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Seeking greener pastures: a theoretical and empirical investigation into the changing trend of foreign direct investment flows in response to institutional and strategic factors

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Abstract

A generic theoretical model is proposed that provides a holistic conceptualization of the phenomenon of changing trend of FDI flows. Integrating both institutional and strategic factors, a rationale for such a change is provided, and the circumstances under which future shifts might take place are identified. A collection of criteria and incentives that various host governments and their agencies must provide to attract FDI are outlined. Several propositions that lead to empirically testable hypotheses are developed from this model. Statistical evidence is then provided of a shift in FDI flows, and the change in their determinants, by empirically analyzing investment by US multinational enterprises into Western Europe and Asia over the 20-year period, 1981–2000.

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1. Introduction

Globalization is the mantra of a rapidly integrating world economy. International trade, which has increased phenomenally in the last few decades, is expected to grow much more rapidly. But the acceleration in foreign direct investment (FDI) flows has been even more spectacular, far outstripping both *world trade* and *world output*. Between 1984 and 1998 the worldwide flow of FDI increased by over 1000%, while *world trade* grew by 91%, and *world output* merely by 27% (WTO, 1998). Hence, this paper focuses only upon the *FDI flows*, the more significant component of globalization, and not on international trade.

Globalization of markets and production is being facilitated by the progressive liberalization of most economies, resulting in lower investment barriers. For instance, while between 1991 and 1996, over 100 countries made 599 changes to liberalize FDI regulations, during 1997 alone, 76 countries made 151 such regulatory changes (United Nations, 1998). Implicit in these statistics, and explicitly highlighted in the UN/WTO annual reports is the key role often played by governments, and institutions under their aegis, in attracting FDI. These reports also indicate that FDI is no longer flowing to the traditional destinations, and that its determinants and motive have changed. The changing trend of investments by multinational enterprises (MNEs) to new destinations, however, cannot entirely be explained by the liberalization measures undertaken by governments, or its institutions, like the *inward investment agencies* (IIAs) (Mudambi, 1999). Other factors also are obviously involved. FDI has seldom been envisioned holistically, since researchers have often taken different snapshots of the phenomenon, through respective theoretical lenses. Combining two or more perspectives can thus be useful, as this could yield a more realistic conceptualization, which offers better explanations for the changes in the determinants and destinations of FDI flows. However, the sheer complexity of the international business environment (IBE) does not allow a single model to fully incorporate all FDI factors through time, for all MNEs, and for all countries. Hence this study attempts to integrate only the macro-economic, institutional, and strategic aspects.

The issue of the level of analysis, however, needs to be addressed first. FDI is a firm level decision, one that evolves from the firm's idiosyncratic strategic objectives in the prevailing IBE. The levels of development in different countries, and their governments' policies, also differentially affect FDI decisions. But, FDI trends indicate that MNEs often invest in a particular country or region almost in droves, notwithstanding variations in individual investment decisions. There is also a *bandwagon effect* to exploit emerging markets, for reasons of oligopolistic rivalry (Knickerbocker, 1973). Such shifts in FDI flows over time could therefore be analyzed at a country level of analysis, since the determinants under investigation have a homogenous effect on all MNEs (Freeman, 1978). Our approach thus incorporates country-level data in the analyses.

The need to integrate institutions into theory, to facilitate designing of appropriate incentive structures, can hardly be over-emphasized. The foregoing statistics amply illustrate the success of various institutional measures in attracting FDI, and in enhancing such flows. But this paper argues that institutional support is merely one

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