in contrast Norwegian firms are considered to have a more centralised structure that chiefly allocates production activities to their foreign affiliates.

Of macroeconomic independent variables, we find the *interest rate lending* to have a negative insignificant effect on Finish FDI, and a positive significant effect on Norwegian FDI. The second macroeconomic variable, *taxes on income and profit*, shows a negative effect on all Northern FDI with significant effects reported mainly for Finish firms, suggesting that the level of host countries' taxes negatively affect Northern FDI (similar to the effect observed for French and Dutch FDI). Considering trade related independent

variables, *trade as a percentage of GDP* shows a positive and significant effect on Finish FDI, while the effect is generally insignificant on Norwegian FDI with the exception of model 1.2. The second trade related variable, *stock traded as a percentage of GDP*, similarly shows a positive significant effect on Finish FDI, and a positive insignificant effect on Norwegian FDI. The overall effect of trade related variables are similar to those observed in case of LMEs and CMEs.

The effect of *civil liberties* on Northern countries' FDI is negative with significant results reported only in case of Norway, indicating that higher level of civil liberties affect FDI flows from Norway in a negative and significant manner, while the effect observed is weaker in case of Finland. The findings are in line with hypothesis (1) and the results are similar to those observed in case of CMEs and LMEs, and in favour of findings of Coates, et al. (2010) and in contrast to studies that have found a positive relationship between the level of civil liberties and FDI including Coughlin, et al.(1991) and those who have found a positive insignificant relationship such as Blanton and Blanton .

The effect of *political rights* on Finish FDI is insignificant and negative while a positive significant effect is reported for Norwegian FDI. The results in case of the effect of host countries' level of political rights on Norwegian FDI are in line with hypothesis (2) provided in section 7.2.3, supporting of the view of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007). The insignificant negative effect of level of political rights on Finish FDI is in favour of the findings of Asiedu (2001) and Coates, et al. (2010) who have found an insignificant negative relationship. Finally our overall findings with regard to the effect of political rights on Northern FDI are in line with the findings of Li and Resnick (2003) who have reported both positive and negative influences. Therefore, we find evidence of non-linear effect of the host countries' level of political rights on Northern FDI, and in the view of our set of home countries, we find that while political rights in general have a positive effect on FDI flows into host countries (as predicted by our theoretical arguments), the effects are non linear across countries, as evidenced by the negative effects reported in case of German and Finish FDI.

Of institutional variables, we find *government stability* to have a positive significant effect on Finish FDI, while a negative and insignificant effect is reported in case of Norwegian FDI. The effect of *bureaucratic quality* is positive in case of both Finish and

Norwegian FDI, while the significant effect is observed only in case of Norway. Finally, the effect of *law and order* on Northern countries' FDI is reported to be insignificant across countries, with a positive effect reported for Finish FDI, and a negative effect reported in case of Norwegian FDI. The overall effect of institutional factors on Northern countries' FDI is much weaker than CMEs. Considering our initial arguments in favour of using disaggregated FDI flows in section 7.2.3, we claimed that the use of disaggregated data enables one to provide detailed information on the effect of determinants of FDI flows in case of each industry/sector. Consequently we will revisit the findings of this section in section 7.3.2 in order to compare the effects observed in this section with those provided from a sectoral analysis in order to investigate whether such considerations provide better understanding of the forces that affect FDI flows.

**Table 7—9: Estimation of determinants of Northern aggregated FDI**

Table 7-9		Estimation of Determinants of Northern FDI (Total FDI)					
		Model 1.1		Model 1.2		Model 1.3	
Variable name	STATA label	Finland	Norway	Finland	Norway	Finland	Norway
GDP	lgdp	0.884***	0.608	1.283***	0.891***	1.374***	0.783**
		(0.135)	(0.414)	(0.214)	(0.320)	(0.131)	(0.338)
Production of Electricity	Oiproduct_elec	-0.099	-0.518	-0.127	-0.579	-0.089	-0.666
		(0.222)	(0.509)	(0.337)	(0.558)	(0.278)	(0.505)
Interest rate lending	litrstRL	-0.768	0.628	-0.436	0.775*	0.140	1.370**
		(0.564)	(0.641)	(0.430)	(0.449)	(0.489)	(0.582)
Wage per hour	Olwageph	0.566**	0.189	0.322	-0.069	0.317	-0.174
		(0.286)	(0.445)	(0.264)	(0.302)	(0.278)	(0.231)
Taxes on income (total)	ltxinctot	-0.680	-0.355	-1.630***	-0.950	-1.649***	-1.783***
		(0.542)	(0.497)	(0.443)	(0.899)	(0.405)	(0.633)
Air freight	Olairfreight	-0.749***	-0.023	-0.528*	0.341	-0.701*	0.126
		(0.178)	(0.439)	(0.272)	(0.484)	(0.375)	(0.423)
Trade percentage of GDP	ltradevgdp	1.301***	1.326	1.927***	1.515**	1.954***	1.211*
		(0.430)	(0.864)	(0.511)	(0.739)	(0.389)	(0.710)
Stock traded (total)	Olstktrdtot	0.681	0.787	0.773***	0.767**	0.650*	0.540
		(0.490)	(0.503)	(0.248)	(0.382)	(0.357)	(0.470)

Political Rights	FHPR			-0.237	0.284	-0.055	0.824*
				(0.371)	(0.545)	(0.367)	(0.429)
Civil Liberties	FHCL			-0.384	-0.972*	-0.543	-1.226***
				(0.404)	(0.512)	(0.356)	(0.445)
Government Stability	gov_stab					0.236***	-0.061
						(0.083)	(0.195)
Law & Order	law_order					0.057	-0.054
						(0.195)	(0.462)
Bureaucratic Quality	bureauc_qual					0.511	1.333**
						(0.365)	(0.660)
Constant	_cons	-21.275***	-16.814	-30.720***	-22.343*	-38.330***	-20.337*
		(5.293)	(16.070)	(7.215)	(12.705)	(4.894)	(11.229)
N		250	119	245	118	243	118
Pseudo R2		0.19	0.1387	0.2568	0.2318	0.2876	0.2773

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10. Source: Author's estimations in STATA

The results of the regression analyses of aggregated FDI using models 2.1-2.3 and the relevant discussions are provided in appendix 7.5.

### 7.3.2. Sectoral net FDI flows

One of the characteristics that most of the studies exploring determinants of FDI share is that they examine the relationship between various factors and FDI using national level FDI. Blonigen (2005) as well as Kiyota and Utara (2004) point out the importance of the using disaggregated FDI data. The reasoning behind the latter is that various variables have different effects on FDI in different industries and that using disaggregated FDI data provides a more clear evidence of how variables impact FDI flows in certain industry level. In other words the impact of variables on FDI flows is not the same in all industries<sup>124</sup> and therefore, their effects on different industries offset one another when it is assumed otherwise and therefore analyses based on aggregate data does not capture the effect of variables on FDI flows in a thorough manner. Blonigen (2005) argues that effect of variables on country level FDI is ambiguous. The consideration of effect of determinants of FDI in a sectoral manner by no means is new. For instance, Froot and

<sup>124</sup> The impact of exchange rates on FDI flows differs from one industry to another.

Stein (1991), Blonigen (1997), Stevens (1998), Klein and Rosengren (1994), Sazamani, Yoshimura and Kiyota (2003) and Kiyota and Urata (2004) examine the impact of exchange rate movements on FDI, using disaggregated FDI data<sup>125</sup> in order to provide a more thorough examination of the impact of exchange rates on FDI flows.

In this section we explore the effect of our set of variables put forward in the previous section in a sectoral context in order to distinguish between various effects of our explanatory variables on FDI flows. This is in line with our theoretical arguments made in chapter (4) with regard to the effect of civil liberties and political rights on labour intensive versus capital intensive sectors. The regressions provided in table 7-10, empirically explore the manufacturing and services net FDI flows from our set of home countries into 140 host countries for the period of 1990-2009, using regression model 1.3, discussed in section 7.2.3. Of firms' motives, the effect of Market seeking motives reflected by market size (*GDP*) shows a positive and significant effect on all countries' manufacturing FDI flows. This suggests a significant Market Seeking (MS) behaviour of all firms when manufacturing FDI is considered. Considering services FDI, we find an overall significant positive effect of MS motives on all countries, except Finland for which the results indicate an insignificant positive effect.

Considering the effect of Resource seeking motives reflected by *production of electricity* we find a negative significant effect in case of German manufacturing FDI while the reported effect on other countries tend to be insignificant and negative in all cases with the exception of FDI from British and Finish firms. In contrast the review of the effect of *production of electricity* on our set of home countries' services FDI, we find a negative and significant effect reported in all cases, with the exception of Finland for which the effect reported is positive and insignificant. Interestingly, the results indicate a greater RS behaviour in services FDI, in comparison to manufacturing FDI. The further exploration of the latter could be carried out by considering tradable, versus non-tradable composition of the products and services, produced in these sectors, however, considering the limits of this research we leave this to the future researches on the subject.

Of ES variables, we find *wage per hour* to have a positive and significant effect on CMEs' manufacturing FDI, while the effect on LMEs' manufacturing FDI is negative and

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<sup>125</sup> In case of Kiyota and Urata (2004) paper both aggregated and disaggregated data is considered and the results still confirmed that a depreciation of host country currency attracts FDI.

insignificant. Considering the effect of ES variables on services FDI, we find a negative effect of *wage per hour*, on Finish and Dutch services FDI, while the effect on other countries is positive, but significant only in case of UK, German and French services FDI. The overall effects reported indicate that the influence of *wage per hour* on manufacturing FDI is different than that observed for services FDI with the exception of Germany and France, for which the effects are similar across sectors.

Considering the SAS variable, *air freight* on manufacturing FDI we find a positive effect reported on LMEs' manufacturing FDI while the effect is negative in case of US CMEs' and Northern firms with significant results reported only in case of Finish manufacturing FDI. Considering the effect of *air freight* on services FDI we find a positive effect reported for LMEs services FDI, however, the effect is only significant in case of US firms. In contrast we find a negative effect of *air freight* on CMEs' services FDI with significant results reported only in case of Germany. The overall evidence indicates that the effect of quality of infrastructure is positive on LMEs, with significant effect reported only in case of US sectoral FDI. Furthermore, we find a negative insignificant effect of quality of infrastructure on Northern firms across sectors. This confirms the arguments made in the previous section with regard to the centralization/decentralization and the types of activities that are undertaken in foreign affiliates of MNEs. Consistent with our earlier arguments we find that US firms show a more centralised structure that is consistent across sectors. This centralised structure mainly allocates production activities to the affiliates abroad taking advantage of cost differentials while the R&D activity tends to be chiefly undertaken at the home country. In contrast we find Finish firms to show a rather decentralised structure that tends to outsource its R&D to its affiliates in the host countries. The evidence from German and Dutch firms is not conclusive as we observe various effects reported in different sectors. However, the indication from French FDI shows a decentralised structure of French firms' coordination activities across sectors.

Of macroeconomic variables, the effect of *interest rate lending* is positive on LMEs' and Northern and Dutch manufacturing FDI with significant results reported for US and Finish manufacturing FDI. In contrast we observe a negative and insignificant effect of *interest rate lending* on German and French manufacturing FDI. Considering the effect of *interest rate lending* on services FDI, we find a positive effect reported for LMEs', German, French and Northern which is significant only in case of German services FDI,

while a negative insignificant effect is reported for Dutch services FDI. The results demonstrate that the effect of *interest rate lending* on most CMEs' FDI varies by sectoral consideration.

The second macroeconomic variable, *taxes on income and profit*, has a positive effect on Dutch and LMEs' manufacturing FDI with significant results reported in case of US manufacturing FDI. In contrast we observe a negative effect of taxes on German, French and Finish manufacturing FDI, with significant results reported for Finish manufacturing FDI at 10%. Considering the effect of taxes on services FDI, we find a positive effect reported for LMEs which is significant only in case of US services FDI, while the effect on other countries' services FDI is negative and significant. The overall results thus demonstrate that services FDI is more sensitive to taxes in comparison to manufacturing FDI. Furthermore, the effect of taxes is negative and significant on Finish FDI across sectors, indicating a significant effect of taxes on Finish FDI. The effect of taxes on most countries' sectoral FDI is similar across sectors, with the exception of Dutch sectoral FDI. It is possible to take the opportunity to point out that in several cases, so far, we have observed that the effect of variables on sectoral FDI of the same countries differs due to various differences that exist between sectors. These differences in turn influence the coordination activity of the firms, and thus result in various effects observed across sectors. Therefore, our findings so far support the argument made by Blonigen (2005) that consideration of disaggregated FDI flows, allows a more concise exploration of determinants of FDI. In particular our sectoral level of aggregation has provided evidence on the way the same variables affect the FDI from firms from the same country abroad, in contrasting ways.

The third group of macroeconomic variables are trade related variables. The effect of *trade as a percentage of GDP* on manufacturing FDI is positive on all countries' manufacturing FDI with significant results reported in case of US, Finish and Dutch manufacturing FDI. Considering the effect of *trade as a percentage of GDP* on services FDI, we find a positive effect on all countries' services FDI with significant results reported for UK, German and Dutch services FDI.

The effect of *stock traded as a percentage of GDP* on manufacturing FDI from all countries is positive and significant only in case of Dutch and Finish manufacturing FDI.



Considering the effect of stock traded on services FDI we find an overall positive significant effect, with insignificant results reported only for US services FDI.

The effect of *civil liberties* on manufacturing FDI is negative in all cases, and significant in case of LMEs and French manufacturing FDI providing support for the findings of Coates et al. (2010). In contrast a positive insignificant effect is reported in case of German manufacturing FDI providing support for the findings of Coughlin, et al. (1991), Pournarakis and Varsakelis (2004) and Blanton and Blanton (2007). Furthermore, considering the effect of civil liberties on services FDI we find a negative and significant effect on all countries' services FDI confirming the findings of Coates et al. (2010). The results of the effect of civil liberties on sectoral FDI indicate the existence of a non-linear relationship at sectoral level in case of German sectoral FDI. This finding is in support of the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and Resnick (2003) and our theoretical findings, and in contrast to our earlier empirical findings that considered the effect of civil liberties on aggregate (total) net FDI flows. Furthermore the effect of civil liberties on services FDI flows is considerably greater than manufacturing sector, providing empirical support for the theoretically established effect of sectoral characteristics, namely the ratio of labour versus capital intensity of production in a specific sector, on sectoral FDI flows. In particular we show that the effect of civil liberties on FDI flows is intermediated by the ratio of labour to capital intensity of sectors, therefore the existence of a non-linear effect of civil liberties on FDI flows is expected considering the characteristics of the sectors in which FDI is considered.

Considering the effect of *political rights* on manufacturing FDI, we find a positive effect reported for LMEs', Dutch and French manufacturing FDI with significant results reported only for UK and French manufacturing FDI. This is in line with hypothesis (2) provided in section 7.2.3 and in support of the findings of Jensen (2003); Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007). In contrast we find an insignificant negative effect of political rights on German and Finish manufacturing FDI abroad, providing support for the view of Asiedu (2001) and Li and Resnick (2003). The effect of political rights on services FDI is positive and significant on FDI from all countries with exception of insignificant results reported for German and Dutch services FDI. Therefore the results empirically support the findings of Jensen (2003), Addison and Heshmati (2003) on existence of a significant positive effect

and the results of Wheeler and Mody (1992) and Sethi, et al. (2003) on existence of positive insignificant effect of political rights on FDI. Therefore, the overall results of the effect of political rights on sectoral FDI empirically demonstrate the existence of a non-linear effect of political rights on sectoral FDI flows in line with findings of Li and Resnick (2003).

Of institutional variables, the effect of *government stability* on manufacturing FDI is positive in case of LMEs', and French manufacturing FDI, with significant results reported for LMEs' manufacturing FDI. In contrast we find a negative insignificant effect of *government stability* on German, Dutch, and Finish manufacturing FDI. The effect of *government stability* on services FDI is positive and significant in case of LMEs' services FDI. The effect reported for CMEs' and Northern FDI ranges from a positive insignificant effect reported for French and Finish services FDI and negative insignificant effects reported for German and Dutch services FDI. Therefore, government stability shows a positive significant effect on LMEs, while the evidence from CMEs sectoral FDI while linear across sectors, tends to be insignificant. Finally the effect of government stability on Finish sectoral FDI is non-linear.

The effect of the second institutional factor, *bureaucratic quality* on LMEs is positive and insignificant, while a negative and insignificant effect reported in case of CMEs. Finally the effect of *bureaucratic quality* on Northern countries' representative, Finland, is positive and significant. Considering the effect of *bureaucratic quality* on services FDI is positive in case of all countries, with the exception of a negative insignificant effect reported for UK services FDI. Furthermore, the effect of *bureaucratic quality* is significant only in case of US services FDI. The evidence suggests that the effect of *bureaucratic quality* on British and CME sectoral FDI varies across sectors.

The effect of the third institutional variable, *law and order* on manufacturing FDI is positive in all cases with the exception of an insignificant negative effect reported in case of UK manufacturing FDI. Furthermore, a significant and positive effect of *law and order* is reported in case of German and Finish manufacturing FDI. The effect of *law and order* on services FDI is positive on FDI from all home countries with the significant results reported for British and German services FDI. The overall evidence suggests that the effect of *law and order* on all countries is positive with the exception of British sectoral FDI for which the effects vary across sectors. Therefore the overall results of the institutional

variables indicate that the effect of various aspects of institutional environment of host countries affect FDI from various market economies in different ways. Furthermore, we find that the effects in some cases are non-linear across sectors. The latter explains the provision of mixed results on the effect of institutional variables on FDI flows.

Table 7—10: Estimation of determinants of home countries' sectoral FDI

Table 7-10		Estimation of Determinants of Sectoral FDI (All countries)											
		Manufacturing (Model 1.3)						Services (Model 1.3)					
Variable name	STATA label	US	UK	Germany	Netherlands	France	Finland	US	UK	Germany	Netherlands	France	Finland
GDP	lgdp	1.094***	0.930***	0.743***	0.478**	0.677***	1.604***	0.954***	1.023***	1.150***	0.912***	1.198***	0.241
		(0.097)	(0.124)	(0.234)	(0.222)	(0.178)	(0.182)	(0.073)	(0.117)	(0.115)	(0.179)	(0.121)	(0.213)
Production of Electricity	Olprod_ele c	-0.112	0.111	-0.184	-1.024*	-0.351	0.220	-0.741***	-0.404*	-0.600***	-0.971***	-0.721***	0.131
		(0.088)	(0.325)	(0.513)	(0.575)	(0.343)	(0.244)	(0.118)	(0.238)	(0.166)	(0.288)	(0.202)	(0.431)
Interest rate lending	lintrstRL	0.664***	0.366	-0.153	0.009	-0.269	0.745**	0.190	0.196	0.363**	-0.158	0.449	0.375
		(0.160)	(0.290)	(0.579)	(0.405)	(0.266)	(0.357)	(0.134)	(0.160)	(0.157)	(0.118)	(0.291)	(0.296)
Wage per hour	Olwageph	-0.181	-0.064	0.750***	0.839***	0.493**	0.350	0.023	0.244**	0.273**	-0.195	0.428***	-0.511*
		(0.129)	(0.170)	(0.262)	(0.305)	(0.216)	(0.232)	(0.096)	(0.105)	(0.127)	(0.134)	(0.137)	(0.261)
Taxes on income (total)	ltxinctot	0.628***	0.081	-0.040	0.105	-0.362	-2.262***	0.341*	0.114	-0.786**	-1.075***	-0.894***	-1.222***
		(0.233)	(0.508)	(0.612)	(0.848)	(0.457)	(0.544)	(0.181)	(0.366)	(0.339)	(0.305)	(0.314)	(0.293)
Air freight	Olairfreight	0.166	0.165	-0.014	-0.201	-0.178	-0.697**	0.208**	0.352	-0.501***	-0.058	-0.306	-0.370
		(0.145)	(0.347)	(0.313)	(0.391)	(0.182)	(0.271)	(0.085)	(0.230)	(0.142)	(0.170)	(0.210)	(0.311)
Trade percentage of GDP	ltradepgdp	0.500***	0.121	1.056	1.131*	0.704	1.708***	0.248	0.548**	1.018***	0.491	0.979***	0.227
		(0.188)	(0.457)	(0.734)	(0.584)	(0.503)	(0.455)	(0.157)	(0.225)	(0.292)	(0.361)	(0.311)	(0.529)
Stock traded (total)	Olstktrdtot	0.204	0.488	0.308	0.535*	0.098	1.112***	0.280	0.405*	0.519***	0.562***	0.562*	0.779**
		(0.188)	(0.380)	(0.428)	(0.288)	(0.340)	(0.331)	(0.191)	(0.211)	(0.147)	(0.100)	(0.333)	(0.302)

Political Rights	FHPR	0.150	0.373*	-0.117	0.262	0.418**	-0.083	0.225**	0.275*	0.056	0.188	0.293*	0.520*
		(0.102)	(0.225)	(0.349)	(0.368)	(0.174)	(0.260)	(0.090)	(0.158)	(0.204)	(0.237)	(0.154)	(0.289)
Civil Liberties	FHCL	-0.256**	-0.786**	0.192	-0.346	-0.792***	-0.172	-0.468***	-0.798***	-0.360*	-0.777***	-0.786***	-0.669**
		(0.124)	(0.304)	(0.414)	(0.486)	(0.261)	(0.303)	(0.103)	(0.164)	(0.203)	(0.253)	(0.224)	(0.276)
Government Stability	gov_stab	0.250***	0.156*	-0.193	-0.030	0.140	-0.024	0.128*	0.117**	-0.083	-0.016	0.035	0.036
		(0.066)	(0.083)	(0.191)	(0.147)	(0.087)	(0.101)	(0.076)	(0.054)	(0.059)	(0.058)	(0.085)	(0.131)
Law & Order	law_order	0.038	-0.120	0.697**	0.342	0.082	0.358*	0.039	0.175*	0.397***	0.014	0.183	0.235
		(0.042)	(0.175)	(0.353)	(0.331)	(0.191)	(0.186)	(0.048)	(0.106)	(0.114)	(0.132)	(0.142)	(0.252)
Bureaucratic Quality	bureauc_qual	0.138	0.183	-0.904	-0.868	-0.160	0.810**	0.478***	-0.013	0.062	0.202	0.211	0.449
		(0.137)	(0.367)	(0.614)	(0.605)	(0.315)	(0.344)	(0.154)	(0.174)	(0.234)	(0.225)	(0.317)	(0.441)
Constant	_cons	-32.447***	-22.370***	-19.473*	-12.340	-16.474**	-43.475***	-24.889***	-28.191***	-29.965***	-18.266***	-31.153***	-4.736
		(3.558)	(5.372)	(10.286)	(8.823)	(7.518)	(5.359)	(2.478)	(3.466)	(3.905)	(6.168)	(4.181)	(6.590)
N		1268.000	360.000	363.000	222.000	350.000	175.000	987.000	847.000	887.000	607.000	806.000	296.000
Pseudo R2		0.1611	0.1925	0.0735	0.0984	0.1328	0.4027	0.2322	0.2233	0.17	0.1539	0.2054	0.1323

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10.

Source: Author's estimations in STATA

The results of the regression analyses of disaggregated FDI using models 2.1-2.3 and the relevant discussions are provided in appendix 7.3.

### 7.3.3. Sensitivity Analysis of the Effect of the level of Civil Liberties on Total FDI

This section investigates the effect of civil liberties and political rights on FDI flows into two groups of countries: (1) countries with high and moderately high level of civil liberties; and (2) countries moderately low and low level of civil liberties. The main motivation is to explore the factors that influence the investment into free and moderately free countries in comparison to those affecting FDI flows into moderately repressed and repressed countries. In particular we would like to empirically examine the theoretical findings of chapter 4, through empirical investigation of hypotheses 1 and 2 where groups of countries with distinct disparities with regard to the level of civil liberties are considered. The latter can be viewed as sensitivity analysis of the findings and discussion of section 7.3.1. The investigation is carried out in aggregate level (total FDI flows) as well as disaggregated level (sectoral level) following the structure of this research. The classification of countries based on their level of civil liberties is carried out by consideration of the Freedom House rankings.

This section's investigations are inspired by Adam and Filippaios (2007) paper that considers countries with civil liberties' rankings of less than or equal to three as free and moderately free countries ( $FHCL \leq 3$ ), and those with civil liberties' rankings of greater or equal to four, as moderately repressed and repressed countries ( $FHCL \geq 4$ ). The description of the meaning of the ranking of countries based on their level of civil liberties provided by Freedom House is provided in the Appendix 6.5.

The initial empirical investigation of aggregate and sectoral FDI using model 1.3<sup>126</sup>, and Adam and Filippaios (2007) categorization indicates a low number of observations on net FDI flows for countries with low level of civil liberties, particularly in case of sectoral FDI, resulting in lack of statistical confidence in the results. With the intention of provision of consistent categorization of countries across various levels of aggregation, we adopt a more flexible categorization based on which countries with civil liberties' rankings of less than three are considered as free and moderately free countries ( $FHCL < 3$ ), and those with civil liberties' rankings of greater than three are considered as moderately repressed and repressed countries ( $FHCL \geq 3$ ). This categorization allows provision of more

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<sup>126</sup> Model 2.3 is not considered in the sensitivity analysis due to low number of observations available for Investment in Research and Development (Irnd).

balanced samples, where each group entails a considerable number of observations on net FDI flows for empirical analysis. Furthermore, whilst our alteration of categorization allows for more number of observations for FDI in both group of countries when aggregated and disaggregated FDI flows are considered, we find that a number of independent variables suffer from low number of observations. This leads to a significant reduction in the number of observations, since STATA automatically drops the observations for which the values are not available for all variables. The variable that suffers from considerably low number of observations is wage per hour (Olwage). Consequently, with the intention to provide a consistent analysis across various levels of FDI activity, we consider a variation of model 1.3 that excludes the ES variables from our empirical analysis in this section. The results of these considerations are the regression models tabulated in table 7-11.

**Table 7—11: Models used for Sensitivity Analysis**

Sensitivity Analysis Model 1.3; Adam & Filippaios (2007) categorization	Sensitivity Analysis Model 1.3; Author's categorization	Sensitivity Analysis Model 1.3 variation; Adam & Filippaios (2007) categorization	Sensitivity Analysis Model 1.3 variation; Author's categorization
Civil Liberties $\leq 3$ & Civil Liberties $\geq 4$	Civil Liberties $< 3$ & Civil Liberties $> 3$	Civil Liberties $\leq 3$ & Civil Liberties $\geq 4$	Civil Liberties $< 3$ & Civil Liberties $> 3$
Log(GDP)	Log(GDP)	Log(GDP)	Log(GDP)
OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)	OLog(production of Electricity)
Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)	Log(Interest rate lending)
OLog(Wage per Hour)	OLog(Wage per Hour)	OLog(tax on income total)	OLog(tax on income total)
OLog(tax on income total)	OLog(tax on income total)	OLog(Airfreight)	OLog(Airfreight)
OLog(Airfreight)	OLog(Airfreight)	Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)
Log(trade as a percentage of GDP)	Log(trade as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)
OLog(total Stock traded value as a percentage of GDP)	OLog(total Stock traded value as a percentage of GDP)	Civil Liberties	Civil Liberties
Civil Liberties	Civil Liberties	Political Rights	Political Rights
Political Rights	Political Rights	bureauc_qual	bureauc_qual
bureauc_qual	bureauc_qual	gov_stab	gov_stab
gov_stab	gov_stab	law_order	law_order

law_order	law_order		
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Note that the results of the empirical models that use authors' categorization of civil liberties based on Freedom House ranking are reported in this section while the results of regression models that use Adam and Filippaios (2007) categorization of civil liberties based on Freedom House are reported for readers' information in the appendix 7.11 and 7.13.

Moreover, with the intention to provide consistent empirical exploration, we do provide the results of the original regression model 1.3, in the appendix 7.12. It is worth mentioning that while the results of analysis using the original model suffer from low number of observations that undermine the credibility of statistical inference, they are consistent with respect to those observed in case of model 1.3 variations provided in table 7-12, and in particular in terms of the effect of civil liberties on FDI activity.

Having discussed the main empirical models that are considered in this section we proceed to discussing the empirical results of the sensitivity analysis of the effect of civil liberties, in order to further explore the non-linearities observed. In particular we conduct our empirical inquiry in both aggregate and sectoral levels, in order to provide a consistent analysis in this chapter.

The regressions provided in table 7-12, cover the home countries aggregate FDI flows from 1990-2009. The results are not fully discussed in this section due to the limitations applied to the length of this research. However, with the intention to provide the reader with the full discussion on the results provided in table 7-12, the relevant discussions are available from appendix 7.7. In this section however, we mainly focus on the effect of civil and political liberties on aggregated FDI flows into host countries with various levels of civil liberties.

The effect of *civil liberties* on FDI into host countries with higher level of civil liberties is negative and significant in case of firms from all home countries, with the exception of Finish FDI for which the effect is reported to be negative and insignificant. Furthermore, considering the effect of civil liberties on FDI into host countries with lower level of civil liberties we find that the effect is negative and insignificant in case of most countries with the exception of negative significant effects reported for US and Finish FDI into host



countries with lower level of civil liberties. The results are in support of our theoretical findings and in line with hypothesis 1. Therefore our empirical investigation of the effect of civil liberties on aggregate FDI flows into two groups of countries with different levels of civil liberties, are in favour of existence of a negative effect and in support of the findings of Coates et al. . However, we find that the aggregate FDI flows are more sensitive to changes in the level of civil liberties in the group of host countries with high and moderately high level of countries in comparison to those with lower level of civil liberties. In case of countries with low level of civil liberties, we find significant negative effect of an increase in the level of civil liberties, on US and Finish FDI, while the effect is insignificant and negative in case of other home countries.

The effect of *political rights* on FDI into host countries with higher level of civil liberties is positive and insignificant in case of all countries with the exception of German and Finish FDI. The effect of political rights on FDI into host countries with low level of civil liberties is positive and insignificant in case of LMEs and France, while in contrast we observe a negative effect in case of CMEs' (with the exception France) and Northern FDI. Therefore the overall evidence suggests that in contrast to our theoretical finding, and hypothesis 2, the effect of political rights on FDI into host countries with various levels of civil liberties is non-linear. Furthermore, we find that the effects are symmetric across groups in all cases with the exception of Dutch FDI. In particular we find that Dutch FDI is positively affected by political rights in countries with higher levels of civil liberties, while the effect is negative in case of host countries with lower levels of civil liberties. Furthermore, the results suggest that the effect of political rights on LMEs FDI is positive and insignificant, indicating that LMEs tend to invest in countries with higher level of political rights, irrespective of their level of civil liberties. This is in line with findings of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007) who reported a positive relationship between the level of political liberties of the host countries on the FDI. In contrast we find a negative insignificant effect of the level of political rights on German and Finish FDI, across groups, indicating that German and Finish firms tend to invest in politically repressed countries, irrespective of their level of civil liberties. This is in line with the findings of Asiedu (2001) and Li and Resnick (2003), who have reported a negative effect of political rights on FDI.

Table 7—12: Estimation of determinants of home countries' aggregated FDI into host countries with various levels of civil liberties

Table 7-12		Estimation of Determinants of Total FDI (Model 1.3)											
		Countries with high and moderately high level of civil liberties $FHCL < 3$						Countries with moderately low and low level of civil liberties $FHCL \geq 3$					
Variable name	STATA label	US	UK	Germany	Netherlands	France	Finland	US	UK	Germany	Netherlands	France	Finland
GDP	lgdp	0.834***	1.022***	1.270***	1.284***	1.272***	1.494***	0.758***	0.845***	1.210***	0.574**	0.922***	2.353***
		(0.256)	(0.141)	(0.086)	(0.120)	(0.103)	(0.234)	(0.188)	(0.147)	(0.074)	(0.249)	(0.082)	(0.585)
Production of Electricity	Olprod_ele c	-0.659**	-0.030	-0.582***	-0.927***	-0.967***	0.185	-0.282	-0.226	-0.187	-0.576	0.036	0.175
		(0.315)	(0.224)	(0.130)	(0.156)	(0.204)	(0.312)	(0.244)	(0.305)	(0.202)	(0.385)	(0.514)	(0.901)
Interest rate lending	lintrstRL	-0.363	0.234	0.163	0.402*	0.183	-0.166	0.338*	0.431**	0.291	0.736*	1.945***	1.588
		(0.348)	(0.185)	(0.160)	(0.233)	(0.274)	(0.489)	(0.176)	(0.202)	(0.246)	(0.392)	(0.613)	(1.131)
Taxes on income (total)	ltxinctot	0.982	0.414	-0.966***	-0.282	-0.396	-2.515***	-0.044	-0.026	-0.050	-0.644*	0.501	-0.425
		(0.612)	(0.405)	(0.287)	(0.217)	(0.355)	(0.453)	(0.228)	(0.269)	(0.112)	(0.338)	(0.438)	(0.595)
Air freight	Olairfreight	0.152	0.559**	-0.003	-0.078	-0.071	-0.417	-0.320*	0.212	-0.272	0.492	0.072	1.705
		(0.279)	(0.220)	(0.130)	(0.144)	(0.102)	(0.348)	(0.179)	(0.208)	(0.171)	(0.333)	(0.286)	(1.117)
Trade percentage of GDP	ltradepgdp	0.471*	1.159***	1.427***	1.450***	1.237***	2.094***	1.825***	0.671**	1.400***	0.588	0.848**	1.589**
		(0.272)	(0.330)	(0.284)	(0.424)	(0.318)	(0.692)	(0.346)	(0.274)	(0.173)	(0.489)	(0.410)	(0.796)
Stock traded (total)	Olstkrtdtot	0.438	0.331***	0.197	0.490***	0.218*	0.950**	-0.187	0.403*	-0.111	0.201	0.165	0.886
		(0.428)	(0.126)	(0.126)	(0.185)	(0.127)	(0.373)	(0.242)	(0.233)	(0.140)	(0.294)	(0.304)	(0.597)
Political Rights	FHPR	0.019	0.315	-0.016	0.208	0.495	-0.604	0.134	0.021	-0.065	-0.075	0.514	-0.015
		(0.456)	(0.303)	(0.445)	(0.473)	(0.454)	(0.564)	(0.111)	(0.207)	(0.105)	(0.135)	(0.357)	(0.238)

Civil Liberties	FHCL	-0.882**	-0.648***	-0.249*	-0.766***	-0.698***	-0.345	-0.321**	-0.077	-0.047	-0.173	-0.615	-0.651*
		(0.411)	(0.203)	(0.128)	(0.208)	(0.203)	(0.536)	(0.158)	(0.376)	(0.164)	(0.221)	(0.537)	(0.383)
Government Stability	gov_stab	0.182**	0.187**	0.006	0.149*	-0.049	0.143	0.102*	0.157*	0.128**	0.253***	0.011	-0.273
		(0.088)	(0.079)	(0.054)	(0.077)	(0.055)	(0.109)	(0.058)	(0.093)	(0.058)	(0.079)	(0.132)	(0.233)
Law & Order	law_order	0.049	-0.296***	0.092	0.106	-0.031	0.156	0.313**	-0.214	0.155	0.118	0.576***	0.316
		(0.222)	(0.095)	(0.116)	(0.153)	(0.133)	(0.159)	(0.134)	(0.165)	(0.102)	(0.215)	(0.178)	(0.407)
Bureaucratic Quality	bureauc_qual	0.605**	0.638***	0.225	0.150	0.325*	0.383	-0.253	0.337	0.063	-0.431	-0.350	-1.061**
		(0.303)	(0.179)	(0.174)	(0.285)	(0.189)	(0.365)	(0.156)	(0.233)	(0.125)	(0.325)	(0.325)	(0.401)
Constant	_cons	-22.526***	-29.542***	-30.594***	-35.537***	-31.744***	-37.132***	-22.496***	-22.315***	-35.219***	-13.134	-31.058***	-64.147***
		(6.811)	(4.921)	(3.311)	(4.502)	(3.981)	(7.352)	(6.418)	(4.356)	(2.701)	(8.429)	(4.701)	(18.458)
N		204.000	248.000	313.000	265.000	303.000	205.000	187.000	218.000	310.000	147.000	202.000	80.000
Pseudo R2		0.3903	0.4456	0.4186	0.4224	0.5384	0.3086	0.2662	0.3347	0.514	0.2157	0.345	0.4748

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10.

Source: Author's estimations in STATA

#### 7.3.4. Sensitivity Analysis of the Effect of the level of Civil Liberties on Sectoral FDI

This section investigates the effect of civil and political liberties on sectoral net FDI flows from our set of home countries (US, UK, Germany, Netherlands, France, and Finland) into 140 host countries which are grouped into two sets of countries: (1) host countries with high or moderately high level of civil liberties ( $FHCL < 3$ ); and (2) host countries with moderately low and low level of civil liberties ( $FHCL \geq 3$ ). The motivation is to investigate the effect of civil and political liberties on sectoral FDI flows into groups of host countries with various levels of civil liberties, in order to examine the theoretical findings of chapter 4. In particular we are investigating the hypotheses 3 and 4 discussed in section 7.2.3.

The regressions provided in table 7-13, cover the home countries sectoral FDI into host countries with high and moderately high level of civil liberties, flows from 1990-2009. The results are not fully discussed in this section due to the limitations applied to the length of this research. However, with the intention to provide the reader with the full discussion on the results provided in table 7-13, the relevant discussions are available from appendix 7.8. In this section however, we mainly focus on the effect of civil and political liberties on aggregated FDI flows into host countries with various levels of civil liberties.

The effect of *civil liberties* on LMEs' sectoral FDI into host countries with higher level of civil liberties is negative and significant. The evidence on the effect of civil liberties on CMEs' manufacturing FDI shows a negative and insignificant effect on German and French manufacturing FDI, while the effect reported in case of Dutch manufacturing FDI is in contrast, positive and insignificant. The effect of civil liberties on CMEs' services FDI is negative and significant on Dutch and French FDI, while a negative insignificant effect is reported in case of German services FDI into host countries with higher level of civil liberties. Considering the Northern sectoral FDI into host countries with higher level of civil liberties, we find a positive insignificant effect reported in case of Finish manufacturing FDI, while in contrast a negative and significant effect is reported in case of Finish services FDI into host countries with higher level of civil liberties.

The overall evidence suggests that increases in the level of civil liberties in the host countries with higher level of civil liberties act as a deterrent to sectoral FDI from LMEs. Furthermore the negative effect of civil liberties on LMEs', Dutch and French FDI across

sectors, indicates that there are no differences in the way civil liberties affect LMEs' FDI into sectors with greater labour share of production in comparison to those with higher capital share of production, in contrast to our theoretical findings of chapter 4 and hypothesis 3. Consequently we refute the hypothesis 3, and find the evidence in support of the findings of Coates et al. . However, the sectoral analysis of the CMEs' (with the exception of Germany) and Northern FDI demonstrates that civil liberties has a greater effect on FDI into sectors with higher labour share of production (services) in comparison to sectors with greater capital share of production (manufacturing), thus providing evidence in support of the hypothesis 3.

Furthermore, the effect of civil liberties on services FDI is negative supporting the findings of Coates et al. , while the review of the effects observed in case of manufacturing FDI indicates both positive insignificant effect (case of Dutch and Finish manufacturing FDI) and negative effects (case of LMEs, Germany and France) with significant results reported only for LMEs, giving support to the findings of Coates et al. in case of LMEs, Germany and France, and the works of Asiedu and Lien (2011), Adam and Filippaios (2007), and Li and Resnick (2003) in case of Dutch and Finish FDI. Therefore considering LMEs' and Germany's sectoral FDI into host countries with higher level of civil liberties, we find a symmetric negative effect across labour and capital intensive sectors, in contrast to our theoretical findings which leads to refuting hypothesis 3, while the evidence on Dutch, French and Finish sectoral FDI into host countries with higher level of civil liberties suggests a greater influence of civil liberties on labour intensive sector, in line with our theoretical findings, and in support of hypothesis 3. The comparison on the effect of civil liberties on sectoral FDI flows into host countries with higher and lower levels of civil liberties are made in section 7.3.4, in order to provide a better understanding of the effect of civil liberties on FDI flows.

The effect of *political rights* on US manufacturing FDI into host countries with higher level of civil liberties is positive and insignificant across sectors, while the effect reported in case of UK manufacturing FDI is consistently negative across sectors, and significant only in case of UK manufacturing FDI. The effect of political rights on CMEs' sectoral FDI into host countries with higher level of civil liberties is positive and insignificant with the exception of a positive and significant effect reported in case of French services FDI. In contrast a non-linear effect of political rights on Northern FDI is observed with a negative

and insignificant reported for Finish manufacturing FDI, and a positive and significant effect is reported in case of Finish services FDI.

Therefore the overall evidence suggests that the effect of political rights on U.S. and CMEs' sectoral FDI into host countries with higher level of civil liberties is positive and in line with hypothesis 2. In contrast, the review of the effect of political rights on UK sectoral FDI indicates the presence of a negative effect in line with the findings of Asiedu (2001) and Coates et al. (2010). However, the review of the effect of political rights on Northern FDI, shows that the effect is reported to be insignificant and negative on manufacturing FDI, while a positive and significant effect is reported in case of Finish services FDI. This non-linear effect of political rights on FDI is in line with the findings of Li and Resnick (2003) who have reported both positive and negative influences of political rights on FDI.

Table 7—13: Estimation of determinants of home countries' sectoral FDI in host countries with high and moderately high level of civil liberties

Table 7-13		Estimation of Determinants of Sectoral FDI (All countries); countries with high and moderately high level of civil liberties <i>FHCL</i> < 3											
		Manufacturing (Model 1.3)						Services (Model 1.3)					
Variable name	STATA label	US	UK	Germany	Netherlands	France	Finland	US	UK	Germany	Netherlands	France	Finland
GDP	lgdp	1.216***	0.814***	0.550	-0.013	0.408*	1.497***	0.847***	1.076***	1.119***	0.882***	0.958***	0.668***
		(0.125)	(0.158)	(0.358)	(0.421)	(0.212)	(0.184)	(0.092)	(0.141)	(0.142)	(0.188)	(0.129)	(0.231)
Production of Electricity	Olprod_elec	0.048	0.168	0.149	-1.026	-0.994***	0.140	-0.711***	-0.516**	-0.488**	-1.163***	-1.047***	0.459
		(0.199)	(0.280)	(0.577)	(0.701)	(0.320)	(0.303)	(0.147)	(0.203)	(0.209)	(0.233)	(0.300)	(0.284)
Interest rate lending	lintrstRL	0.619***	0.417*	-0.579	0.027	-0.474**	0.712**	-0.725**	0.617**	0.149	-0.100	0.049	0.096
		(0.231)	(0.229)	(0.720)	(0.586)	(0.223)	(0.323)	(0.283)	(0.261)	(0.327)	(0.182)	(0.355)	(0.234)
Taxes on income (total)	Itxinctot	0.334	0.495	-0.212	0.959	0.868	-1.919***	0.626**	-0.393	-0.747*	-0.738	-0.495	-1.361***
		(0.270)	(0.554)	(0.686)	(1.304)	(0.624)	(0.567)	(0.281)	(0.382)	(0.383)	(0.548)	(0.659)	(0.411)
Air freight	Olairfreight	-0.050	0.232	0.437	-0.405	-0.180	-0.217	0.254*	0.416*	-0.318**	-0.040	0.111	-0.752**
		(0.165)	(0.255)	(0.404)	(0.593)	(0.203)	(0.298)	(0.138)	(0.242)	(0.140)	(0.224)	(0.159)	(0.353)
Trade percentage of GDP	ltradevgdp	0.612***	-0.042	0.647	0.056	0.850**	2.471***	0.511*	0.550	1.048***	0.807**	1.254***	0.969*
		(0.224)	(0.530)	(0.770)	(0.811)	(0.378)	(0.440)	(0.273)	(0.352)	(0.322)	(0.371)	(0.385)	(0.540)
Stock traded (total)	Olstkrtdtot	0.095	0.479*	0.496*	0.676	0.247	0.759**	-0.011	0.455**	0.432**	0.370*	0.257*	0.860***
		(0.268)	(0.248)	(0.255)	(0.556)	(0.214)	(0.364)	(0.192)	(0.209)	(0.170)	(0.221)	(0.146)	(0.214)
Political Rights	FHPR	0.348	-0.895**	0.244	0.003	0.764	-0.155	0.094	-0.332	0.391	0.998	0.847*	1.704**
		(0.249)	(0.412)	(0.814)	(1.673)	(0.495)	(0.782)	(0.271)	(0.586)	(0.509)	(0.648)	(0.438)	(0.745)

Civil Liberties	FHCL	-0.768***	-0.836***	-0.100	0.619	-0.413	0.221	-0.861***	-0.755***	-0.640	-1.259***	-0.888**	-0.562*
		(0.242)	(0.318)	(0.626)	(0.746)	(0.359)	(0.397)	(0.202)	(0.212)	(0.490)	(0.242)	(0.361)	(0.287)
Government Stability	gov_stab	0.025	0.111	-0.190	0.099	-0.011	0.051	0.048	0.085	-0.073	-0.117*	0.078	0.103
		(0.060)	(0.082)	(0.188)	(0.193)	(0.109)	(0.082)	(0.055)	(0.073)	(0.048)	(0.067)	(0.092)	(0.103)
Law & Order	law_order	0.037	-0.478***	0.389	0.157	-0.317	0.048	-0.244*	-0.095	0.057	-0.075	-0.453**	0.472
		(0.151)	(0.168)	(0.406)	(0.278)	(0.204)	(0.233)	(0.130)	(0.182)	(0.188)	(0.184)	(0.189)	(0.290)
Bureaucratic Quality	bureauc_qual	0.441*	0.146	-0.749	-0.035	0.401	1.066***	0.692***	0.501**	0.300	0.538*	0.639**	-0.231
		(0.246)	(0.311)	(0.719)	(0.700)	(0.319)	(0.398)	(0.183)	(0.235)	(0.271)	(0.324)	(0.305)	(0.587)
Constant	_cons	-34.309***	-16.470***	-10.286	-1.552	-13.757**	-45.489***	-20.578***	-28.012***	-28.158***	-20.201***	-25.650***	-19.346**
		(4.099)	(6.098)	(13.379)	(14.426)	(6.028)	(5.640)	(3.118)	(4.956)	(4.199)	(4.948)	(5.706)	(7.579)
N		881.000	321.000	301.000	192.000	289.000	158.000	710.000	770.000	740.000	542.000	656.000	272.000
Pseudo R2		0.1574	0.2072	0.071	0.0504	0.0504	0.4275	0.2242	0.2176	0.1688	0.1585	0.2239	0.1179

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10

Source: Author's estimations in STATA



The regressions provided in table 7-14, cover the home countries sectoral FDI into host countries with moderately low and low level of civil liberties, flows from 1990-2009. The results are not fully discussed in this section due to the limitations applied to the length of this research. However, with the intention to provide the reader with the full discussion on the results provided in table 7-14, the relevant discussions are available from appendix 7.9. In this section however, we mainly focus on the effect of civil and political liberties on aggregated FDI flows into host countries with various levels of civil liberties.

The effect of *civil liberties* on US sectoral FDI into host countries with lower level of civil liberties is negative and insignificant in case of US manufacturing FDI while a positive insignificant effect is reported for US services sector. Similarly we observe an asymmetric effect in case of UK sectoral FDI into host countries with lower level of civil liberties with a negative insignificant effect observed in case of UK manufacturing FDI and a positive insignificant effect reported for UK services sector. The influence of civil liberties on CMEs' manufacturing FDI tends to be positive for Germany, and negative for Dutch and French manufacturing FDI, and insignificant in all cases. Considering the effect of civil liberties on CMEs' services FDI, we find a positive insignificant effect on all CMEs' FDI across sectors. The influence of civil liberties on Northern FDI into host countries with lower level of civil liberties is negative and insignificant across sectors. Thus the overall evidence suggests that civil liberties has a symmetric effect on FDI from Germany and Finland across sectors, while in contrast an asymmetric effects are reported for all other countries across sectors, emphasising that firms' behaviour vary across sectors, and consequently their FDI behaviour. Therefore we find that consistent with our earlier arguments, the effect of civil liberties and political rights among many other factors that influence FDI activity, vary across sectors. Hence, we argue that a through analysis of factors influencing the FDI activity should use disaggregated data in order to shed more light on micro drivers of FDI activity in order to explain the aggregate of these influences on macro level and thereby explain FDI activity.

Moreover, the comparison of the effect of civil liberties on FDI into capital intensive (manufacturing) and labour intensive (services) sectors, would allow us to investigate the hypothesis 4 provided in section 7.2.3. The overall review of the effects reported show that they are all insignificant across sectors and countries. Furthermore an increase in the level of civil liberties in manufacturing sector (capital intensive sector) affects FDI from

US, Netherlands, France and Finland in a negative manner, while FDI from UK and Germany are affected in a positive manner. The latter indicates that an increase in the level of civil liberties will have a negative insignificant effect on the manufacturing FDI from 4 out of 6 home countries considered. Reviewing the effects reported in case of services (labour intensive) sector show that an increase in the level of civil liberties in services sector would affect FDI from UK and Finland in a negative manner while FDI from US, Germany, Netherlands, and France (CMEs) are affected in a positive manner, demonstrating that an increase in the level of civil liberties has a negative effect on the services FDI from firms from 2 out of 6 home countries considered. Therefore, we do not find empirical support for hypothesis 4, demonstrating that the effect of civil liberties on services FDI (labour intensive production) is greater than that on manufacturing FDI (capital intensive production), in case of repressed and moderately repressed countries. Hence, we refute the hypothesis 4.

Furthermore, comparison between sectoral FDI into host countries with high and low level of civil liberties allows us to investigate the FDI activity further. Considering the manufacturing sector, and consulting tables 7-13 and 7-14 we find that the effect of civil liberties on manufacturing FDI into host countries with higher level of civil liberties is greater in case of LMEs, with significant and negative results reported for US and UK manufacturing firms. In comparison, the results from LMEs' manufacturing FDI into host countries with low level of civil liberties indicates presence of insignificant effects that are negative in case of US, and positive in case of UK manufacturing FDI. Thus increase in the level of civil liberties in host countries irrespective of their level of civil liberties deters US FDI, providing support for the findings of Coates et al. . However, the effect is more significant in countries with higher level of civil liberties. UK manufacturing FDI similarly shows a negative significant effect when host countries with higher level of civil liberties are considered. However, an increase in the level of civil liberties, in host countries with lower level of civil liberties, affects UK manufacturing firms in an insignificant and positive manner, indicating a non-linear effect of civil liberties across groups of countries with different levels of civil liberties, in support of the findings of works of Asiedu and Lien (2011), Adam and Filippaios (2007), and Li and Resnick (2003). Similarly, we observe a non-linear effect of civil liberties on German, Dutch and Finish FDI manufacturing FDI into two groups of countries with different levels of civil liberties. However, the effect of civil liberties on French manufacturing FDI, is linear, insignificant

and negative across sectors giving support to the findings of Coates et al. . Thus we observe a non-linear effect of civil liberties on UK, German, Dutch and Finish manufacturing FDI, while a linear and negative effect is observed in case of US and French manufacturing FDI.

Examination of the services FDI flows into the two groups of host countries with various levels of civil liberties shows that civil liberties have a greater effect on services FDI into host countries with higher level of civil liberties. Furthermore, the results indicate that the effect of civil liberties on services FDI into host countries with higher level of civil liberties is consistently negative, while in contrast civil liberties have a negative effect on only two countries of UK and Finland when countries with lower level of civil liberties are considered. Comparing the results suggests that civil liberties affect US, German, Dutch, and French services FDI in a non-linear manner, giving support to the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), and Li and Resnick (2003). In contrast the effect of civil liberties on UK and Finish FDI is linear and negative, in support of the findings of Coates et al. . Therefore, the comparative analysis of the findings of the two sectors shows that in most cases the effect of civil liberties on sectoral FDI is non-linear.

The effect of *political rights* on manufacturing FDI flows from UK, France, Netherlands, and Finland into host countries with low level of civil liberties is insignificant and positive, and in support of the findings of Wheeler and Mody (1992) and Sethi, et al. (2003), while the effect on German and US manufacturing FDI is reported to be insignificant and negative, supporting the findings of Asiedu (2001) and Coates et al. (2010). In contrast the effect of political rights on services FDI flows into host countries with low level of civil liberties is insignificant and negative in all cases with the exception of German services FDI for which a positive insignificant effect is reported. Therefore the overall evidence suggests existence of a non-linear effect of political rights on sectoral FDI for most countries except US. Furthermore, the effect of political rights on manufacturing FDI is generally positive and in line with hypothesis 2 and findings of Wheeler and Mody (1992) and Sethi, et al. (2003), while the effect of political rights on services FDI is insignificant and negative, in line with the findings of Asiedu (2001) and Coates et al. (2010). Thus, it is possible to argue that the sectoral composition of the data that is used by the researcher in empirical analysis of the effect of institutional factors, civil liberties and political rights on FDI, influences the findings of the research. Therefore, it is credible to

speculate that most of the researches that have found a positive effect of political rights on FDI activity, have used aggregate data that draw a great deal more from manufacturing sector than services, and vice versa. However due to limitation of this research, the further examination of this claim is left for future research.

Table 7—14: Estimation of determinants of home countries' sectoral FDI in host countries with moderately low and low level of civil liberties

Table 7-14		Estimation of Determinants of Sectoral FDI (All countries); countries with moderately low and low level of civil liberties $FHCL \geq 3$											
		Manufacturing (Model 1.3)						Services (Model 1.3)					
Variable name	STATA label	US	UK	Germany	Netherlands	France	Finland	US	UK	Germany	Netherlands	France	Finland
GDP	lgdp	1.030***	1.241***	1.324***	-0.568	1.068***	2.000***	0.983***	0.959***	1.155***	0.844**	0.622***	1.941
		(0.119)	(0.172)	(0.309)	(0.499)	(0.273)	(0.555)	(0.125)	(0.180)	(0.149)	(0.327)	(0.204)	(5.151)
Production of Electricity	Olprod_elec	-0.494	0.559	0.156	-0.677	-0.826	-1.329	-0.397	0.043	0.382	0.245	-0.620	-4.060
		(0.352)	(0.497)	(0.724)	(1.413)	(0.954)	(1.198)	(0.310)	(0.403)	(0.882)	(0.828)	(1.002)	(27.043)
Interest rate lending	litrstRL	0.933***	1.732**	0.767	-3.379	1.457	1.615	0.603***	0.140	1.684***	1.741**	0.993	-1.262
		(0.180)	(0.850)	(0.916)	(2.281)	(1.056)	(1.226)	(0.169)	(0.302)	(0.354)	(0.840)	(0.902)	(7.149)
Taxes on income (total)	Itxinctot	0.028	-0.593	0.153	-0.344	-0.059	-0.401	0.208	0.255	-0.331	-0.744	-0.340	-1.569
		(0.427)	(0.500)	(0.631)	(0.755)	(0.550)	(1.115)	(0.285)	(0.157)	(0.991)	(0.580)	(0.386)	(3.390)
Air freight	Olairfreight	0.343*	-0.793	-0.427	-0.539	0.105	0.776	0.004	-0.035	-0.594*	0.334	-0.127	-0.993
		(0.182)	(0.527)	(0.545)	(1.659)	(0.910)	(1.646)	(0.207)	(0.247)	(0.338)	(0.481)	(0.801)	(5.164)
Trade percentage of GDP	ltradepgdp	1.275***	2.428***	2.309***	0.033	0.134	1.916	1.330***	1.316**	1.367***	2.303***	2.017**	6.765
		(0.291)	(0.632)	(0.756)	(1.792)	(1.323)	(1.844)	(0.325)	(0.513)	(0.502)	(0.815)	(0.908)	(21.937)
Stock	Olstkrtdtot	-0.165	0.756*	-0.345	-0.242	0.296	0.581	0.030	0.647	1.071*	-0.461	-0.214	0.534

traded (total)		(0.232)	(0.416)	(0.558)	(1.457)	(0.652)	(1.083)	(0.262)	(0.408)	(0.574)	(0.748)	(0.427)	(1.451)
Political Rights	FHPR	-0.026	0.033	-0.389	0.077	0.490	0.180	-0.107	-0.151	0.234	-0.102	-0.210	-0.489
		(0.155)	(0.325)	(0.752)	(0.653)	(0.382)	(0.551)	(0.141)	(0.148)	(0.273)	(0.518)	(0.262)	(5.785)
Civil Liberties	FHCL	-0.011	0.221	0.756	-0.077	-0.733	-0.020	0.033	-0.124	0.251	0.019	0.597	-0.550
		(0.208)	(0.631)	(1.008)	(1.634)	(0.707)	(1.279)	(0.271)	(0.339)	(0.537)	(0.946)	(0.646)	(14.744)
Government Stability	gov_stab	0.147**	0.135	-0.313	-0.247	0.290	-0.205	0.078	-0.169*	-0.248**	-0.094	-0.286	-0.638
		(0.065)	(0.135)	(0.296)	(0.280)	(0.302)	(0.508)	(0.058)	(0.088)	(0.112)	(0.158)	(0.243)	(5.587)
Law & Order	law_order	0.214**	-0.036	0.964	0.728	0.242	0.495	-0.173	0.347	0.273	0.199	0.755***	-0.782
		(0.097)	(0.217)	(0.754)	(0.602)	(0.440)	(0.621)	(0.109)	(0.215)	(0.314)	(0.530)	(0.229)	(13.072)
Bureaucratic Quality	bureauc_qual	-0.281	0.536	-0.194	-1.398	0.355	-0.801	0.200	-0.640**	0.422	0.058	-0.978*	-4.671
		(0.179)	(0.385)	(1.384)	(0.874)	(0.926)	(0.562)	(0.213)	(0.291)	(0.558)	(0.681)	(0.544)	(23.395)
Constant	_cons	-32.929***	-45.366***	-46.266***	31.469	-33.636***	-60.665**	-30.084***	-27.409***	-38.708***	-31.487***	-23.317**	-48.456
		(3.586)	(6.959)	(13.651)	(24.891)	(12.600)	(25.461)	(3.420)	(7.171)	(6.424)	(11.812)	(9.336)	(110.090)
N		668.000	107.000	99.000	64.000	106.000	45.000	498.000	205.000	265.000	157.000	242.000	44.000
Pseudo R2		0.1465	0.2359	0.1987	0.267	0.1766	0.5895	0.1524	0.2119	0.1689	0.1396	0.1111	0.3598

Note: t-statistics are provided in parentheses. Asterisks denote the statistical level of significance; those with \*\*\* reflecting significance at %1; \*\* %5; and \* %10. The values marked in red indicate low number of observations, which in turn indicate that the results are not statistically reliable.

Source: Author's estimations in STATA

## 7.4. Conclusion

In this chapter we empirically investigate explanatory power of our independent variables stemming from the firms' FDI motivations, macro-economic characteristics, institutional quality, level of civil liberties and political rights of the host countries, on our dependent variable which reflects net FDI flows. The main purpose of this exercise is to examine the empirical validity of our theoretical findings of chapter 4. In this spirit, following the arguments made in chapter 4, the analysis is conducted in two main levels of aggregation; country level total FDI flows, and sectoral FD flows.

The examination of the effect of independent variables on aggregate FDI flows is carried out through analysis of two, three-stage regressions. In each set of regressions the primary model is populated with traditional variables that have been used extensively in the literature in explaining FDI activity, namely: independent variable that proxy for firms' motivations of FDI, and host countries' macroeconomic variables. Then institutional variables are added to the model and the explanatory power of model, and independent variables are reviewed with regard to FDI flows. Finally, we include civil liberties and political rights as explanatory variables for FDI flows, following our discussions in chapter four, and examine the effect of them on FDI activity. The two sets of regressions differ in that, the second set of regressions includes investment in research and development, that is considered to proxy for SAS motives of FDI activity. However, since the number of observations is low for R&D variable, we have enclosed it as an auxiliary analysis that provides some information with regard to the way MNEs coordinate their FDI activity abroad.

The examination of the effects of firms' motivations and macroeconomic characteristics of host countries on aggregated net FDI flows, show that motivation of firms influence net FDI flows differently across markets economies (LMEs and CMEs) and countries. In particular we find that firms from LMEs, CMEs, and Northern countries, tend to be influenced by market seeking, efficiency seeking and resource seeking variables in a similar manner, while the effect of strategic asset seeking on FDI flows of LMEs and CMEs is significantly different. The differences in the way Strategic Asset Seeking (SAS) motives affect firms from LMES and CMEs were explored in the light of the differences in the way firms from different market economies coordinate their activities. We find that firms from LMEs tend to coordinate their research and development activities in a

centralised manner and outsourcing their production activities abroad while the evidence from CME show that they coordinate their activities in a more decentralised manner and thus their FDI investment does not have emphasis only on production and includes research and development activities.

The overall results of the empirical examination of aggregate FDI flows (total FDI) show that motivations of FDI, macroeconomic characteristics of host markets, their institutional environment as well as the level of civil liberties and political rights affect the total FDI flows. Furthermore, we find that the effects in case of host countries' taxes, investment in Research and development and infrastructure on FDI vary across firms from different types of market economies and that the consideration of the type of economy from which firms originate provides more detailed information with regard to their total FDI activity. We also show that the effect of level of civil liberties on total FDI flows is considerably different than the effect of political rights in the host markets on total FDI flows. The effect of the level of political rights on total FDI flows is generally positive supporting the findings of Jensen (2003), Addison and Heshmati (2003), Sethi et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007). In contrast to this positive effect, we also find an insignificant negative effect of political rights on German and Finish<sup>127</sup> FDI abroad, providing support for the view of Asiedu (2001) and Li and Resnick (2003). Therefore the overall results of the effect of political rights on sectoral FDI empirically demonstrate the existence of a non-linear effect of political rights on sectoral FDI flows in line with findings of Li and Resnick (2003). The effect of civil liberties on total FDI is generally negative and in most cases significant, supporting the findings of Coates et al. (2010).

Considering the effect of institutional quality of the host countries on total FDI flows, we find dominating evidence in favour of a positive effect supporting the findings of Lipsey (1999) and Campos and Kinoshita (2003), indicating that in general firms tend to invest in host countries with higher institutional quality. However, the contrary evidence on negative effects reported in a number of cases, raises the question on whether the positive effect of institutional quality of host countries is generalizable. We argue that the overall effect of institutional variables on FDI flows indicates presence of an asymmetric

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<sup>127</sup> German and Finish firms coordinate their activities in a decentralised manner.



effect, at least in a number of cases, that is in line with the findings of Aleksynska and Havrylchuk (2012) who exploring the role of institutional distance on the FDI show that institutional distance has an asymmetric effect on FDI depending on whether investors choose countries with better or worse institutions. It is also possible to relate our findings to those of Alvaro Cuervo-Cazurra (2006) who find that the relationship between ill-functioning institutions<sup>128</sup> and FDI is modified by the country of origin of the FDI.

The examination of the effects of firms' motivations and macroeconomic characteristics of host countries on sectoral net FDI flows, show that motivation of firms influence net FDI flows differently across sectors as well as markets economies (LMEs and CMEs). In particular we find that while all firms show MS dominating behaviour in their sectoral FDI activity, their ES behaviour varies considerably across sectors. Furthermore, RS, and MS behaviour of firms is similar across sectors if the quality of transportation is considered, while consideration of expenditure in R&D indicates that firms SAS and ES behaviour varies across sectors. The differences in the behaviour of the firms' FDI activity in various sectors stems from the fact that they coordinate their activities according to the sectoral characteristics. Consequently we find evidence supporting Blonigen (2005) arguments that analysis of aggregate FDI flows provides information with regard to the combination of affects reported for combination of sectors/industries. Since the empirical our results provide evidence on asymmetric, and in many cases, the non-linear effects of variables on FDI flows across sectors, the consideration of disaggregate FDI flows would allow one to gain a better understanding of the micro drivers of the industry and sectoral FDI. Therefore, we argue that it is necessary to explore the more disaggregated measure of FDI flows (i.e. industry of sectoral FDI flows) in order to provide a detailed and meaningful view of the way firms invest abroad and the factors that influence their behaviour.

Moreover, we find that civil liberties and political rights affect sectoral FDI flows in different ways. The majority of the results of sectoral analysis with respect to the effect of civil liberties and political rights on FDI are in line with those reported for aggregated FDI. The effect of civil liberties on sectoral FDI for most countries across sectors tends to be negative, in support of hypothesis (1) in provided in section 7.2.3 and the findings of Coates et al. (2010). However we find that the effect of civil liberties on Dutch and Finish

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<sup>128</sup> Corruption is the institutional literature is often referred to as ill-functioning institutions, indicating that in the absence of well functioning institutions, corruption arises as auxiliary informal ways of coordination of activities that are not addressed in a healthy manner by the current institutional structure of the host countries.

manufacturing FDI when Investment on R&D in the host countries is considered, and the positive effect of German manufacturing FDI in the model 1.3, indicate the existence of a positive effect of civil liberties on sectoral FDI in line with the findings of Coughlin, et al. (1991) , Pournarakis and Varsakelis (2004) and Blanton and Blanton (2007). Therefore the overall results of the effect of civil liberties on sectoral FDI are in line with the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and Resnick (2003) and our theoretical findings, and in contrast to our aggregate empirical findings that suggested the existence of a sole negative effect. Therefore the results provide first empirical support for the theoretically established effect of sectoral characteristics, namely the ratio of labour versus capital intensity of production in a specific sector, on sectoral FDI flows. In particular we show that the effect of civil liberties on FDI flows is intermediated by the ratio of labour to capital intensity of sectors, therefore the existence of a non-linear effect of civil liberties on FDI flows is expected considering the characteristics of the sectors in which FDI is considered.

Furthermore, the effect of political rights effect on sectoral FDI flows is generally positive, in line with hypothesis (2) provided in section 7.2.3 and in support of the findings of Jensen (2003), Addison and Heshmati (2003), Sethi et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007). In contrast to this positive effect, we also find an insignificant negative effect of political rights on German and Finish<sup>129</sup> manufacturing FDI abroad, providing support for the view of Asiedu (2001) and Li and Resnick (2003). Therefore the overall results of the effect of political rights on sectoral FDI empirically demonstrate the existence of a non-linear effect of political rights on sectoral FDI flows in line with findings of Li and Resnick (2003). The effect of institutional quality of host countries on sectoral flows is in general in line with the findings reported for aggregate FDI as we observe that firms generally tend to invest in host countries with higher institutional quality, with a few exceptions indicating that the effect of institutional variables on sectoral FDI flows are subject to consideration in various cases as the results are not conclusive in all cases.

Considering the effect of institutional quality of the host countries on LMEs' sectoral FDI flows, we find dominating evidence in favour of a positive effect supporting the

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<sup>129</sup> German and Finish firms coordinate their activities in a decentralised manner.

findings of Lipsey (1999), Campos and Kinoshita, Y. (2003), indicating that in general LMEs tend to invest in host countries with higher institutional quality. However, the contrary evidence on negative effects reported in case of CMEs' and Northern sectoral FDI, suggest that institutional variables have an asymmetric effect, at least in a number of cases. The latter is in line with the findings of Aleksynska and Havrylchyk (2012) who exploring the role of institutional distance on the FDI show that institutional distance has an asymmetric effect on FDI depending on whether investors choose countries with better or worse institutions. It is also possible to relate our findings to those of Alvaro Cuervo-Cazurra (2006) who finds that the relationship between ill-functioning institutions<sup>130</sup> and FDI is modified by the country of origin of the FDI.

In order to explore the non-linearities observed in terms of the effect of civil liberties and political rights on FDI flows, we provide two sets of sensitivity analysis. The sensitivity analysis affords us the opportunity to group countries with various levels of liberties in order to explore, and compare the investment behaviour of firms into each group of countries. The sensitivity analyses are conducted on both aggregate and disaggregate FDI flows using an empirical model that is slightly altered. In particular the model used for sensitivity analyses excludes ES variables and one of the SAS variables (expenditure on R&D), in order to allow provision of higher number of observations for the analyses, and consequently ensuring the credibility of the statistical results provided.

A more detailed investigation of the effect of civil liberties on FDI into host countries with higher level of civil liberties is negative and significant in case of firms from all home countries, with the exception of Finish FDI for which the effect is reported to be negative and insignificant. Furthermore, considering the effect of civil liberties on FDI into host countries with lower level of civil liberties we find a negative and insignificant effect in case of most countries with the exception of negative significant effects reported for US and Finish FDI into host countries with lower level of civil liberties. The results are in support of our theoretical findings and in line with hypothesis 1. Therefore our empirical investigation of the effect of civil liberties on aggregate FDI flows into two groups of countries with different levels of civil liberties, is in favour of existence of a negative effect and in support of the findings of Coates et al. . However, we find that the aggregate FDI

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<sup>130</sup> Corruption is the institutional literature is often referred to as ill-functioning institutions, indicating that in the absence of well functioning institutions, corruption arises as auxiliary informal ways of coordination of activities that are not addressed in a healthy manner by the current institutional structure of the host countries.

flows are more sensitive to changes in the level of civil liberties in the group of host countries with high and moderately high level of countries in comparison to those with lower level of civil liberties. In case of countries with low level of civil liberties, we find significant negative effect of an increase in the level of civil liberties, on US and Finish FDI, while the effect is insignificant and negative in case of other home countries.

The effect of civil liberties on sectoral FDI flows into two groups of countries with various levels of civil liberties suggest that civil liberties have a non-linear effect on sectoral FDI flows into countries with various level of civil liberties. In particular, we find that the effect of civil liberties on sectoral FDI into repressed countries is much weaker than that observed in case of countries with higher level of civil liberties. We also find civil liberties to have a positive insignificant effect on most countries' (exceptions: UK and Finland) services FDI into repressed countries, in contrast to the results for services FDI into countries with higher level of civil liberties. Furthermore, the empirical evidence demonstrates that the effect of civil liberties is intermediated by the sectors' ratio of labour/capital share of production in countries with higher level of civil liberties. In other words we find that the higher the ratio of labour/capital share of production, the greater the sensitivity of the firms to changes in wages which can be altered through changes in the level of civil liberties, and therefore the greater effect of civil liberties on FDI flows into host countries with higher level of civil liberties. However, we do not find empirical evidence supporting the existence of such intermediating effect in case of countries with lower level of civil liberties. Therefore our proposition with regard to the effect of the ratio of labour/capital share of production on the effect of civil liberties on sectoral capital flows into host countries with lower level of civil liberties whilst theoretically just, remains empirically unsupported. This perhaps is related to the level of civil liberties of the group of host countries that are considered as those with lower level of civil liberties. A possible interpretation of the latter is that the level of civil liberties are so low in the group of repressed and moderately repressed countries, that the distinction between the effect of civil liberties on capital intensive, versus labour intensive sectors is not very pronounced. However, further analysis of the effects observed is left to future research.

Moreover, we find that civil liberties have a symmetric effect on FDI from Germany and Finland across sectors, while in contrast an asymmetric effects are reported for all other countries across sectors, emphasising that firms' behaviour vary across sectors, and

consequently their FDI behaviour. Therefore we find that consistent with our earlier arguments, the effect of civil liberties on sectoral FDI flows into countries' with various levels of civil liberties, vary across sectors. Hence, we argue that a through analysis of factors influencing the FDI activity should use disaggregated data in order to shed more light on micro drivers of FDI activity in order to explain the aggregate of these influences on macro level and thereby explain FDI activity.

The overall evidence on the effect of civil liberties on aggregate FDI flows in general gives support to the existence of a negative effect of civil liberties on FDI flows irrespective of the level of civil liberties of host countries (i.e. free or repressed) considered, giving support to the findings of Coates et al. . However, the analyses of the effect of civil liberties on sectoral FDI flows indicates that the effect of civil liberties is not symmetric and linear across sectors, for all countries, emphasising the sector specific coordination activities of firms that influences their preferences and FDI activity. Our empirical investigation of the effect of civil liberties on aggregate FDI flows into two groups of countries with different levels of civil liberties, are in favour of existence of a negative effect and in support of the findings of Coates et al. (2010). Furthermore, we find that the effect of civil liberties on sectoral FDI into host countries with various levels of civil liberties is non-linear and asymmetric for most countries providing more detailed evidence on the way firms invest in free and moderately free host countries in comparison to moderately repressed and repressed countries. Therefore empirical investigation of the effect of civil liberties on sectoral FDI, and on sectoral FDI into host countries with various levels of civil liberties, give support to the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and Resnick (2003) who have found the effects to be non-linear. In particular we argue that the sources of this non-linearity is related to sector specific characteristics, the type of home country that MNEs' originate from, as well as host countries' specific characteristics such as level of natural resources.

A more detailed investigation of the effect of political rights on FDI flows by consideration of aggregated FDI flows into two groups of countries with various levels of FDI shows that the effect of political rights on FDI into host countries with higher level of civil liberties is positive and insignificant in case of all countries with the exception of German and Finish FDI. The effect of political rights on FDI into host countries with low level of civil liberties is positive and insignificant in case of LMEs and France, while in

contrast we observe a negative effect in case of CMEs' (with the exception France) and Northern FDI. Therefore the overall evidence suggests that in contrast to our theoretical finding, and hypothesis 2, the effect of political rights on FDI into host countries with various levels of civil liberties is non-linear, giving support to the view of Asiedu (2001) and Li and Resnick (2003).

The effect of political rights on aggregated FDI flows into host countries with various levels of civil liberties, in contrast to our theoretical finding, is non-linear. The lack of empirical evidence in case of host countries with lower level of civil liberties is attributed to the lower level of civil liberties in the repressed countries that naturally makes it difficult to examine the intermediating effect of the labour/capital share of production on the relationship between civil liberties and FDI flows. We also find that the effects are symmetric across groups in all cases with the exception of Dutch FDI. In particular we find that Dutch FDI is positively affected by political rights in countries with higher levels of civil liberties, while the effect is negative in case of host countries with lower levels of civil liberties. Furthermore, the results suggest that the effect of political rights on LMEs FDI is positive and insignificant, indicating that LMEs tend to invest in countries with higher level of political rights, irrespective of their level of civil liberties. This is in line with findings of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007) who reported a positive relationship between the level of political liberties of the host countries on the FDI. In contrast we find a negative insignificant effect of the level of political rights on German and Finish FDI across groups, indicating that higher level of political rights deters sectoral FDI from German and Finish firms, irrespective of their level of civil liberties. This is in line with the findings of Asiedu (2001) and Li and Resnick (2003), who have reported a negative effect of political rights on FDI.

The exploration of the effect of political rights on disaggregated FDI flows into host countries with various levels of civil liberties, provides empirical evidence in support of a non-linear effect of political rights on sectoral FDI flows, in line with findings of Li and Resnick (2003).

Furthermore, we find that the effect of political rights on sectoral FDI in each group tends to be asymmetric. Thus, it is possible to argue that the sectoral composition of the data and the choice of host countries that are considered for empirical research influence the

findings of the research. Therefore, it is credible to speculate that most of the researches that have found a positive effect of political rights on FDI activity, have used aggregate data that draw a great deal more from either host countries with higher level of civil liberties, or manufacturing sector. However due to limitation of this research, the further examination of this claim is left for future research.

## **Chapter 8 : Concluding Remarks**

### **8.1. Introduction**

In this chapter we summarise the arguments made, the developments that allowed theoretical and empirical investigations of the research question, research findings, and the research limitations. Furthermore, we discuss this researches' contribution, and set forward a number of immediate avenues for the future research.

### **8.2. Summary of Thesis Argument**

In the introduction of this research we suggested that the effect of civil liberties and political rights on FDI activity is far from conclusive. In support of our original claim chapter 3 reviewed the literature that empirically investigates the effect of institutional factors, democracy, civil liberties and political rights on FDI flows and showed that indeed, the literature on the effect of civil and political liberties on FDI is inconclusive.

In the light of the globalization of markets in recent decades, the disparities in the economic prosperity of nations are often a matter of concern. One of the factors that stimulate the economic growth of the nations is the Foreign Direct Investment (FDI). Therefore we believe that further exploration of the factors that influence the FDI activity of countries would benefit the greater understanding of the factors that influence nations' economic growth, and consequently the global economic development, as a whole.

The determinants of Foreign Direct Investment (FDI), both in terms of the level of FDI as well as its composition have been of great debate over the past seventy years. The recent strand of literature on the effect of institutional quality of the host countries on their FDI inflows has focused on the disaggregated measures that constitute the institutional quality of the host countries, mainly civil liberties and political rights. However, in spite of existence of numerous studies on the topic, the literature on the effect of political and civil liberties on FDI is far from being conclusive. For instance, authors such as Huntington and Dominguez (1975), Wintrobe (1998), and Greider (1998) provide discussions and evidence in favour of the idea that multinational enterprises (MNEs) tend to invest in countries with low level of liberties (countries with high levels of repression) while others such as Olson (1993), McGuire and Olson (1996), and Ursprung and Harms (2001) provide discussions



and evidence contrary to the later arguing that MNEs invest more in countries where democratic rights of people are respected. Others such as Przeworski, Limongi, and Voigt (2003) argue that none of the two arguments is convincing. Recent studies including Li and Resnick (2003), Adam and Filippaios (2007), and Asiedu and Lien (2011) tend to provide evidence in favour of existence of non-linear relationships between the two.

Since the literature on the effect of civil liberties and political rights (liberties) on FDI is inconclusive, we investigate the effect of civil liberties and political rights (liberties) on FDI. The objectives of our research are as mentioned in chapter 1 subsection 3, as follows: Firstly, we explore the effect of the level of civil liberties, and political rights in host countries on the level of aggregated (total) and disaggregated (sectoral) FDI flows into them. Secondly, we examine the linearity of the effects of civil liberties and political rights on FDI flows. Thirdly, we examine whether the consideration of the type of market economy from which MNEs originate provides useful information with regard to their FDI decision and behaviour (whether there are differences between the ways firms from LMEs and CMEs coordinate their FDI activity).

To achieve this we first examined the factors that might influence the findings of our research by conducting a Meta analysis of the literature that has empirically explored the effect of institutions, democracy, civil liberties, and political rights on FDI.

To investigate the effect of civil liberties and political rights on FDI flows, we built a theoretical model that considers the civil liberties to affect FDI activity by influencing the bargaining process between MNEs and the local labour representatives, while the effect of political rights is considered to be channelled through taxes imposed on MNEs in the host markets. The level of civil liberties is assumed to be directly related to the labour rights in establishing entities to represent employees. Consequently we consider that in countries with low level of liberties, unions have low (if any) power in representing employees' voice. Based on the latter we explored the effect of civil liberties on FDI through union power. Moreover, we consider the level of civil liberties to influence FDI through productivity of work force, arguing that in countries' where civil liberties are repressed, the productivity of work force dampens, which in turn results in lower efficiency of production.

In our view the cost of FDI in the host market, influences the probability of MNEs' investment. Consequently we argue that while foreign firms bargain over lower wages in order to increase their return on investment, they tend to consider a sector specific threshold, when bargaining over wages, which leads to lower cost of production, as well as higher efficiency in terms of production. This is in line with Adam and Filippaios (2007) who conceptually established a non-linear relationship<sup>131</sup> between civil liberties and FDI and empirically showed the existence of such relationship. This research contributes to the literature by theoretically relating this non-linearity to the sectoral characteristics arguing that in sectors where labour share of production is higher than that of capital, since the products are more sensitive to labour input and that labour share of production cost is considerable, MNEs tend to be more sensitive to the wages. In contrast we argued that in capital intensive sectors, since the production is less reliant on labour input and that the labour share of cost of production is comparatively lower than that observed in case of labour intensive sectors, the incentive of MNEs tend to be less sensitive to the wages. Therefore we find that MNEs in the sectors where the labour share of production is higher than capital, since wages constitute a larger share of firms' cost, wages tend to play a greater role on the cost of FDI and therefore FDI flows. In such setting the level of civil liberties that enhances the ability of employees to bargain over higher wages play a greater role on FDI decision and flows, in sectors where the labour share of capital is higher than capital.

It is considered that in countries with low level of political rights, the low quality of electoral process, and low degree of political pluralism and participation tends to result in the governing bodies that are not representative of the people. Consequently it is assumed that the low level of political rights is directly related to the radical changes in policies, specifically in terms of tax policies applied to MNEs. Consequently we consider taxes on income as the main channel through which political rights affect FDI decision. However, the incorporating political rights into our theoretical model through consideration of taxes, shows that there are no distinct effect of political rights through taxation on FDI flows.

Furthermore, in this research we draw on the institutional differences (the channels considered are the existing level of civil and political liberties) between different types of

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<sup>131</sup> Other studies that have discussed the non-linearity of the effect of civil and political liberties include Asiedu and Lien (2011), and Li and Resnick (2003)

economies (VoC) and their influence on the bargaining processes between MNEs (firms) and unions in host countries. In order to incorporate the latter into our theoretical model, we consider the anatomy of different types of market economies provided by Hall and Soskice (2001) in the theory of Varieties of Capitalism (VoC) that clusters different types of economies based on their market structure and the coordination activities of the firms in those markets. By doing so we develop a theoretical bridge between International Business and political science that allows us to take into account the characteristics of the MNEs' home market economy characteristics with regard to coordination of firms' activities, when theoretically exploring their bargaining behaviour and FDI activity.

Moreover, in our theoretical model, we distinguish between the coordination activity of the firms in the labour intensive sectors and capital intensive sectors. The latter allows the possibility of exploring the coordination activities of firms in sectors where the labour share of production is higher than that of capital as opposed to those with higher capital share of production. This genuine consideration allows this research to extend its analysis to sectoral FDI. Our reasoning is that understanding of the FDI activity requires knowledge of micro processes that form industry/sector level FDI, the combination of which accumulates to be aggregate FDI. Therefore in line with that of Blonigen (2005), we argue that a closer examination of the factors that influence the disaggregate FDI flows is imperative to our overall understanding of FDI activity. The theoretical model provided allows us to set forth a number of hypotheses that are empirically tested in a quantitative manner.

### **8.3. Summary of Thesis Research Findings**

This section reviews the main findings of this research. Firstly, considering the results of empirical investigation of aggregated FDI flows, we find that the effect of civil liberties on aggregate FDI flows is negative and in line with the findings of Coates, et al. (2010). Similarly, the effect of political rights on aggregate FDI flows is positive and in line with the findings of Jensen (2003), Addison and Heshmati (2003), Sethi, et al. (2003), Wheeler and Mody (1992) and Adam and Filippaios (2007).

Secondly, considering the results of empirical investigation of sectoral FDI flows, we find that the effect of civil liberties on sectoral FDI is non-linear in support of the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and Resnick (2003) and our

theoretical findings, and in contrast to our earlier empirical findings that considered the effect of civil liberties on aggregate (total) net FDI flows. Furthermore, the effect of civil liberties on services FDI flows is considerably greater than manufacturing sector, providing empirical support for the theoretically established effect of sectoral characteristics. In particular we show that the effect of civil liberties on FDI flows is intermediated by the ratio of labour to capital intensity of sectors, therefore the existence of a non-linear effect of civil liberties on FDI flows is expected considering the characteristics of the sectors in which FDI is considered. Similarly, the effect of political rights on sectoral FDI flows is non-linear in line with the findings of Li and Resnick (2003) who have reported both positive and negative influences of political rights on FDI flows. In particular we find a positive effect of political rights on sectoral FDI flows of all countries giving support to the findings of Wheeler and Mody (1992) and Sethi, et al. (2003), and Asiedu (2001) and Coates, et al. (2010), with the exception of German and Finish manufacturing FDI. Thus the overall findings indicates the existence of positive insignificant, positive, and negative insignificant effect of political rights on sectoral FDI flows of our set of home countries into 140 developed, developing and less developed countries.

Thirdly, we find that the effect of civil liberties on aggregate FDI flows into two groups of countries with different levels of civil liberties is in general negative, in support of the findings of Coates, et al. (2010). Furthermore, the evidence suggests that aggregated FDI flows are more sensitive to changes in the level of civil liberties in the group of host countries with high and moderately high level of civil liberties in comparison to those with lower level of civil liberties. Furthermore, we find that the effect of political rights on aggregate FDI flows into host countries with various levels of civil liberties is non-linear.

While political rights and civil liberties are separate components of democracy, there is a certain level of dependency between the level of political rights and civil liberties in the societies.<sup>132</sup> The latter indicates that in many cases societies that enjoy higher level of civil liberties, often have higher level of political rights. Furthermore, our conceptual arguments and theoretical model indicate that higher level of political rights tend to promote FDI flows at least in aggregate level, by promoting a number of factors such as lower level of taxes and greater stability of governments, while higher level of civil liberties tend to

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<sup>132</sup> For further reading on this claim please refer to (Ariel BenYishay & Roger Betancourt, 2013) on related discussions.

influence the wage bargaining processes by affecting labour rights, and level of labour representation and consequently raises the cost of labour in the host markets, thereby negatively affecting FDI flows, in an aggregate level. Therefore, our finding is intuitive in that in societies with higher level of civil liberties, higher level of political rights influence FDI flows in a positive manner. In contrast to the latter and in line with the arguments provided, in societies with lower level of civil liberties, increase in the level of political rights would influence the governing bodies, as well as civil liberties, and thus affects FDI flows in a non-linear manner, in that higher level of political rights leads to lower taxes, whilst it leads to higher level of liberties, in particular civil liberties, that influence FDI flows in a negative manner. Therefore, a non-linear effect of political rights on FDI flows into host countries with various levels of civil liberties is expected.

Fourthly, we find that the effect of civil liberties on sectoral FDI into host countries with various levels of civil liberties is non-linear and asymmetric for most countries providing more detailed evidence on the way firms invest in free and moderately free host countries in comparison to moderately repressed and repressed countries. Therefore empirical investigation of the effect of civil liberties on sectoral FDI, and on sectoral FDI into host countries with various levels of civil liberties, give support to the findings of Asiedu and Lien (2011), Adam and Filippaios (2007), Li and Resnick (2003) who have found the effects to be non-linear. In particular we argue that the sources of this non-linearity is related to sector specific characteristics, the type of home country that MNEs' originate from, as well as host countries' specific characteristics such as level of natural resources.

The exploration of the effect of political rights on sectoral FDI flows into host countries with various levels of civil liberties provides empirical evidence in support of a non-linear effect of political rights on FDI activity, in line with findings of Li and Resnick (2003). Furthermore, we find that the effect of political rights on sectoral FDI in each group of host countries with various levels of civil liberties, is asymmetric. Thus, it is possible to argue that the sectoral composition of the data and the choice of host countries that are considered for empirical research influence the findings of the research.

In the fifth place, considering the effects of institutional quality on aggregated and disaggregated FDI flows, we find dominating evidence in favour of a positive effect supporting the findings of Lipsey (1999), Campos and Kinoshita (2003), indicating that in

general firms tend to invest in host countries with higher institutional quality. However, the contrary evidence on negative effects reported in a number of cases, raises the question on whether the positive effect of institutional quality of host countries is generalizable. We argue that the overall effect of institutional variables on FDI flows indicates presence of an asymmetric effect, at least in a number of cases, that is in line with the findings of Aleksynska and Havrylchuk (2012) who exploring the role of institutional distance on the FDI show that institutional distance has an asymmetric effect on FDI depending on whether investors choose countries with better or worse institutions. It is also possible to relate our findings to those of Alvaro Cuervo-Cazurra (2006) who finds that the relationship between ill-functioning institutions<sup>133</sup> and FDI is modified by the country of origin of the FDI.

In the six place, the examination of the effects of firms' motivations and macroeconomic characteristics of host countries on aggregated net FDI flows, show that motivation of firms influence net FDI flows differently across markets economies (LMEs and CMEs) and countries. In particular we find that firms from LMEs, CMEs, and Northern countries, tend to be influenced by market seeking, efficiency seeking and resource seeking variables in a similar manner, while the effect of strategic asset seeking on FDI flows of LMEs and CMEs is significantly different. The differences in the way Strategic Asset Seeking (SAS) motives affect firms from LMEs and CMEs were explored in the light of the differences in the way firms from different market economies coordinate their activities. We find that firms from LMEs tend to coordinate their research and development activities in a centralised manner and outsourcing their production activities abroad while the evidence from CME show that they coordinate their activities in a more decentralised manner and thus their FDI investment does not have emphasis only on production and includes research and development activities.

Moreover, the examination of the effects of firms' motivations and macroeconomic characteristics of host countries on sectoral net FDI flows, show that motivation of firms influence net FDI flows differently across sectors as well as markets economies (LMEs and CMEs). In particular we find that while all firms show MS dominating behaviour in their sectoral FDI activity, their ES and RS behaviour vary considerably across sectors.

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<sup>133</sup> Corruption is the institutional literature is often referred to as ill-functioning institutions, indicating that in the absence of well functioning institutions, corruption arises as auxiliary informal ways of coordination of activities that are not addressed in a healthy manner by the current institutional structure of the host countries.

Furthermore, SAS behaviour of firms is similar across sectors if the quality of transportation is considered, while consideration of expenditure in R&D indicates that firms SAS behaviour varies across sectors. The results of the sectoral analysis of FDI flows in two main sectors of manufacturing and services shows that firms in manufacturing sector behave differently in pursuing their RS FDI, while we observe a weaker and rather partial<sup>134</sup> evidence of the latter in case ES FDI. The differences in the behaviour of the firms' FDI activity in various sectors stems from the fact that they coordinate their activities according to the sectoral characteristics. Consequently we find evidence supporting Blonigen (2005) arguments that analysis of aggregate FDI flows provides information with regard to the combination of affects reported for combination of sectors/industries. Since the empirical results provide evidence on asymmetric, and in many cases, non-linear effects of variables on FDI flows across sectors, the consideration of disaggregate FDI flows would allow one to gain a better understanding of the micro drivers of the industry and sectoral FDI. Therefore, we argue that it is necessary to explore the more disaggregated measure of FDI flows (i.e. industry of sectoral FDI flows) in order to provide a detailed and meaningful view of the way firms invest abroad and the factors that influence their behaviour.

In the seventh place, the examination of the effects of firms' motivations and macroeconomic characteristics of host countries on aggregated and disaggregated net FDI flows, show that motivation of firms influence net FDI flows differently across markets economies (LMEs and CMEs) and countries. In particular we find that firms from LMEs, CMEs, and Northern countries, tend to be influenced by market seeking, efficiency seeking and resource seeking variables in a similar manner, while the effect of strategic asset seeking on FDI flows of LMEs and CMEs is significantly different. The differences in the way Strategic Asset Seeking (SAS) motives affect firms from LMES and CMEs were explored in the light of the differences in the way firms from different market economies coordinate their activities. We find that firms from LMEs tend to coordinate their research and development activities in a centralised manner and outsourcing their production activities abroad while the evidence from CME show that they coordinate their activities in a more decentralised manner and thus their FDI investment does not have emphasis only on production and includes research and development activities. In other words, we find

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<sup>134</sup> We find that the ES behaviour of firms from most countries vary across sectors with the exception of Germany and France.

that LME firms tend to have a more centralised structure that centralises the R&D activities of the firms at the home country and allocates production activities to the affiliates abroad taking advantage of cost. In contrast we find Northern firms to show a rather decentralised structure that influences these firms to allocate some of their R&D activities to its affiliates in the host countries. The evidence from CME firms is weaker, but indicative of a more decentralized structure than their LME counterparts.

#### **8.4. Research Limitations**

One of the limitations of this research is that we mainly consider the factors that affect the monetary motivations of the firms. In other words we have investigated the effect of civil liberties and political rights on the cost structure of foreign firms in providing the results. In many cases the value of firm specific assets cannot be fully translated into quantitative concepts. For instance in case of larger MNEs, in many cases FDI takes place based on competitor motives, rather than basic IB motives relating to different sectoral productions. Factors such as competition are much harder to quantify unless a specific case is considered. Therefore, this study provides a simple model that mimics some but not all factors that affect MNEs' FDI decision. Furthermore, in case of the effect of political rights on FDI, we considered the effect of political rights through its effects on taxes on income and profits. However, political rights' effect on FDI flows could be reviewed in a variety of ways. For instance it is possible to view the effect of political rights on FDI through the effect of political repression on life time of governments in repressed countries, and in turn the safety of the investment in repressed countries. Therefore, further research on the effect of political rights on FDI especially in sectoral context would be fruitful. Moreover, the nonlinearities on the way civil liberties and political rights affect FDI flows in groups of countries with various levels of liberties could be further explored in a sectoral context in order to provide more information on the effect of these factors on FDI flows. Finally, the effect of external factors such as time, and countries' level of income should be considered in empirical investigation of FDI activity. In particular the analysis of the effect of time on FDI activity could be useful in determining the general trend of investment activity in different economic cycles. This would help determining the way different factors affect FDI in different sectors in time. Furthermore, the analysis of the effect of time on FDI activity would provide some information on the way the landscape of investment activity changes in time and in turn shapes the economic activity across countries.



The analysis of the effect of civil liberties and political rights on sectoral FDI activity has not been carried out before, in spite of popular advocacy for the use of disaggregated measures of FDI in determining the determinants of FDI activity. Perhaps this is mainly due to lack of available and extensive data on sectoral FDI. In the case of this research two main resources were used in order to provide comprehensive information on FDI activity that would allow analysis of sectoral FDI. However, in spite of the efforts made, the number of observations for most sectors did not allow singular sectoral investigation and thus the author has produced specific manufacturing and services FDI data in order to provide labour and capital intensive sectoral comparisons.

Moreover, the observable differences between the sectoral classification of North American Industry Classification System (NAICS), Standard Industrial Classification system (SIC), and European Classification (NACE) makes it tremendously difficult for the researchers to obtain sectoral data that is consistent across countries, and thus discourages detailed sectoral analysis.

Another problem that discourages sectoral analysis is the scarcity of data for most countries over a considerable length of time. While the data used in this research covers the period of 1990-2009, for most countries the data provided generally covers 1996-2009, which in turn limits the time span over which the empirical investigation is carried out. Moreover, the frequency of data in general provides limited possibilities for statistical inference. In this research the annual data is used for FDI analysis. In this research the annual net aggregated FDI flows of 8 home countries, and disaggregated FDI flows from 6 home countries into 140 host countries is considered, however, in most cases firms from each home country tend to invest in a selected number of countries, and their FDI is generally conducted in a selected number of sectors leaving the researcher with a low number of observations overall, in spite of consideration of all sectors, and an extensive number of years. Access to data with higher frequency would help in provision of detailed analysis on FDI flows, particularly in case of sectoral FDI. Moreover, it is imperative to note that consideration of firm level data in studies similar to ours would be immensely informative, however due to lack of access to extensive firm level data (both in terms of firm level data from a number of home countries, as well as data that is consistent for a long period of time), we could not pursue a firm level analysis.

The short coming of our theoretical model in explanation of the non-linear effect of political rights on sectoral FDI perhaps stems from the way that we have theoretically introduced the political rights into our theoretical model. In our theoretical model political rights are assumed to be affecting FDI activity through taxes on income and profit. However, it is possible to review the effect of political rights on FDI activity through consideration of different factors that embody the political rights index, namely: *electoral process*; *political pluralism & participation*; and *Functioning of Government*. Whilst consideration of political rights in the light of its encompassing elements would benefit the analyses of the effect of political rights on the FDI activity, due to lack of detailed data on these sub-components we would not be able to empirically test our theoretical findings. Thus, this research has followed the specification introduced by Adam and Filippaios (2007).<sup>135</sup>

## **8.5. Research Contributions**

### **8.5.1. Contributions to Research**

This research contributes to the literature by incorporating Varieties of Capitalism framework into FDI literature and providing a novel theoretical model that explores the effect of civil liberties and political rights on FDI activity. The effect of civil liberties is explored in our theoretical model through wage setting and employee recruitment, while the effect of political rights on FDI is examined through its effects on taxes on profit and incomes. Moreover, we theoretically show that the effect of civil liberties on FDI behaviour of firms is influenced by sectoral characteristics. This theoretical finding is empirically validated.

By incorporating VoC framework into our model, we distinguish between the FDI from various market economies based on the existing differences between the coordination activities of firms within them. Consequently we distinguish between the firms from LMEs, CMEs, and Northern countries, based on their coordination activities, market structures, and home countries differences and explore the ways in which MNEs from different market economies coordinate their FDI activities. This allows bridging the IB theory with political science which in turn allows the researcher to draw on the economic

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<sup>135</sup> Since the scope of this research is rather limited due to word count, we do not make any further alterations to explore the non-linear effect of political rights on manufacturing FDI, and leave the latter to the future research.

and political characteristics of the home countries from which MNEs originate in explaining their coordination of FDI, and thereby their FDI behaviour. Furthermore, our empirical results indicate that the behaviour of firms from various market economies is indeed different from one another in most cases. Therefore, this research contributes to IB literature by incorporating VoC into IB literature and thereby allowing for a new avenue through which arguments from the older tradition of political science can inform, and influence our exploration of determinants of FDI.

The overall empirical evidence from analyses of the effect of civil liberties and political rights on FDI flows demonstrates that while the effects of these factors on aggregate net FDI flows are seemingly linear, further exploration of the effect of these factors on disaggregated FDI, and the sensitivity analysis of the effect of political rights on aggregated FDI flows into host countries with various levels of civil liberties, suggest that the effect of civil and political liberties are inherently non-linear on FDI flows. This research contributes to the literature by theoretically relating this non-linearity to the sectoral characteristics arguing that in sectors where labour share of production is higher than that of capital, since the products are more sensitive to labour input, the wage setting incentive of MNEs is more in line with increasing the productivity of work force rather than repressing wages. In contrast we argued that in capital intensive sectors, since the production is less reliant to labour input, the incentive of MNEs with regard to wage setting is more in line with repressing wages in order to gain higher return on investment.

Furthermore, our empirical investigation contributes to the literature by considering the effect of firms' motives, as well as host countries' level of civil liberties, political rights, institutional quality, and macroeconomic characteristics, on aggregated (total) and disaggregated (sectoral) FDI in order to provide detailed information on the effect of civil liberties and political rights on total as well as sectoral FDI flows. Furthermore, we empirically establish the existence of non-linear effects of civil liberties and political rights on FDI flows and argue that the seemingly linear effects observed in case of aggregated FDI flows are the by products of summation of the non-linear sectoral/industry level effects which in turn lead to loss of informative data on the way these factors influence FDI flows in detail. Our empirical investigation also confirms that ratio of labour to capital share of production acts an intermediating factor that influences the relationship between civil liberties and disaggregated FDI flows.

The empirical investigation method used in this research is based on Bootstrap estimation of Quantile Regression Models (QRM). The choice of empirical method is mainly motivated by non-normality of the data. Since the non-normality entailed both Skewness and Kurtosis, and that in general social scientist is interested in exploring the abnormalities in the general patterns, we strived to avoid extensive data manipulation. Unfortunately the literature on FDI is generally populated by studies that continue to use the same specifications and methods in their design. The non-normality observed in the data indicates that in many cases the use of conditional mean models (i.e. OLS, Maximum Likelihood models, etc.) would result in provision of statistically meaningless results. Thus, it is imperative for researchers and practitioners to avoid adopting empirical methods based on their popularity, and to investigate the sufficiency and efficiency of their statistical methods with respect to their data. Thus, this research contributes to the literature by questioning the common methods of statistical inquiry and adopting one that is more adequate for statistical analysis of panel FDI data for the given period. This in effect should inform and influence the subsequent studies, and encourage questioning of the traditional practices and views in the literature.

Finally, since the literature on the effect of host countries' level of civil liberties and political rights on FDI is still in its infancy, provision of studies such as ours sheds more light on the topic and by doing so elevates the level of understanding, and promote further considerations and policy related discussions that can potentially provide a basis for practical policy decision making in the future.

## **8.6. Recommendations**

This research provides its analyses on aggregated and sectoral FDI flows. The future research on sectoral FDI flows perhaps can take the examination of the drivers of FDI into lower levels of disaggregation by exploring the factors that influence more detailed sectoral, or industry level FDI. Furthermore, in this study the analyses of the sectoral FDI are conducted using variables that reflected motivations of FDI at country level. It is recommended that the future studies use variables that reflected motivations of FDI at sectoral/industry level. For instance, it is possible to use the ratio of sectoral growth value added as a percentage of GDP, to the GDP, as a measure of market size instead of the

traditional GDP or GDP per capita, in order to provide more detailed information of the FDI activity.

In line with these recommendations the future research on the effect of civil and political liberties on FDI is advised to use sub-indicators (sub-categories) of civil liberties and political rights to further examine their effect on FDI activity. This would help determining the how various aspects of these concepts influence FDI activity.

Furthermore, this research showed that firms from various market economies coordinate their activities in differently, and that as a result the way they coordinate of their FDI activity, varies. However, in many cases we find that there are considerable differences between the ways UK firms coordinate their activities in comparison to their US counterparts. Perhaps a further distinction could be made in case of UK, as a hybrid market economy that is influenced and has inherently formed through both European and American experiences.

The evidence from the effect of quality of transportation along with the mixed effects provided for a number of other variables on services FDI in general gives support to the idea that the firms' FDI activity and behaviour in services sector are rather more complex in comparison to manufacturing sector. In particular we argue that the current literature trying to explain services FDI using Behrman (1974) taxonomy of firms' motivations, institutional differences between various types of market economies (VoC), and macroeconomic factors, falls short of provision of credible explanations of the reasons why firms' services FDI behaves in such a peculiar manner. Perhaps, future research on sectoral FDI could provide a more extensive analysis on the subject building on the current.

Overall, Foreign Direct Investment (FDI) has been considered as one of the factors that significantly influence the economy of countries through affecting the balance of payments, increasing employment, transfer of technology and resources. While the effect of FDI on economic growth of countries is still debated<sup>136</sup> both in aggregate and disaggregate manner, nevertheless the existence of its effect on economies is widely accepted. Further investigation of the drivers of FDI mainly in sectoral context would provide useful information with regard to factors that influence different types of FDI activities in host countries.

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<sup>136</sup> Alfaro et al. (2005)

Moreover, the observable differences between the sectoral classification of North American Industry Classification System (NAICS), Standard Industrial Classification system (SIC), and European Classification (NACE) makes it tremendously difficult for the researchers to obtain sectoral data that is consistent across countries, and thus discourages detailed sectoral analysis. Future research on the possible statistical methods that could be applied to provide data sets that could accommodate meaningful statistical indices from various classification systems, especially over time, could tremendously benefit the future economic research on sectoral and industry level analyses.

Globalization has on its own merit affected the economic activity of the countries across the world, while the enhancements in information technology in turn have made it possible for firms to coordinate their activities in a more efficient way. In this setting it is easier for firms to outsource their activities to other countries in order to gain a competitive advantage and in turn improve the economic advancements of the less developed nations. Therefore, in the world of today, it is essential for most countries to integrate into the new economic system that is forming, in order to be able to enhance their economic activity and ensure better economic future. FDI as one of the factors that has a great potential to contribute to economic activity of the countries, particularly in case of developing and less developed countries can play a significant role in improving the economic condition of nations and help in alleviating the significant differences observed in terms of equality across the world. Therefore, further research on FDI activity especially in terms of their sectoral determinants, as well as their compositional effect on foreign nations' growth would provide useful information that would inform policy making.

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