CHAPTER II

LITERATURE REVIEW

2.1   ASEAN Overview

Association of Southeast Asian Nations or better known as ASEAN is a group of 10 countries in the Southeast Asia region, consisting of Laos, Cambodia, Myanmar, Philippines, Thailand, Vietnam, Malaysia, Brunei Darussalam, Singapore, and Indonesia. ASEAN main purposes is creating cooperation between countries in the technological field, cultures, social, economy, politics, and science (Sawatdirakpong & Osathanunkul, 2012). The reason why we only pick five countries in ASEAN countries because Indonesia, Malaysia, Thailand, Philippines and Vietnam almost have the same profile like meaningful acreage under rice, rate of urbanization, or urban rural divide and all of them is developing countries.

2.2   Theoretical Framework

2.2.1   Foreign Direct Investment Theory

FDI is defined as source of technologies and skills valuable in the long term (Gray, 2002). FDI is also one of the essential element in economic

development process. Hence, it is good for developing countries to attain a big significant amount of FDI, also it is good for investor to invest in developing countries rather than developed countries because of the return and cheap labor cost.

Foreign Direct Investment (FDI) is described as an investment involving a long-term relationship and reflecting a sustained interest and influence of resident entity in a single economy (Foreign direct investor or parent enterprise) in an enterprise place in an economy other than that of foreign direct investor place (FDI enterprise or affiliate or foreign affiliate). FDI indicates that the investor exerts a significant degree of impact on the other economy's enterprise resident operation. Such investment includes both the original transaction between two companies and all subsequent transactions, between them and foreign partners, both incorporated and unincorporated. FDI is not only can be taken by company but also by individual. Flows of FDI include capital supplied by a foreign direct investor to an enterprise (either directly or through other affiliated enterprises) or capital obtained from investing enterprise by a foreign direct investor. (UNCTAD, 2007)

Foreign direct investment (FDI) refers to a category of cross-border investment affiliated with a resident in one economy having control or significant degree of impact on the operation of enterprise that is resident in another country (IMF, 2009). The FDI concepts highlights two differences: FDI versus foreign portfolio investment (FPI). FDI manages investment actively, while FPI is passive

(Mankiw, 2011). For the purpose of exercising control over an enterprises, FDI is undertaken. (UNCTAD, 2016)

Foreign direct investment are made up of three basic components: (i) **Equity capital** is the foreign direct investor's buying the shares of an enterprise out of foreign direct investor's own country. (ii) **Reinvested earnings** comprise profits which are not collected by the foreign direct investors. (iii) **Intra-company loans** are short or long-termed debt and credit funds between direct investors and affiliate enterprise at issue.

According to the generally accepted theory of Dunning (1993) and Dunning and Lundan (2008) firms that make investments abroad can be categorized as resource seekers, market seekers, efficiency seekers and strategic asset or capability seekers. The natural resource seekers intend to take advantage of the physical resources, the labour force and the managerial skills and capabilities of host countries. Market seekers penetrate foreign markets mainly due to their size, growth and structure, while other strategic factors are of equal importance as well. Economies of scale and scope and risk diversification are the main drivers for efficiency seeking FDI, while the strategic asset or capability seekers carry out mergers, acquisitions or joint ventures in order to maintain or further enhance their competitive position. Strategic asset or capability seeking FDI aim at advancing the investing firm's competitiveness in any manner and, thus, their motives usually fall into in one of the previous three categories. These are enterprises that invest in a particular country or region to supply goods or services to local and regional markets. Market-seeking investment may be

undertaken to sustain or protect existing markets, or to exploit or promote new markets. Together with market size and market growth of the host economy, obstacles to accessing local markets, such as tariffs and transport costs, also encourage this type of FDI.

There are several theories that explain Foreign Direct investment; The eclectic paradigm of dunning, The Theory of Exchange Rates on Imperfect Capital Markets, The internalization Theory.

2.2.1.1   OLI Paradigm Theory

The Eclectic paradigm already can be traced in the early 1950s (Dunning, 2001). Through his works, professor Dunning developed a theory incorporating the three different subjects, ownership, location, and internalization, all based on the themes of ownership and location advantages, internalization, and international location of economic activity. This theory name usually goes with OLI eclectic paradigm of international production. Eclectic theory tries to answer the debate why an enterprise would like to have the manufacture process in a foreign location instead of exporting or entering into licensing agreement with local enterprise (Lim, 2001). According to this theory, there are three condition that must be satisfied for multinational enterprises to engage in foreign direct investment. The eclectic theory developed by Professor Dunning is a mix of three different theories of foreign direct investment:

1.   Ownership Advantages (O)

Ownership Advantages relate to intangible assets, which are exclusively owned by the company for at least a while and can be transmitted at low cost within transnational companies, resulting in either greater incomes or lower expenses.

But there are some extra costs faced by transnational companies operations in different countries. A business must have certain features that would triumph over operating costs on a foreign market in order to enter a foreign market successfully. These advantages are the property ability or the specific company's benefits. The company has a monopoly over its own specific advantages and use it overseas, thus the company will have higher marginal profitability or lower marginal cost compared to other rivals company (Dunning, 1988).

There are three types of specific advantages:

A.   monopoly advantages in the form of privileged markets access by ownership of natural limited resources, patents, trademarks;

B.   Technology, knowledge widely defined so as to contain all forms of innovation activities

C.   Economies of large size such as economies of learning, economies of scale and scope, greater access to financial capital.

2. Location (L)

The extent of which companies choose to find their operations outside their national boundaries will depend on their profitability. In other words, it must be more profitable to use these ownership advantages they have in combination with at least some factors inputs positioned overseas; otherwise, they should be exported. The location advantages relate to the issue of whether the expansion is best achieved at home country or abroad for the companies. The specific advantages of each country can be divided into three categories:

A.   the economic benefits consist of quantitative and qualitative factors of production, cost of transport, telecommunication, market size etc.

B.   political advantages: a government policies that whether support or disabled FDI flows.

C.   social advantages: includes distance between the home and home countries, cultural diversity, attitude toward strangers, etc.

3. Internalization (I)

If the first two requirements are met, the use of these advantages in cooperation with at least some variables outside the nation of origin must be profitable for the business (Dunning, 1988).

This third characteristics of the eclectic paradigm OLI provides a framework for evaluating various ways in which the company will exploit its powers from

the sale of products and services to multiple contracts that could be signed betwen the companies. As cross-border market internalization benefits is bigger, the more the company will want to participate in foreign production instead of providing this right under license, franchise.

OLI's eclectic paradigm demonstrates that OLI parameters differ from com pany tocompany and rely on context and reflect the economic, political and social character of the host country.The Company's goals and strategies, magnitude and production pattern will therefore decided on the difficulties and prospects provide d by various nations

2.2.1.2. Resource Based Theory

As a strategy, Resource based theory is a way to achieve competitive advantage by taking into consideration the company's positioning, where to compete, and how to compete. Resources are the core capabilities of companies, including financial resources, physical resources, human resources, and organizational resources (Grant, 1991)**.** The ability of a company to gain a profit rate above its capital cost relies on two variables: the attractiveness of the industry in which it is located and its competitive advantage over its competitors (Grant, 1991). When entering a strategic factor market and applying a product market strategy, the financial resource is a requirement for companies.All companies need to think thoroughly about financial strategies, including various sources of capital, capital structure, capital enterprises costs, and dividend policy effects.

Physical resources are described as tangible stuff like plants, equipment, land, and natural resources (Grant, 1991). (Roos, 1988) defines human resource as knowledge, skills, and experience of employees. Therefore, human resources include the skills, strengths, dedication, motivation and loyalty of staff. In attracting FDI, this element was considered essential.The organisational resource relates to the intangible resource that is very critical for companies in making decisions and policies. This includes enhanced use of intangible resources such as technology, patents, trademarks, copyrights, licensed designs, technical staff and trade secrets and methods. So, whether it physical, financial, organizational or human resource play a role in determining FDI inflows (Thanyakhan, 2008)

2.2.1.3.   The Internalisation Theory

This theory attempts to explain the development of the transnational companies and their motivations for foreign direct investment. Buckley and Casson created the concept in 1976, then Hennart in 1982 and Casson in 1983. Coase initially introduced the concept in a national context in 1937 and Hymer in a global context in 1976. Hymer recognized two significant determinants of FDI in his Dissertation. One was the elimination of competition. The other was the benefits that certain companies have in a particular activity (Hymer, 1976).

Buckley and Casson, who established the theory, demonstrate that their internal operations are organized by transnational companies in order to create particular benefits to be exploited afterwards.The theory of internalization is also

considered as very significant by Dunning, who uses it in eclectic theory, but also claims that this explains only portion of FDI flows. (Hennart, 1982) develops the idea of internalization by developing models between the two types of integration: vertical and horizontal

Hymer is the author of the concept of firm-specific advantages and shows that FDI only takes place if the advantages of exploiting company-specific advantages outweigh the comparative expenses of operations abroad. According to (Hymer, 1976) the MNE appears due to the market imperfections that led to a divergence from perfect competition in the final product market. Hymer discussed the issue of foreign-respected information costs to local companies, distinct government treatment, currency risk (Eden & Miller, 2004). The result implied the same conclusion: when the investments are produced abroad, transnational businesses face some adjustment expenses. Hymer acknowledged that FDI was a decision on a firm-level approach rather than a monetary decision on the capital market.

2.2.2 Population Growth Theory

2.2.2.1 Malthusian

The Malthusian model was initially pioneered by Thomas Robert Malthus who was a British priest. In 1798, Malthus created a book "An essay on the Principle of Population". Malthus stated that food sources are important for

human survival, meanwhile human lust cannot be easily held back and population growth is faster than the growth of natural resources. Given above stipulates that whereas population is increasing at a geometric rate, food production was increasing with arithmetic rate. According to Malthus, there are two ways to restrict the population growth like preventive checks and positive checks. Preventive checks is to reduce population growth by human interference like delaying birth by delaying marriage and if measures were not put in place to check how rapidly population is growing then the population will check itself through what he termed as "positive check". According to him the earth and its entire resources are fixed in supply and since population growth exceed food production, there will be famine, wars and other natural disasters as a positive check on the population growth. Malthus proposed that since population growth slowing down economic growth of one nation, binding measures should be be expressed, which includes moral suasion, education, delay in marrying, spacing of child births, and the use of contraceptives and so on. The Malthusian model is considered accurate in pre-industrial societies but fails to work correctly in industrialized environments where division of labour and specialization are possible.

Malthus's opinion on his theory:

1.   People will continue to experience poverty due to the continuous increase in population   that outstrip the food supply

2.   The population growth can be explained by series of geometric, so the multiplication of population is each 25 years, meanwhile the multiplication facilities for life tends to be slower

2.2.2.2   Marxist

Karl Marx and Friedrich Engels are two figures who pioneered Marxist. This theory does not agree with Malthusian theory. According to Marxist, the population of country put impact on employment rather than natural resource of food supply. It is also stated that the bigger the population, hence the higher the output produced in country. So there is no need to put restriction of population growth. A lot of countries that support Malthus's theory are generally countries with capitalist economic system such as America, Britain, France, Australia, and Canada. Meanwhile the countries that supports Marxist theory is generally a country with socialist economic system such as Eastern Europe, China, Korea, Russia, and Vietnam.

Marxist stated that throughout the history humans will be adjust to the times. So, Marx and Engels concluded that the main cause of poverty was the capitalist system that tormenting its people, and the capitalist system need to change its structure into socialist.

2.2.2.3　　　　Neo-Malthusian

In the twentieth century, Malthusian ' come to the surface again. The group from the Neo-Malthusian theory supports the previous theory but more radical and pioneered by Garret Hardin and Paul Ehrlich. Neo-Malthusian recommends to reduce population by using the preventive checks from the previous method. Paul Ehrlich write "The Population Bomb" book and describes the population and environment with three assumptions. First, the world already had too many people in it. Second, the condition of food supply is very limited. Third, the excessive number of people causes the world to suffer and create a pollution for the environment.

2.2.3　　　　Population density

Distribution of population in a country is generally not the same in every region. The community will generally prefer live in areas close to the sugar economy. Level of density the population describes the number of people who live on an area. Generally the economic sugar region has a density level. A denser population, compared to areas that are not sugar economy. Regions that have a densely populated population density, generally in urban areas. Cities are chosen because they have all facilities. Prices of tanned goods and services tend to be more expensive modified rural areas. According to (Tiffen, 1995) density residents have a significant negative relationship to growth economy. Land, water

and land are limited in number. Because it's limited these resources will become scarce, it will increase the price of these resources. Price increase without offset by the increase in purchasing power will reduce economic growth.

2.2.4   Life Expectancy

Health is an important capital for individuals to carry out activities, including economic activities. Level status health of a country can describe the level of welfare the country. If a country has a health level status well, the population of the country is generally prosperous. According to (Alsan et al., 2006) states the better the health status of the population a country, the more productive the population of that country produces output. Life expectancy in many studies is used as parameter of a country's health status. According to BPS, the expectation number life is a long estimate of the average human being passed during life, since the human was born. Life expectancy has a positive and significant relationship towards economic growth.

2.3   Empirical Studies

2.3.1   Kok, R., & Ersoy, B. 2009, "Analyses of FDI Determinants in developing countries."

The purpose of this paper is to find out the best determinants of Foreign Direct Investment (FDI) in developing countries. The methods that is used in this

study are fully modified OLS (FMOLS) and SUR (seemingly unrelated regression) for 24 developing countries, over the period 1983-2005 for FMOLS and 1976-2005 for cross-section SUR.

The variables used in this study are gross foreign direct investment (GFDI), electric power consumption (LOGELEC), total external debt (LOGEXDEBT), technology gap (TGAP), total debt service percent of GDP (TDSGDP), inflation (INFLATION), domestic gross fixed capital information (GFCF), telephone number (TELEPHONE), market size – GDP per capita growth (GDPpcgro), Trade (TRADE), and gross capital information (GCF).

The regression result shows GDP per capita growth rate has a positive effect on FDI and almost all of the variable had positive impact on FDI except inflation and total debt service. However, the best FDI determinant is communication (telephone mainlines) and it has positive effect on FDI. In this study it is know that the competition among government to attract FDI has grown significantly. With tax and other incentives, many countries have not only decreased or eliminated such constraints, but have also moved towards promoting FDI. Appropriate domestic policies will support attract FDI and maximize its benefits while removing local business barriers at the same moment. Foreign companies, like domestic ones, pursue a good business environment rather than the unique favors provided to cause foreign businesses to enter the areas offering incentives, the transparency and accountability of governments and corporations are basic conditions for creating a trustworthy and efficient structure for people's social, environmental and economic lives. They bring enormous challenges to

national governance not only for the advantage of foreign investors, but also for national company and society as a whole.

2.3.2 Alsan, Marcella, Bloom David E. and Canning David, 2006. "The Effect of Population Health on Foreign Direct Investment Inflows to Low- and Middle-Income Countries."

The purpose of this paper is to investigate the effect of population health on gross inflows of Foreign Direct Investment (FDI). The methods that is used in this study is panel data analysis of 74 industrialized and developing countries over 1980-2000.

The variables used in this study are gross FDI inflows, total population, GDP per capita, openness of economy, bureaucratic quality, corruption in government, life expectancy, education, telephones, distance to major markets, population coastal, and landlocked. The econometric models in this study is shown below:

$$logI_{it} = a + \alpha logPop_{it} + \beta logGDP \, per \, cap_{it} + \theta Health_{it} +$$

$$\mu logEdu_{it} + \gamma X_{it} + \delta Z_{it} + D_t + \varepsilon_{it} \qquad (1)$$

Where the subscript i refers to a country, while t refers to the time period. We include log population (Pop) and log GDP per capita as scale variables. Following our theory, we also include measures for worker health and education levels as productive components of human capital. Further input per capita

measures are included in the vector X, while vector Z represents barriers to trade that may deter FDI. We include time dummies, Dt, to capture investment flows over time (due to changes in the world price or rate of profit), and e represents the error term.

The regression results shows life expectancy has a positive and statistically significant effect on FDI. Every additional year of life expectancy is associated with 9% increase in gross FDI flows to low- and middle-income countries. Total population is also highly significant at 1% level. GDP per capita, openness of economy and bureaucratic quality also has a positive and significant impact on FDI. In this study it is known that health is beneficial and statistically significant determinant of gross FDI inflows to low- and middle-income countries.

2.3.3 Akin Mustafa Seref (2009). "How is the Market Size Relevant as a Determinant of FDI in Developing Countries? A Research on Population and the Cohort Size"

The purpose of this paper is to investigate the relevancy of market size in developing countries. The methods that is used in this study is cross-sectional OLS from 1980 to 2000. The variables used in this study are FDI, Telephone mainlines, Import, GDP per capita, GDP growth, Population growth, Pop density, Pop total, Life Expectancy, GDP (PPP), 0-14 age pop, 14-65 age pop, 65 over pop. The econometric models in this study is shown below:

$$FDI = \alpha + \beta(Population\ Variables) + \Pi\ (Control\ Variables) + u_i\ (2)$$

Where α is a constant coefficient, β and Π are the estimated coefficients on the independent variables and ui is an error term. The regression results shows population density are not promoting FDI and Population size is positively correlated with FDI and significant. In this study it is known that the relatively small size of the market is connected with non-market-seeking FDI operations due to the low-income argument in developing countries. While per capita GDP is a poor market indicator seeking FDI operations in developing countries, but both the population and GDP are crucial. This outcome indicates that FDI takes into consideration the size of the market in developing nations not on a per capita basis but on an aggregate size basis. More specifically, FDI is more likely to concentrate on regional regions with comparatively greater purchasing power rather than expansion across the country.

2.3.4. Hoang H. Hiep and Duc H. Bui (2014). "Determinants of Foreign Direct Investment in ASEAN: A panel approach"

The purpose of this paper is to analyzes the factors of FDI inflows in ASEAN countries over the period 1991 to 2009. The methods that is used in this study is panel of the six ASEAN Countries: Vietnam, Indonesia, Malaysia, Philippines, Singapore, and Thailand. The variables used in this study are Market size derived from Gross Domestic Product, Trade openness, Wage derived from labor cost, Human capital, Labor productivity, Political Stability, Inflation rate,

Interest rate, Financial Development, Infrastructure derived from total numbers of phone and mobile phone users, and Exchange rate. The econometric model is shown below:

$$FDI_{it} = F(MARKET_{it-1}, OPEN_{it-1}, WAGE_{it-1}, HUMAIN_{it-1},$$

$$PRODUCTIVITY_{it-1}, INFLATION_{it-1}, INFRASTRUCTURE_{t-1},$$

$$RISK_{t-1}, CORRUPTION_{t-1}, EXCHANGE_{t-1}, INTEREST_{t-1},$$

$$FINANCE_{t-1}) \tag{3}$$

Where i for some countries and t for some time units. Most explanatory variables are taken in original terms one-year lagged from the year of the dependent variable. The use of lagged explanatory variables helps to solve endogeneity problems and relates to a simple hypothesis for the foreign investor decisionmaking. In this study it is known that the domestic market size has a positive effect statistically significant for FDI flows into ASEAN. These findings have a number of consequences for policy. First, they demonstrate that while market size is one of the key variables in FDI inflows, tiny ASEAN countries can also attract FDI by enhancing their institutions and policy environment. The two best ways to minimize political hazards and uncertainty in the investment setting for foreign investors are political stability and excellent control of corruption. Moreover, through regional integration, they can also attract FDI driven by market research. These countries should link their national and neighboring markets closely. Removing tariff and non-tariff barriers with neighboring nations, building global infrastructure (particularly the transnational highway system) are the best methods to create a single national market. This also indicates a single

transnational business interest in the Indo-chinese, which has a distinctive ASEAN stance as it is not split by the ocean. The findings also indicate that the backward countries of ASEAN (such as Vietnam, Laos, Cambodia, Myanmar) that attract tiny quantities of FDI must accelerate the growth of infrastructure, trade liberalization, trade openness, and advancement towards ASEAN regional integration. In addition, a weak level of the national currency against the U.S.Dollars can boost their exports, but also promote FDI flows in ASEAN countries, while the labor quality is really an important factor. In fact, attracting labor-intensive FDI projects rather than big technology-intensive projects is the benefit of inexpensive labor. ASEAN countries should therefore concentrate on the growth of human capital, enabling them to compete in attracting and efficiently absorbing FDI.

2.4   Research Framework

Foreign direct investment is important for developing and emerging market countries. Their companies need the multinationals' funding and expertise to expand their international sales. Their countries need private investment in infrastructure, energy, and water to increase jobs and wages.

A lot of studies already using macroeconomic factors as a determinant of FDI whether it is on developed country or developing country. Only a few number of research use demographic variables as a determinant. Since developing countries had a lot of population advantage thus increase the return of market-seeking FDI enterprise. As a writer, I think it is important to discuss which factors

is considerable to create an attractiveness for MNEs to invest in ASEAN Countries.

This study use total population, life expectancy, population density, and gross domestic product growth rate as an explanatory variables. Therefore, to perform this analysis, a research framework is needed to give a more brief explanation:

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┌──────────────────────┐
│      Population       │
└──────────────────────┘

┌──────────────────────┐
│    Life Expectancy    │          ┌──────────────────────────┐
└──────────────────────┘          │ Foreign Direct Investment │
                                   └──────────────────────────┘
┌──────────────────────┐
│  Population Density   │
└──────────────────────┘

┌──────────────────────┐
│    GDP growth rate    │
└──────────────────────┘
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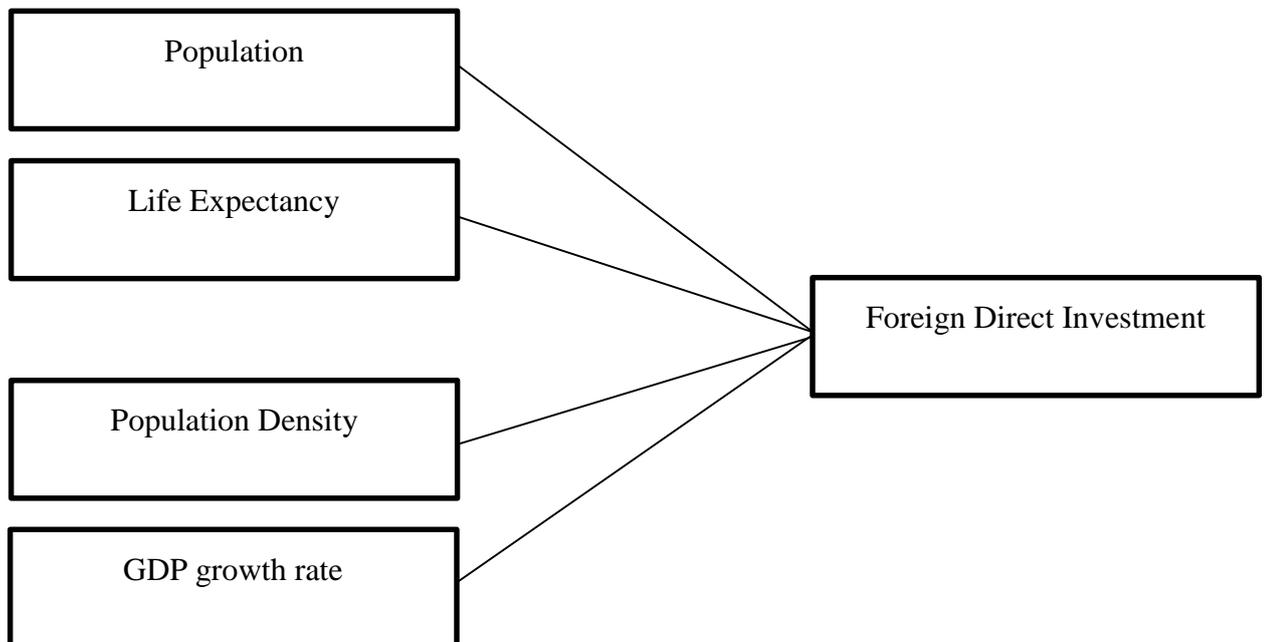
2.5   Research Hypothesis

According to the empirical studies that is discussed before, we can acquire the research hypothesis as follows:

1.   Total population have a significance and positive impact to FDI in five ASEAN Countries (2008-2015)

2.   Life expectancy have a significance and positive impact to FDI in five ASEAN Countries (2008-2015)

3.   Population density have a significance and negative impact to FDI in five ASEAN Countries (2008-2015)

4.   GDP growth rate have a significance and positive impact to FDI in five ASEAN Countries (2008-2015)