Chapter 4
The Role of Governance on Outward Foreign Direct Investment in Emerging Market Economies

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ABSTRACT

Emerging market economies have clear deficit in governance infrastructure and also have an increasing trend in the amount of foreign direct investment (FDI) outflows compared with advanced countries. Hence the main issue of the study is to identify the determinants leading to the increase in FDI outflows with special emphasize given to the role of governance infrastructure. Thus, the aim of the study is to analyze the effect of governance infrastructure together with other control variables on FDI outflows in emerging market economies. It is found that improvement in all measured aspects of governance infrastructure leads to increase in FDI outflows from emerging market economies and governance infrastructure, human capital and physical infrastructure are base factors for MNCs taking outward FDI decision from emerging market economies. It is also found that FDI outflows from emerging market economies are not market or efficiency seeking; instead they are resource, labor or finance seeking.

INTRODUCTION

There are several benefits that the home countries derive from outward FDI. First, and most distinctive, is that the stream of income, mainly in the form of repatriated profits, from foreign earnings through affiliates in host countries. Second, it creates employment and contributes to growth in home country if outward FDI complements home country production as such as affiliates in host country import intermediate products or inputs from the parent company in home country. Third, MNCs may learn new skills and technics from exposure to host countries through outward FDI. (Nourbakhshian et.al., 2012; Behbehani and Al Hallaq, 2013), Fourth, outward FDI allows MNCs to explore new global markets, to

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generate higher profits and incomes through the production and sales in host country markets (Bukari, 2016). Fifth, efficiently utilized and managed abundant natural resources in host countries decrease costs and increase the price competency of MNCs (Bukari, 2016). Finally, affiliates in host countries generally use production techniques that are developed and patented in home country R&D base; hence it is another stream of income for home country.

Governance infrastructure of a country may affect outward FDI in two ways. First, and most distinctive, is the positive impact of quality of governance on outward FDI both in the short and long run. The effect of governance on FDI is through the effect of institutions on investment environment of a country and through the decreasing transaction costs, production costs and uncertainty (Bellos and Subasat, 2012). Second effect is the negative short run effect of governance infrastructure on outward FDI mainly referred as escape response of outward FDI due to low quality of governance in home countries (Klimek, 2015; Witt and Lewin, 2007).

The main issue of the study is to identify the determinants leading to the increase in FDI outflows with special emphasize given to the role of governance infrastructure. Thus, the aim of the study is to analyze the effect of governance infrastructure together with other control variables on FDI outflows in emerging market economies.

The study claims that governance infrastructure as a base factor has positive significant effect on outward FDI in contrast to studies maintaining escape response argument. Hence, the study builds a new theoretical perspective for the outward FDI before delving into the empirical analysis.

Next section presents background for the study. A new theoretical perspective for FDI theory is developed in third section. Fourth section explains how governance is measured in thesis. Fifth section presents data, variables and methodology used in thesis. Statistical analysis is carried out in sixth section. Seventh section presents empirical analysis. Last section provides concluding remarks.

BACKGROUND

There are numerous studies in the literature that have concentrated on the role of governance on inward FDI. The studies examining the role of governance on outward FDI or considering governance as a determinant of outward FDI are limited (Globerman et. al., 2006; Witt and Lewin, 2007; Kayam, 2009; Das, 2013; Subasat and Bellos, 2013; Klimek, 2015). Also, there are other studies in the literature analyzing the effect of host country governance on outward FDI of home countries such as Mishra and Daly (2007). This type of studies is not included in the empirical survey.

Globerman et. al. (2006) found statistically significant positive effect of governance on outward FDI in both emerging and transition European economies and emerging markets for the period 1995-2001. They used principal component analysis of six main WGI governance variables as a proxy for overall governance performance of the countries. They had only three-year data for each governance indicator, hence they extrapolated them which may lead to biased results since 57% of governance data were extrapolated.

Witt and Lewin (2007) argued that outward FDI is an escape response from perceived misalignments between firms' needs and home country institutional environment in advanced industrialized nations in the context of societal coordination. The main drawback of their study is that the conclusion they reached does not base on an empirical analysis. Instead they reviewed the literature on IB without even employing meta-analysis based on the selected studies.