Macro and Micro Perspectives on Foreign Direct Investment (FDI): Effects of FDI, and Competitive Advantage of MNEs

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This study explains the effects as well as motivation behind foreign direct investment (FDI) by reviewing related literature from both macro and micro perspectives. The relationship between FDI and economic growth, as well as poverty reduction, has been examined from a macro perspective. From a micro perspective, the concept of spillovers and linkages has been applied to explain the effects of FDI. According to the literature, the effects of FDI differ depending on the host country's absorptive capacity. Multinational enterprises (MNEs) have been the subject of studies that seek to explain the motivations behind FDI. To examine these motivations and strategy of MNEs, this study employs an OLI framework and alternative theories that have developed in this perspective. Recent literature in this field explores how MNEs overcome institutional voids in emerging markets, and a comprehensive theoretical perspective is presented from two viewpoints: the adaptive strategy and the environmental change strategy. Recent studies of both literature on the effects and motivation of FDI focus on institutional structures in emerging markets.

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Outline

1. Introduction

Globalization has progressed during the last several decades, with two forces dominating the global economy: effects of homogeneity and heterogeneity. The concept of homogeneity is represented by inter-governmental organizations (e.g., WTO). The economies of scale as well as scope are key reasons for globalization and provide a cooperative viewpoint. Meanwhile, from the perspective of economic environment, there are pressures for increased heterogeneity, including different economic systems, economic stability, monetary and fiscal policies, depending on the countries involved. In addition, from a political viewpoint, the form of government, policies on foreign investment, role of military, and trade restrictions also differ, depending on countries' economic strategies. In a globalized economy, multinational enterprises (MNEs) have played an important role in the global economy. Dunning (1998) argued that MNEs engage in internationalization for four primary reasons: market seeking, efficiency seeking, resource seeking, and strategic asset seeking. Although globalization provides these opportunities for MNEs, they are also at risk of the plights in host countries and frictions stemming from differences between countries (e.g., language and other cultural differences).

Foreign direct investment (FDI) is a primary research issue when considering the effects of globalization. This issue maintains two viewpoints: effects on host countries and motivation for MNEs. This paper aims to present an overview of the literature related to FDI from both macro and micro perspectives, and to analyze the common links in these recent studies.

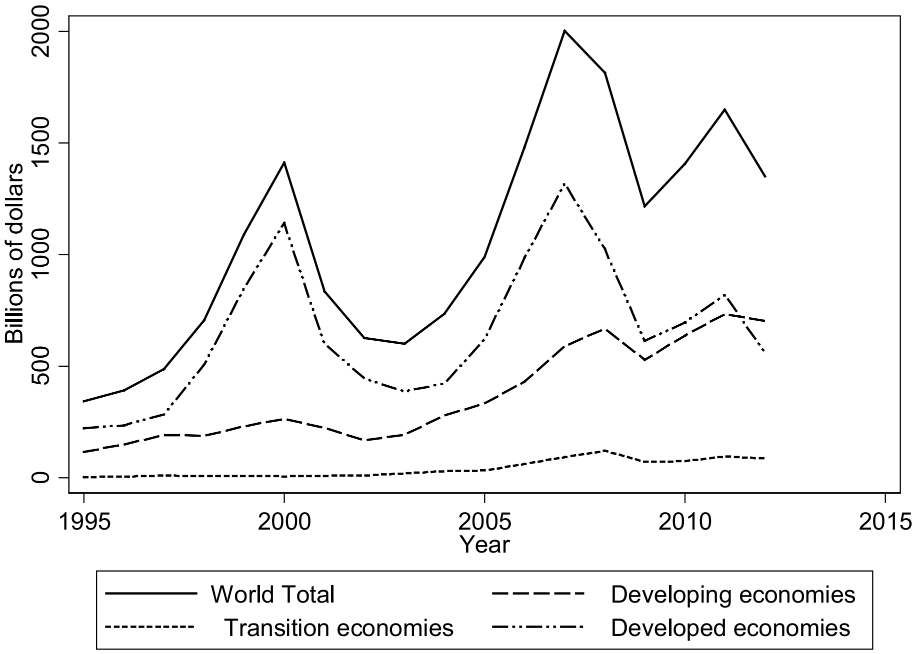
2. Foreign direct investments in developing countries

Prior to the 1960s, firms' foreign investments were considered simple international capital movements. Because these firms were not often subject to detailed research, the phenomenon was usually studied using macro level analyses. At the beginning of the 1960s, portfolio theory, which argues that capital movement occurs in response to countries' interest rates, was introduced to the FDI literature as a dominant theory. This study, therefore, begins with an overview of current trends in FDI.

According to the UNCTAD (2013), the flow of FDI to developing countries, estimated more than $700 billion per annum, played a crucial role in 2012, and was the second highest volume ever recorded. Conversely, the flow of FDI to developed countries declined to $561 billion, which is one-third of its peak, recorded in 2007. Between one-fourth and one-third of all global FDI goes to developing countries. FDI in developing countries acquired more than 52% of the world's FDI inflows in 2012 (Figure 1). Moreover, 11 of the top 20 host economies for FDI in 2012 were either developing or transition economies.

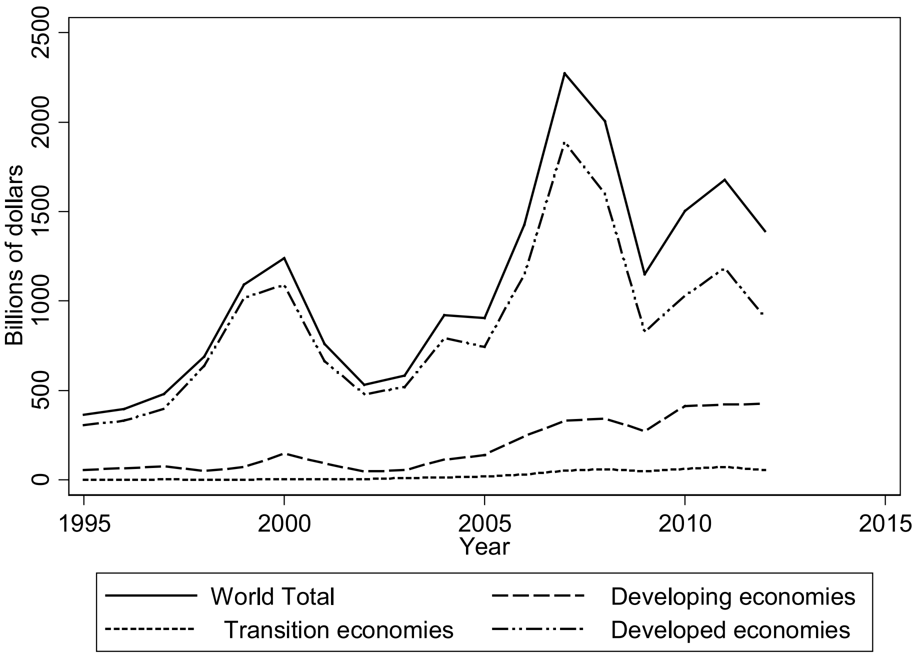
The share of developing countries in the global market for FDI is also increasing and its 2012 share is estimated at 35% (Figure 2). On the other hand, the global market share of developed countries has declined. Moreover, FDI increasingly originates from developing countries (more than 30%); among the top 20 outward investors, seven were in countries with developing or transition economies.

Figure 1. Inward FDI flows.



Source: UNCTAD (2013)

Figure 2. Outward FDI flows.



Source: UNCTAD (2013)

Figures 1 and 2 suggest that, compared to past participation, a growing number of developing countries are becoming involved as investors in FDI. Various authors have argued that FDI provides benefits for host countries as well, both from macro and micro perspectives. In addition, previous studies have found that, from a micro perspective, MNEs can maximize the value of their own FDI.

3. Effects of foreign direct investments from a macro perspective

From the macro perspective, previous studies have investigated the direct and indirect relationships between inward FDI and poverty reduction. In these studies, it was found that economic growth mediates this relationship.

Chowdhury and Mavrotas (2006), for example, examined the direction of causality between FDI and GDP growth in three major countries (Chile, Malaysia, and Thailand) between 1969 and 2000. They found that GDP growth attracted increased FDI in Chile, although the converse does not hold. In both Malaysia and Thailand, there is strong evidence of the causality between GDP and FDI. Dollar and Kraay (2002) suggested that economic growth tends to lift the incomes of poor proportionately with overall growth, and that FDI is the key to leading this growth; therefore, FDI is the most important ingredient for poverty reduction.

Moreover, Hermes and Lensink (2000) examined moderating effects in the relationship between inward FDI and economic growth. They found that the development of a financial system in the recipient country is an important condition for FDI to influence economic growth because developed financial systems contribute to the process of technological diffusion associated with FDI inflows. Apergis, Lyroudia, and Vamvakidis (2007) tested the impact of FDI on economic growth using a panel dataset from 1991 to 2004 for 27 European countries. They showed that FDI has a positive effect on economic growth for host countries, which achieved higher levels of income and have since then implemented successful privatization programs.

Although a large number of empirical studies have investigated the relationships between inward FDI and economic growth, as well as between inward FDI and poverty reduction, the empirical results are mixed at best. Therefore, to clarify these relationships, previous research has focused on the moderating effects of FDI. A country's capacity to absorb the benefits of FDI and industrial characteristics has mainly been examined as a moderating effect. Nunnenkamp (2004) argued that it is required for developing countries to attain a minimum level of economic development to capture valuable benefits from inward FDI. Host country conditions that indicate weak institutions and insufficient factors for production will critically constrain the positive effects of FDI. Nunnenkamp (2004) also insisted that, for host countries, acquiring value from FDI is more difficult than attracting FDI.

4. Effects of foreign direct investments from a micro perspective

Aforementioned prior research has demonstrated the benefits of FDI by focusing on the effects they have on countries (e.g., a macro perspective). Some authors have also investigated the relationship between FDI and host countries' economic environments by focusing on MNEs. From this micro perspective, Kwok and Tadesse (2006) presented a thoughtful and influential paper that demonstrates how FDI is used by MNEs to shape a host country's institutional environment. They examined a causal relationship between the levels of FDI and corruption in host countries, finding that FDI reduces corruption in host countries. Government corruption is generally defined as the sale of government property by government officials for personal gain (Galang, 2012). The authors provide three mechanisms to explain these relationships: (1) regulatory pressure effects, (2) demonstration effects, and (3) professionalization effects.

They argue that foreign subsidiaries are embedded not only in MNEs but also in the host countries' local environments. In addition, they maintain that, because there is regulatory pressure from the host government and international business community, subsidiaries are reluctant to engage in offering bribes to government officials in host countries. This is a regulatory effect. Second, competition stemming from FDI makes it possible for host countries to strategically shape their production technology and introduce cutting edge management styles to acquire competitiveness. In addition, firms in host countries can learn from MNEs' subsidiaries by forming relationships between them. Moreover, MNEs can train employees of local firms in the host countries. These are called demonstration effects. Finally, professionalization effects refer to formal and specialized tertiary education and the proliferation of professional networks in the host countries. MNEs provide job opportunities for host countries; however, in the host country, workers are expected to adopt global business practices to acquire employment in MNEs. This is the professionalization effect.

Following these three mechanisms, this paper argues that MNEs act as institutional change agents in their host countries by applying the dominance theory in organization science; thus, this study focuses on MNEs as opposed to their host countries.

The effects of FDI are also explained by the concept of spillover effects, which is a micro perspective. Spillover effects occur when the efficiency of local firms improves as a result of FDI, and the foreign firms do not internalize the benefits, or when local firms acquire benefits from an MNE's superior knowledge without incurring a high cost. Blomström and Kokko (1998) offered two forms of spillover effects. The first is productivity spillover. According to Blomström and Kokko (1998), " Productivity spillovers are said to take place when the entry or presence of MNE affiliates leads to productivity or efficiency benefits in the host country's local firms, and the MNEs are not able to internalize the full value of these benefits (p. 3)." The second is market access spillovers. The main barriers for local firm growth in developing countries are the export markets. MNEs enable local firms to overcome these barriers by providing access to distribution networks, access to marketing outlets, and information about consumer preferences and regulatory standards. Moreover, the concept of linkages closely relates to that of spillover, because spillover contains direct as well as indirect effects. Indirect spillovers result from demonstration effects such as labor turnover and enhanced competition (Giroud & Scott-Kennel, 2009). As a result, these effects influence local firms' behaviors and performance. On the other hand, direct spillovers result from linkages that MNEs create with their local affiliates. A broader definition of linkages includes both business and non-business relationships.

Giroud and Scott-Kennel (2009) classified the concept of linkage into three forms: supply chain linkages with either suppliers, collaborative linkages with other firms such as alliance partners, or institutional linkages (e.g., with governments and universities). The concept of linkage is the same as that of social capital. Lin (2001) argued that social capital suggests that resources embedded in the social structure are accessed or mobilized in purposive actions. Social capital is derived from the structure of actors' social relationships, which make it possible for organizations to acquire flows of information, influence, and solidarity (Adler & Kwon, 2002).

5. Case study on foreign direct investments

The following concrete example demonstrates the positive effects of FDI in host countries. According to the National Graduate Institute for Policy Studies (GRIPS) development forum (2003), large infrastructure investments were conducted in Vietnam by Taiwan and Japan in the 1990s. The aim of these investments was to improve National Highway No. 5 (NH5) and to expand the Hai Phong Port, which was completed in 2000. As a result, the volume of container cargo at the Hai Phong Port increased by 50% between 2001 and 2002. This investment also reinforced the link between two growth centers and enhanced Hanoi's access to global markets. Nearly 90% of the new FDI would not have been conducted without improvements to these two transport facilities. Moreover, these improvements have encouraged and facilitated other industries such as tourism. Between 1995 and 2001, the number of tourists to Vietnam increased by more than five times. All these effects contributed to the creation of new employment and income for workers at factories and hotels (direct jobs). It also created employment and income for workers in the transport and other service industries (indirect jobs). As of mid-2003, these investments had created 14,000 job opportunities, and employee earnings have risen.

This example demonstrates the relationship between FDI and economic growth, as well as that between economic growth and poverty reduction. As described earlier, the effect of FDI on economic growth and poverty reduction differs depending on the industries involved. This example suggests that investments in infrastructure are truly beneficial for the host countries. In this case, an important consideration is that

Vietnam has a minimum technology and skilled labor force, because of the long time experience of their operations.

Considering the aforementioned concepts of linkages, although the effects are not referred to directly in this case, it is clear that the capability of local firms operating the Hai Phong Port was insubstantial or inadequate. Therefore, it is assumed that indirect knowledge or technological spillovers occurred through this investment. Industrial characteristics, the strategy of MNEs, and the absorptive capacity of host countries are primary conditions that influence spillover effects and encourage the positive effects of linkages. Moreover, in this case, home and host countries' governments played crucial roles in facilitating these investments; that is, governments can shape incoming FDI through regulatory policies. Thus, we present a brief overview of governmental policy issues in the following section.

6. Interface with governments

Spar (2008) provided a comprehensive view of governmental intervention on domestic markets. States provide policies that influence MNEs' decisions to trade and invest in foreign entities. As stated above, MNE investments can have potentially positive effects for their host countries. The relationship between states and firms is not one-way, but interactive. Regarding this interface between states and MNEs, states are, through their regulatory capacity, able to constrain or shape the behavior of MNEs.

(1) Export control

The rule of trade is key for a nation's domestic and international policies. States have tried to limit the export of goods, motivated by domestic inflationary impact from excess foreign demand. Moreover, states are politically motivated to prevent other states from acquiring access to key resources from what is exported.

(2) Protectionism

The classic tactics of protectionism include tariffs, quotas, and other barriers to trade. In this way, states intend to protect domestic firms from fierce foreign competition and support domestic firms by providing quantitative, or price restrictions.

(3) Strategic trade policy

A state's strategic trade policy reflects the characteristics of its domestic industries. Strategic trade policies determine the growth or demise of industries whose determinant factors for competitive advantages are the effects of externalities and economies of scale (e.g., the aircraft industry); therefore, a state-level strategy to protect or encourage competition in specific industries is required for states.

(4) FDI control

One more rule that directly influences the international business environment concerns FDI, and thus, directly affects the success of investing firms. First, states can restrict investment by foreign entities. On the other hand, states can also attract foreign entity investments by offering advantageous policies for MNEs. For example, valuable tax treatment and beneficial access to labor forces are common enticements for promoting and directing FDI as a development strategy.

(5) Capital control

States control capital flows from foreign markets to buffer against the free-flowing forces of the international capital market. This control is relatively more crucial for developing countries rather than developed countries. The development of international capital flows reduces the efficacy of rules on capital, and the pressure from global markets causes financial uncertainty for developing countries.

(6) Regulation

States regulate various fields in their domestic markets to improve economic efficiency by repairing natural market imperfections. Price gaps, wage control, and health and safety standards are primary policy tools to accomplish this purpose. This requires MNEs to understand which industries are subject to regulation and to establish relationships between states of both countries. In addition, MNEs need to realize that regulatory structures are quite different among countries, even within the same industries.

(7) Anti-trust competition policy

Rules of competition and anti-trust comprise a final set of rules. A fundamental assumption of these rules is that markets occasionally cause anti-competitive situations. The main purpose of these policies, then, is to prevent firms from engaging in unwelcome market control behaviors such as dominant pricing or excessive market concentration.

These are the seven primary elements for host and home governments to consider when regulating to acquire the maximum benefit from FDI. These policies definitely influence MNEs' strategies in host countries. Because these governmental strategies differ among countries, MNEs are required to realize specific situations in individual host countries. Although previous literature has focused on how host countries can acquire and maximize benefits from FDI, this study now examines the issue from the viewpoint of MNEs.

7. MNEs: motivation and competitive advantage with foreign direct investments

(1) OLI framework

The previous discussion on the effects on FDI has paid adequate attention to both macro and micro perspectives; thus, we now discuss the FDI motivations and strategies of MNEs. The previously discussed macro level literature leaves an unanswered question: why do organizations engage in internationalization, even though they face barriers, such as a lack of knowledge regarding their industries in different host countries? This question is directed at the firm-level motivation behind their internationalization efforts.

Hymer (1976) offered a sophisticated answer, insisting that firms investing in foreign countries possess specific advantages that are adequate to outweigh the disadvantages faced in those host countries. He also argued that this advantage derives from market imperfections, which is an assumption that differs from the traditional economic theory. This emerging theory, called the internalization theory, attempts to explain why a firm's coordination of internationalization is conducted from within the firm rather than through organizational interactions. As this discussion relates to organizational boundaries, transaction economics theory provides a useful viewpoint. According to this theory, markets fail because of the existence of uncertainty, small numbers bargaining, bounded rationality, and opportunistic behavior. Because these factors generate higher transaction costs in the market, firms internalize all their internationalization activities (Coase, 1937).

Besides these questions of “why” and “how” firms engage in internationalization, (Dunning, 1988) provided a comprehensive perspective (i.e., OLI paradigm) by answering the question of “where” MNEs select to transfer their operations. He argued that location-specific advantages are derived from clusters, which indicates the agglomeration of economic and other external environmental factors within host countries (i.e., culture and governmental regulations) are critical considerations for firms’ location choices. This OLI paradigm (ownership, internalization, and location advantages) has been the most influential theory of international business. Ownership advantages indicate that the greater the competitive advantage of the investing firm, the more they are likely able to engage in international trade. Locational advantages mean that the more immobile, natural, or created endowments favor a presence in a foreign location, the more firms will choose to internationalize. Internalization advantages demonstrate that the greater the net benefits of internalizing cross-border intermediate product markets, the more likely a firm will prefer to engage in foreign production. Hennart (1991) argued that a market is likely to fail in the presence of uncertainty, small numbers bargaining, bounded rationality, and opportunistic behavior of actors. The OLI framework is used to explain firms’ entry modes, as illustrated in Figure 3. If organizations have only ownership advantages, they engage in activities on export. If firms retain ownership as well as location advantages, they engage in licensing with local partners. Finally, when organizations are allowed to acquire all three advantages, they are more likely to engage in FDI.

Figure 3. OLI framework and entry modes.

<table>
<tr><th colspan="2" rowspan="2">OLI Framework</th><th colspan="3">Categories of Advantages</th></tr>
<tr><th>Ownership Advantages</th><th>Location Advantages</th><th>Internalization Advantages</th></tr>
<tr><td rowspan="3">Market entry form</td><td>Export</td><td>Yes</td><td>No</td><td>No</td></tr>
<tr><td>Licensing</td><td>Yes</td><td>Yes</td><td>No</td></tr>
<tr><td>FDI</td><td>Yes</td><td>Yes</td><td>Yes</td></tr>
</table>

Source: Dunning (2001)

(2) Alternative perspectives of the OLI framework

As with other prevalent theories in organization science, this influential paradigm does not provide a completely comprehensive view of MNE behaviors. First, this paradigm argues that organizationally superior resources are a key factor for overcoming potential liability in a foreign environment; however, this theory does not offer sufficient explanation as to how firms strategically establish their resources. This could mean that organizational dynamic perspectives are not considered in this framework. The concept of "liability of foreignness" is defined as the costs of doing business abroad, which results in a competitive disadvantage (Zaheer, 1995, p. 342), and this cost is primarily due to a lack of legitimacy in host countries. In addition, this theory does not consider organizational interaction effects (i.e., competition and isomorphism). These arguments have clearly stated that it is required to complement Dunning's OLI paradigm. Moreover, just as the internalization theory applies transaction economics to develop a logic of MNE internalization, the dominant theory in organization science and strategy has been applied to this field to reveal the related behavioral and performance mechanisms of multinational companies. Following the emergence of the OLI paradigm, international business research has evolved two lines of study applying the predominant theory and aimed at encouraging a deeper understanding of the OLI paradigm and the mechanisms that complement it.

In research regarding the former line of study, scholars have investigated organizational entry modes and location choice strategies (e.g., Kogut, 1988). Because the foundation of international business is FDI, considerable research has focused on organizational entry behaviors. However, only a few studies have examined organizational post-entry behaviors such as backward integration and termination mechanisms (Makino, Chan, Isobe, & Beamish, 2007).

Research on the latter line of study has revealed new perspectives. First, on the basis of the value chain concept introduced by Porter (1986), the question of "what activities" emerges. This question has encouraged research on the concept of global sourcing, defined as "the process by which companies undertake some activities at offshore locations instead of in their countries of origin (Kenney, Massini, & Murtha, 2009)."

Second, the resource-based view, learning perspective, knowledge-based view, and business network theory have all been introduced to explain how organizations establish their competitive advantages (Kogut & Zander, 1993). In contrast with the argument by Hymer, these perspectives address not only how firms exploit their capabilities, but also how they develop or create the capabilities. An organization's ability to match their behaviors with other actors' capabilities (i.e., in alliances and joint ventures) also has been explained by this inter-organizational perspective of firms.

The knowledge-based perspective assumes that knowledge is an extremely important resource for developing value-added activities. This perspective is closely related to the resource-based perspective because knowledge is surely an organizational resource. For example, Zaheer (1995) investigated how MNEs overcome the liability of foreignness in host countries by comparing the logic of firm-specific knowledge flows between a headquarters and its subsidiaries, using the institutional theory. According to the institutional theory, organizations can acquire legitimacy to adopt local practices and therefore become isomorphic within a local context (Tolbert & Zucker, 1983).

The knowledge-based perspective also represents an organizational learning perspective (Levitt & March, 1988) because knowledge is generated primarily through learning-by-doing. This notion is based on the Uppsala internationalization model, which is a traditional theory introduced by Johanson and Vahlne (1977). The basic argument of this model is that a firm's internationalization process is also the firm's organizational learning process. In the literature regarding MNEs, this theory substantiates the organizational-path-dependent view.

In addition, the network perspective views MNEs as mutually linked entities, existing somewhere between their home and host countries, and describes the embeddedness among subsidiaries and with their home offices (Ghoshal & Bartlett, 1990). This perspective places greater emphasis on not only internal knowledge flows, but also on how organizations acquire knowledge through the extended networks in which they are embedded. These perspectives have focused on the organizational processes involved in developing resources that yield strategic competitive advantage.

Figure 4 illustrates sources of competitive advantage from the aforementioned perspectives. Transaction cost theory points to the market utilization cost of organizational transactions. The resource-based view explains organizational competitive advantages by considering what kinds of resources and capabilities organizations have. The Uppsala Model and knowledge-based perspectives are closely related because experiential organizational capabilities are considered as accumulated organizational knowledge and thus as a competitive advantage. The network-based view argues that having valuable relationships with actors in local markets is an advantageous competitive resource.

Figure 4. Sources of Competitive Advantage.

	Transaction Cost	Resource-Based View	Uppsala Model	Knowledge-Based View	Network-Based View
Source of competitive advantage	Effectiveness in circumventing transactional market failures.	Possession of resources that are rare, inimitable, and valuable.	Ability to generate experiential knowledge.	Knowledge (tacit and explicit) as core resources to effectively leverage capabilities.	Resources derived from network relationships in local markets.

Following the question of "where" MNEs extend their operations, another important stream of literature on international business is based on the institutional theory approach to MNEs (DiMaggio & Powell, 1983). This theory argues that organizations strategically adapt to the host country's environment. Werner (2002) classified international business studies into 12 categories[1]. Ghemawat (2001) clearly pointed out that the risks involved and physical distances between countries are decision-making determinants that define an organization's behavior and performance. How organizations adapt to the political risks in host countries and

1 The twelve categories consist of global business environment, internationalization, entry mode decisions, international joint ventures, foreign direct investment, international exchange, transfer of knowledge, strategic alliances and networks, multinational enterprises, subsidiary-HQ relations, subsidiary and multinational team management, and expatriate management.

political distances between home and host countries have been critical issues in this field.

Some previous research offers insight on these issues (e.g.,Tsang & Yip, 2007). Ubiquitous within the existing literature are studies on cross-national distances, which is commonly held as a main explanatory variable in many international business studies (Berry, Guillén, & Zhou, 2010). In addition, latent host country risks have received critical examination in recent international business studies (Holburn & Zelner, 2010). Increases in cross-national distances and risks in home countries strongly indicate the aforementioned liability of foreignness for firms (Zaheer, 1995). Research on cross-national distances among countries has examined how these distances influence organizational behavior and performance (e.g., geographic and economic). Berry et al. (2010) summarized prior research on effects of distances and developed nine categories [2]. Tsang and Yip (2007) examined the relationship between economic distances and FDI. Ragozzino and Reuer (2011) revealed determinant elements of merger and acquisition (M&A) successes by addressing geographic distances. Other studies combined multiple distances to specifically investigate cross-national differences in how distances influence the behavior and performance of organizations (Chan, Isobe, & Makino, 2008).

Studies regarding risks in host countries have primarily focused on the political aspects. Roy and Oliver (2009) analyzed how the legal environment in host countries influences the partner selection criteria, which organizations use to form joint ventures. Henisz and Delios (2001) examined how policy uncertainty in host countries influences organizational foreign entry behavior, suggesting that they are less likely to enter countries with more political uncertainty. They argued that organizations tend to resemble each other in their response to risks. In addition, García-Canal and Guillén (2008) investigated how macro-economic and political uncertainty in host countries affect organizational entry strategies. They argued that, when uncertainty is relatively high, organizations are more likely to choose non-equity

2 The nine dimensions of cross-national distances are economic, cultural, political, administrative, financial, demographic, knowledge, connectedness, and geographic.

entry, thus describing an organizational entry behavior. In addition, Holburn and Zelner (2010) argued that firms in riskier countries acquire more sophisticated political capabilities to deal with political uncertainty in host countries. They found that firms with greater political capabilities are more likely to enter countries with higher political uncertainty. Meyer, Estrin, Bhaumik, and Peng (2009) examined causal relationships between institutions in host countries and organizational entry strategies by focusing on their internal resource capabilities, thus describing organizational responses to risk that involve focusing on organizational capabilities. Although these studies investigate how cross-national distances and risks in host countries influence organizational behavior, a large number of studies have also examined how distances and risks affect organizational performance (Lavie & Miller, 2008).

8. Concept of institutional voids

Scholars of international business have applied the concept of "institution" from both economic and sociological perspectives. While the former perspective views the concept of institution as rules of the game, the latter suggests that institutions consist of structures that maintain and regulate cognitive, normative, and regulatory activities that offer stability to social behavior (North, 1990). Aforementioned discussions on the institutional theory concern the latter perspective, and research on the concept of institutional voids links the former one.

This stream of literature has developed the concept of institutional voids in emerging markets (e.g., Mair, Marti, & Ventresca, 2012). This concept is consistent with the aforementioned literature concerning how host countries derive the positive effects of FDI depending on their absorptive capacity. This has become a key issue in emergent markets. Khanna, Palepu, and Sinha (2005) provided a meaningful framework to identify institutional voids in the host country. The five concepts they offered to explain institutional voids in the host country, as illustrated in Figure 5, are political social systems, openness, product market, labor market, and capital market. These viewpoints are critical concerns for managers in MNEs.

Figure 5. Five factors to explain institutional contexts.

Five Factors	Description
Political social systems	Countries' political systems will affect their products, labor, and capital markets. Political system means the degree of democracy or degree of government authority and centralization. Empirical evidence suggests that democratic regimes reduce risks for multinational firms (Bucheli & Aguilera, 2010).
Openness	The openness of host countries is also a critical consideration for firms. The best way for foreign entry is to enter markets where the government welcomes firms' investments.
Product market	In developing countries, firms are more likely to suffer from a lack of customer information as well as their business partners. It is, for example, difficult for almost all firms to predict foreign consumption patterns and create marketing strategies.
Labor market	In developing countries, firms also suffer from inappropriate human capital. This is mainly because search firms and recruiting agencies are rare or absent, thus leading to difficulties finding appropriately skilled labor.
Capital market	Capital and financial markets are not sophisticated in emerging economies, where actors, credit-rating agencies, investment analysts, bankers, and venture capital firms are inadequate or unreliable. Because of this, firms cannot gain substantial funding for their local business. In addition, because corporate governance does not function well in those actors, it is difficult to trust them as business partners.

Source: Khanna et al. (2005)

9. Organizational responses to institutional voids

Khanna et al. (2005) also provided meaningful suggestions for MNEs dealing with institutional voids in emerging markets. First, they argued that organizations must adapt to the local environment. Adaptive strategy argues that organizations develop a viable match between external environmental uncertainty and organizational capabilities and resources (Chaffee, 1985). Moreover, they suggested initiatives to change local institutions in host countries. Here, we present an original theoretical viewpoint on these two organizational responses.

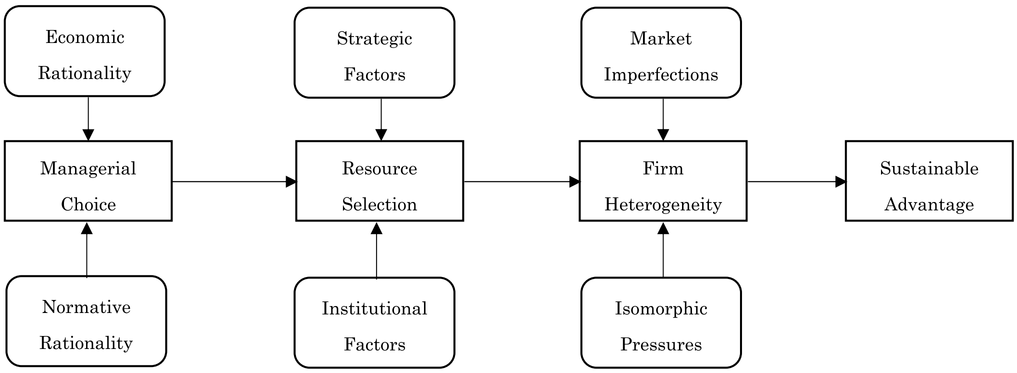
(1) Adaptive strategy

As mentioned earlier, research on country risks, as well as distances between countries, falls under the institutional theory approach. The concept of liability of foreignness (Zaheer, 1995) is used to explain firms' trials and tribulations in foreign markets, including the crucial pressure caused by the host country's institutional environment. In this section, two approaches to organizational adaptive strategy are presented: static and dynamic viewpoints.

Oliver (1997) provided a comprehensive picture on of these two perspectives, as illustrated in Figure 6. First, organizational behavior is mainly explained by the resource-based perspective (Barney, 1991). This theory argues, as discussed above, that inimitable, rare, and valuable resources are sources of organizational competitive advantage. Moreover, the institutional perspective has been discussed in regard to the field of management (Oliver, 1997). The middle row in this model indicates organizational processes and outcomes. While economic rationality, strategic factors, and market imperfections suggest resource-based determinants, normative rationality, institutional factors, and isomorphic pressures indicate institutional determinants.

From a resource-based perspective, managerial decision making is conducted by economic rationality and the pursuit of efficiency. Resource selections are determined by considering supplier and consumer power, competition in an industry, and product market structure. In addition, market imperfections are defined as barriers to acquisition, imitation, and the substitution of key resources. From an institutional

Figure 6. Sustainable advantage: determinants of the process.



Source: (Oliver, 1997, p.699)

perspective, "firms operate within a social framework of norms, values, and taken-for-granted assumptions about what constitutes appropriate or acceptable economic behavior (Oliver, 1997, p. 699)." Managerial choices are influenced by not only efficiency aspects but also socially constructed habits, norms, and customs. Therefore, motivating human behavior is not an economic optimization, but rather a social justification. Institutional factors refer to pressure from governments and social expectations, such as norms, rules, and environmental issues. Isomorphic pressures suggest that organizations are forced to conform under pressure from coercive, normative actors (DiMaggio & Powell, 1983).

While the resource-based perspective argues that organizational processes lead to economic performance, the institutional perspective suggests that this form of organizational process makes it possible to acquire legitimacy from the external environment, which indicates a license to operate in that environment (Scott, 1981).

In the process of organizational internationalization, firms must consider many institutional factors. However, the pressure for isomorphic behavior is relatively strong because of the differences between countries being quite difficult to understand immediately. As a result, these two perspectives provide meaningful insight to analyze the behavior and performance of MNEs in host countries.

Concerning a dynamic viewpoint, organizational adaptive processes can be explained by the concept of routine. Theoretically, an organization can be defined as a structured system of routines, which form a repetitive pattern of activities by organizational members (Cyert & March, 1963; Nelson & Winter, 1982), and organizational routine is defined as a stable pattern of behaviors characterizing an organization's reactions to variegated, internal, and external stimuli. Similarly, Simon (1993) argued that each individual business firm faces its strategic decisions against the background of its history and what it comprises. Therefore, this path-dependent argument suggests that an organization's behavior is more likely to be influenced by its own successful experiences in the past.

Changing this routine is explained by the concept of dynamic capabilities. Zollo and Winter (2002) defined dynamic capabilities as "a learned and stable pattern of collective activity through which the organization systematically generates and modifies its operating routines in pursuit of improved effectiveness (Zollo & Winter, 2002, p. 340).” According to Teece, Pisano, and Shuen (1997), this concept assumes that organizations generate or modify their capabilities when the external environment is in rapid flux.

When the external environment changes radically, organizations are required to change their routine to adapt to the external environment. If organizations apply the same routine to adapt to the environment, even if the environment changes radically, it is more likely to generate a success trap as well as competency trap (Levinthal & March, 1993; Levitt & March, 1988). According to these perspectives, once organizations develop sophisticated activities in specific fields, they are more likely to develop these activities, regardless of whether they can apply them in different or changed environments. Because these activities are more likely to cause failure, firms must change their routines if they are required to adapt to the changing environment.

(2) Changing the environment

Regarding the second organizational strategy, the main question remains: how do organizations change local institutions? This perspective considers states and government under a traditional view. Previous research defines corporate political activities as firms’ efforts to influence or manage political entities, such as lobbying and contribution activities (Hillman, Zardkoohi, & Bierman, 1999). Organizations intend to exploit opportunities by engaging in corporate political activities. An awareness of issues explains why organizations engage in political activities, which organizations engage in these activities more proactively, how these activities are conducted, and the outcomes of these activities for organizations (Hillman, Keim, & Schuler, 2004). Previous studies argue that organizations must undertake some political activities to mitigate the uncertainties created by being under the control of a foreign state government or its institutions, by proxy (Lux, Crook, & Woehr, 2011).

Hillman and Hitt (1999) described three strategies firms use to conduct their corporate political activities: information, financial, and constituent-based. Information strategy primarily concerns organizational lobbying activities, financial strategy mainly relates to contributions to politicians, and constituent strategy primarily indicates public relations. Considering organizational internationalization, Hillman and Wan (2005) empirically investigated how foreign subsidiaries engage in their political activities in host countries by conducting a questionnaire survey. As explained in the previous section, Hillman and Hitt (1999) postulated that firms conduct their corporate political activities in three ways: information, financial, and constituent strategy. Hillman and Wan (2005) referred to this influential study, when exploring what types of subsidiaries adopt which form of political strategy. They explored the effects of size and age of subsidiaries as well as the level of a parent firm's international diversifications and political strategies. This literature has investigated how organizational actions shape governmental policies and organizational performance. MNEs engage in corporate political activities to shape governmental policies, meaning that MNEs intend to change the host country's local environment.

Especially in emerging markets, MNEs suffer from institutional voids in their host countries. In this situation, MNEs have two options to deal with these difficulties: an adaptive strategy or an environmental change strategy.

10. Concluding remarks

This paper presents a review of the literature on FDI from both macro and micro perspectives. This body of literature has investigated how foreign countries acquire benefits from FDI, and has recently demonstrated that the positive effects of FDI differ depending on the host country's environment (e.g., regional differences, host country industrial capabilities). At a micro level, the effects of FDI on host countries are also explained by the concept of spillovers and linkages.

In focusing on the motivations and challenges for MNEs, previous studies have analyzed the strategic course of MNEs and their strategies for maximizing the benefits of internationalization. The most influential theory for explaining the observations presented is the OLI framework provided by Dunning and complemented through alternative perspectives. These studies primarily reflect the general theories in organizational science. For example, the Uppsala Model argues that organizational internationalization is a process of organizational learning. Moreover, the business network theory argues that subsidiaries' local networks are sources of significant organizational competitive advantage. The literature focusing on MNEs has developed the concept of institutional voids in host countries, especially in emerging markets. Because MNEs are required to engage in adaptive strategies and behaviors to change (or control) the host country environment, theoretical backgrounds for considering these strategies and behaviors are also provided in this paper.

Recently, studies on the effects of FDI and the strategies of MNEs have been discussing the same issue, according to which MNEs must pay more attention to the institutional environments in emerging markets. While scholars have argued that a minimum level of absorptive capacity is required for host countries to achieve positive effects from FDI, recent studies suggest that greater emphasis should be placed on how MNEs overcome institutional voids in host countries. This is not just a link between the literature on causes and effects of FDI, but also an interface between the macro and micro perspectives. Institutional voids are most prevalent in emerging markets, which are increasingly becoming part of the global market economy. Because the causal relationships in these dynamic situations are quite complex, further research, both quantitative and qualitative, is needed to improve our understanding.

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