A systematic literature review of Corporate Governance and Foreign Direct Investment

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Abstract:

This literature review paper aims to analyze the existing body of research on Foreign Direct Investment (FDI). FDI plays a crucial role in shaping economic growth, development, and globalization. This review seeks to identify theories and empirical findings related to FDI and corporate governance by examining a wide range of studies. The paper also highlights the policy implications associated with FDI. Through this analysis, the review aims to contribute to a deeper understanding of FDI and its implications for both developed and developing economies.

Introduction

Foreign Direct Investment (FDI) refers to the investment made by individuals, companies, or governments from one country into businesses or assets located in another country. FDI typically involves a long-term commitment and ownership or control over the invested assets.

FDI has a strong impact on the economy of a nation. A study done by Mehic et al., (2013) points out clearly that FDI can make gross fixed capital formation can influence the growth of the economy. FDI can improve the domestic country's performance by providing a healthy competitive environment, thus local players will also improve on quality (Liu et al., 2014). Cost reduction and profit maximization are the major aims of FDI. Cheaper labor will always attract more FDI (Alam & Shah, 2013). This is one of the highlights that developing nations can provide. The study in Turkey showed that rather than developed countries developing countries' FDI has more influence on the economy (Lee, 2010). Country-level variables like GDP, inflation, interest rate, exchange rate, government expenditure and technological advancement are having a huge impact on FDI decisions (Asiamah et al., 2019; W. Wu et al., 2020).

MNCs wish to invest in countries where corporate governance is low so that they will have the upper hand in regulating and controlling the host companies(Contractor et al., 2020).

Agency theory

In agency theory corporate executive and board members are obligated to act for shareholders. Agency theory focuses on potential conflicting interests among different actors that make up an organization's monitoring mechanism that can align the competing interest, cost mechanism and strategic performance implication.

Agency-based research suggests that family-owned enterprises have good monitoring control over the other forms of ownership. This scenario mostly works better with international subsidiaries (Filatotchev et al., 2007). The formulation of the FDI strategy of the patent

company will be influenced by agency conflicts and information asymmetries from the subsidiaries (Filatotchev et al., 2007).

Researchers where proposing a new theory that integrates all the factors of agency theory, internationalization, corporate governance, and family firm theory (Aguilera et al., 2020) or integrating agency theory and transaction cost economics theory to identify the family-owned enterprise's governance (Gedajlovic and Carney, 2010; Verbeke and Kano, 2010, 2012). Similarly, agency theory provides various insights into the governance mechanism (Mcclelland & O'Brien, 2011).

Transaction cost theory

Transaction cost theory basically tries to find an equilibrium between the cost incurred during a business's expansion. Transaction cost theory is not a simple theory, it compares most of the factors.

The main benefit that an organization is looking for will be course reduction. Transaction cost theory considers the cost that affects the organization internally and externally. The remuneration of directors, various factors of production, and the size of the firm can be considered internally whereas the negotiation of contractors with suppliers and market transactions (sales and other taxes) can be considered as external.

If you look closely, you can see that arbitrary theory is also discussed in the transaction cost theory. The cost advantage that a company gets when transacted with a cheaper market or with a cheaper production process is stated in the transaction cost theory. Not only the arbitrage theory the agency theory is also mentioned. As how effectively an organization can manage its operation and activities.

Transaction cost theory is the best-suited theory for corporate governance as it provides a better knowledge of the factors that are moderating the governance mechanism (Mcclelland & O'Brien, 2011). Rygh & Benito (2018) state that R&D is a company-specific asset. This makes the knowledge-specific asset superior and difficult to obtain. One of the main motives of FDI is knowledge assets (Dunning, 1977). Transaction cost theory focuses on a potential market as the volume of sales will be high (Cuypers et al., n.d.). Market seeking is the major factor that emerging markets are looking for while planning for FDI (Behera & Mishra, 2022). Gao (2005) study shows that companies are focusing on south Asian countries mainly due to cost reduction. The headquarters will have a close watch on the price mechanism of subsidiaries to mitigate the governance cost (Rygh & Benito, 2018). The institutional distance are going to increase the transaction cost between the companies (J. Wu et al., 2022). That's why while going for FDI the companies look for the near by markets (Aykut et al., 2003).

Echelons theory

Upper Echelons theory says that top management's strategic decision-making leads to the performance of the organization. Upper Echelons theory mostly comprises psychological factors and observable factors. In psychological factors, cognitive-based values will be determined. In observable factors age, functional track, other career experience, education, social economic growth, financial position, and group characteristics-based factors will be evaluated. These factors affect the strategic choice that a management is going to take. The main strategic choices that are going to come under are unrelated diversification, Related

diversification, Acquisition, Capital intensity, Plant and equipment newness, Backward integration, Forward integration, financial leverage, administrative complexity, and response time. So, these strategic choices are going to affect the firm's performance which can be measured easily through profitability or variation in profitable growth and survival rate of the organization. In this theory, observable democratic factors are not considered a reliable portrait of a person's decision-making key publicity.

CEO characteristics are a major area in theory. As the top executive are the core of the business how they analyze the situations and make decisions have a high impact on governance (Hambrick, n.d.).

Some of the main findings of Hambrick & Mason's (1984) theory are as follows. The educational background of top management has no relation with the performance unless it is technical knowledge. The inside experience of a manager will bring out a high profit but low strategic choices as they had limited exposure. But functional experience in top management will increase profitability, Innovation, and diversification. The profitability of the firm and the top manager's salary are positively correlated. The low social economic background will lead to diversification, mergers, and acquisition. Group heterogeneity will act positively toward the turbulence time in an organization.

Information process theory

Information process theory is how people process store and use information. While constructing a corporate strategy the information processing of the complexity of tractions is critical (Hoskisson et al., 2002). The manager's ability to make FDI decisions is highly influenced by the board's character (Lien et al., 2005). The success of FDI is depending on how the information asymmetries and potential conflicts are tackled (Filatotchev et al., 2007).

Research gap

From the above discussion, it is clear that there is a need for a firm-specific study on corporate governance and FDI. The three main areas of focus will be market-seeking, knowledge-seeking, and cost-effectiveness. As there are the foremost reasons for the FDI (J. Wu et al., 2022). These factors are going to moderate the corporate governance of FDI and this study will give a clear understanding of the corporate governance practices.

Conclusion and Policy recommendations for maximizing Foreign Direct Investment and its benefits

Improve the business environment: Governments should focus on creating a favorable business environment that promotes transparency, efficiency, and ease of doing business. This includes streamlining administrative procedures, reducing bureaucratic red tape, and enhancing the efficiency of regulatory frameworks. Clear and consistent investment policies and regulations can instill investor confidence and attract higher levels of FDI.

Enhance infrastructure development: Adequate infrastructure, including transportation networks, communication systems, power supply, and logistics, is essential for attracting and sustaining FDI. Governments should prioritize infrastructure development to enhance connectivity, reduce costs, and facilitate efficient movement of goods, services, and people. Public-private partnerships can be leveraged to bridge infrastructure gaps and mobilize private investment in infrastructure projects.

Promote innovation and research and development (R&D): FDI is often attracted by countries that offer an environment conducive to innovation and R&D. Governments should invest in education and skills development to create a highly skilled workforce that can support technological advancements. Establishing research institutions, innovation hubs, and technology parks can foster collaboration between academia, industry, and international investors to drive innovation-led FDI. Governments should enact and enforce laws that protect intellectual property rights and provide effective legal mechanisms for enforcing patents, copyrights, and trademarks. This will encourage knowledge-intensive industries and incentivize multinational enterprises to invest in countries with strong IPR frameworks.

These policy recommendations aim to create an enabling environment that attracts high-quality FDI, encourages technology transfer and innovation, and maximizes the positive spillover effects on the host economy. Implementing these policies requires a long-term vision, effective governance, and continuous dialogue with relevant stakeholders, including domestic and foreign investors, to ensure policy coherence and sustained success in attracting and benefiting from FDI.

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