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Extending Dunning's Investment Development Path: The role of home country institutional determinants in explaining outward foreign direct investment

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ABSTRACT

Recent years have seen an increase in outward foreign direct investment (OFDI) from emerging markets and post-communist economies alike. Given the specific institutional fabric of these countries, the question is whether mainstream theory can explain the drivers of foreign direct investment outflows or whether new theories are needed to explain this phenomenon. This paper aims to investigate the home country determinants of OFDI from post-communist economies. We augment the Investment Development Path (IDP) with explanations derived from institutional theory and explain the effects of home country institutional factors on the level of OFDI. We test our hypotheses using random effects estimations on a comprehensive panel dataset comprising of OFDI from 20 Central- and Eastern European countries. Our results support the IDP's main propositions but also highlight the importance of accounting for home country institutional factors when investigating the determinants of OFDI. In particular, we find that the inclusion of institutional variables increases the explanatory power of our models and that competition policy and overall institutional reforms play a crucial role in explaining OFDI from CEE countries with important implications for FDI theory.

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1. Introduction

The aim of this paper is to investigate the home country determinants of outward foreign direct investment (OFDI) from post-communist economies. In particular, we address the following research questions: To what extent does the Investment Development Path explain OFDI from post-communist economies? How do home country institutional factors affect OFDI from post-communist economies? How can policy makers encourage OFDI? In doing so, we address several research objectives: First, we put forward a novel conceptual framework, extending Dunning's Investment Development Path (IDP) (Dunning, 1981, 1986, 1988) by incorporating institutional variables, drawing on institutional theory (Meyer & Nguyen, 2005; North, 1990; Peng, 2002; Wright, Filatotchev, Hoskisson, & Peng, 2005). Second, we test this new conceptual framework using a panel data set of 20 post-communist economies for fifteen years (1996–2010). Third, we put forward several contributions to theory and practice. We present below the justification for our paper.

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Firstly, recent years have seen an increase in outward foreign direct investment (OFDI) from emerging markets and post-communist economies alike (da Silva, da Rocha, & Carneiro, 2009; Luo, Xue, & Han, 2010; UNCTAD, 2011). Given the specific institutional fabric of these countries (JIM, 2010), the question is whether mainstream theory can explain the drivers of OFDI outflows or whether new theories are needed to explain this phenomenon (Kalotay & Sulstarova, 2010; Kalotay, 2008; Liu, Buck, & Shu, 2005; Zhang & Dally, 2011). For example, patterns of OFDI from Russia challenge the propositions of the Uppsala School and the Investment Development Path (IDP) and indicate the need to extend the eclectic paradigm (OLI) to include home country institutions (Kalotay, 2008; Kalotay & Sulstarova, 2010). Moreover, Buckley, Cleg, Cross, Liu, and Voss Zheng (2007: p. 499) argue that in order to explain Chinese outward FDI, three special explanations (capital market imperfection, special ownership advantages and institutional factors) need to be 'nested within the general theory of the multinational firm'.

We follow Ramasamy, Yeung, and Laforet (2012) and Buckley et al. (2007) according to whom, rather than rejecting conventional theories, specific modifications are needed to explain OFDI from emerging economies. The recent increase in FDI from emerging and post-communist economies suggests that these countries have reached levels of economic development and competitiveness that allow them to generate OFDI. In other words, based on the economic development and competitiveness of the home country, local firms have developed ownership advantages that allow them to expand successfully aboard. However, the IDP alone does not explain the surge in OFDI for countries that are technically in stage 2 of their investment development path (Kalotay, 2008; Kalotay & Sulstarova, 2010). The IDP does not account for the ownership advantages of firms that are 'embedded' in the institutional context of their home country and that allow multinational enterprises (MNEs) to overcome the 'liability of foreignness' when expanding abroad. This suggests extending the IDP by drawing on institutional theory and accounting for differences in the home countries' institutional context. By augmenting the IDP to explore the home country institutional determinants of OFDI from post-communist economies we answer calls by Peng, Wang, and Jiang (2008), Dunning and Lundan (2008a,b) and Eden (2010) for International Business research to focus more on institutions. This is our first contribution to theory.

Secondly, in line with Meyer and Peng (2005), we believe that through their distinctive institutional context, the Central and Eastern European countries (CEECs)[1] represent an ideal context to test the applicability of extant theories and to develop new ones by exploring the role of home country institutional determinants in explaining OFDI. For the greater part of the last two decades these countries have been known as 'transition economies' (EBRD, 2010a), a distinctive group of countries (Meyer & Peng, 2005). These countries share a communist legacy and the radical challenges of the political and economic transformation that followed the fall of Communism (Meyer & Peng, 2005). Furthermore, many of the transition reforms have continued even after EU membership and are still in progress, especially in the Commonwealth of Independent States (CIS) and the South-Eastern European countries (EBRD, 2011). These reforms have affected considerably the institutional environment and business strategy in the CEECs (Meyer & Peng, 2005), highlighting the need to account for institutional factors when investigating the determinants of OFDI from this geographical area.

Furthermore, the CEECs are distinctive from other emerging economies (Hoskisson, Eden, Lau, & Wright, 2000; Meyer & Peng, 2005; UNCTAD, 2011). Andreff (2003) argues that, although there are commonalities between transition economies across various geographical areas, MNEs from [European] transition economies are distinct from third world multinationals. They have different drivers and have different starting points for their internationalisation process. This makes comparisons through longitudinal studies difficult, as third world multinationals have reached higher stages of internationalisation than [European] transition economies and some emerging economies are in a later stage of the IDP than the CEECs (Andreff, 2003). Furthermore, due China's specific institutional characteristics – such as it's one party system, its reliance on state owned enterprises, its guanxi and Confucianism, its size, its different reforms path (Peng et al., 2008) and its heavily regulated economy (Kang & Jiang, 2012) – comparisons between the CEECs and China – another 'transition economy' – are also challenging. According to Demekas (2007), European emerging markets are different from other emerging economies because they have different economic fundamentals and different policy challenges. Moreover, unlike other emerging economies, their post-communist transformation has been influenced dramatically by their economic and political relations with the European Union, including the accession to the EU or the prospect of such membership. Political stability, economic convergence and the liberalisation of trade and capital brought by the quest for EU membership have also affected OFDI from these countries (Andreff, 2003; Demekas, 2007). Furthermore, emerging European economies are more advanced than other emerging economies with regard to institutional factors such as democracy, rule of law, intellectual property rights, regulation quality and financial sector development (Demekas, 2007). All these institutions are likely to affect directly or indirectly OFDI, thus limiting the applicability of extant research on emerging economies to the CEECs (Klein & Wöcke, 2007; Pananond, 2007). Moreover, at present there is a lack of cross-country studies of determinants of OFDI from post-communist economies and this study aims to fill this gap.

By focusing on the CEECs we are able to clarify the boundaries of extant theories, test the limits of the applicability of the IDP to a specific context and demonstrate the need to extend the IDP by drawing on institutional theory. This is our second contribution to theory. In particular, we show that overall institutional reforms and competition reforms increase the

[1] In this study we use the terms 'post-communist economies', 'transition economies' and the CEECs interchangeably.

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