TOWARDS A BETTER UNDERSTANDING OF DRIVING FACTORS FOR FDI ALLOCATION.
A COUNTRY'S GOODWILL: A NEW HOST COUNTRY'S FDI DETERMINANT?

by

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Abstract

This Thesis proposes a new approach to explaining the allocation of foreign direct investments (FDI), by applying the accounting framework for valuating a company's intangible assets at a country level. This framework allows us to identify a valuable group of a country's assets that previously had not been taken into account: a group of assets that forms a country's Goodwill, or national Goodwill. National Goodwill includes all those unmeasurable, unquantifiable or not easily identifiable assets that add to (or subtract from) a country's market value and that can, in turn, generate FDI inflows. The research shows how a simple accounting method identifying a company's goodwill can be adapted into a formula that proxies a country's Goodwill.

By identifying and then quantifying a particular country's Goodwill, for a large sample of countries, this Thesis postulates that it is possible to test the power of a country's Goodwill to explain the cross-sectional and time-series variation in FDI flows for a broad set of countries.

The ultimate aim of this research is, by placing the difficult to factor, yet extremely important -'intangible assets' of a country,- into a more quantifiable form, to provide a much needed specificity to our understanding of the factors that more accurately define a country's value and attractiveness for FDI investments.

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List of Abbreviations

AICPA   American Institute of Certified Public Accountants of the United States

CDS   Capitalist Development State

FASB   Financial Accounting Standards Board (USA)

FDI   Foreign Direct Investments

GDP   gross domestic product

GNP   gross national product

IAS   International Accounting Standards

IASB   International Accounting Standards Board

IASC   International Accounting Standards Committee

IFRS   International Financial Reporting Standards

IPE   International Political Economy

LDCs   Less Developed Countries

MNC   Multinational Company

R&D   research and development

SFAS   Statement of Financial Accounting Standards (USA)

TNC   Transnational Company

WIR   World Investment Report

UEC   Union of European Accounting Experts

It is important to define the term 'international investment community' that will be referred to throughout this Thesis at the outset. International investment community is an inclusive term comprising not just FDI investors but all those who determine a country's investment value: international investment rating agencies like Moody, Standard & Poor's; academics, analysts, journalists, professional magazines, academic journals and investment reports (e.g. UN World Investment Report) as well as investment asset managers, brokers, and international organisations (e.g. World Investment Forum, OECD, UN) etc.

Note: In the discussion which follows, the term 'Goodwill', with a capital G, is used to denote the 'model' or 'concept' of Goodwill at the **national** level, that is, the cumulative characteristics of a country which add to its national value and which may be important as a determinant of the FDI allocation to individual countries. When the term is used more generally in the text, and/or refers to the concept of goodwill in relation to accounting, corporate and business practice, it is presented as 'goodwill', with a lower case "g" (unless of course, it is the first word of a sentence in which case normal grammatical rules are applied).

CHAPTER 1. INTRODUCTION

1.1 Research question

A vast body of theoretical and empirical literature attempts to explain what factors – economic, political, institutional, historical – drive foreign direct investment (FDI) across countries[1]. The findings from this literature remain mixed at best in that the determinants of capital flows in and out of countries proposed by conventional theories do not appear to be able to explain a substantial fraction of the observed movements of foreign capital. This raises the question of whether the underlying theories omit a key mechanism that drives investors' decisions to allocate capital and determines how countries become the recipients of international capital. The purpose of this Thesis is to contribute to this literature by addressing, directly, the question of why apparently similar countries, in terms of their economic and other circumstances, often receive very different amounts of foreign capital and FDI, in the quest for a novel explanation of the drivers of capital flows, and specifically FDI, across the world.

The distribution of capital flows across countries is very uneven, and it seems that investors favour some countries more than others for reasons that are not fully understood. Unfortunately, conventional factors that are expected to be the attractors of investment flows (such as a country's population size, human capital, geographical location or natural resources) are not always either necessary or sufficient conditions for skewing FDI inflows. Much empirical literature on the

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[1]FDI is defined as both physical investment (e.g. plant) and also includes significant portfolio investments that lead to ownership of at least 10% of a company on the territory of a host country.

determinants of capital flows and the development of emerging markets highlights how countries with relatively similar country factors and economic conditions may enjoy very different levels of foreign capital (e.g. OECD, 2002; Kinoshita and Campos, 2003; Blonigen, 2006; Buthe and Milner, 2008; Groh and Wich, 2009).

For example, how would one explain why South Korea has enjoyed much more foreign capital than some Eastern European countries such as Romania or Bulgaria? When assessing their initial conditions, the geographical location of Romania and Bulgaria is preferable for investors given their related proximity to Europe and the US, where the majority of investments come from, relative to the more distant South Korea. Also, if a country's size matters (Aziz and Makkawi, 2012), why does a large country such as Argentina enjoy so much less foreign capital investment than Israel? And if a country's political regime matters, why does Singapore, as a largely authoritarian country, become a large financial centre with huge capital inflows while some, more democratic countries in Africa do not? It is also commonly thought that cheap labour is a key attractor for FDI. However, the example of the current popularity of China as an FDI destination illustrates the inadequacy of this argument: China is no longer a place for cheap labour, nor does it offer such enticements as tariff protection and tax reductions. Nevertheless, this has not stopped recent and current FDI inflows into its economy; these remain very sizeable. There must be reasons why investors choose to move their capital more towards some economies than others, but the factors commonly used to define foreign investment preferences seem unable to provide a satisfactory answer to questions like those raised above. Even the

policies and methods recommended by international organisations, such as bilateral investment treaties (BITs), tax reductions, tariff protection or the encouragement to improve the infrastructure of a country cannot guarantee FDI inflows. Otherwise, how is it possible to explain the case of Indonesia, which received $19.3 billion dollars of injections of FDI in 2012 after the upgrade of its investment status by Fitch Ratings (Hussain, 2012; Bellman, 2012), when its infrastructure, human capital and corruption are problematic, and labour laws remain rather weak. All this remains somewhat puzzling.

An influential UNCTAD World Investment Report (WIR) of 2012 published a new FDI Potential Index that identifies two groups of countries that attracted significantly more – or significantly less – FDI than would be expected on the basis of their economic and other FDI determinants. Interestingly, the report also identifies some resource-rich countries that – even though the Potential Index takes into account the presence of natural resources in these countries – exceeded expectations in attracting FDI inflows. More precisely, the report presents one category of countries that attracted significantly more FDI than was expected, taking into account the country's economic and other conditions; and another group identifying those countries that continue to receive FDI below their potential, including the Philippines and South Africa (WIR, 2012).

Since commonly recognized FDI determinants fail to provide a satisfactory explanation for FDI allocation, this study tries to advance the debate by proposing the addition of a new determinant to the existing literature, placing at centre stage of this Thesis the hypothetical concept of national 'Goodwill'. Goodwill is known and widely used in corporate accounting, business studies and

international political economy literature as a valuable intangible asset of an entity that explains that entity's market value (its value for investors) over and above the value of the entity's current tangible and other intangible assets. Goodwill generally represents an entity's future earning capacity.

The Goodwill Model provides an analogy with the existing concept of goodwill and proposes "National Goodwill" (generally referred to in this Thesis as Goodwill) as a new FDI determinant. The model argues that a country's current tangible assets – its economic determinants, political factors and the quality of its institutions and governance etc. – matter less than is generally accepted. What also matters is the reputation of the country in the international investment community and the latter's subjective perceptions and expectations of the country's future potential for economic growth. The hypothesis is simple; since investors are looking for future returns on their capital, what matters to them is the future development of the country's economy rather than the present situation or indicators of the current state of its economy. If a country is perceived by investors as having potential for economic growth and high returns on invested capital, investors will invest into this country and conversely, if a country is perceived as having little or no potential for economic growth, investors will be reluctant to invest even if the country's current economic and other indicators are similar to the countries that investors favour.

Applying the concept of Goodwill at a country level explains why a country's observable factors fail to explain the allocation of FDI investments satisfactorily. There might, instead, be another factor or set of factors that are not related to the country's current tangible assets – a country's intangible asset, its

Goodwill – which defines its reputation in the international investment community. Goodwill, as an asset, is very well known in corporate accounting as a company's valuable intangible asset, which drives its market value, yet there is no analogy of such an asset at a country level. This factor will be evaluated and tested in this PhD Thesis in an attempt to analyse whether goodwill (referred to as Goodwill when applied to the national level) also exists at a country level. With Goodwill it becomes possible to explain why countries with similar economic and other factors receive different levels of FDI: the more Goodwill a country has the more FDI it will receive.

Konrad and Kalamova (2010) recognise the importance of a country's reputation; however, their study considers reputation as a set of stereotypes and subjective beliefs about the history of the country and its fundamental characteristics, whereas Goodwill, in contrast, is not a stereotype but rather arises from the subjective assessments and expectations of investors about the country's **future** earning capacity – its potential for economic growth and delivering good returns on their invested capital.

Due to the obvious difficulties of predicting the future with a satisfactory degree of accuracy, investors have to make their own prognoses about the future of countries, develop their own perceptions, and these perceptions (whether correct or not) drive their investment decisions. Thus, this study intends to test whether the power of subjective perceptions and expectations of investors about a country's earning capacity – its Goodwill - is a **determinant** that explains the allocation of FDI flows.

The research question of this Thesis, therefore, is the following:

- Why do countries with similar economic and other factors attract different levels of FDI? How can this phenomenon of uneven allocation be explained?

To address the above question, the research also sheds light on the following sub questions:

- How do countries attract FDI? What strategies do they use? What does the literature say about host country's FDI determinants?

- How can the observed uneven allocation of capital be explained? Is the conventional analysis proposing various FDI determinants[2] missing an important factor or a set of factors? If so, what might these be?

- Can the concept of goodwill, as a widely established and legally recognised important asset of an entity driving its market value, be applied at a country level? Is there national Goodwill?

- How is national Goodwill built? What are the possible factors building or changing a country's Goodwill? Can they be identified?

- Is national Goodwill detectable empirically?

- What role does national Goodwill play in determining FDI flows across countries?

While this Thesis does not provide a full or conclusive answer to each of these questions, it provides a set of data and arguments that point to the importance of national Goodwill for FDI determination and hopefully helps to promote and steer further research in this fruitful direction.

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[2] primarily conducted by the International Finance discipline

1.2 Importance of the question

The reason why there is a vast body of literature trying to understand the determinants of FDI flows is that FDI has direct and indirect beneficial effects on the recipient country. On top of a large injection of cash into the recipient economy, FDI also brings new technology from advanced countries, helps to advance labour skills and reduces unemployment. For this reason understanding the drivers of FDI inflows and knowing how to attract FDI not only contributes to academic knowledge on FDI determinants but, perhaps more importantly, helps policy makers to direct their efforts and policies towards more efficient and effective FDI attracting strategies. This is especially pivotal for the least developed countries (LDCs) whose financial resources are mostly limited and therefore, need to be spent wisely on policies and practices that can attract FDI.

1.3 Research methods

In order to address the research questions, this study employs both quantitative and qualitative analysis as their complimentary contributions help to lay a solid foundation for determining the importance of national Goodwill in explaining FDI allocation.

Using a qualitative approach, the research seeks to explore the phenomenon of uneven allocation of FDI across countries by reviewing the literature on the drivers of investors' priorities and their decisions. It also evaluates the literature on host countries' FDI determinants and state strategies. Since most current literature struggles to explain the observed allocation of FDI across countries satisfactorily, the study investigates existing valuation methods

used in accounting and business studies. The accounting literature and practice identifies goodwill as an asset that is a major determinant of the entity's market value (its value for investors). This Thesis attempts to understand whether the concept of goodwill can be applied at a country level and, if so, what national Goodwill can be or consists of.

Using a quantitative approach, the study attempts to understand whether national Goodwill is detectable and if so, how can it be detected. It aims to develop a reliable formula to proxy the Goodwill of a country, and also to provide (some approximate) figures in order to understand to what extent Goodwill explains FDI.

Using the following methodological steps the study will

- Design a proxy to detect national Goodwill by adapting the concept of goodwill of a company to the context of a country;

- Apply this theoretical proxy to observable data in order to construct a time-series of Goodwill for a large number of countries.

- Test the power of Goodwill, as captured by the proxy constructed earlier, to explain FDI across countries by applying regression analysis.

As a preliminary to this regression analysis, initially, the data will be examined using descriptive statistical tests. Also, the degree of correlation between the dependent variable (FDI) and various independent variables (a country's Goodwill as well as other host country's FDI determinants) will be analysed.

1.4 Contribution of the Thesis

This Thesis contributes to the literature on FDI determinants by providing an innovative approach that makes it possible to explain the uneven allocation of FDI across countries. It emphasises the importance of a country's intangible assets and in particular, a country's Goodwill and its role in contributing to the country's value and attractiveness for investors. It achieves this in four particular ways. Firstly, only a small number of papers explicitly emphasise the importance of a country's intangibles and their role in attracting FDI (e.g. Konrad and Kalamova, 2010); this study complements them by providing empirical evidence of the importance of one of those intangible assets.

Secondly, this study expands our understanding of the factors responsible for building a country's market value (its value for investors). By borrowing from the accounting framework for defining and distinguishing assets responsible for market value, the study defines a new, hitherto ignored asset and tests, empirically, its power to attract FDI. The fact that Goodwill is shown to be an important FDI determinant makes a significant contribution to the literature on FDI determinants that allows us to understand better, the driving factors behind FDI inflows.

Thirdly, although some of the Goodwill components are separately recognised as influencing investment inflows (e.g. country's image, country's relationship with investors), no proper framework has been developed to estimate the cumulative impact of such unmeasurable assets on a country's attractiveness for investors. It is clear that it is simply not possible, due to their incorporeal

properties, to robustly calculate their individual impact on investment inflows. This Thesis offers an innovative approach that allows an estimation of their cumulative impact on FDI. By applying the concept of Goodwill to a country it becomes possible to measure the cumulative impact of factors previously viewed as unmeasurable.

Finally, since the literature on goodwill components (goodwill building factors) does not exist as such, this Thesis is a pioneering study that makes a first attempt to define clearly, the components for a country's Goodwill, thereby adding to our knowledge of how a country can improve its Goodwill and what are the factors it should consider in attempting to do so.

1.5 Structure of the argument

The Thesis consists of nine chapters. Analysis begins with an overview of the theoretical background on the investors' priorities, FDI determinants and policies, and strategies used by states to attract FDI. This is presented in the next two chapters together with a section on the limitations of these approaches to explain why countries, even with similar conditions, attract different levels of FDI.

To answer this question the study moves on to consider the literature on goodwill and the Goodwill Model that provides a plausible explanation for such a phenomenon. On the basis of this information the study proposes a new factor – a **country's Goodwill**, presented in the fifth chapter, where the concept is outlined along with factors which are responsible for generating goodwill. The chapter also

explores existing goodwill-building policies employed by different countries in order to demonstrate the concept has practical meaning, albeit not yet fully formed and understood.

Chapter six is devoted to testing the validity of our hypothetical 'country's Goodwill' concept and establishing its empirical power to explain the real distribution of FDI across countries. For this a formula for identifying the Goodwill of a country is developed. This makes it possible to estimate Goodwill and to build the data necessary to test the relationship between Goodwill and FDI. The research hypothesis, that Goodwill has a positive relationship with FDI inflows is then tested. Chapter seven describes the statistical methods employed for the quantitative analysis and chapter eight is devoted to discussing the empirical results from the various tests conducted.

The final chapter discusses the overall results achieved by this study and evaluates them with regards to the objectives of the Thesis.

CHAPTER 2. EXISTING APPROACHES TO DETERMINANTS OF FDI FLOWS

This chapter reviews previous studies which examine the reasons why countries have to compete for Foreign Direct Investments (FDI) and how they do it; what methods, techniques and strategies they use. The chapter starts with the Competition State theory that explains incentives and the necessity for states to compete for FDI, because FDI is the most beneficial type of investment which, with the right set of domestic policies, produces positive spill over effects for the recipient economy. It promotes economic development and growth as well as boosting technological advancement of the recipient country by introducing new technology and training to the labour force and teaching them new skills.

Since the theory does not provide an explanation for exactly how states compete for foreign capital, the analysis is followed by a review of various strategies employed by states to attract FDI. The chapter then moves on to review literature, across a number of disciplines, (i.e. international finance, international business studies, sociology, political science), on host country factors that are known to attract and influence the volume of FDI inflows into a country – i.e. host country FDI determinants. Due to the immense volume of research across disciplines on host country FDI determinants, this literature review cannot claim to be exhaustive. However, despite its potential limitations, I believe, it reflects all the main factors necessary to understand the background and importance of the question, and is sufficiently comprehensive to provide an adequate picture of the previous research. In the final section, the chapter outlines the shortcomings of the

previous research in explaining the observable, real world patterns of uneven allocation of FDI inflows across countries, highlighting the gap in knowledge this study attempts to fill.

Before moving forward, it is important to define clearly FDI for the purpose of this Thesis. Although different sources have various explanations and definitions for this term, I employ the FDI definition as described by UNCTAD (2007, p. 245):

> " an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate). FDI implies that the investor exerts a significant degree of influence on the management of the enterprise resident in the other economy. Such investment involves both the initial transaction between the two entities and all subsequent transactions between them and among foreign affiliates, both incorporated and unincorporated".

A definition from OECD (2013) adds an important note on ownership:

> "FDI is a cross-border investment by a resident entity in one economy with the objective of obtaining a lasting interest in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence by the direct investor on the management of the enterprise. Ownership of at least 10% of the voting power, representing the influence by the investor, is the basic criterion".

2.1 Role of the state in attracting Foreign Direct Investments

Competition State theory is important for this Thesis as it highlights the necessity of states to engage in competition for foreign capital. The theory was developed in the middle of nineteen eighties by Philip G. Cerny (1990, 1997, 2000, 2005) who theorized the economic and social role of the state during the changing international environment of the past few decades. Cerny conceptualised the shift from the Welfare State to the Competition State, whereby states have increasingly accepted the neoliberal approach and changed their policies towards prioritising innovation, efficiency and profitability in their private and public sectors instead of being the conventional source providing welfare to its population.

Such shift in function from welfare to competition allows states to extract the benefits of free markets and foreign capital. By creating a favourable investment environment to attract foreign capital, states aim to boost their economic growth, solve domestic economic problems, increase the living standards of their population and acquire access to new technological advances from developed countries (Cerny, 1990; Palan and Abbot, 1996; Palan, 2000; Murphy and Kirby, 2008).

Competition State theory is an important theoretical framework for this study because it accepts globalisation as a distinctly new phase and reality to which states have to adapt, by: 1) recognising the importance of foreign capital and FDI, especially for the economic growth of the country; 2) competing with each other in the race for FDI; and, 3) accepting the necessity of using various strategies and policies to attract scarce foreign capital into their economies.

According to Palan et al. (1996), those states that fail to compete in the race for foreign capital stay on the "loser" side by paying the price of a decline in economic growth and development. Therefore, it seems that there is no alternative for states but to compete for FDI and try to persuade investors about the attractiveness of their economies.

A states' competitiveness and its ability to attract FDI has been perceived as an innovative policy tool that directly impacts on the unemployment level by reducing it, and positively affects the living standards of its population - something that previously had been attributed to the Welfare State responsibilities (Cerny, 1997). States' competitiveness, that is, their international competitiveness, according to Fougner (2006, p. 175), refers not to the capacity of national companies to compete with foreign firms for shares in the international or domestic market anymore, but to the capacity of the state itself to compete with *other states* in the race for foreign capital. In other words, the concept of international competitiveness has largely moved from companies to states. Thus, the primary goal of state policies is no longer making domestic companies more competitive or providing basic welfare services, but to make the state itself more competitive in relation to other states:

> "With international competitiveness understood in terms of "attractiveness, **statesmanship** is transformed into **salesmanship** – not in the sense of promoting the products and services of its national firms in external markets, but in the sense of **selling the state as a location to globally footloose capital and firms**; with "selling understood in the broad sense of developing, branding, promoting, marketing and selling a

product, the state is constituted as a competitor and entrepreneur operating in a global market for investment" (Fougner, 2006, p. 180).

In response to the increasing competitiveness and the search for investment capital, state authorities throughout the world have equipped themselves with national competitiveness councils, investment promotion agencies and suchlike, in and through which the state reconstitutes and acts as a competitive and entrepreneurial 'place-seller' in the global market for investment (Fougner, 2006). What is currently observed is states acting and competing in a similar way to businesses and enterprises to promote their economies as an attractive destination for foreign capital. More precisely, states' authorities sell their territorial space as a place-commodity in a global marketplace[3] to foreign multinational companies, in order to gain their FDIs which are known to boost the recipient country's economic growth and development. How successfully a state competes and attracts foreign investments will determine the level of prosperity and economic growth it will achieve; as a result of which, defining the state's competitiveness is a current primary objective for government officials.

The main contribution of Competition State theory and its value for this study is based on the assertion that, in the era of globalisation, in order to "survive", states **must** compete with each other for foreign capital by adopting different policies, practices, strategies and methods aimed at convincing investors

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[3] Former US President Bill Clinton, in his speech in 2008 at the Democratic National Convention in Denver, emphasised the state's main function as prioritising the "only true and fundamental social policy: economic growth; all else derives from that ... and the key for the effective promotion of growth is the state-supported promotion of competition as **the most fundamental** foundation stone of successful capitalism" (Foucault, 2008, pp. 120-121).

about the attractiveness of their domestic economy for the investors' international capital.

National competitiveness has become responsible for generating economic growth and raising the living standards of the population. The distinction between national and international policies is no longer tenable and they are increasingly integrated and blurred into an overall national competition strategy (Palan, 1998). To sum up, Competition State theory provides a theoretical framework for the necessity for states to attract foreign capital in order to sustain competition in a globalised world and to promote economic growth.

However, the theory does not provide an explanation for how exactly states compete in today's world or how states should attract foreign capital in a highly competitive international environment. Therefore, the next step will be to provide an overview of state strategies used to compete for foreign capital (including FDI) as defined, for example, by Palan, Abbot and Deans (1996).

2.2 States' strategies to compete for Foreign Direct Investments

Palan, Abbot and Deans in their comprehensive book *State Strategies in the Global Political Economy* (1996) identify how the Competition State model varies across countries and what are the strategies states have undertaken in order to compete in the international environment for foreign investments. The authors identify six different strategies commonly used by states worldwide: 1) large markets; 2) Capitalist Development State model (for example, East Asian countries); 3) "Shielding"; 4) Hegemony strategy; 5) Tax heaven and off-shore strategy; 6) Downward mobility.

The strategy a state will choose depends on a number of considerations: historic and geographical preconditions, a state's own choice or the nature of its economy, e.g. whether it specialises in the promotion and provision of financial services or industrial, manufacturing or natural resources (Palan, Abbot and Deans, 1996). It is also a common practice among states to emulate the most successful strategies adopted by one another, that is, those that have previously proved to be successful when used by other states. However, Palan, Abbot and Deans (1996) argue that emulation and adoption can never be achieved fully as each state's system, its historical heritage and social structure are unique. Therefore, even by adopting the same strategy states may achieve different outcomes. Below are the six strategies described in detail.

1) Large Markets strategy

This was first implemented with the creation of the Single European Market by the EU states. It served only partly as a pattern for emulation and was associated with the creation of other regional organisations such as NAFTA, Mercosur, the Maghreb Union and, to a lesser extent, APEC.[4] Larger markets, as argued by neoclassical economists, create economies of scale, allowing better conditions for trade for the member states and, most importantly, create a large internal consumer market that attracts foreign investments. The principal characteristics of a single market are lower tariffs, coordination of laws and regulations, and often a common currency. States, by merging into a large single

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[4] "Such collective attempts by states, to create larger economic units ... coined the strategy of size ... which became a strategy of competition" (Palan, Abbot and Deans, 1996, p. 56).

market, pursue benefits from economies of scale that would not be possible to achieve in isolation. Regionalism, in this respect, is viewed as one of the strategies pursued by states to improve their global competitiveness in order to accumulate capital inside the economic block. With respect to FDI, the data show that investors also prioritise larger economic zones which provide them with a large consumer market and opportunity to reduce their overall, long term costs. Consequently, the size strategy can be considered as one of the most effective in attracting foreign capital[5]. However, there is no guarantee that all the member states of the block will equally attract FDI into their territories. Thus, the problem with this strategy is that, while being effective and beneficial to attract investments into the block *per se*, it does not necessarily attract foreign capital into each state economy within the block.

2) Capitalist Developmental State (CDS) Model

This strategy has been successfully implemented by Asian states and attracted large flows of foreign investments into their economies, thereby boosting their economic growth. As argued by Deans (1996), the model was initially used by Japan and then successfully emulated and adjusted by other Asian states such as South Korea, Singapore and Taiwan. The model has three principle characteristics. First and most importantly, it assumes a blurred distinction between private and public sector particularly with regards to ownership. This works particularly well for East Asian societies that have appropriate cultural,

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[5] The example of Mexico joining NAFTA, fearing disinvestment, demonstrates the fear of states of losing investments in comparison to their neighbouring states, which had already merged into a single economic block. This fear of disinvestment drives states "seeking closer ties" with the block (Bhagwati, 1993).

historic and institutional arrangements for this strategy, as well as the state taking deliberate action to increase its control over national assets. The process of development in such states is driven by a planned economy carried out by highly educated and often dedicated autocrats who put forward economic development as the primary goal of the state. For this reason politics and economics are indistinguishable and overlap strongly in this strategy, and are reflected in the blurring of private and public ownership.

A planned national economy is a second important feature of the CDS model. For example, in China the role of market forces in trade and commerce is not central to the Chinese political economy (Palan, Abbot and Deans, 1996), and, in fact, trade and commerce are governed and tightly supervised by the state. The state is the most decisive actor in the economic and political decision-making process in this model, setting national goals and priorities as well as governing private and public enterprises. The success of the planned, rational economy can be explained by its ability to carry out a focused long-term strategy which is greatly beneficial for economic development. This control of the state over private and public enterprises assumes not only targeting and developing certain industrial sectors but also supporting and protecting its businesses in order to achieve a common goal by providing all necessary assistance and support from the government (legal, financial etc). This cooperation also explains fast recovery from the oil crises of 1970s as well as from the 1997 Asian financial crisis (Deans, 1996).

The third distinctive characteristic of the CDS model is the existence of an autonomous technocratic elite that directs a centrally planned economy (e.g.

Johnson, 1987; Amsden, 1989; Wade, 1990). These technocrats ruling the country are usually highly educated, skilled and devoted patriots of their country, "committed to the task of economic reform and progress", which explains their policies and support from the public (Palan, Abbot and Deans, 1996, p. 94).

This strategy is probably one of the most successful in promoting economic growth and attracting foreign capital, and has been made apparent by the fast progress and economic development of East Asian economies. Apart from being successful in attracting foreign capital and FDI in particular, it has also allowed these countries to move up their product cycle from producing simple goods such as textiles to increasingly complex manufactured products, such as electronics and computers. "The standards of living, level of education and access to health care facilities in these countries have also expanded to levels that bear comparison to any country in Western Europe or North America" (Deans, 1996, p. 97).

According to Palan, China, as the principal example of this strategy, is likely to be the world's single largest economy and market sometime in the 21st century. Nevertheless, when evaluating the applicability of this strategy to other states, we can observe problems with its replicability and suitability for non-Asian societies due to the very specific cultural, ideological and historical settings of the Asian nations. One of the reasons why Asian governments are able, easily, to control their society and labour is the submissive nature of Asian culture and the role of Confucian heritage, which prioritises collective goals over individual

goals.[6] Another important factor, wisely recognised by Palan et al. (1996), is that it would be hard for other states to replicate a devoted and dedicated technocracy willing to work for the "commonly held national interest rather than towards their own interests ... Drawing up intelligent and coherent policies is one thing; being able to implement these policies is another" (Palan et al. 1996, p. 99). For this purpose a very special culture and national patriotism is required, not only on the part of the technocratic elite but also from the public, to be willing to implement the commonly outlined policies.

3) *The Shielded strategy*

This has proved to be an effective competition strategy for many medium-size and small European countries like Sweden, Finland, Austria, Norway, or Switzerland. The main feature of this strategy is that while these countries pursue a very open policy, protection is offered to industrial and agricultural sectors which otherwise may not be strong enough to sustain foreign competition. Another distinctive feature of the Shielded state is that it is mainly a welfare state aiming at full employment of its population by providing it with accessible and affordable education and training, and investing in research and innovation. This results in accumulating one of the most expensive and highly skilled labour forces in these states, allowing them to specialise mainly in advanced areas of

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[6] "The Confucian ideal viewed individual (i.e. private) desires as essentially selfish, as opposed to the collective (i.e. public) desires, which implied virtuous action in accordance with universal principles. The moral superiority of the group (often identified by those in power as the state) over the individual has been a *powerful tool for control* in these societies. A key aspect of state ideology has been its use of nationalism and its creation of nationalist symbols in order to achieve specific developmental ends. The Japanese, South Korean and Taiwanese cases support Hintze's (1975) thesis that internal class relations are the product of both domestic and international factors, of which the second is of greater importance" (Palan, Abbot and Deans, 1996, p. 85).

manufacturing or services which face low or minimum competition. Examples include the Finnish Nokia Telecommunication Company, various Swiss watch and mechanical companies, German, Swedish, Italian home appliances (e.g. Electrolux, Zanussi, Indesit), high end fashion and textile industries.

Although a shielded strategy can be a successful competition strategy for some European states, it does not aim at attracting foreign investment into the domestic economy and is mainly concentrated with delivering a good platform for its business while preserving its historical and cultural heritage. Therefore, although the strategy is identified here as one of the competitive strategies used by states, it is not directly relevant to the research question which aims to identify and analyse how states attract and compete for foreign capital.

4) The *Strategy of Hegemonic State*

This is mainly identified in the works of Strange (1987), and Palan, Abbot and Deans (1996). It relates primarily, to the policy of the current leading hegemon, the US, although it has a generic application to any leading state in the future.

The concept of this strategy is that the hegemon uses its power to acquire a favourable competitive position in the international system to promote its economic and political interests. However, the use of power does not necessarily have to be abusive and harmful for other states. Very often the hegemon, with the example of the US, acts as a rule setter spending a lot of its resources on building and supporting a cooperative international system that could be beneficial, not just for its own interest but, for other states as well. In many cases the hegemon

represents law and order in the international system and acts as a mediator in resolving international disputes and conflicts.

To sum up, the hegemonic strategy cannot be applicable to and is not adoptable by any other states than the hegemon itself, due to the very nature of this strategy and, therefore, cannot serve as an example for a competitive strategy for other countries.

5) *Tax Heaven and Off-shore Finance strategy*

This is often termed a "parasitic" strategy. In contrast to the Hegemonic strategy, this is easily adoptable and, in fact, has gained wide acceptance among states because of its effectiveness and easy adoption. The main concept is to offer reduced regulation or capital tax for incoming finance with the purpose of attracting capital and money into its economy.

The "parasitic" strategy is very popular among states as it does not require the building of sophisticated infrastructure or time to attract investments, so it has been adopted or emulated by at least forty states around the world. The main features include minimal or no direct taxes and the ability to exist and operate without having a developed and "proper" banking or finance infrastructure. Their "clients" may only have a registered account in such countries, officially existing only on paper, while their main operations and activities could take place in developed financial centres such as London, New York, Singapore or Hong Kong. Tax heavens and off-shore finance are strategies specifically aimed at the financial sector. Although they are often considered as a single "parasitic" strategy, they are, nevertheless, different from one another. While the tax heaven strategy relates

to special tax conditions for foreign capital and non-residents who may well settle important parts of their business operations in the country and employ members of the local labour force, the off-shore financing strategy usually assumes that those countries/markets that allow raising funds from the operations of its non-residents, invest or lend these funds to non-residents free of taxes and regulations (Hanzawa, 1991). This strategy is particularly popular among small states that do not have anything else to offer to attract capital and foreign investments into their territory. Such states as the Cayman islands or Bahamas, Bahrain and the British Virgin Islands have neither a competitive advantage in the size of their territory, natural resources, or useful geographical location, nor large number of inhabitants to offer cheap or skilled labour to transnational investors. Very often this strategy is the only one that is available for them to employ.

To assess the effectiveness of this strategy in terms of its competitiveness and implications for development, it is necessary to observe its direct impact on the ability to attract foreign capital and also to take into account its implications for the global political and economic system. With regard to its direct and indirect benefits (e.g. Palan, Abbot and Deans, 1996; Hampton, 1994), which include increased government revenue and employment of local populations in banking and finance, the strategy is considered to be highly effective. For example, off-shore activities in Jersey generated about 88 percent of government revenue in 1990. In the Cayman Islands, around 20 percent of the workforce is employed in the provision of financial and banking services. Tax heavens Anguilla and Aruba have experienced dramatic economic success and been recorded, at some points, as some of the fastest growing economies in the world with growth rates of 8.8%

and 10% in 1990 respectively (CIA, 1991). The beneficial effect applies also to "improvement of states' own financial systems, greater access to international capital markets, and the internationalization of the local economy which should attract greater foreign direct investments" (Palan, Abbot and Deans, 1996, p. 177).

However, the main disadvantage of this strategy is that it may place a country's economy in a position of extreme dependence on outsiders, their decisions and the choices they make, especially in a world where "the speed of the capital movement from one haven to another is measured in days or weeks rather than months or years" (Palan, Abbots and Dean 1996, p. 178). Moreover, parasitic states have been under heavy international pressure from the UN, the EU and the US for some time in an attempt to curtail tax avoidance and money laundering, and to abolish bank secrecy laws. It is not unreasonable to say that the use of secret banking might be abolished in the near future, making it very difficult or even impossible to use this strategy. Furthermore, the employment of this strategy may lead to the loss of international reputation for any country which is considered as a shield for money laundering and shelter for gangsters, drug dealers and international criminals.[7]

When evaluating the effectiveness of this strategy as a competition strategy, and its ability to attract foreign capital and FDI, despite the criticisms above, it is considered to be fairly effective for the states concerned. However, those countries that do manage to achieve some positive results usually employ

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[7] "The Bahamas, for instance, lost a lot of their business in the 1970s as a result of negative publicity concerning alleged drug-trafficking and corruption. Consequently, the Bahamas slipped from being the third largest international finance centre to the eleventh" (Palan, Abbot and Deans, 1996, p. 179).

this strategy in combination with other policies and mechanisms to develop and expand the domestic economy (e.g. Singapore).

6) **The** *Downward Mobility strategy*

This is largely employed by poor and developing, third world countries at the beginning of their development process. The concept of this strategy lies in achieving economic growth by attracting transnational investment capital at *any* cost. Usually the states deliberately allow transnational capitalists to use and exploit their environment and workforce. For this purpose the state may limit or omit stringent labour and environmental legislation and may even repress trade unions through increasing authoritarianism. This strategy aims to attract FDI while, at the same time seeking to acquire financial capital for the development of its economy, integrate into the world economy and benefit from the learning process thereby developing a more skilled workforce. The fundamental purpose of the downward mobility strategy is attraction of FDI by allowing some degree of exploitation by transnational companies, offering a low cost labour force, extraction of the country's natural resources, compromising on pollution and accepting certain environmental costs – this is the price they pay to persuade MNCs to move their capital into their economy.

This strategy has also been referred to, pejoratively, as "bloody Taylorisation" and was used primarily by East Asian countries, including China, Malaysia, Indonesia and Thailand at the beginning of their development process. Statistics from the International Labour Organization shows that about 100 million children under the age of 15 are employed as part of the workforce in Asia

(Schaffer, 1995). However, it is not only Asian countries have adopted this strategy; some form of emulation can be traced in the strategies of a number of Arab and African resource-rich countries, and also in Russia, which allows foreign oil and gas endowment companies to extract their natural resources.

Exploitation of the labour force and environment are not the only characteristics of the Downward Mobility strategy. With the rapid economic development of Asian countries, many have shifted their policies towards export-orientated production, aiming at competition for more advanced and technologically sophisticated industries such as electronics and new technologies. Nowadays China can easily be argued to be a serious competitor in technology and the production of high end goods; Taiwan and South Korea have become experts in producing competitive electronic goods, cement and flat glass (Palan et al., 1996). Many successful countries that first started with this strategy later employed other strategies and policies that helped them to attract, not only FDI, but also encouraged export promotion which involved the devaluation of their currencies in order to lower the price of their exports in the world market. Other policies have included lowering tariff barriers that had protected nascent industries, tax holidays, monopoly rights, transportation subsidies and the creation of export processing zones.

The Downward Mobility strategy can be referred to, fairly, as a strategy for the poor, underdeveloped and developing countries. It was employed at the beginning of the development path of East Asian countries as a springboard for their successful economic development and FDI attraction. The later process

involves reconsideration and replacement of these policies and engaging other mechanisms and instruments to attract FDI on a sustainable basis.

In conclusion, a state does not usually use only one strategy but rather combines several, employing a range of policies and enticements and creating its own unique competition strategy. This argument can be traced back to the work of Porter (1986, 1990), who states that each state is unique due to its historical and social peculiarities and has its own ways to compete and attract foreign capital. Unfortunately, Porter's theory neither provides us with clear tools for strategy evaluation nor with a clear set of factors to help with the design of a strategy that successfully attracts or influences FDI inflows. It is stated by many international institutions, including the UN, World Bank and IMF, that FDI flows follow some logic and can be attracted into a state economy if certain policies and measures are employed. Therefore, the next logical step is to identify and evaluate these policies and commonly defined FDI host country's determinants.

2.3 Theories of a host country's FDI determinants

FDI determinants are extensively studied by various disciplines and institutions (e.g. UNCTAD, the World Bank, OECD and other governmental and nongovernmental organisations) and can be considered as a field on its own. Through decades of research on FDI patterns, different theories have been developed and numerous FDI determinants identified both theoretically and empirically. Scholars in International Finance, Business Studies, Management and Sociology all have contributed to studying FDI determinants.

The literature on FDI determinants can be divided into three main sub-areas: 1) host country FDI determinants – the recipient country's specific factors, assets and main indicators influencing the amount of FDI the country receives; 2) home country FDI determinants - factors influencing the amount and direction of FDI from the donor country; and also 3) FDI at the level of a MNC or TNC company - their motives and preferences.

It is important to understand form the beginning that the research scope of this PhD Thesis is only on the recipient's host country FDI determinants and not on donor country or the corporate level of MNCs and TNCs. Thus, although this literature review will briefly go through the main theories and basic sub-areas in the whole body of FDI literature, the purpose of this subchapter is to identify the most significant factors of the **host** country that play the biggest role in attracting FDI.

There is a vast literature studying general patterns of FDI, their relationship with macroeconomic and political variables of the host country including the size of the host market, the country's economic stability, the degree of openness of the host economy, its income level, quality of institutions, democracy level and level of development (e.g. Williamson, 1981; Rugman, 1986; Casson, 1987; Woodward, 1992; Ethier and Markusen, 1996; Barrel and Pain, 1999; Haufler and Wooton, 1999; Bevan and Estrin, 2004; Frenkel, Funke, Stadtmann, 2004 Evans, 2005, 2008, 2009; Child, 2009; Walsh & Yu, 2010; Eicher, Helfman, Lenkoski, 2011; Lu, Liu, Wright, Filatotchev, 2014).

There are also various theories developed to explain FDI patterns. For example, Dunning (1958, 1988, 2000) proposes the eclectic OLI (Ownership,

Location, Internalization) model, suggesting that market size and proximity of markets are important FDI determinants. Casson (1987), Ethier (1986), Ethier and Markusen (1996), Rugman (1986), Williamson (1981), focus on the importance of the scale of the consumption market in attracting FDI.

Another theory coming from international finance and attempting to explain FDI patterns is the New Trade theory (Ekholm, Forslid, Markusen, 2007; Bergstrand and Egger, 2007) which argues for the importance of regional trade agreements. However, the major shortcoming of this theory is that it fails to provide sufficient empirical evidence of the importance of trade agreements when controlling for such FDI determinants as transport and investment costs (Eicher, Helfman, Lenkoski, 2011). [8]

In addition, a number of types of FDI have been distinguished depending on their purpose, type and mode of entry into the host country. The Knowledge Capital Model, coming from the domain of International Finance, differentiates between two separate types of FDI: vertical and horizontal, in accordance with the goals of the multinational company (MNC): cost reduction or the search for new markets, respectively. These two types of FDI flows, according to Markusen (1984, 1996, 1997) and Helpman (1984), must be differentiated from one another since the way they prioritise a host country's factors is likely to be different.

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[8]The economics literature has also proposed multi-country, world models, stressing the importance of neighbouring countries' characteristics (e.g. GDP, trade costs, endowments) on FDI inflows into a given host country (Baltagi, Egger and Pfaffermayr, 2007). This literature also highlights the importance of the type of FDI (horizontal, vertical, export platform, etc.) which is influenced by a different set of factors. Again, the theory finds only weak empirical evidence for export-platform and vertical interaction FDI (Eicher, Helfman, Lenkoski, 2011).

Vertical FDI relates to investments that geographically fragment production by stages. They have the headquarters in the "home" country, where the product, is usually designed; while plants producing the goods or different parts of the good are located in "host" labour and resource effective countries. Aiming at reducing costs of production, such vertical FDI prioritises low-cost economies for labour and resource intensive production. A good example of vertical FDI would be the well-known English home-ware brand *Laura Ashley*, which has plants and factories producing clothes and home accessories in various cost and resource effective countries (e.g. India, Bangladesh). Vertical FDI will be particularly promoted by developed countries where the home country is small in size, skilled labour is abundant and labour costs are high. The most important determinant of the host country for this type of FDI, according to the theory, would be low transport costs and low costs for unskilled labour.

Horizontal FDI, in contrast, aims at gaining new consumers in other countries by investing in building plants and replicating operations from the main headquarter company in the markets of the potential consumers (Blonigen, 2011). Such MNCs are interested in accessing markets where firms face trade restrictions, for the purpose of saving on export costs. A good example of horizontal FDI is the largest cosmetic multinational company, *L'Oréal*, having its subsidiary in China in order to be closer to Asian consumers.

Also, FDI can be differentiated in terms of sector orientation. Initially FDI was mainly identified as manufacturing-related and resource seeking; however, during the last several decades, there has been a dramatic rise of FDI entering the service sector, rising from just one quarter of total FDI in the 1970s to around

60% in 2002 (Banga, 2005). FDIs, in particular vertical FDI, can also be differentiated in accordance with two types of entry mode: Joint Venture (joint ownership of the plant or factory of minimum 10%) with the purpose of obtaining voting and decision-participation power, and Whole Venture (sole ownership).

The results of empirical studies of the Knowledge Capital Model highlight the importance of the following FDI determinants: high transport costs and relative similarity of the host and home countries (their size, language, traditions, etc.) in promoting horizontal FDI (Markusen ,1984, 1996, 1997; Helpman, 1984; Keith and Ries, 2008). In general, the determinants of horizontal FDI, Blonigen (2011) suggests, are mostly captured by the Gravity Model, which is the next theory to be evaluated. It is worthy of note that some have observed that horizontal FDI seems to be far more prevalent in the world. As a result, some theories often do not distinguish between horizontal and vertical motives (Carr, 2001).

The mainstream research studies which have conducted statistical analysis on FDI patterns, as well as major international institutions such as the IMF and the World Bank, do not tend to differentiate FDI into vertical and horizontal types but usually conduct their analysis on total inward FDI (e.g. Buthe and Milner, 2008; Jensen, 2006; Morriset, 2003; Kinoshita and Campos, 2003). This PhD Thesis follows this mainstream trend.

One of the most prominent theories practising such trend is the Gravity Model (there are various less popular, similar models too that do not distinguish FDI for their entry mode). According to Blonigen (2011), this model captures the incentives for horizontal FDI, although the theory itself does not recognise the

factors identified as being exclusively attributed to horizontal FDI and considers them as valid for all types of FDI. The Gravity model explains bilateral trade flows in terms of economic size of and distance between two countries (Tinbergen, 1962). Originally, the theory evolved to explain trade patterns and later started being used for testing the significance of various FDI determinants proposed by different theories. The Gravity model argues that the closer the donor and the recipient country are located to each other, the more they will engage in trade with each other. This argument is viewed to be reasonable as transportation costs will be lower between closely located countries than between those located far apart. Also, factors such as language relationships, tariffs, colonial history and exchange rate regimes are important FDI determinants since they make trade easier between neighbouring countries rather than between those located geographically far apart. The Gravity model also shows that FDIs are positively related to GDP levels both in host and home countries and negatively related to the distance between the donor and recipient country.

Turning to the literature at the company level of MNCs and TNCs, the Uppsala model from the International Business Studies domain, also known as the Nordic model, emphasises the importance of network linkages and shared knowledge among MNCs in the development of their location preferences (Johanson and Vahle, 1977, 2009; and also Chen and Chen, 1998). Lien and Filatotchev (2015) write about importance of ownership characteristics of the donor company and their impact on the FDI location decision. More generally, the study of Lien at al. (2005) emphasises how different governance characteristics of a donor company affect its likelihood to invest abroad. They find that family-

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controlled firms are more predisposed to FDI than firms with similar attributes but with institutional shareholders at the Board of Directors. The study concludes that the latter firms have a greater propensity to invest abroad and that the composition of the Board of Directors has an impact on FDI decisions. The study of Lu at al., (2014) emphasises the impact of diversification of the top management teams in MNCs and TNCs on the choice and preferences for FDI.

Moving to the scope of this PhD Thesis, which is on host country FDI determinants, a large number of factors such as economic, development, physical infrastructure, policy framework, civic society, institutional, geography, social stability, labour costs, economic growth and market size of the host country have been tested and argued to be important in a range of different studies from various disciplines (e.g. Bevan and Estrin, 2004; Frenkel, Funke, Stadtmann, 2004).

In order to make sense of such wide range of research, Child (2009) arranges the extensive number of the proposed FDI determinants into three main categories: material, ideational and institutional parameters, where material parameters refer to economic and technological factors; ideational refer to political, cultural, language and religious characteristics; and institutional parameters refer to government, intermediate institutions, regulations and standards.

Eicher, Helfman, Lenkoski (2011) provide the first comprehensive study, which is also supported by sound empirical evidence, to identify robust FDI determinants. The authors offer a rigorous empirical approach, testing various proposed FDI theories and determinants, controlling for model uncertainty and

selection bias. The study uses Bayesian methods to deal with model uncertainty and discriminate between alternative theories and determinants. They find empirical evidence for the significance of only the following FDI determinants, allocating them into two groups:

1) Economic. These are host's market size, market potential, level of development (growth in the country), lower taxes, high productivity;

2) Country Characteristics. These are common colonial background between host and home country, lacking a common border, absence of religious tensions in the host country, absence of socio economic tensions in the host country and its level of corruption.

It is important to emphasise that the majority of the host country's FDI determinants explored in the early literature are tangible country assets in the sense that they can be measured directly and have monetary or numerical value. Their impact on FDI inflows can be easily measured when conducting quantitative analysis. However, in the last two decades the importance of intangible assets of the host country has also started to attract attention from the academic literature. These factors, unlike tangible ones, are without physical substance and, therefore, cannot be measured in numeric or monetary terms. Their impact on FDI inflows is more difficult to measure and usually a proxy for such factors is employed when conducting a quantitative analysis for establishing their real impact.

An illustrative example of such intangible factors is democratic regime and good governance of the host country, emphasised by Evans (2005, 2008, 2009). He argues that countries that wish to attract FDI should first create a good

governance structure and become democratic, and economic success and FDI will follow. However, Evans (2005, 2008, 2009) does not test this theoretical assumption empirically, which is understandable. It might be possible to identify an intangible factor but it is not possible to measure it directly in numerical or monetary terms. In such cases a proxy is usually employed in an attempt to conduct empirical analysis to establish the impact of such a factor.

In marketing, Nation Brand theory is the first to emphasise the importance of the intangible assets of the country and a country's reputation for FDI determination (Kalamova and Konrad, 2010). The authors use a general index of nation brands as an aggregate for stereotypes of a country. The Nation Brand theory focuses on testing the strength of the "country **stereotypes** or consumer perceptions" by the general public using the following proxies: individuals' perceptions about a country's attractiveness from a tourism perspective, a country's governance regimes, its products, its cultural status, perceptions about the population, and the economic and social conditions of the country (Kalamova and Konrad, 2010).

Filatotchev, He and Broouthers (2012) draw attention to another intangible factor: the institutional distance between host and home country. By institutional distance they mean the difference between the institutional settings and arrangements of the donor and the recipient country. This is another obviously intangible factor as institutional quality and difference/distance between countries cannot be measured directly.

Perhaps, the most extensive source on host country FDI determinants is the UN World Investment Report of 1998 which introduces the most

comprehensive list of host country FDI determinants available, to date. These are tangible and identifiable intangible determinants that are grouped into three main categories: national policy framework necessary for FDI attraction, economic determinants and business facilitation for FDI. For easy access they can be found in the Appendix 1 Graph 1.

It is worth noting that, despite its extensive list, four years later the same report published the FDI potential index (UN World Investment Report, 2012, p. 30) which emphasises how differently countries with similar FDI determinants can be valued by investors with some countries being significantly overvalued receiving more FDI than they should, and some countries being significantly undervalued attracting less FDI than they should. The report states that conventionally recognised country factors – a country's economic determinants (i.e. natural resources, national markets, low cost labour, infrastructure, etc.) – fail to explain such a phenomenon. Other studies also state that countries with similar initial assets and economic conditions enjoy different levels of FDI (e.g. OECD, 2002; Kinoshita and Campos, 2003; Blonigen, 2006; Buthe and Milner, 2008; Groch and Wich, 2009). All this suggests that despite the extensive research on FDI determinants it still omits a factor or a set of factors that influence cross border investments. This Thesis attempts to understand the nature of such uneven allocation and fill this gap in knowledge by analysing investors' priorities and the underpinning factors influencing their decision-making process, as well as various valuation methods used by investors and different disciplines to determine market (investment) value.

2.4 The limitations of current approaches

Various theories on host country FDI determinants have been reviewed in this chapter, but the question still remains as to why countries with similar economic and other factors (e.g. geographical location, country's population size, human capital, institutional quality, infrastructure, natural resources, political regime, cost of labour) attract very different levels of FDI inflows. There may be a factor (or a set of factors) omitted from the literature on FDI determinants, and this is the gap in knowledge this PhD Thesis attempts to fill. It seems that investors choose countries for reasons that are not well understood. The example of success of the BRIC[9] countries (Brazil, Russia, India, China), and later the MIKT (Mexico, Indonesia, South Korea, Turkey)[10], in being able to attract FDI, suggests that investors prefer countries with high potential for economic growth and high probability of delivering good returns on invested capital. During the surge of the BRIC concept, these countries were perceived as places with great potential for economic growth, being the future "bricks" of the world economy; and all of them received large FDI inflows during that period. Russia demonstrates how subjective perceptions of the international investment community can stimulate and trigger FDI inflows. In 2006 Russia became the 4th most attractive prospective destination in the world for FDI (UNCTAD, 2007). In 2010, when Russia was perceived as a "rising star", it became the largest recipient

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[9] The acronym coined in 2001 by Jim O'Neill. Please see O'Neill, J. (2001). *Building Better Global Economic BRICs, Global Economics Paper No: 66*. Goldman Sachs.

[10] MIKT the acronym that replaced the BRIC, in 2012, proposed by Jim O'Neil. Please see in Forchielli, A. (2013) and Robinson, G (2011).

of FDI in Europe (Ernst & Young, 2011; OECD, 2011). However, since 2012 the BRIC acronym has been replaced by the MIKT[11], Russia has no longer been a major recipient of FDI investments. Instead, Indonesia, the "I" in the MIKT, has become a new "rising star" and a favourite for FDI investments. In the same year as the rise of the MIKT concept, Indonesia received $19.3 billion of FDI despite its generally weak country indicators in terms of conventional FDI determinants. Also, Indonesia is a Muslim country which challenges the explanatory power of the "common ties" FDI determinant[12].

These real-world examples cast serious doubt on the ability of existing theories about host countries' FDI determinants, to satisfactorily explain the observed cross border investments. It becomes especially difficult when one tries to explain uneven allocation of FDI flows into countries with similar economic and other country factors. As another example, Indonesia and the Philippines have always been perceived as rather similar countries in many respects: location, climate, population, labour force, percentage of educated population, unemployment etc. In fact, if looking from the perspective of the conventional country FDI determinants, the Philippines should be more appealing to FDI investors than Indonesia, given that the Philippines have better infrastructure

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[11] O'Neil equally proposes the MIKT and the MINT economies as a replacement for BRIC with only one country variation in these acronyms - South Korea (the "K" in MIKT) and Nigeria in MINT.

[12] "common ties," FDI determinant include: common culture, religion, language between the donor and the recipient country. Since the majority of FDI comes from the Western countries where Christianity is prevailing this is somewhat rather contradictory.

levels and greater "relative similarity of host and home country"[13] with the US. Relative similarity involves recognising their common ties: common colonial background[14], common religion (Philippines being a Christian country) and a common language[15] (English being an official language of Philippines). In contrast, Indonesia is a Muslim country with Indonesian as the main, and Javanese as the second, most common language. Nevertheless, despite all these factors the Philippines are largely ignored by FDI investors and Indonesia, instead, is a current favourite. Malaysia, Indonesia's neighbour, is another example of how, despite similar host country factors between these two countries, a nation may currently be undervalued by FDI investors. This is largely because, after the 1998 Asian Crisis, Malaysia lost its reputation and popularity among the international investment community (Kong, 2012).

These examples illustrate that some countries are "overvalued" and some are "undervalued" by investors despite having similar economic and other country factors. The reasons for this are not well understood by the academic literature.

A similar argument is put forward by the UN World Investment Report (WIR) of 2012, which develops the FDI Potential Index. This index makes it possible to identify two groups of countries: those that have attracted significantly more or significantly less FDI than was expected, based on the country's FDI

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[13] "Relative similarity of the host and home country" FDI determinant is proposed by the Knowledge Capital Model (Markusen, 1984, 1996, 1997; Helpman, 1984).

[14] Common colonial background is not only one of the features of the "relative similarity" FDI determinant but is also argued to be statistically significant on its own in attracting FDI (Eicher, Helfman, Lenkoski, 2011).

[15] FDI determinant proposed by Knowledge Capital Model as part of the "relative similarity" determinant and also tested as a separate one by Eicher, Helfman, Lenkoski (2011).

determinants including: natural resources, infrastructure, low-cost labour, size of the market, GDP growth rate, etc. (WIR, 2012). Countries that received FDI below their potential include the Philippines, illustrating that Philippines is an undervalued country by FDI investors.

This Thesis tries to fill the gap in knowledge on uneven allocation of cross border investments by conducting a detailed analysis of investors' priorities and specifically, the importance of their subjective perceptions about a country's investment potential, i.e. a country's reputation among the investment community. In fact, as noted by Aharoni (2011), managers of MNCs and their behavioural characteristics are largely ignored by the studies on FDI determinants. In the traditional literature on FDI determinants, the researchers' attention is drawn, primarily, to the "variables that can be measured", which "tend to be treated as more "real" than those that cannot be measured, even though the ones that cannot be measured may be more important" (Aharoni, 2006, pp. 203-204). The suggestion put forward by Aharoni (2010) is to shift attention from measurable internal and external factors to managerial *perceptions* and their influence on FDI allocation. There is virtually no literature so far that attempts to investigate whether investors' subjective assessments about a country's potential to deliver good returns on invested capital (or, in other words, country's reputation among the international investment community) influence FDI inflows into a country. This is surprising given the failure of conventional indicators and characteristics to explain to a satisfactory standard, the observed patterns of FDI flows across countries (Blonigen, 2005).

Perhaps, the most relevant study that draws attention to the importance of a country's reputation is that by Konrad and Kalamova (2009). The study, based on focus group methods, analyses the general public as a research group and the impact of their perceptions on FDI inflows into a country. While this provides valuable insights, the main limitation of this study is that it does not focus on investors as a research group. Instead, the study considers perceptions of the general public about a country, which are likely to be different from those who actually make decisions about FDI. FDI investors prioritise different factors and indicators to those of the general public as their (investors') actual decision-making is typically more complex (Hoffmann, 2013; Slovic, 1969; Kuhberger, Schulte-Mecklenbeck, and Perner, 2002). Such an approach and difference in the focus group is likely to have substantial consequences for the analysis and results. For example, the general stereotype of the public about a country as a destination for tourism or its cultural aspects (Konrad and Kalamova, 2009) can be very positive but may not be what would convince investors to invest millions of dollars of their largely irreversible FDI capital into the economy of that country. Many examples can be cited for this difference, even in the developed world; for example, Italy attracts relatively little FDI (for many reasons, such as a business environment that is complex and bureaucratic, an inefficient judicial system and the high cost of labour) while being a major destination for tourism and cultural travel.

Thus, this PhD Thesis tries to improve our understanding of why countries with similar country factors often attract different levels of FDI inflows and whether investors' subjective assessments and perceptions about a country, as a

potential destination for their investments, influence their choice for allocation of their cross-border investments across countries.

The bulk of existing research on FDI determinants (e.g. reports from OECD, UN World Investment Reports) is concentrated on how to attract FDI *per se* into a country and/or testing the validity and effectiveness of specific instruments. Only a few studies concentrate on *what* is important to investors and what they regard as *driving* factors in their decision-making process. Therefore, the next step is to understand what, in fact, matters to investors and what factors they consider to be important when choosing a country as a destination for their capital. For this, cross disciplinary research will be conducted in the following chapters exploring the Theory of Investment behaviour from the International Finance domain. In addition, the work on goodwill from the literature in International Political Economy, which relates to the value of subjective assessments of investors and creditors reflected in the reputation of the entity will be examined. This Thesis will take seriously the Goodwill concept, and will look carefully at the literature on valuation methods across academic disciplines as well as the valuation methods used by professional investors. Such extensive interdisciplinary, inductive analysis will help to shed light on investors' priorities and their choices for countries, revealing insights that were previously hidden and providing novel evidence for the observed allocation of cross border investments and for overvaluation and undervaluation of countries in terms of their attractiveness for FDI.

Chapter 3. Establishing a different approach to a country's attractiveness for FDI

Since current approaches, reviewed above, fail to provide a comprehensive explanation of the observed allocation of FDI flows across countries, this Thesis takes a different route and analyses what is actually important to the decision-makers, – FDI investors, and what are the factors that are important to *them* on the basis of which *they* make their decisions about which country becomes a recipient of their capital.

3.1 Analysis of investors' priorities

Before identifying the priorities of FDI investors, it is necessary to define who they are and how they can be categorised. According to UNCTAD, "FDI may be undertaken by individuals as well as business entities" (UNCTAD, 2007, p.245). This implies that FDI investors are both individual investors and multinational or transnational companies (MNCs and TNCs), in particular, the strategic and investment senior managers of these companies.

3.1.1 Theory of Investment Behaviour

To understand investors' priorities for FDI allocation and what drives their decisions, it is useful to start from the Theory of Investment Behaviour that explains the general incentives of investors (Ferber, 1967). According to this theory, investors' decisions are driven by the optimal accumulation of capital which helps to enhance the value of the firm (Jorgenson, 1967). The theory challenges the common notion that investors only prioritize high profits (Meyer

and Kuh, 1957, p. 9) as it would be "too narrow to encompass the full scope of modern entrepreneurial motives". Instead, business firms maximise utility or, more precisely, aim at optimising capital accumulation, of which short-term profits are just a relatively small component.

The contributions of the influential book by Ferber (1967) provide empirical support to the argument that investors' behaviour is driven not by immediate profit maximization or short-term heightened profits but by the optimal accumulation of their capital. Optimal accumulation of capital means maximizing the present value of the firm at each point in time during the whole existence of the company (Jorgenson, 1967). Such a notion is based on "going concern" – another basic underlying assumption that an entity or a business is able and shall continue to operate indefinitely, carrying out its activities[16].

In relation to FDI investments and the choice of a country as a destination for investing such capital, following the theory, it would be logical to assume that a country should have such an environment and characteristics that provide conditions for invested capital to grow and accumulate in value over time. Thus, a country with steady economic growth would provide such a fruitful environment that allows investors to obtain good returns on their capital.

However, the purpose of this study is not to demonstrate that countries with booming economies receive large FDI inflows, a fact which is evidently

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[16] For reference please see: AICPA Statement on Auditing Standards No.1 Codification of Auditing Standards and Procedures, Section 341, " The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern"(AU Section 341).

"The assumption of going concern implies that people are operating on the basis of futurity…" (Atkinson, 2009, p. 437, 434)

illustrated by the BRICs (countries that attracted large amount of FDI inflows for over a decade) and the Asian Tigers,[17] - but rather, to understand whether a **positive perception** among investors about a country's potential for economic growth and its ability to generate good returns can be a significant factor, in itself, influencing investors' decisions towards that country.

Investors' decisions are made in the "*present*" time in the sense that the country's situation is well known. However, returns on invested capital, especially in the case of FDI, which are largely irreversible long term investments, are obtained in the long term *future* since it takes time to build an entity or establish a business in a foreign country – a process that may take several years before seeing any returns. Thus, knowing the future of the country in the long term would be more important for investors than knowing its current economic indicators. Yet, there is no way to predict the distant future with great accuracy, for any country. Past performance may be a broad indicator but the extensive variety of internal and external factors that may intervene and affect a country's stability and its path towards economic growth and development mean there is always some degree of uncertainty. That is why investors have to operate on the basis of subjective assessments, rely on prognoses and their perceptions about the future economic situation of any country. Therefore, investors' subjective assessments and perceptions about a country's potential and ability to generate good returns in the future would be a driving factor in investment decisions for FDI.

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[17] The four Asian Tigers or Dragons, a term used in reference to the prosperous economies of Hong Kong, Singapore, South Korea and Taiwan.

3.1.2 Role of subjective assessments and perceptions

It seems reasonable to assume that when investors consider a country and analyse the potential of its economy, they carefully study its past and present economic indicators and other country factors such as geographical location, political stability, human capital, investigating specialised reports, etc. However, scholars studying investors' behaviour conclude that very often investors make their decisions less rationally without introducing heavy calculations based on the real economic situation of the market, instead, simply relying on their "animal spirits" (Keynes, 1936) or following their network linkages (Filatotchev, 2007). Shiller (2000) observes that investors do not usually make their own prognoses and estimations but often follow a common trend of their community. Their logic, he argues, lies in a free-rider concept: when there are so many big investors, academics, hedge funds and analysts studying a market and building a forecast on its future value confirming its potential, why should one (e.g. a CEO of a multinational company responsible for FDI decisions) challenge their opinion, devote time to trying to determine the real situation or fair prices instead of doing what others are already doing, – investing into the "rising star"? One might, as well, herd with other investors, experts, hedge funds and professional analysts who have already investigated the potential of a particular market or a country (Shiller, 2000). In other words, just as "herding" appears to be a fairly common practice among investors in stock markets and in domestic financial markets more generally, it is likely also, to characterise foreign direct investments. Indeed, FDI can be very sensitive to signalling effects: if one firm makes a commitment to a particular country by investing largely irreversible FDI capital, this would signal

to other firms that the country (in terms of its economy and market assessment) is safe and worth investing in, thus encouraging further FDI inflows.

The logic of investing into a country that is perceived as having good potential for economic growth implies that a country's reputation among the international investment community may be an important factor influencing allocation choice for foreign investments. If a country is believed by investors to have a potential for high economic growth and deliver good returns on invested capital, investors will invest into such a country and vice versa. Thus, if a country has investors' favour and is positively perceived as a good destination for their capital, then it has a competitive advantage acting as a valuable intangible asset for that country driving FDI into its economy. In business and accounting, which has tools to determine an entity's market value (i.e. investment value) such intangible asset is officially recognised as the entity's goodwill. Therefore, it may be argued that just as corporations claim to possess goodwill, so too do countries; in the form of national Goodwill, representing the value of investors' favour towards the country, based on their subjective perceptions and expectations of obtaining high future returns on invested capital.

3.2 The Goodwill Model

In a Goodwill Model a country's tangible assets – its economic determinants, good governance etc., are only a part of the story. What attracts FDI inflows, or is at least equally important, is whether or not a country is perceived by the international investment community as a destination with high potential for economic growth and the ability to generate good returns on invested capital or

not, i.e. a country's reputation among investors. This reputation is, in turn, a country's valuable intangible asset – Goodwill[18] - that acts as a country's competitive advantage in attracting foreign investments.

A general process of investment decisions is well described in the analysis provided in international political economy (IPE) by John Commons:

> "On a rising market, because prices have risen, the business man *buys more* instead of less because prices are *expected* to rise. In contrast, on a falling market … the business man buys less and sells more because prices are *expected* to fall. So it is all about *expectations,* the future…The business man is compelled to buy *early* on a rising market, *otherwise* others will buy what he must have... If they expect the price of, for example, coal to rise they will lay up a stock of coal for the winter, if they expect the price to fall they will not stock up… Then, when all are competing to buy first on a rising market, in order to exclude others from buying what is *expected to rise* in price…then the conflict of interests adds to self-interest forcing the rise into "boom" (Commons, [1934] 2005, pp. 557-558).

The same principle may be applicable to FDI investors and their decisions about investing into an economy. If the economy is perceived by investors as an economy that is expected to do well (grow) in the future, then this positive perception plays to a country's advantage, becoming its valuable intangible asset that helps it draw more investments into its economy compared to its competitors - those countries which are expected to do less well, to stagnate or decline.

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[18] National Goodwill is a theoretical proposition

If the positive trend remains for a certain period of time, this causes, as Commons ([1934] 2005) argues, competition among investors who will be "competing to buy first on a rising market, in order to exclude others from buying what is *expected to rise*". This process generates a "boom" for this economy and, as a consequence, large injections of investment capital. If certain national policies that help to extract benefits from FDI investments are in place, then such large injections of financial resources into the hosting economy are likely to boost its growth, feeding investors' expectations. It then follows that, if such a trend persists, there is a chance it will take the form of a boom through a self-fulfilling mechanism where current investment flows generate further investments into the country.

Shiller (2000) argues that once a notion about the profitability of a particular market is created, this notion by itself, will drive investments into this market and appreciation in its value. "[Investors] sometimes do not realise that they themselves, as a group, determine demand for a particular market" (Shiller, 2000, p. xv). These arguments are consistent with the argument of Commons ([1934] 2005) presented above. Then, as soon as a country or a market is perceived by the international investment community as an eligible place for investment, this positive perception turns out to be an important asset for a country, which in this Thesis called national Goodwill. It is then that the notion of a "booming economy" or a country with high potential for economic growth is created, which acts as a country's brand attracting investments in itself.

Loosely speaking, the mechanism described above suggests that investors' positive perceptions about a country's potential for economic growth would be an

important intangible asset for a country to possess and potentially may stand as an explanation for the phenomenon of uneven allocation of foreign capital. To be clear, however, Goodwill need not be a reflection of irrational investment decisions; rather it may well reflect perfectly rational behaviour of investors who take into account not only the current, conventional economic and political indicators of a country but also its intangible assets, including perspectives on its future development which, to date, much of the literature has not given due consideration.

The next chapter will be devoted to the examination of cross disciplinary research to identify the theoretical and legal underpinnings of goodwill. Such a comparative analysis not only helps to understand better the basic concept of goodwill, but it also provides valuable insights into its components – the building blocks of goodwill –and the practices used to measure it. On the basis of this analysis goodwill equivalent attributes for countries will be proposed together with a new proxy attempting to estimate national Goodwill of a country.

3.3 Origins of goodwill

Goodwill, as a valuable intangible asset, has only been established for businesses, albeit extensively, by corporate accounting. A Goodwill Model, with a country's Goodwill presented as a national asset attracting FDI, is established by analogy in this PhD Thesis. Although corporate goodwill is a well-known concept, there is, as yet, no universal definition nor a universal method of estimating it. Also, various disciplines define different factors or components of goodwill differently. Below, the concept of business goodwill and its components

are reviewed across various disciplines and countries in order to clarify the conceptual underpinnings of the concept before making inferences on a possible general definition of a country's goodwill-like asset – national Goodwill.

3.3.1 Goodwill in Law

The legal concept of goodwill in a business has long been recognized and is based on an old English case, which held that "goodwill is the probability that customers will return to the old stand" (Cruttwell, 1810, p.134). Judge Cardozo expanded this to include the tendency for customers to return to the same location or company because of its name or for other reasons, regardless of its location (In re Brown, 1926).

In general, the legal concept of goodwill focuses on the idea that it is an asset which generates excess earnings (Parkman, 1998). Initially, the legal concept was only applied to businesses. However, over the last thirty years, goodwill was extended to consider individuals as well as businesses, although often these cases have not made a clear distinction between business and personal goodwill[19]. Such an extension of goodwill to individuals possessing this valuable advantage allows us to also consider the possibility of existence of a country's Goodwill.

The shift to viewing reputation as goodwill is illustrated by a number of Washington and New Mexico cases. In *"In re the Marriage of Lukens"* (Washington Court of Appeals, 1976) the Washington trial court found that the

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[19] A review of cases on professional goodwill is available in Kisthardt, M.K., (1996) "Professional Goodwill in Marital Dissolution Cases: The State of the Law," in Ronald L. Brown, Valuing Professional Practices and Licenses: A Guide for the Matrimonial Practitioner, Second Edition, 2-1 and Oldham, J.T., (1997) Divorce, Separation, and the Distribution of Property, pp. 10-23.

value of the goodwill in an osteopathic practice was $60,000, with goodwill referring to the advantage of the practitioner's age, health, past earning power, reputation in the community for judgment, skill, and knowledge, and his comparative professional success, i.e. everything that adds to the earning capacity and advantage of his business relative to new or other osteopathic practices.

Nowadays, the law on corporate goodwill varies between countries which define and treat goodwill differently. This section is devoted to the analysis of the UK and the US law on goodwill.

In the UK, law on goodwill is well defined by the UK HM Revenue and Customs (HMRC) which states:

> "The goodwill of a business is the whole advantage of the reputation and connection with customers together with the circumstances...which tend to make that connection permanent. It represents, in connection with any business or business product, the value of the attraction to the customers which the name and reputation possesses."[20]

Another legal definition of the term "goodwill" was presented in the House of Lords on 20 May 1901 in AC 217:

> "Goodwill is the benefit and advantage of the good name, reputation and connection of a business...It is the one thing which distinguishes an old-established business from a new business at its first start".

In essence, goodwill, representing the advantage of a company's reputation and its relationship with its customers, is not defined very precisely by the law but rather vaguely.

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[20] Halsbury's Laws of England, 4th edition, Vol. 35 p. 1206

The decision of the Special Commissioners in Balloon Promotions Ltd v Wilson, SPC 524 [2006] STC (SDC) 167, demands priority for goodwill to be construed in accordance with legal principles over the accountancy principles, a ruling which has certain consequences for how goodwill is defined.

Goodwill is treated differently by UK law from the way it is treated by accounting in the UK, Europe and those countries complying with the Standards of International Financial Reporting (IFRS). Unlike accounting, which only recognises purchased goodwill, acquired via acquisitions and does not recognise internally generated goodwill, UK law, recognises internally generated goodwill, treating it as an entity's valuable asset:

> "The fact that goodwill may not be reflected in the balance sheet of a business does not mean that it does not exist. In the same way, the writing off of purchased goodwill in the accounts of a business does not mean that its value has decreased or that it has ceased to exist…It is important to remember that many professional firms do not reflect goodwill in their balance sheets but this does not mean that it does not exist."[21]

The law gives internally generated goodwill the right to exist and to be recognised. Meanwhile, the law does not contradict the accounting standards on the rules for treating acquired goodwill. It confirms that goodwill is inseparable from the business in which it exists: "Goodwill is inseparable from the business in which it is generated."[22]

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[21] See HMRC the law on Chargeable Gains 68010 - Goodwill: meaning of goodwill

[22] See HMRC Chargeable Gains 68030

Goodwill is captured in the price for the company's share and is likely to be valued at the market price:

> "Valuations of goodwill can be obtained from shares... A valuation of goodwill is made on the assumption that the business was put on sale as a going concern in the open market" (HMRC).

Goodwill is not a black box but rather an asset with some legally defined components. The next section in this chapter is devoted to shedding light on those constituents of goodwill as defined by UK law:

Technical know-how

"Any consideration attributable to technical know-how is treated as part of the consideration paid for goodwill."[23] The know-how is defined as: manufacturing or processing goods or materials; working a source of mineral deposits (including searching for, discovering or testing mineral deposits or obtaining access to them); carrying out any agricultural, forestry or fishing operations.

Commercial know-how

Commercial know-how is defined as market research, customer lists and sales techniques. Although commercial know-how can stand as separate assets under certain conditions, it is counted as part of goodwill in some cases:

> "Payments for imparting or disclosing commercial know-how during the course of a trade which are not excluded from being taken into consideration for chargeable gains (CG) purposes will normally be treated as capital sums derived from goodwill under TCGA92/S22, see

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[23] HMRC CG68200 - Goodwill: know-how

CG68050…Where a trade or part of a trade is transferred as a going concern any consideration attributable to commercial know-how will be treated as part of the consideration paid for the disposal of goodwill."[24]

Unregistered trade marks

UK law on goodwill CG68210 states that unregistered trade marks are related to goodwill:

"An unregistered trade mark is an intrinsic part of the goodwill of a business. It does not exist as a separate asset …and is not capable of assignment separate from the goodwill of the business in which it is used."[25]

A trade mark is defined as the name or symbol used to identify the goods produced by a particular manufacturer or distributed by a particular dealer that distinguishes them from products associated with competing manufacturers or dealers. It can also refer to a name or a symbol used to identify services provided by one undertaking, from those provided by other undertakings.

Registered trade marks

UK law on Trade Marks Section 24 states that a registered trade mark can be considered either as a goodwill constituent or independently of it:

"Registered trade mark is transmissible by assignment, testamentary disposition or operation of law in the same way as other personal or

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[24] HMRC CG68200 - Goodwill: know-how. CG purposes means Chargeable Gains for taxation purposes
[25] HMRC CG68210 - Goodwill: unregistered trade marks

moveable property. It is so transmissible either in connection with the goodwill of a business or independently." [26]

In the latter case when a registered trade mark is identified as an independent asset it would be identified as a part of Intellectual Property assets.

Not registered image rights

Unless an image right is registered, in which case it becomes an attribute of Intellectual Property, it is referred to as a property of goodwill:

> "As there is no such thing in UK law as an "image right" CG68405, unless there are identifiable Intellectual Property Rights (e.g. a registered trade mark or copyright), when an "image right" is assigned CG68420 the asset concerned for CGT is likely to be goodwill CG68010. In the absence of any specific rights that are assets for CGT purposes, the assignment of "image rights" is likely in practice to be an assignment of goodwill."[27]

The US legal definition of goodwill is different from that of the UK and can be obtained at the U.S. Government Publishing Office (US GPO). Goodwill is defined as:

> "an unidentifiable intangible asset, originates under the purchase method of accounting for a business combination when the price paid by the acquiring company exceeds the sum of the identifiable individual assets acquired less liabilities assumed, based upon their fair values. The excess is commonly referred to as goodwill. Goodwill may arise from the acquisition of a company as a whole or a portion

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[26] HMRC CG68220 - Intellectual Property Rights: registered trade marks
[27] HMRC CG68415 - Intellectual Property Rights: image rights: passing-off and goodwill

thereof. Any costs for amortization, expensing, write-off, or write down of goodwill (however represented) are unallowable."[28]

In the United States, goodwill is attached to a piece of intellectual property (e.g. trademark), which is different from how it is defined by the UK law. The US courts, for instance, state that a trademark cannot continue to maintain its value or uniqueness separately from goodwill and that the goodwill of a particular trademark or a brand is always linked to the trademark that describes that brand (Anson, 2007).

To sum up, on the basis of the legal information on goodwill evaluated above, the constituencies of goodwill identified by law are the following:

- reputation of the company among its customers
- the advantage of permanent connection of the company with its customers
- The good name of the business that acts as a competitive advantage in the operating industry
- Technical know-how
- Commercial know-how in the form of market research, unregistered customer lists and sales techniques[29]
- Unregistered trademarks that make the business or the product recognisable among its potential and returning customers
- Registered trademarks in some cases[30]
- Unregistered image rights.

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[28] Code of Federal Regulations, 48 31.205-49
[29] See previous page on Commercial know-how or HMRC CG68200 - Goodwill: know-how
[30] See previous page or Anson, 2007 for US practises and also the UK S24 of the Trade Marks Act 1994

In conclusion, on the basis of the UK and the US laws cited above, the legal system officially recognises goodwill as an entity's valuable asset and defines some of its components as demonstrated above. It also states that goodwill is captured in the price of a company's share.

3.3.2 Goodwill in Corporate Accounting

The accounting concept of goodwill is directed not so much at the nature of goodwill, as to its measurement (Beresford and Moseley, 1983). The International Financial Reporting Standards (IFRS) published by the International Accounting Standards Board (IASB) are the global accounting standards that define and issue regulations on the valuation of goodwill. Although some countries do not comply with IFRS rules, using their own national accounting standards instead (e.g. the US, China), the vast majority of countries around the globe, including the EU countries, United Kingdom, Canada, Russia, India, South Africa use the guidance of IFRS in defining and valuating goodwill[31].

The IFR Standards distinguish goodwill from tangible and *identifiable* intangible assets, obliging identifiable intangible assets to be listed separately from goodwill on a company's balance sheet. Intangible assets, if they are different from goodwill, must be separated from goodwill and amortized over the perceived life of the asset (Koller et al., 2010; Accounting Standards Board, 1998).

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[31] The EU countries and United Kingdom act in accordance with *IFRS standards adopted by the EU*. This differs from general *IFRS standards as published by IASB* mainly because of amending *International Accounting Standard 39: Financial Instruments: Recognition and Measurement*. Since this standard does not affect the treatment and valuation of goodwill, IFRS standards on goodwill are valid for both the EU, the UK and also those countries that comply with general IFR Standards as issued by IASB.

In accounting, as well as in Corporate Finance, goodwill is defined as "future economic benefits arising from assets that are not capable of being individually identified and separately recognised" (IFRS 3 Business Combinations, IASB, 2004, para. 51). This definition shows, explicitly, that the value of a company, as a whole, is more than the sum of its countable and identifiable assets (Elliott and Elliott, 2015). Thus, goodwill is the aggregate of all the unidentifiable assets of the company that increase its market price above the fair price of the company's identifiable assets.

Although accounting identifies internally generated goodwill, unlike UK law, it does not recognise it as a company's asset: "Internally Generated Goodwill shall not be recognised as an asset" (IAS 38 in Elliottt and Elliott, 2015). Such a rule restricts the possibility of establishing the value of internally generated goodwill unless the company is sold or merges with another; nor does accounting officially define goodwill's components. Goodwill is only recognised during an acquisition process when one company purchases another, paying more than the fair value of the company's identifiable assets (Petitt, Ferris, 2013). It is only during business acquisitions that goodwill is officially recognised when its value can be determined as:

Goodwill = Price paid for the company - Fair price of all company's identifiable assets

According to IFRS rules, this goodwill's initial value or "cost" must be reported in the financial statement of the company (Higson, 1998). In addition the value of goodwill must be revised on an annual basis using an impairment test that

captures how the value of acquired goodwill has changed over time (Berk, DeMarzo, 2014; Petitt, Ferris, 2013; Brealey et al., 2011).

Although accountants recognize a variety of intangible assets such as patents, copyrights, trademarks and leaseholds, they often attribute their value to goodwill without distinguishing between them (Kieso and Weygandt, 1998). Thus, in accounting and corporate finance, goodwill is an aggregate of all the unidentifiable intangible assets whose value officially arises only during the acquisition process and is a measure of how much the value of the purchased company exceeds the value of its individual identifiable assets (Moles, Parrino, Kidwell, 2011). In the United States the same approach of valuing goodwill was adopted in 2001 (Koller et al., 2010). The American Institute of Certified Public Accountants of the United States (AICPA) defines goodwill as all those intangible assets as well as *supporting assets* that contribute to the advantage of the business compared to other comparable businesses in the same industry − in other words, *image*, customer base, *reputation, perceptions*, etc. (as cited in Anson, 2007).

> "Goodwill is that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified" (AICPA, Regulations and Definitions).

3.3.3 Goodwill-based valuation methods

As Fernandez demonstrates (2007), various valuation methods exist to determine an entity's market value and goodwill. Some methods aim at measuring the value the entity will generate in the future − its goodwill − a capital gain resulting from the value of its future earnings (Fernandez, 2007). In general, an entity's value is measured as the combined value of its assets plus a quantity

which is related to the future earnings. Fernandez (2007) identifies seven different methods of how to measure the value of a company and its goodwill. In each of these methods goodwill is measured differently, highlighting how difficult and challenging it is to measure it.

1) The "classic" valuation method

This method estimates goodwill as the company's net income at **n** number of times or as a certain percentage of the turnover of the company. A company's value is measured as the value of its net assets plus the value of its goodwill:

$$V = A + (z * F),$$

where, A – net asset value; z – percentage of sales revenue; F – turnover.

2) The simplified "abbreviated goodwill income" method or the simplified Union of European Accounting Experts (UEC) method,

This method explains a company's value as its adjusted net worth plus the value of its goodwill:

$$V = A + a_n (B - i * A),$$

where, $a_n (B - i * A)$ – goodwill;

A – corrected net assets or net substantial value;

a_n – present value at a rate t of n annuities, with n between 5 and 8 years;

B – net income for the previous year or a forecast for the coming year;

i – interest rate obtained by an alternative placement.

The value of goodwill is obtained by capitalising, by the application of a coefficient a_n, the "super-profit" that is counted as the difference between the net

income and the investment of the net assets "A" at an interest rate "i" corresponding to the risk-free rate.

3) *The UEC method*

This measures a company's total value as its substantial value (or re-valued net assets) plus the goodwill. The difference between this and the above method is that they measure goodwill differently. In this case it is calculated from the total company's value, V, whereas the simplified method calculates it from its net assets, A. The total company's value, V, is calculated by capitalising a super-profit at a compound interest (using a_n factor):

$$V = A + a_n (B - iV);$$

$$\text{giving:} \quad V = [A + (a_n \times B)] / (1 + ia_n).$$

The super-profit is calculated as the profit, less the flow obtained by investing at a risk free rate i, and a capital equal to the company's value V.

4) *Indirect method*

This method has a number of variations depending on how much weight is given to the substantial value and the earnings' capitalisation value. The basic version is presented here:

$$V = (A + B / i) / 2; \text{ or can be expressed as: } V = A + (B - iA) / 2i$$

The rate i is the interest paid on long-term Treasury bonds. As can be seen, this method gives equal value to the company's net assets and the value of the return.

*5) **Anglo-Saxon or direct method**,*

Here, the value of goodwill is obtained by restating, for an indefinite duration, the value of the super-profit obtained by the company:

$$V = A + (B\text{-}iA)/t_m$$

Where B-iA is the super-profit placed at interest rate i.

Capital in this case is the value of the company's assets with t_m interest rate earned on fixed-term securities, adjusted for the risk (multiplied by coefficient between 1.25 and 1.5).

*6) **Annual profit purchase method**,*

In this method the value of goodwill is equal to a certain number of years of super-profit.

$$V = A + m (B – iA)$$

The investor is prepared to pay the value of the net assets of the company plus m-years of super-profit m (B-iA). M is a range of 3 and 5, and i- is the interest rate for long term loans.

Methods of the valuation of goodwill were changed four times during the last four decades illustrating how difficult it is to estimate the value of this intangible asset.

Evolution of goodwill valuation over the last 40 years

The first method used in accounting was writing off the cost of goodwill directly to reserves in the year of acquisition[32] (Lewis and Pendril, 2004). The main critique of such a method, however, was that since the investor (or the customer) treats business as a going concern and, therefore, is willing to pay the excess premium for the business (goodwill), expecting future higher profits, it would be wrong to write off goodwill in the year of acquisition. This is because the loss in goodwill value does not occur at the time of acquisition but gradually diminishes over subsequent years. Thus, loss in value of goodwill should be charged each year. Making charges directly to reserves stops this charge from appearing in future income statements.

As a result, a second method was adopted that required reporting goodwill at cost in the statement of financial position (Elliott and Elliott, 2015). The main critique of this method pointed out that such a procedure was also incorrect since goodwill value is likely to change or even decline over time. Keeping goodwill unchanged in the statement of financial position and not amortising it on a yearly basis would be incorrect.

The third method required reporting goodwill at cost, but amortising over its expected life (Lewis and Pendril, 2004). Although this method is theoretically more appealing, in practise it would be very difficult to determine the life of goodwill precisely and choose an appropriate method for amortising since the life

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[32] SSAP 22 Accounting for Goodwill, was issued in December 1994, which required companies to write off goodwill immediately, against reserves; it also permitted them to capitalise goodwill and to amortise it in arriving at the profit or loss on ordinary activities. It was replaced by FRS 10 Goodwill and Intangible Assets.

of goodwill can vary significantly depending on the company, industry and the product. This difficulty outlines the limitations of this method.

Lastly, current valuation of goodwill follows IFRS rules which prohibit amortisation of goodwill and treats it as an asset with an indefinite life (Elliott and Elliott, 2015). Goodwill must be reported at cost and checked annually for impairment. If the value of goodwill is greater in any given year than its recoverable value, the difference must be written off. Nevertheless, some argue that this method also has disadvantages: under the new rules it is assumed that goodwill has an indefinite economic life, which implies that it is not possible to make a realistic estimate of the actual economic life of goodwill (Elliott and Elliott, 2015).

In conclusion, not only is there no universal definition for 'corporate' goodwill but there is also no universal method to estimate goodwill value. This is understandable given the complexity and confusion of defining both goodwill and its component parts. The above methods can only serve as examples of the variation of methods developed over the years in the attempt to estimate a company's goodwill and they continue to remain open to future discussion and improvement.

Implications for treating corporate goodwill differently

Since goodwill is treated differently by countries and by different accounting standards, there are a number of implications for firms. However, as Koller et al. (2010) argue in their empirical study, the difference in treating goodwill in accounting standards does not affect the company's market value or the price of company's shares. He argues that this is because investors care about

the company's underlying performance and not its choice of accounting standards. The authors conducted a test by looking at 54 companies from the US and Europe that used new standards for accounting goodwill and found that the share prices of these companies did not change significantly on the day a write-off was announced. Book value of the company and whether goodwill was amortized or impaired had little, if any impact on share prices and company's overall market value.

In conclusion, accounting recognizes that the value of an entity is more than the sum of its tangible and measurable intangible assets, thereby distinguishing goodwill as a separate asset. Goodwill, according to accounting practices, is the aggregate of all those unidentifiable assets that increase the market price of an entity. Although various valuation methods exist to determine an entity's market value and its goodwill, none of them is preferential or superior and each has its own limitations. When applying different methodologies to measure a company's value, each of them will produce a different number. For example, Fernandez (2007) conducts the following experiment: he takes a hypothetical company Alfa Inc., and calculates its goodwill and the overall company's value using the above seven methods. The results for the company's value are the following (in chronological order of the methods): $213 million, $176.9 million, $166.8 million, $197.5 million, $218.3 million, $197.5 million, and $185 million. This is very confusing highlighting the fact that it is very difficult to measure expectations of future returns - goodwill, and although various methods exist, none of them is superior; the methodology for estimating goodwill is still in its embryonic stage. This simply implies that when trying to

estimate Goodwill for a country, various methods can be considered. This Thesis is intended to initiate this new discussion on estimating Goodwill for a country by proposing one of them.

The basic conceptual method to identify a company's goodwill is the difference between its market and fair value:

Goodwill = Market Value – Fair Value

3.3.4 Goodwill in Business and Corporate Finance

Corporate finance and business disciplines use the same definition for goodwill as accounting under IFRS rules. Below Table 1 provides a simple example of how a company's total asset portfolio looks like as shown in Anson (2007).

Table 1. Goodwill quantified.

Publicly Traded Manufacturing Company	Values
Market Cap (total value based on the stock price multiplied by the number of shares)	$500 M
Less tangible asset values (plant & equipment)	$300 M
Less value attributed to trademarks based on professional valuation	$50 M
Less patent, copyright, and software value as determined by professionals	$50 M
Balance left to goodwill	**$100 M**

On a company's balance sheet, goodwill appears as the amount of value *in excess* of the other assets *that can be measured* – both tangibles and intangibles. It is a very specific number that is calculated as:

Total stock market value – value of tangible assets – value of intangible assets = Remainder ascribed to goodwill

To calculate goodwill value, it is necessary first to define the book and market value of the entity. The book value of an entity represents an accounting measure of the net worth of the entity and is the difference between the entity's assets and liabilities written in the balance sheet (Berk, DeMarzo, 2014). In theory, the balance sheet should provide an accurate assessment of the true value of the firm's equity. However, in practice this is rarely the case. Firstly, the book value of the assets and liabilities shows their historical or *original* value rather than their current value. Book values are "backward-looking" measures of value, which may be very different and often much smaller than the true value of the asset today (Brealey et al., 2012; Berk, DeMarzo, 2014). Secondly, and most important, many of the company's valuable assets are not presented in the balance sheet. These are: the expertise of the company's management team and skilled labour, the company's reputation in the marketplace, its relationship with customers and suppliers, and the value of ongoing research and development innovations (Berk, DeMarzo, 2014). These are all difficult to measure, company valuable intangibles, that are the constituents of goodwill, but are not captured by the book value. Therefore, the book value of equity is an inaccurate assessment of the actual, real value of the firm's equity. It usually differs substantially from the company's market value which, unlike book value, takes into account all these

intangibles. Very often successful companies borrow and are given more credit than would be appropriate if taking into account only the company's book value. This is because creditors recognise that the market value of the company is much higher than what is written in accounting statements. Investors are often willing to pay a much higher price for a successfully operating business than its book value (Berk, DeMarzo, 2014). In sum, it is the market value of the company that takes into account the value of goodwill and it is market value of the company that is important for shareholders and investors rather than the company's book value (Brealey et al., 2012). As Brealey at al. state:

> "Market price is not the same as book value. Market value, unlike book value, treats the firm as a going concern…..Market value is the amount that investors are willing to pay for the shares of the firm. This depends on the earning power of today's assets and the **expected** profitability of future investments. ….It is not surprising that stocks virtually never sell at book or liquidation values. Investors buy shares on the basis of present and future earning power. Two key features determine the profits the firm will be able to produce: first, the earnings that can be generated by the firm's current tangible and intangible assets, and second, the opportunities the firm has to invest in lucrative projects that will increase future earnings" (Brealey et al., 2012).

Market value of a company is calculated as the number of shares outstanding, multiplied by the company's market price per share:

Market Value of Company = Shares outstanding x Market price per share

The market price of an entity is often referred to as market capitalisation (or "market cap"). The market share price depends on how highly investors value

it and what they expect those assets to produce in the future (Berk, DeMarzo, 2014). Investors operate on the basis of a going concern when evaluating an entity; they are willing to pay a premium for the company in excess of the company's book value if they expect high returns in the future, from this company. 'Going concern' is the basic concept for accounting and business, operating on the assumption that the business has an indefinite life (Elliott and Elliott, 2015; Mard, Hitchner and Hyden, 2011). Thus, in business it is recognized that the difference between market value and a company's book value is goodwill and is reflected in the market price of the entity.

3.3.5 Goodwill and Intangible Assets

It is important to understand the difference between goodwill and other intangible assets as they have different properties. Since all assets are divided in two classifications: tangibles and intangibles, goodwill is classified under the intangible group. Yet, goodwill is separate and different from other intangible assets. Since, the distinction between goodwill and intangible assets is not straightforward, because intangible assets, intellectual property and goodwill are overlapping concepts, this subchapter is devoted to highlighting clear differences between them.

Intangible Assets

The concept of intangible assets is often confused with goodwill. Some books on Corporate Finance suggest that goodwill consists of all intangible assets. This, in fact, is incorrect and such imprecision may cause confusion in distinguishing these two different concepts; they therefore, need to be clarified.

Goodwill is an entity's/company's/person's intangible asset since it is not tangible (cannot be measured directly and since accounting divides all assets into only two groups; either tangibles or intangibles, goodwill belongs to the group of intangibles) but goodwill is different from all other intangible assets identified by accounting.

Intangible assets refer specifically to those assets that are NOT tangible but CAN be measured (measurable) and to which a value may be attached. For example, a company's good reputation is a concept embedded in the goodwill of that company; whereas the brand of the company is a specific intangible asset that can be measured and valued (Levick, Wooq and Knox, 2002; Mueller and Supina, 2007; Anson, 2007). Although the variety of intangible assets is extensive, they all share common characteristics. According to Anson (2007):

- The asset is *identifiable* both within a specific company, and in a general sense

- The value of the intangible asset can be quantified

- The intangible asset can be legally owned

- The birth and development of the intangible asset can be traced

- The intangible asset can be protected

- There is proof of its existence in the form of a contract, registration, database, etc.

- The intangible asset has a lifetime that can be determined. The lifetime of the asset, in most of the cases, can be renewed (e.g. renewal of trademarks or patents every 5-10 years)

- Similar or compatible assets can be found in other companies or in the marketplace (Anson, 2007)

In contrast, goodwill consists of all those assets whose individual value cannot easily be identified or quantified. Since these assets are nonetheless, valuable, adding to the competitive advantage of the company and increasing its market value, they have been separately allocated into an aggregate group - goodwill.

Intellectual Property Assets

Another group of assets that overlaps with goodwill in some respects, is Intellectual Property - another subgroup of the "family" of intangibles. The primary, distinctive feature of an asset from the Intellectual Property subgroup is that it has formal legal protection (Anson, 2007). All Intellectual Property assets are protected by specific laws. This is the main difference of these assets that distinguishes them from other intangible assets and goodwill. The Intellectual property subgroup specifically includes registered:

- Trademarks, trade names

- Patents

- Trade secrets and know-how

- Copyrights

- Domain names

- Software and mask names (Anson, 2007).

However, in some cases Intellectual Property assets are counted as goodwill components under certain circumstances. Specifically, those Intellectual

Property assets that have not been registered but add value to the company are legally recognised to be a part of a company's goodwill. Even registered assets of Intellectual Property, such as trademarks, can be counted as goodwill in some cases.[33]

In summary, the main **difference** between goodwill and other intangible assets is that goodwill is composed of all those intangible assets that are not easily identifiable nor individually measurable in monetary terms. Since the goodwill components are difficult to measure, they are grouped into a unifying subgroup – goodwill. Thus, goodwill represents the aggregate value of its unmeasurable, difficult to identify, assets. 'Intellectual Property Assets' is also a subgroup of intangible assets and includes those intangible assets that have formal legal protection. Usually, until Intellectual Property assets are registered, they are counted as part of goodwill.

3.3.6 Goodwill in Heterodox Economics

Goodwill, as a valuable asset, attracts significant attention in heterodox economics, which attributes certain important properties to goodwill that are ignored by other domains (e.g. accounting, which is only interested in valuing goodwill and not in its conceptual underpinnings; also, corporate finance and business studies) but are paramount to the concept of a country's Goodwill. Thus, heterodox economics is the main domain of this PhD Thesis from which it borrows the main conceptual underpinning for the hypothetical concept of a

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[33] For specific cases see UK law S24 on Trade Marks/ Act 1994

'country's Goodwill'. In heterodox economics goodwill has two main attributes: 'futurity' and 'going concern' which will be discussed in detail below but first, a definition and the historical development of the concept of goodwill are presented.

In heterodox economics goodwill, as a "business' incorporeal property", owes its recognition, primarily, to three scholars; Macleod (1872), Veblen (1904, 1909 1919) and Commons ([1919] 2005, 1924, [1934]2012). Macleod (1872) was the first to define goodwill as a business' property, "the right to the future use of things", whether it is ownership, the right to use or interest for this possession. Endres relates goodwill to the trade names and trademarks of the business (Endres, 1985). Veblen (1904) refines the meaning of goodwill stating that goodwill is a property, the right of ownership which comprises such things as: "established customary business relations, reputation for upright dealing, privileges," among others (Veblen, 1904, p. 139). Later, Commons clearly distinguished the tangible and intangible assets of a business. He separates goodwill from business' tangible assets and relates it to the part of business' intangible property that is responsible for generating profits. Similarly, Black (1994) states: "A firm's market value consists of the value of both tangible and **intangible** capital, **including the goodwill value of ongoing relations with its [firm's] customers**".

According to the seminal work of Commons ([1919] 2012), goodwill is an intangible asset of an entity/business that gives its owner a competitive advantage and lifts it above the "daily means of competition," enabling it to "thrive without cutting prices" (Commons, [1919] 2012). Commons also states that goodwill is a good reputation among those whose patronage is desired. "A credit received on

good terms and conditions is only the good will of bankers and investors" (Commons, p. [1919] 2012).

Then, according to these definitions, a country's Goodwill would be the country's good reputation among investors (i.e. how well investors perceive and evaluate the country); those whose patronage is desired, or in other words, investors' favour that acts as a country's competitive advantage, lifting it from "daily means of competition" among other competing countries and allowing it to attract FDI without the need for "cutting prices", introducing concessions such as reducing taxes, or allowing exploitation of its labour, tolerating pollution, etc.

An important contribution from heterodox economics, to the concept of a country's Goodwill, derives from the fact that goodwill, as a concept, is based on the premises of **futurity** and **going concern,** concepts that are paramount to this study.

From an economic perspective, goodwill is an asset, whose value, as with all other assets, depends upon the future returns that it will generate (Parkman, 1998). As Commons argued ([1934] 2005), it is always the principle of futurity and going concern that dominates human activity:

> "Man lives in the future but acts in the present" (Commons, [1934] 2005, p. 84).

> "Humans act in the present in anticipation of expected consequences of those actions. Since going concern functions within a time sequence, it is really the expectation that the transactions will continue in the future that keeps going concern" (Parsons [1942]1970, p. 358).

This is also true for investments. Investors operate in the present in anticipation of future returns on invested capital. What they are essentially buying with their money is the right to future profits. Operating under the notion of a country's going concern implies the anticipation that the country will continue operating in a positive trajectory in indefinite time into the future, delivering expected returns. Going concern allows investors to conduct current investment transactions, anticipating future returns.

> "The assumption of going concern implies that people are operating on the basis of futurity…Going concerns provide structure in all aspects of life from families to nations…" (Atkinson, 2009, p. 437, 434).

One important contribution from Commons ([1934] 2005) to the concept of goodwill is that he argues that when evaluating a business which consists of corporeal and incorporeal property, time and futurity must be taken into account, as time has economic value. Without time and futurity, he argues, it is not possible to estimate the real value of a business. Thus, it is the future or, more precisely in our case, the country's future that really matters to investors rather than the country's present (its current economic indicators, etc.) because it is the future that determines whether or not they see their returns and how much that return is worth.

FDI literature on host country's determinants does not consider a country's futurity (or to be more precise, expectations of a country's future performance) as a factor influencing FDI at all but only the country's past and present values. This is surprising given their inability to explain FDI to a satisfactory standard.

The concept of a country's Goodwill captures the impact of investors' perceptions about a country's future, and takes this factor into account when estimating the country's value for investors.

As argued by Commons ([1934] 2005), value and ownership do not exist until time and futurity are attributed to them. Ownership of corporeal and incorporeal property is always a present right to future use, which relates to human expectations regarding this property. As was implied by the labour theory of Ricardo and Marx:

> "Value is only expectation of future income and outgo" (Commons [1934] 2005, p. 408).

Thus, futurity and going concern (expectations of a country's future performance) are embedded in the concept of Goodwill, and are the factors that are likely to be responsible for and explain FDI flows into a country.

3.4 Goodwill is still a contested concept

As we saw above, there is no universal definition of goodwill. Different standards and disciplines define and measure goodwill differently. There is an ongoing debate on improving valuation methods of goodwill. Also, if the UK law recognizes internally generated goodwill, Corporate Finance, Business studies and accounting do not. Such diversity in definitions and valuation approaches creates difficulty to establishing a single clear cut definition and valuation method for a country's Goodwill.

With regards to the constituent parts of goodwill, they are defined by accounting, very vaguely, as "non-identifiable and non-measurable" assets,

although HMRC provides some hints about them. However, these are still remain vague and contradictory. In the next chapter, I will try to propose a definition of a national Goodwill, develop a valuation method to estimate a country's Goodwill and also pin down the factors that generate Goodwill, employing induction analysis across various disciplines and countries to define the constituent elements of national Goodwill.

CHAPTER 4. TOWARDS A THEORY OF A COUNTRY'S GOODWILL

Whereas the concept of company's and individual goodwill is accepted in law and accounting, there is no equivalent – a country's Goodwill – recognised or exists for a country so far. Scholars and analysts speak broadly of a country's reputation as a factor influencing investments inflows but, to the best of my knowledge, the concept of a country's Goodwill is not developed or used. This Thesis attempts to develop the concept of a country's Goodwill, expanding and extending it from company's and individuals' also to countries.

4.1 Country's Goodwill

Based on the definitions of goodwill across disciplines a hypothetical concept of country's Goodwill is proposed:

> A **country's Goodwill** is the **aggregate of all the country's factors that add to the country's competitiveness** but cannot be easily identified, or quantified.

> A country's Goodwill is reflected in a country's earning capacity i.e. expectations of obtaining future returns on capital invested into that country.

My hypothesis is that investors tacitly recognise such a concept and will react to it in their FDI decisions. Thus, whereas a country's Goodwill cannot be measured, we can measure one of its effects – the amount of FDI capital investors are willing to allocate to that country.

Since, "Goodwill … is the collective opinion of those whose patronage is desired" (Commons [1919] 2013), then, in the case of the country, a country's Goodwill would be the collective opinion of investors and the international investment community overall, since they are the ones who decide on the country's investment value. Their collective opinion would be expressed in their positive or negative subjective perceptions, expectations and prognoses about the country's future economic performance, reflected in the expectations of the country's economic and other indicators.

As we saw in the previous chapter, futurity is fundamental factor in developing the concept of a country's Goodwill as it takes into account future value, not just present value. Since investors operate in the present in order to obtain future profits, what they really value and want to purchase is a country's futurity – its earning capacity, since it is the future that determines whether and how much profit they will receive, not the country's present performance or its current economic and other indicators. In fact, the efficient market hypothesis (Malkiel, 2003) states that returns are not correlated with past values, nor do they depend on the past information (in our case country's past economic indicators), but rather, they fully respond to a new information and new factors, which are unpredictable. Thus, since it is not possible to know future factors or the future of any country, especially in the long term, and FDI is a long term investment, positive expectations about a country's future play a vital role in determining its value for investors. How positive these expectations are reflects and depends the current volume of FDI inflows the country is to receive.

This is the main difference and main feature that distinguishes Goodwill from any other host country FDI determinant proposed by FDI literature.

Although FDI literature devotes full attention to and explores a full range of a country's tangible and intangible assets, it has not yet identified Goodwill as another asset, or a group of assets, responsible for defining market value. Since goodwill forms such a large proportion of market value for an entity it is reasonable to investigate whether a country's national Goodwill exists and if so, how important it is in explaining a country's attractiveness for FDI investments.

As we saw, the UK HM Revenue and Customs (HMRC) states that goodwill is the advantage of a permanent connection of the company with its customers...which tends to make that connection permanent. According to Black (1994), discussed in the previous chapter, goodwill is the "**value of ongoing relations with its** [firm's] **customers**". These relationships cannot be separated from the entity as they produce additional profits, which can be viewed as an asset of that entity, i.e., goodwill. Goodwill of an entity is created by the standard economic method of investors investing current resources to increase future profits (Parkman, 1998).

Then, it follows that the Goodwill of a country would be related to the existence of some form of business relations with investors or more generally, the international investment community as a whole. If a country succeeds in establishing good relationships with them, then the country's Goodwill will be increased. Profit-generating goodwill is an evanescent asset which all competitors seek to capture, whether these are entities trying to increase their market value or countries trying to obtain capital from cross border investments. As Endres (1985,

p. 645) puts it, "The future success of competitors in this connection will bear the magnitude of goodwill for a particular enterprise." Then, the magnitude of Goodwill would play a decisive role in a country's competitiveness for FDI.

The UK HM Revenue and Customs (HMRC) also defines goodwill, as we saw, as the whole advantage of the reputation of a business among its customers. By the same token, a country's Goodwill would be the whole advantage of the country's reputation among investors – its current and potential customers, and also its creditors. The importance of reputation can be traced back to as early as the sixteenth century. Muldrew (1998) conducted a detailed study on the households in early modern England to highlight how important it was for them to have a good reputation among creditors in order to access to their finances [34]. What really mattered in order to acquire credit, he wrote, was how a business or a household was **perceived** by its creditors and banks, as it is this perception shared by the community of the creditors that defined, whether the business or household would get access to loans the amounts of loans, and how favourable the conditions of loans would be; consequently, reputation played a decisive role in acquiring wealth for both businesses and households.[35]

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[34] "Good reputation was of great social importance. Credit in social terms – the reputation of fair and honest dealing of a household became the currency of lending and borrowing. Credit referred to the amount of trust and consisted of a system of judgements about trustworthiness. Since, by the late sixteenth century most households relied on the market for the bulk of their income, the establishment of trustworthiness became the most crucial factor needed to generate and maintain wealth. The result of this was the development of a competitive piety in which households constructed and preserved their reputation in order to bolster the credit of their households so that they could be trusted." (Muldrew, 1985)

[35] "The reputation of all members of households determined whether a household could obtain credit, and a business could not prosper nor a household increase its level of consumption without it. By the late sixteenth century, with so many more households competing for a share of business

If we draw a parallel with the importance of a positive perception from the creditors' side to our case, then a country's access to long term investments - FDI - depends on the country maintaining its Goodwill, that is, its high credibility and the positive notion shared by investors of the country being a good destination for their capital.

> "Reputation was produced and communicated for profit. In this way householders attempted to maintain access to the circulation of credit…Reputation … generated their wealth…As community reputation became increasingly important, it was this which traders came to rely on when deciding with whom to do business" (Muldrew, 1985).

Nowadays, countries act as businesses acted four centuries ago, trying to convince FDI investors that *they* are a worthy destination for their capital (Fougner, 2006). What really matters for obtaining credit or, in our case FDI, is what investors think about the country and whether they perceive it to be worth investing in or not. As in those times, credit itself and the amount of it, depends on what creditors think about the borrower and his/its credibility. [36] As Commons ([1919]2012, p. 18) puts it:

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in the economy, any doubts about reputation could mean that fewer goods would be sold to a household on credit. It would also have left the business more vulnerable to any sudden financial catastrophe. Because households were the basic economic unit, reputation had competitive economic implications and this is why credit became synonymous with reputation… [The] ability to profit depended upon reputation…Each individual household had to earn profits on the market, whether it was merely to survive or become wealthy, and establishing a reputation for reliability was needed to do this…" (Muldrew, 1998).

[36] For this reason Thomas Wilson claimed that: "…a good name is better than all the goods in the world" (Meldrew, 1998, p. 155).

"Goodwill is good reputation, and reputation is the collective opinion of those whose patronage is desired."

Another striking example of the importance of having a good reputation for a country and its power to attract FDI is observed from the Nation Brands theory and the worldwide practice of establishing investment promotion agencies which work on the improvement of a country's image, to convince investors of the attractiveness of the country's economy. The value of the Nation Brands theory for this PhD Thesis is substantial as it is the first theory that explicitly emphasises the importance of a country's intangible assets and of its reputation, specifically, in attracting FDI inflows.

The difference, however, between the Nation Brands theory and this PhD Thesis is how a country's reputation is defined and measured. Kalamova and Konrad (2010) use a general index of nation brands as an aggregate for stereotypes of a country shared by common people. The Nation Brands theory focus group is the general public: their individual **stereotypes** about a country's attractiveness from a tourism perspective, a country's governance regimes, its products, its cultural status, perceptions about the country's population, its economic and social conditions. In contrast, this PhD Thesis is not interested in the effects of stereotypes from the general public; instead it narrows the focus, specifically and only, to the behaviour of a particular focus group - the international investment community and the impact of *their* subjective perceptions and assessments about the country's earning capacity. When investors consider a country as a possible destination for their capital they are likely to evaluate and assess the country and the risks differently from the general public and prioritise

different indicators; their (investors') actual decision-making is typically more complex (Hoffmann, 2013; Slovic, 1969; Kuhberger, Schulte-Mecklenbeck, and Perner, 2002). For example, a general stereotype of the public, about a country as a destination for tourism or its cultural aspects, can be very positive but may not be enough to convince investors to allocate their capital into its economy. They [investors] may perceive economic and social conditions of a country very differently from the general public. The stereotype about a country can vary according to the purpose of a specific group of individuals. As argued by the theory of Investment Behaviour, investors, when considering a country as a destination of their capital, prioritise mainly one single factor, that is, the ability to generate maximum returns on their capital and being able to increase the value of their investments over time. Thus, perceptions of a country based on its tourism attractiveness, culture or even governance regimes may be irrelevant.

The second fundamental difference between the Goodwill of a country and Nation Brand theory is that the latter represents the aggregate of various stereotypes. A stereotype, by its definition, is a permanent property: once it is acquired, it is fixed to a person or an object (Cobuild, 2006). Stereotypes tends to change more slowly over time than goodwill which is dependent on the market (i.e. the international investment community and their rationale). As Kalamova and Konrad (2010) highlight, in Nation Brand theory stereotypes and subjective beliefs about the country may be formed and deeply rooted into the history of the country along with other fundamental characteristics. In contrast, goodwill, according to its very definition in IPE:

"… is fragile…Goodwill is not merely past reputation, it requires continuous upkeep through continuous repletion of **service**. It breaks easily by deterioration' (Commons, [1919]2012, p. 26).

Thus what distinguishes a country's Goodwill from the stereotypes of the general public about the country, is that a country's Goodwill is fugitive and needs constant upkeep. It is not merely a reputation of past actions, profits or events but is a notion fed by constant upkeep with investors' expectations. Again, the BRIC concept being replaced by the MINT is an eloquent example of how fugitive Goodwill can be. In addition, investors' perceptions about a country are not always positive. A country can also gain "badwill" implying the reluctance of investors to invest into a particular country which, in turn, reflects in the undervaluation of the country and an undersupply of capital inflows. A very important distinction to acknowledge is the difference between real economic growth and the perception of economic growth; these are not the same things. The purpose of this study is not to prove that countries with booming economies receive large FDI inflows - which is well demonstrated already - but to detect whether investors' positive perceptions alone can be a factor driving investment flows.

Goodwill can contribute to the overvaluation or undervaluation of a country's investment value, consequently influencing the flow of FDI it receives. Commons ([1919] 2012) states that goodwill is an incorporeal and intangible property and sometimes, can be more valuable than tangible assets. This important argument provides an explanation for the overvaluation of a country by investors relative to the aggregate value of the country's tangible and measurable

intangible assets. With Goodwill it is possible to explain why countries with similar country factors (such as geographical location, infrastructure level or institutional quality) receive different levels of FDI; those countries that are perceived by investors as able to generate good returns would attract more FDI than those that are perceived as a less good place to invest.

Thus, in simple words, the concept of a country's Goodwill captures the impact of investors' perceptions about a country's future, and takes this factor into account when estimating the country's value for investors.

A country's Goodwill is a country's intangible asset that allows it to attract more investments than the country would otherwise have attracted, solely on the basis of its present tangible and measurable intangible assets. It is through expectations that the economy will continue to grow and develop, that investors continue to perceive a country as a good destination for capital while the expectation that the invested capital will continue to give returns drives current investment flows into the economy. Operating under the assumption of a "going concern" allows investors to operate in a predictable future expecting the country to continue its path towards sustainable economic development and delivering maximum returns on their capital.

In heterodox economics, Commons relates goodwill to intangible assets and incorporeal property that sometimes can be more valuable than the entity's tangible properties or assets; business goodwill, commercial goodwill, trade name, trade reputation, and trademarks, often exceed in value the physical plant and the inventory of stock on hand (Commons, [1919] 2012).

4.2 Importance of applying the accounting framework

Countries, as destinations for investment capital, similarly to companies, have certain properties (assets) that investors look at and evaluate when deciding upon a country as a place of potential investment. As Fougner (2006)[37] suggests, countries and companies, in the way they are assessed by investors and the way they are trying to promote themselves to investors are very similar. Thus, when trying to estimate a country's investment value (i.e. its market value) it makes sense to apply the accounting framework that identifies all the assets responsible for a market value. Such a simple procedure, when applied at a country level, points to a third group of assets - Goodwill, which has not been noticed so far by the FDI literature.

In accounting, tangible assets are those assets that are measurable and identifiable; whereas intangible assets refer to those that are without physical substance (Anson, 2007). In a similar way, it may be argued that a host country's assets responsible for its investment value can also be divided into these two categories: tangibles and intangibles. Tangible assets of a country would then be those that are identifiable and measurable resembling tangible values, such as a country's natural resources, GDP level, productivity, infrastructure, etc.; whereas intangibles would be the ones that lack physical substance but still add or detract from a country's investment value, such as political stability, economic stability, social stability, institutional quality of the country, etc.[38] Applying this taxonomy

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[37] Please see Chapter 2

[38] This PhD thesis is a pioneering study that only points at the usefulness of applying the accounting framework for evaluating a country's market value, making a first step in organising a

to the country assets allows us to identify a third group of its assets that is largely about future – Goodwill.

Table 2 on "Host country assets responsible for the country's investment value" shows the classification of a host country's FDI determinants when this framework is applied.

Since at a company level valuation of its market value on the basis of the company's tangible and intangible assets without taking into account goodwill, is unrepresentative (Mueller and Supina, 2002), it makes sense to consider what could such an asset for a country be.

On the basis of the definition of corporate goodwill in accounting, Goodwill, the national asset of a country, would be the aggregate of all those factors that add to the country's advantage in attracting investments, raising country's investment value but which cannot be easily identified, quantified nor can their individual impact on FDI be measured, and thus are combined under a unifying subgroup of intangible factors of a country - Goodwill. Applying the accounting framework for distinguishing and identifying assets to a country is useful because it provides the opportunity to identify Goodwill and recognise its impact on a country's market/investment value.

Table 2. Host country's assets responsible for the country's investment value

Tangible	Intangible

country's assets into Tangibles and Intangibles. Further research and detailed analysis is required to build a more detailed and precise framework for the arrangement, identification and allocation of a country's assets.

current time indicators	current time indicators
• GDP growth rate as a measure of growth potential of the market • GDP value as a measure of size of the market • GDP per capita as a measure of spending power • Infrastructure • Productivity • Income per capita and Market Size • Low cost labour • Natural resources	• Institutional Quality • Government Stability • Political Regime • Economic Stability • Social Stability
	Goodwill: all uneasily identifiable unquantifiable factors including expectations of future development of current Tangible and Intangible assets of the country

Data available on a country's FDI determinants only captures the value of such determinants in a given year in the past or their current value at best, but does not capture expectations/prognoses of their future performance. Future performance of a country's assets is not a part of their current values but it matters even more to investors (and thus contributes to investment value of the country) because FDIs are long term investments and investors will only see their returns in the future. Thus, it is the future values of a country's tangible and intangible assets that matter to investors more than the current values. For this reason expectations of future values of tangible and intangible assets should be taken into account when estimating a country's attractiveness and investment value.

Goodwill is a unique asset because it is the only asset in financial statements that captures futurity; that is, investors' perceptions and prognoses

about future development and performance of a country's current tangible and intangible assets. The information captured by Goodwill is not necessarily accurate and representative of the real long term future of the country and its assets. In fact, it is very subjective. But this is what drives current investments because it is investors (the market) who decide whether and how much to invest into a country and, therefore, their perceptions (whether correct or not) determine a country's current investment value and the size of investments it is going to receive.

4.3 Factors building a country's Goodwill

Guidance on the components of a country's Goodwill comes from the interdisciplinary research recorded and discussed in Chapter 3; that is, IPE literature and accounting literature, as well as the UK law that nails down some of the factors and assets building corporate goodwill. Please note that a number of the assets proposed by the literature on corporate goodwill, for example, technical and commercial know-how, are only intrinsic to a company and do not have direct equivalents at a country level. Such factors, therefore, can serve only as approximate guidelines. This Thesis analyses each of the identified components of corporate goodwill and adapts and interprets/applies them to a country level. Table 3, below, provides a list of country-level Goodwill building factors.

Table 3. Factors building country's goodwill

I. Country's reputation: **1.1 Expectations of future development and performance of country's tangible and intangible assets:** perceptions, prognoses and estimates of country's assets in a 5, 10 and 15 year period [39] **1.2 Current changes that affect future returns on invested capital into the country:** announcement of launching new policies affecting FDI, current change in the government, etc. **1.3 Country's past actions towards foreign investors:** country's reputation of treatment of foreign investors and their capital	**Tangibles**	• Future GDP growth • Expected Infrastructure Level • Expected Productivity Level • Expected Income Per capita • Expected increase in Market Size
	Intangibles	• Expected Institutional Quality • Expected Government Stability • Expected Economic Stability • Expected Social Stability • Expected Policy changes

II. Advantage of permanent connection with investors
III. Registered and unregistered image rights: promotional and advertisement videos and images of the country that influence investors' perceptions about the country' potential earning capacity
IV. Skills of country's governmental officials Skills and personal influence of a country representatives promoting country's image among the investment community and their personal networks channelling links with investors
V. Culture and Attitude of the labour force Relevant for all types of FDI but particularly important for vertical type

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[39] 5, 10 and 15 year period is a standard practice to define short, medium and long term future.

1)   ***Country's reputation***

A country's Goodwill has something to do with its reputation; but what is reputation? And most importantly, what can the reputation of a country be? The only way to understand this is to reflect on the factors that contribute to building a country's reputation among "those whose patronage is desired" that is, the investors. By defining these factors we can shed light on those unquantifiable, uneasily measurable factors (country's intangible assets) that contribute to building a country's Goodwill. Reputation is built by a set of factors: past events, current events and also reflects expectations of a country's future capacity, thus it is a cumulative rather than a clear cut, single and easily defined attribute. Please note this Thesis specifically targets and studies the reputation of the country among one specific group – the international investment community - from the point of a country's investment value, and the research unit of this study is a country.

1.1)   ***Country's reputation: expectations of future development of a country's tangible and intangible assets***

This factor is generally outside of a country's control and is mainly shaped by the subjective opinion and perceptions of the international investment community. This is because the perception of future returns on invested capital defines how much investment the country receives in the present. In business, company's potential earning capacity is considered a valuable intangible asset defined as "goodwill". If we relate such a concept to a country, then a country's Goodwill reflects the potential earning capacity of the country to generate earnings on invested capital. Potential earning capacity is a property of the future.

Any attempt to calculate the future performance of any country in generating returns in the long term (10-15 year period) would be based on the attempt to estimate, predict or calculate the future performance of the country's tangible and intangible assets or, in other words, the country's economic, political and institutional indicators.

For example, knowing the GDP of a country or purchasing power of its population in 5, 10 or 15 years would be more important for investors than knowing its current GDP. Investors operate under the notion of futurity and going concern, considering a country as a "go on" entity for their investments because returns and profits on their investments are all made in the future. Investments are carried out in the present for the purpose of future profits. Any change from the time of investment to any point in the future would affect revenues on invested capital. Therefore, prognoses and anticipation of expected values of a country's FDI determinants should play a more decisive role in their decision making process than current values of these determinants and thus must be recognised as the factors influencing a country's market value. If the country is not perceived by the international investment community as a country with high potential for economic growth and its future bright or at least positively stable, then investors are unlikely to be optimistic about the country's investment attractiveness, irrespective of how plausible or stable its current economic and other indicators are. Depending on how highly individual FDI investors and the investment community as a whole, expect a country's indicators (i.e. purchasing power of population, GDP, institutional quality, etc.) to perform in the future, determines the sign and the size of that country's Goodwill; positively increasing if investors

are optimistic about the performance of these determinants and expect them to rise and negative or decreasing if they are pessimistic.

Positive expectations of the market increase Goodwill and are likely, therefore, to increase the size of investment inflows, and vice versa: if investors think a country is prone to default or stagnation, or have doubts about a country's future political stability, they will be reluctant to invest in that country. Since returns on invested capital are gained in the future and the future is partly unpredictable, positive perceptions of investors about the future of the country and its earning capacity are of crucial importance for a country's ability to attract investments. This is an important point this PhD Thesis is trying to make and document empirically. Investors' perceptions about a country's future, whether correct or not, are already an FDI determinant in itself, different from all other proposed by the FDI literature that do not take future forward-looking expectations into account but only consider past and present factors.

The UNCTAD World Investment Report (WIR) provides a comprehensive list of a host country's FDI determinants (see Appendix 1). UNCTAD comprehensive list of determinants, however, only alludes obliquely to something that investors are particularly interested in, the future.

The following are not the FDI determinants defined by UNCTAD WIR of 1998 as such, but instead, the expected values of these FDI determinants in the short, medium and long term future and thus, are a part of Goodwill:

• Future GDP growth (as an indicator of growth potential of the market, size of the market and purchasing power of its population);

• Expected Infrastructure level in the short, medium and long term future;

• Expected Productivity level;

• Expected Institutional Quality;

• Expected Government and Political situation – as a way to assess the possibility of inter and intra-state conflicts that are likely to affect labour performance, supply and demand of production.

The importance of current and past values of these FDI determinants is also emphasised in the studies of Dunning (1958, 1988, 2000), Blonigen (2011) on market size and GDP growth; much literature also exists on the size of the host country's consumer market (Casson, 1987; Ethier, 1986; Ethier and Markusen, 1996; Rugman, 1986). On host country's infrastructure, policy framework, civic society, institutional quality, social stability, political stability, economic growth and market size of the host country, see for example Child (2009), Casson (1987), Ethier and Markusen (1996), Rugman (1986), Williamson (1981), Woodward (1992), Barrel and Pain (1999), Haufler and Wooton (1999), Eicher, Helfman, Lenkoski (2011).[40]

1.2) *Country's reputation: current changes affecting future returns on FDI investments*

A country's reputation – Goodwill – is a constantly "moving" attribute that is very sensitive to any external and internal factors which might change the country's economic, political and even social situation. Any host country's

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[40] Please see Chapter 2 "Existing approaches to determinants of FDI flows" the subchapter 2.3 "Theories on a host country's FDI determinants"

policies related to or targeting the treatment of foreign capital and capital gains would influence investors' expectations and prognoses about the country's future earning capacity. For example, a current change in the government or a takeover by a new political party, with different priorities and a different course of actions to the current one, would signal some degree of uncertainty and instability to investors. Also any programs or changes to current law affecting labour costs, taxes, minimum threshold for investments etc. would also be signalling effects to investors. More dramatic changes, for example, political unrest, high probability of the outbreak of an interstate or a civil war in a host country generates uncertainty and negatively affects a country's Goodwill.

1.3) *Country's reputation: past actions towards foreign investors*

A country's Goodwill is also formed by the past experience of investors in dealing with the country; how easy or difficult it was to do business in the country and any previous events and actions of the government in relation to foreign investors, affecting their returns and profits on invested capital. Since investors cannot foresee the future of a country with high accuracy, previous events and actions of the government in relation to foreign investors would have an impact on their perceptions of the country. In business, as is well known, trust is fundamental for long-term relationships and FDI is a long term investment and commitment. Such risky business activities as long-term direct investments are very uncertain and trust is paramount. Once it was undermined, it would significantly damage the relationship between the country and foreign investors, resulting in a tarnished image of the country. And vice versa, countries with a good reputation and relatively stable economies would attract further flows of

capital due to the positive image created. One out of many examples of when past actions of the government have negatively impacted on a country's image and continue to affect the current level of FDI inflows into the country is the case of Malaysia when its government imposed capital controls on foreign investments during the Asian Financial Crisis of 1990. This is how analysts explain why FDI investors have been reluctant to invest in Malaysia since 1990:

> "Malaysia's image had been tarnished and damage had been done. This is because in the world of international finance there are not many major players and especially in the investment banking and hedge funds it is a tightly knit community. This is one of the reasons why Malaysia is off the radar screen when it comes to Foreign Direct investment" (Kong, 2012).

A good stable reputation of the country in dealing with foreign investors and meeting its obligations reassures investors, providing a certain level of confidence about dealing with and investing into such country in the future. Negative experience, in turn, undermines a country's reputation and the confidence of investors, reducing the country's Goodwill or even, in some cases, creating "badwill".

2) *Advantage of permanent connection with its investors*

This valuable country asset is recorded in the definition of Goodwill by the UK HMRC when it defines goodwill as the advantage of permanent connection of the company with its customers. Since countries aim at attracting foreign investments, the targeted "customer" they want to make ties with, would be an FDI investor. At the country level, this asset could be interpreted as the advantage

of a permanent connection of the country with foreign investors. Such an asset is held by many countries including the block of the Eight Central and Eastern European Countries that have set up after-investment services, rendered to established foreign affiliates, which are designed to assist investors in any possible matters regarding their day-to-day operational activities. Such "customer service" aims at promoting good relationships with investors and encouraging their loyalty (Young and Hood, 1994).

The advantage of permanent connection is that it benefits the country by promoting a good relationship with investors, thereby encouraging reinvestment of earnings (from received profits from earlier investments), and acts as a word-of-mouth advertisement from satisfied investors. This category of assets includes development of after-investment services, and all the policies and service techniques that make this connection long lasting.

Any customer services arranged by the country for investors would be related to this asset that builds a country's Goodwill. One example of it is "One-stop" shops designed to assist investors in their daily matters related to FDI projects (Wells and Wint, 1991). The techniques and methods used in "one-stop" shops, the skills and personal qualities of the staff dealing with investors and positively affecting their perceptions, would be the country's personal unquantifiable advantage – Goodwill – which is not possible to measure in quantitative or monetary terms.

This group of assets forming Goodwill also includes any investment facilitation activities that promote good relationships with investors and encourage them to invest or reinvest into the country.

3)   *Registered and unregistered image rights: promotional and advertisement videos and images of the country*

Making a country recognisable among investors and helping them to discover investment opportunities in the country is one of the strategies countries nowadays employ in order to promote themselves to FDI investors. The UK HMRC defines one of the factors contributing to building a company's goodwill as the "registered and unregistered trademarks, unregistered image rights that make the business or the product recognisable among its potential and returning customers"[41]. By implication, at a country level, any promotional advertisements, screen videos, images of the country, etc. that aim at improving the image of the country or making the country to stand out or recognizable would be related to this category of assets. Illustrative examples include Uzbekistan promoting itself as "A Land of Limitless Possibilities"[42] or Kazakhstan's promotional videos, targeting FDI investors; for example, the videos of Kazakhstan on YouTube, arranged by the Ministry of Industry and New Technologies.

4)   *Skills of country's governmental officials*

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[41] Please see Chapter 4, the section on goodwill in law, that identifies various factors contributing to goodwill including this one

[42] https://www.youtube.com/watch?v=66zxKNqeMy0

This asset includes governmental officials' network linkages, personal charm and charisma, influencing and promoting their country's positive image among the investment community and establishing links with investors. All these play to a country's advantage. Governmental officials and a country's representatives, diplomats, ministers, public servants in the Embassies and Consulates dealing with investors, all contribute to shaping the image of the country. The quality of their work in assisting investors, the methods and techniques they employ would not easily be quantifiable and their impact can only be measured as part of a country's Goodwill.

This asset also includes the country's governmental officials' and diplomats' knowledge, experience, skills, training, judgment, intelligence, personal charm and charisma as well as personal networking. Since they represent the country to the rest of the world, and interact with the investment community and foreign investors directly, their personal impact on shaping a country's image cannot be underestimated. They can inspire a certain trust and reassurance in investors about dealing with the country and its future, or they can put investors off.

5) *Culture and Attitude of the Labour Force*

Another unmeasurable, unquantifiable country asset that contributes to the country's competitive advantage, yet unnoticed by the FDI literature is the culture and attitude of the country's labour force. It can easily be taken for a conventional "human capital" factor at a first glance, however, the culture and attitude of the labour force is an absolutely different concept and asset to the widely known

"human capital" factor related to the tangible assets of the country. More specifically, "human capital" is largely understood as the level of education of a labour force and measured as "school enrolment rates", "accumulated years of schooling in the employable age", the "ratio between skilled adults and total adults", "average years of schooling" or average education attainment of labour force (Psacharopolus and Arriagada, 1986; Romer, 1990; Barro, 1991; Barro and Lee, 1993; Nehru, Swanson and Dubey, 1993 as cited in OECD, 2009). It generally represents the skills of labour force measured as education attainment.

"Culture and attitude of labour" factor and intangible asset of a country, however, possess different qualities grounded in the culture and historical settings of the country and concern the *attitude* of the labour force towards the performance of their duties. Culture and attitude of labour force captures such labour qualities as obedience or, its opposite, proneness to strikes, generally hardworking or lazy, culture of meeting the minimum standards set by the company or culture of going that extra mile to achieve good quality of the goods produced. For example, any goods produced in Italy, no matter whether it is clothing, furniture, agricultural products, cars or technical products are generally regarded as having higher quality than those produced in Pakistan or China. Similarly to Italy, Japan, Spain or Portugal are countries that are perceived to have a culture in their labour of producing goods of high quality and accuracy, which is an especially important factor for vertical type of FDI - factories producing designer goods in a foreign country. Not surprisingly, the same international clothing brands (Zara, Benetton, Laura Ashley, etc.) have lines of textile products from different countries; higher quality products that are sold for higher price are

usually produced in Italy, Spain or Portugal, whereas lower quality mass products manufactured from cheaper materials are produced in China, Bangladesh and Pakistan. Another example is Ireland which is much favoured by the US and European FDI investors due to the attitude of its labour force which is generally regarded as hardworking, producing goods to a good standard and quality. China's labour force, also, is generally perceived as obedient, respectful to authorities and not prone to strikes that increase the risk of delays and missing production deadlines. For this reason China too is much favoured by FDI investors who are interested in a stable uninterrupted production cycle of easy to produce goods in bulk quantities.

Very often a country is associated with a level of quality of producing goods and with the attitude of its labour force, both of which can act as the country's brand, as in the case of Italy, or with a generally reliable workforce, as in the case of China. Often goods produced from the same material but with a label "made in Italy", "made in France" or "made in Switzerland" will be priced higher than those with a "made in China" or "made in Pakistan" label. The former will be regarded as having higher quality or simply be regarded as more prestigious, finer goods. Also, furniture and cars produced from Asian manufacturers are usually priced lower in order to compete with European producers of the same goods (like, for example, German Mercedes or Porsche). It is not just quality that is a driver for the price of textiles and personal use products (which in some cases can be very similar if not identical) but there is something about the fact of where the good was produced – the country of origin where it was manufactured adding to that country's competitive advantage – its Goodwill.

This is exactly what this asset – culture and attitude of labour force captures: the intangible properties of a country's labour force acting as a country's competitive advantage and, in some cases, as country's brand.

4.4. Evolution of UNCTAD thinking about intangible assets

UNCTAD recognises the importance of a country's intangible assets in attracting FDI, yet it has not identified a country's Goodwill as an FDI determinant. UNCTAD is one of the pioneers in research on host countries' FDI determinants that recognises the inability of conventional economic and other FDI determinants (tangible factors) to explain, sufficiently, FDI preferences for particular countries. UNCTAD provides a valuable insight on the policies and instruments that increase Goodwill of a country.

In 2012 the UNCTAD World Investment Report (WIR) published the FDI Potential Index that identifies two groups of countries where one group attracted significantly more FDI than could be expected on the basis of the countries' economic and other determinants (tangible assets), and the other group attracted significantly less than was expected by the experts. The report identifies some resource-rich countries that, despite taking into account the factor of their natural resources and other country competitive advantages, exceeded expectations in attracting FDI inflows. The report does not have a plausible explanation for this phenomenon and simply states the fact that some countries attract significantly more FDI than was expected from them, given their main FDI determinants, and some countries attracting significantly below their potential.

The UNCTAD World Investment Report (1998) emphasises how important a country's image among investors is in attracting FDI, and encourages countries to improve it. It highlights the need for promotional activity for all countries generally but, most importantly, for those countries that are outside the radar of investors or perceived negatively by them, if they want to attract this type of investment.

The World Investment Report (1998) recognizes the importance of some of the FDI determinants that belong to the intangible group of assets,, including some that form a country's Goodwill by including them in their extensive host country's FDI determinants list (Appendix 1 Graph 1). UNCTAD has a different framework for organising countries' assets – FDI determinants – compared to the one followed accounting rules presented above. UNCTAD distinguishes them into economic determinants, policy framework and business facilitation. The third group, business facilitation, consists of a mixture of a country's tangible assets such as "social amenities", for example, building bilingual schools, and intangibles; including the reduction of "hassle costs" such as the level of corruption. UNCTAD also identifies goodwill building policies framed as "Investment Promotion" and "After-investment Services". The latter FDI determinants are the factors contributing to building a country's Goodwill, they are aimed at building a positive image of the country among FDI investors, establishing permanent links with them and encouraging reinvestment of their profits.

To summarise, UNCTAD recognizes the importance of a country's image and reputation and all the policies, tools and instruments promoting a country's

Goodwill, even though it does not realise it is a well-known asset in accounting which increases market value, that has a well-established framework for identifying its numerical value and contribution to the market value.

Three host country FDI determinants that are identified by UNCTAD are the policies building Goodwill. *Image Building* is one of the determinants in the "Investment Promotion" subgroup. If one follows the definition of goodwill from Halsbury's Laws of England (Vol. 35 p. 1206), which defines the goodwill of an entity as the whole advantage of reputation, then, *Image Building* is nothing but reputation building – a policy aimed at building a country's Goodwill. UNCTAD explicitly highlights the idea that countries need to build or "fix" their reputation among investors if they want to attract FDI.

Investment Generating and Investment Facilitation policies are also a part of the "Investment Promotion" subgroup. Since WIR (1998) does not provide comprehensive information about these activities, one can only infer that "Investment Generating Activities" may include organising seminars, conferences and meetings with potential FDI investors for the purpose of demonstrating investment opportunities in the country as well as broadcasting a country's promotional videos[43].

"Investment Facilitation Activities" aim at providing assistance to investors during the investment process – also a part of the methods building Goodwill of a country. Due to increased competition for FDI, countries nowadays

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[43]Examples include Kazakhstan promotional videos:
https://www.youtube.com/watch?v=7adGzU0UOhE,
https://www.youtube.com/watch?v=M7BOCuQJE0A

compete with each other by providing as high quality a customer service possible to investors. Some countries are practicing providing support and assistance to FDI investors during the investment process (WIR, 1998). Investment facilitation activities include "…counselling, accelerating the various stages of the approval process and providing assistance in obtaining all the needed permits [for investors]." In developing countries and some developed countries "one-stop shops" have been established for the purpose of handling all matters related to FDI projects (Wells and Wint, 1991). Moreover, investment facilitation services have become rather advanced and now include after-investment services. These are explained in the next section.

Investment generating and investment promotion activities and policies are goodwill-building policies as they best fit into the description of technical and commercial know-how which are legally defined components of goodwill. Neither monetary nor physical value can be attached to such policies as they are not quantifiable nor tangible. However, "One-stop" shops, as a physical entity, would be regarded as corporeal property and a tangible asset of a country since its value, on purely physical terms (the cost of the building, equipment, etc.), can be measured in monetary terms. The skills and methods of the staff promoting FDI investments in these "one-stop" shops, however, cannot be measured and, therefore, are attributed to the intangible assets forming a country's Goodwill.

In sum, "Investment Generating and Investment Facilitation" aim at establishing special links with returning investors and promoting FDI investors' good will towards the country. According to the UK HM Revenue and Customs

(HMRS), "Goodwill is the whole advantage of the reputation and connection with customers".

After Investment services are those rendered to established foreign affiliates regarding day-to-day operational matters (Young and Hood, 1994). As described in the WIR (1998), the reasons for creation of these services are twofold. One is the realization that sequential investment, that is, the reinvestment of earnings by established foreign affiliates, can be a significant source of FDI. Secondly, there is a growing awareness that satisfied investors are the best evidence of a good investment climate in a host country and that, therefore, they can help to attract other investors (WIR; 1998, p.101).

After-Investment Services, like Investment generating and investment facilitation activities, are also goodwill-building policies. They aim at establishing permanent links and special ties with investors. According to the goodwill definition put forward by Halsbury's Laws of England: "Goodwill - is the whole advantage of … connection with customers… which tend to make that connection permanent". Investopedia defines one of the components of goodwill as "customer loyalty, customer's satisfaction" and that is what these services aim at ensuring investors' satisfaction and their loyalty.

4.5. Existing goodwill building policies

Although the term is not widely used, in reality, countries around the world realise the importance of enhancing their Goodwill and apply various methods and policies aimed at shaping investors' expectations about the country's future, encouraging them to invest and reinvest into its economy.

Twelve years after listing goodwill related FDI determinants in WIR (1998), the UNCTAD World Investment Report of 2010 published the goodwill building policies and practices (without using the concept) employed by various countries (e.g. China, Russia, Libyan Jamahiriya and Fiji) for the purpose of FDI attraction.

China, for example, shapes positive expectations of investors by announcing forthcoming positive political or economic changes via a third party, before such changes take place:

> "China's State Council released opinions indicating that the threshold of foreign-invested projects that triggers central level approval will be raised to $300 million, up from $100 million. The implementing regulation encourages foreign investment in high-tech industries, new energy, energy-saving and environmental protection industries" (WIR, 2010).

The impact and positive effect on shaping investors' expectations from such a method cannot be underestimated as it is well known how sensitive investors are to any signalling effects about a country's future. The effects from such methods cannot be quantified or measured directly, thus they cannot be attributed to the country's tangible assets but only to the factors contributing to building a country's Goodwill.

Another example is Libyan Arab Jamahiriya that adopted an investment promotion law that encourages national and foreign investment projects in accordance with national development strategies. Such a policy has incorporeal benefits but its impact on FDI cannot be measured directly and, therefore, the only

possible way of evaluating the benefits of such a program is to count it as a part of Goodwill.

Russia, in turn, used the following technique promoting its Goodwill: it amended its law on Special Economic Zones in order to 1) reduce the minimum investment threshold, 2) widen the list of permitted business activities, and 3) simplify land acquisition and administration procedures. Such changes initiated by its government aim at encouraging FDI and are Goodwill generating policies.

Fiji adopted the practice of establishing a "one-stop" shop technique to encourage and facilitate processes related to foreign and local investment applications in the country. This policy is a clear investment promotion policy aiming at delivering "Investment facilitation services" and, therefore, is a Goodwill building policy aimed at establishing and improving connection with the country's "customers" – investors – assisting them and increasing their satisfaction level.

CHAPTER 5. EMPIRICAL TESTING OF A COUNTRY'S GOODWILL

The purpose of the quantitative element of this Thesis is to try and verify whether Goodwill, as a hypothetical concept for a country, as opposed to a company, is detectable empirically, and to investigate whether Goodwill explains the evolution of FDI across countries and over time (i.e. Goodwill is an FDI determinant). Goodwill is a well-established concept for a company, studied in a comprehensive literature in the disciplines of business and accounting, and this Thesis extends and adapts the concept to the case of a country.

5.1 Research question

The key questions for the empirical analysis are:

1. Is Goodwill detectable empirically?

2. What role does Goodwill play in determining FDI flows across countries?

To answer these questions, quantitative analysis will be employed to identify national Goodwill for countries, and provide (some approximate) figures to understand to what extent Goodwill explains the volume of FDI received by the country.

5.2 Methodological steps

1. Design a method/proxy to identify a country's Goodwill by adopting and adapting the formula used in accounting for identifying a company's goodwill.

2. Take this theoretical proxy to observable data and construct a time-series of Goodwill for a large number of countries. This step addresses question 1 above in a quantitative fashion.

3. Test the power of Goodwill, as identified by the proxy constructed earlier, to explain FDI across countries. [44] This step addresses question 2 above using regression analysis.

Naturally, as a preliminary to this regression analysis the data will initially be examined using descriptive statistical tests. Also, the degree of correlation between the dependent variable (FDI) and various independent variables (country's Goodwill as well as the most significant host country's FDI determinants) will be analysed.

5.3 Research Hypothesis

The null hypothesis H0 and the alternative hypothesis H1 for the regression analysis designed to test the power of a country's Goodwill to attract FDI inflows into the country are as follows:

H0: There is no relationship between a country's Goodwill and the amount of FDI that the country receives. Under this null hypothesis, Goodwill is not a relevant determinant of FDI inflows.

H1: There is a relation between a country's Goodwill and the amount of FDI received by that country, as motivated by the insights of the Sections 3.2 and 4.3. In order for H1 to be valid, not only should Goodwill be significant in explaining FDI inflows, but also the relationship between Goodwill and the FDI must be positive in

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[44] FDI is defined as both physical investment (e.g. plant) and significant portfolio flows that lead to ownership of at least 10% of a company (OECD, 2013).

accordance with our theoretical assumption: the more Goodwill a country has, the more FDI it receives.

H1 is the key Research Hypothesis of the Thesis. Under H1, national Goodwill is significant in explaining FDI.

In case the analysis rejects H0 against H1, I will also consider the economic – in addition to statistical – significance of the relationship between FDI and Goodwill by examining the size of coefficient estimates from the regression analysis. This will make it possible to quantify how well – not just whether – Goodwill explains FDI inflows.

The null hypothesis H0 can be tested using a number of different regression models. The simplest model is one where the dependent variable, namely FDI flows at time t for country j, is regressed only on Goodwill at time t for country j. I will start from this simple static regression. However, it is obvious that there are many different specifications I could engage and it is crucial to test the robustness of the results in many directions. Here I describe some of the directions I intend to follow in order to establish the robustness of the empirical results and to search for the best model capturing the properties of FDI and Goodwill data.

Firstly, it may take time for Goodwill to attract FDI inflows into a country. This suggests that it is plausible to consider a model where FDI flows at time t are regressed on Goodwill at time t-1 (or both at time t and t-1), to capture such a dynamic relationship (a country receives FDI after it has accumulated Goodwill – one year later and not in the same year to ensure it is Goodwill drives FDI and not FDI driving Goodwill).

Secondly, clearly the simple static regression model does not allow for systematic differences in the cross-section of countries. There are likely to be country-specific factors that explain FDI inflows to some extent, for example, the unique case of China, as well as other FDI determinants, and there are multiple ways to model these factors in the regression. I will apply two approaches to address this important issue. Firstly, I will allow for fixed effects in the panel regression models I estimate. These fixed effects capture any unspecified, systematic difference across countries in terms of their FDI flows by using essentially individual, country dummy variables[45]. Secondly, an additional regression will be introduced in order to test the power of Goodwill to explain FDI after controlling for observable country-specific factors (other host country FDI determinants). This is ensure that Goodwill does not simply capture information on the FDI determinants already introduced by the existing literature, in which case Goodwill does not have explanatory power over and above the factors we already know about.

Thirdly, FDI flows are likely to be persistent, meaning that positive (or negative) FDI flows in a country at time t are likely to be followed by positive (or negative) FDI flows in that country also at time t+1 and perhaps also t+2 etc. The regression model should take this into account by allowing for lags of the dependent variable FDI flows on the right hand side of the regression. I will check that the residuals in the regressions are well behaved and have therefore no serial

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[45] I may also consider time dummies if necessary.

autocorrelation, to establish that I have allowed a sufficient number of lags of FDI.

To sum up, the research hypothesis is the following:

H0 – there is no relationship between FDI inflows and Goodwill

H1 – there is a relationship between FDI inflows: Goodwill generates FDI inflows

If the data provide support for research hypothesis H1 and Goodwill of a country for the previous year has explanatory power over the amount of FDI received by the country in the following year, then β (the Goodwill coefficient) should meet 2 requirements:

1. β must be statistically significantly different from zero;

2. β must be positive in order to support the hypothesis that the bigger a country's Goodwill is the more FDI it will receive, i.e. the relationship between FDI variable and Goodwill variable is positive: the more Goodwill a country has the more FDI it will receive.

In summary, I plan to follow a specific-to-general approach to modelling the relationship between FDI flows and Goodwill, whereby I will start from the simplest static model and then augment that model in various directions in order both to improve the model itself and to test the robustness of the conclusions reached with respect to whether H0 or H1 is validated by the data.

5.4 Developing a formula for a country's Goodwill

A country's (or national) Goodwill refers to a country's intangible asset capturing all the factors that build investors' perceptions about the country's

economic potential and its ability to deliver returns on invested capital; it is the country's competitive advantage in attracting FDI inflows. Countries that have accumulated higher Goodwill would receive FDI inflows in larger volumes than those countries that have less positive or even badwill.

Since, by definition, Goodwill is an intangible and incorporeal property, it is not possible to measure or calculate it directly; only detect it by developing a method that identifies Goodwill of a country and then estimates it for a cross-section of countries. Thus, the next step is to develop a formula for detecting a country's Goodwill.

Developing a formula to estimate a country's Goodwill. Part I: Companies

In order to develop a formula to detect Goodwill of a country, a logical first step is to start from the available methods applied in accounting for the purpose of identifying goodwill for a company. The accounting literature has developed a vast body of research. The simplest and most common accounting method to identify a goodwill value for a company is:

Goodwill (Y) = Market Value (Y) – Fair Value (Y),

where Y is a generic company for which goodwill is estimated. Goodwill is the difference between the market value of a company and its fair value. Market value is usually proxied by the market capitalisation (Market Cap) of a company, i.e. the total value of the company's shares. This is a robust proxy complying with HMRC requirement which states that goodwill is captured in the price for the company's share and is likely to be valued at the market price.

The Fair value is not observable using market data and hence it is fair value that needs to be estimated in order to obtain a measure of goodwill. There are many variations in proxies for estimating fair value such as a company's book value, the aggregate of the company's assets and liabilities, or even a company's liquidation value, among others. So, if one chooses to use book value, goodwill for company Y is:

Goodwill (Y) = Market Cap (Y) – Book value (Y).

Since this formula is developed for estimating goodwill for companies, it needs to be adapted accordingly in order to be used for estimating a country's Goodwill.

Developing a formula to estimate a country's Goodwill. Part II: Countries

Following the accounting formula for identifying corporate goodwill, a country's Goodwill is a difference between a country's market value and its fair value:

Goodwill (C) = Market Value (C) – Fair Value (C),

where C is a generic country for which Goodwill is estimated.

Then, finding appropriate proxies for a country's market and fair value would facilitate the estimation of its Goodwill. In statistics, a proxy, according to its definition and purpose (or proxy variable), is a variable that is not in itself directly relevant, but that serves in place of an unobservable or immeasurable variable. In order for a variable to be a good proxy – the condition for a robust proxy - it must have a close correlation, not necessarily linear, with the immeasurable variable of interest. This correlation might be either positive or

negative. Thus, appropriate proxies for market value and fair value of a country would be the ones that satisfy the criterion of having close correlation with them, ideally positive.

The general and most common proxy chosen for market value of a country is the country's market capitalisation (Market Cap or also known as the Total Market Cap) , that is, the total value of the country's stock market or, in other words, the total value of all the publicly traded companies of this country.

Another important reason for choosing a country's Market Cap as a proxy for its market value for the purpose of estimating a country's Goodwill, is that a country's Goodwill should be related to the goodwill of the companies in this country. This is because FDIs are made in the form of direct investments by either purchasing a large percentage of shares of the country's domestic companies (minimum 10%) or by directly setting up factories, companies and entities on the territory of the host country. Then, it follows logically that a country's market value and its attractiveness for FDI investors should be reflected in the market value of the country's domestic companies. For this reason, a country's market value for FDI investors should be proxied as the aggregate of the value of all publicly traded domestic companies of this country or the total value of its stock market (Total Market Cap).

The third important reason for choosing Total Market Cap as a proxy for a country's market value is because a country's stock market price generally reflects, not only the fair value of the country's stock market (the value of how much the country is really delivering), but also encompasses *investors' expectations* about the potential of this stock market to generate future returns,

and we are interested in detecting exactly *these* investors' expectations (market value).

A good proxy for fair value of the country should represent the country's value based on its actual (rather than market-expected or perceived) ability to produce output at a given point in time. This is the real output in products and services the country is able to deliver or produce irrelevant of expectations. A logical way to capture this concept is a country's GDP (Gross Domestic Product) which represents the output of the country in the form of the products and services produced on its territory. Then, GDP would be a robust proxy for the fair value of the country.

Given the above proxies for a country's market value and fair value, then Goodwill for a country, following the basic formula for estimating goodwill, would be:

Goodwill (C) = Market Cap (C) - GDP (C)

This formula, based on the accounting method for estimating goodwill, now needs to be transformed in order to be applicable for the purpose of a comparative analysis. For this reason, subtraction (the minus) has to be replaced with ratio, which would allow to control for market size of a country.

Note, there is a difference between the methods for estimating the goodwill of a company and the goodwill of a country in that, for companies the literature uses numeric difference, whereas for the purpose of a comparative cross-sectional analysis of countries ratio needs to be employed. This is because the values (reflecting Goodwill) must be comparable across countries and years unaffected by a specific country's size. If applying the initial formula to the

comparative analysis of countries, the value representing Goodwill would be directly affected by the size of the economy: for example, imagine country A has GDP of 100 and Market Cap of 110, while Country B has GDP of 1000 and Market Cap of 1100. Using a subtraction approach and comparing the Goodwills of these countries, country's A goodwill would be 10 and country's B Goodwill would be 100, which looks like country B has Goodwill 10 times bigger than country A. This is not quite true. It just in both of these cases the value of Goodwill is affected by the country's size. When applying ratio, instead, for both countries goodwill is 10 percent because market cap is 10 percent larger than GDP for both countries, i.e. the two countries are equally appealing to investors as destinations for capital. To control for the size of the economy, therefore, the formula is adapted to ratio. The ratio, in contrast to the subtraction, detects Goodwill without the Goodwill value being distorted by differences in the size of countries' economies.

Another reason for using the ratio of Market Cap to GDP is that it shows quite naturally whether the country is overvalued by investors relative to its fair value or not. If the country is fairly valued in relation to its performance by the market, then the country's market price should be equal to the country's fair price − which in our case, if we use the ratio, would be 1. If, however, the market undervalues the country, the value should be less than 1. If market value is higher than the fair value of a country (the outcome of the ratio is > 1), then that is how we can detect that a country has Goodwill as this would mean that investors value the country higher than it is currently able to deliver (it is worth in terms of its current performance). Such overvaluation may be because of investors'

expectations of higher profits/revenues in the future, the market's anticipation. And if the fair value of a country is higher than its market value, then this may mean that market (investors) are sceptical about its potential.[46]

In accounting, a company's goodwill is associated with an increase in market value of the company, i.e. overvaluation relative to its fair value of what it is able to deliver/produce in real terms. Based on this concept, in order to detect a country's Goodwill, it is necessary to determine whether a country is overvalued or undervalued relative to its fair value and by how much and the ratio allows us to do this: determine how overvalued or undervalued a country is, i.e. detects a country's Goodwill.[47]

Furthermore, in order to be able to conduct a cross-sectional time-series analysis to understand if there is a relationship between a country's Goodwill and the FDI it receives, using a sample of real countries over a wide period of time, time factor (t) needs to be introduced into the formula. Thus, a country's Goodwill would be identified as:

$$\textbf{Goodwill (C,t) = Market Cap (C,t) / GDP (C,t),}$$

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[46] One could argue, however, the size should affect FDI inflows and hence my definition of Goodwill based on a ratio does not allow size to play a role. In contrast, I am interested in capturing Goodwill as a separate concept from size and hence a Goodwill proxy, which is unaffected by size is appealing. Having said this, I will control for a country's size in the regressions, as the literature suggests that size is a potential determinant of FDI flows.

[47] Of course, the ratio of Market Cap to GDP can be and is used as a proxy for other purposes, not only for detecting goodwill. It may well be that the ratio captures other characteristics along with goodwill. However, given its definition and interpretation in terms of stock market valuation, market cap to GDP captures the logic of the definition of goodwill, which can't be measured directly given its incorporeal and intangible nature.

where, Goodwill (C,t) is the goodwill of a country C, at time t; Market Cap (C,t) is a market capitalisation of country C at time t; and GDP (C,t) is Gross Domestic Product of country C at time t, used to proxy its fair value.

This valuation formula, namely Market Cap to GDP ratio has been widely used by the investment community to estimate a country's investment attractiveness for short and long term investments. On the country's investment attractiveness represented by Market Capitalisation to GDP, please see Forbes (2014).[48] The Federal Reserve Bank of St Louis develops the annual data of Market Capitalisation to GDP for the United States (FRED, Economic Research Department)[49], which the Federal Reserve uses as an input for their monetary policy making. Investopedia – the largest online financial encyclopaedia for individual and professional investors – and Gurufocus – a research platform that specialises on assessing, predicting and evaluating current and future value of markets with the purpose of providing information on the expectations of returns on long term investments for individual investors, investment advisors, brokers and hedge funds[50] – both refer to a country's Total Market Capitalisation to its GDP as a way to estimate whether a country is overvalued or undervalued, as an

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[48] Forbes (2014) "Buffett Wary If Ratio Market Value Of Stocks Greater Than 100% Of GDP", 22/02/2014
Available at: https://www.forbes.com/sites/robertlenzner/2014/02/22/the-stock-markets-valuation-is-at-a-dangerous-115-2-of-the-gdp/?commentId=comment_blogAndPostId%2Fblog%2Fcomment%2F906-13082-5404#1fcc46b3a12c [Last accessed: 04/06/2017]

[49] Available at: https://fred.stlouisfed.org/series/DDDM01USA156NWDB.
[Last accessed: 05/05/2017]

[50] Please see: https://www.gurufocus.com/letter.php [Last accessed: 04/06/2017]

investment entity, and by how much relative to fair value[51]. In 2005 Business Standard news published an article on India being overvalued using its Market Cap to GDP ratio as a method to estimate it (Shirsat and Kadam, 2005) .

The ratio of Market Cap to GDP was initially developed by the well-known professional investor Warren Buffet, who specifically defined it as the percentage of total market cap (TMC) relative to GNP (nominal GDP). He says of this ratio that it is: "…probably the best single measure of where valuations stand at any given moment" (Fortune, 1999). The ratio is used practically for specific markets of different countries, or even for the world market. According to Investopedia.com:

> "Typically, a result of greater than 100% is said to show that the market is overvalued, while a value of around 50%, which is near the historical average for the US market, is said to show undervaluation".

When analysing the US market using this ratio in 2000 (using World Bank data) the ratio indicated the overvaluation of the US market by 53%. With the US market falling sharply after the bubble burst, this ratio went down by 23%, ending at a valuation of the US market of 130% in 2003, which was still overvalued, although it had dropped dramatically. This is an example of the predictive value of the ratio for signalling peaks in the overvaluation of a market.

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[51] Reference to Market Cap/GDP explained to investors on Investopedia is available at: http://www.investopedia.com/terms/m/marketcapgdp.asp. [Last accessed: 01/05/2017]

Gurufocus – investors' web guide on estimating future earnings on long term investments about Market Cap/GDP: http://www.gurufocus.com/stock-market-valuations.php Last accessed: [01/05/2017]

The logic behind this ratio is that market capitalisation (market cap) of a particular economy or a market is used to estimate the market value of that economy or that market. GDP measured in real terms (GNP) is often used in this ratio to represent a real/fair value of this economy/market, although in general, both nominal and real measures of GDP are used. According to its definition, GDP is the monetary value of all the finished goods and services produced inside the country during a one year period. It includes all private and public consumption, government outlays, investments and exports, less imports, that occur within a defined territory. The ratio of Market cap to GDP, therefore, estimates how fair the market value of the economy is relative to its real (fair) value.[52]

The idea of the ratio for Goodwill proposed above, i.e. the market cap to GDP ratio is not novel per se in investment and valuation analysis, as it has been both designed and popularised by Warren Buffet and is widely used by policy makers and investors.

However, I use this valuation tool for a different purpose, which is to explore its ability, via the detection of over- and under-valuations, to capture

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[50] A specialised website for professional investors – Gurufocus.com - develops its own scale with specific intervals for interpreting the ratio based on historical valuations (please see: http://www.gurufocus.com/stock-market-valuations.php). This allows not only the ability to determine whether a market is overvalued or undervalued, but also by how much:

  Ratio < 50%   Significantly Undervalued
  50% < Ratio < 75%   Modestly Undervalued
  75% < Ratio < 90%   Fair Valued
  90% < Ratio < 115% Modestly Overvalued
  Ratio > 115% Significantly Overvalued

If applying this scale to the US economy, then on 03/31/2014 the US Stock Market Ratio = 116% Significantly Overvalued.

those intangible factors that make up a country's Goodwill and potentially play a significant role in driving FDI inflows.

In conclusion, the **ratio of Market Cap to GDP** is a suitable and appealing proxy for detecting the Goodwill of a country as it is consistent with the concept of Goodwill reflected in the overvaluation of the economy in relation to its fair value. This proxy follows the principle of goodwill for a company in business and accounting; that everything that increases market value of a company relative to its fair value is goodwill. In our case, if the market value of a country, represented by the value of its stock market, is higher than its fair value, then a country has positive Goodwill.

CHAPTER 6. DESCRIPTION OF STATISTICAL METHODS

6.1 Sample selection

After building a formula for Goodwill for the selected sample of countries and the period of time examined, the panel regressions will be introduced to investigate, empirically, whether a country's Goodwill has power in explaining FDI allocation on its own and also after controlling for other country specific factors.[53]

For all the parts of the quantitative analysis, for consistency purposes I will use the same sample of 80 countries and one time span. Also, wherever possible, the data set is from a single source - the World Bank database to avoid selection bias.

Country sample

There are 80 countries in the sample as this is the largest set of countries for which the data on Goodwill, as well as for all the variables used in both regressions, could be obtained. Among those countries omitted are unpopulated islands or countries with a population less than 5 million. This is because the recipient country should have a minimum population size in order to attract FDI; population size is associated with two main conditions for receiving FDI: a) labour force (necessary for vertical FDI aiming at cost reduction) or/and b) market

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[53] For the estimation, I will use the statistical package, EViews.

size (necessary for horizontal FDI).[54] The full list of the countries included into the sample is presented in Appendix 1.

The sample period

This is 1989-2012, a 24-year time period, which is long enough to identify the relationship between a country's Goodwill and FDI, as well as observe effects from the change in Goodwill over the years and its impact on FDI inflows. This period is considered to be the most blooming moment in contemporary history for FDI flows with interesting and significant international events such as the Asian crisis of the 1990s, the Russian default of 1998, and also the rise of the BRIC countries.

A 24 -year period for 80 countries generates 1610 real life observations – a sample large enough for, and far exceeding, the threshold of 1000 observations required to reduce sampling error to the minimum.

6.2 Panel regressions

In order to conduct the quantitative part of the analysis for this Thesis, panel regressions will be estimated. These capture both cross-sectional time-series aspects of the data and the relationship between variables, simultaneously.

I will consider different variants of panel regressions. Firstly, I will start from a fixed-effects specification, which will show a clear picture of whether Goodwill has explanatory power to account for influence on FDI and, if so, by how much. The panel regression will then be re-estimated allowing for lags of

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[54] The exception is small islands that attract investments for tax evasion purposes. These cases are of no interest in this research.

FDI, lags of Goodwill, and to control for other host country's FDI determinants. The simpler model tests the power of Goodwill on its own to influence FDI, which is a useful starting point. The richer model(s) allow us to check whether Goodwill provides distinctive information separate from other country's FDI determinants by adding FDI determinants into the model, as well as allowing for other features of the data.

Panel regression with fixed effects

There are several advantages to using panel data for a large sample of cross-sectional time series (i.e. panel) observations. The first is that panel data maximises the number of observations (relative to just cross-sectional or just time-series analysis), leading to more precise estimates of the coefficients in the regression. Secondly, if the time series is long enough it can inform us about the speed of adjustments. For example, in measuring Goodwill, panel data can estimate how the Goodwill of a particular country was changing over time (in our case a 24-year period) and how quickly FDI flows reacted or adjusted to these changes, removing idiosyncratic variation in individual countries and thereby providing an overall view of the link between FDI flows and Goodwill.

Panel regressions with fixed effects allow to control for variables that are unknown, cannot be observed or cannot be measured precisely, such as cultural factors, difference in practices or policies across countries etc. Panel data are better able to identify and measure effects that cannot be measured by pure cross-sectional or pure time-series data (Baltagi, 2005).

Panel regressions with fixed effects also make it possible to analyse the impact of variables that vary over time without the relationship being affected by other unknown or unobservable factors. Fixed effects explore the relationship between independent variable or variables and the dependent variable within an entity, for example, a country. In our case, each country has its own individual characteristics that may or may not influence the predictor variable (independent variable). Let us take China as an example. If we wants to test the relationship between the national Goodwill of China and FDI inflows into China, we may want to control for a country specific factor, for example China's one unique country specific advantage. Fixed effects control just for one country specific factor, which is static and does not change over time and therefore, is different from a goodwill factor, as Goodwill is, by its definition, not static and has a tendency to fluctuate over time.

In other words, fixed effects remove the effect of an unobservable or immeasurable characteristic of an entity, allowing us to observe the predictors' (independent variable's) net effect. The basic model of panel data with fixed effects can be written as follows:

$$Y(i,t) = \alpha(i) + \beta(1)\ X(i,t) + \varepsilon(i,t)$$

where $\alpha(i)$ for $i=1\ldots n$ is a cross-section fixed effect (different intercept for each entity, in our case country); $Y(i,t)$ is the dependent variable for entity i at time t; $X(i,t)$ is an independent variable associated with entity i at time t; $\beta(1)$ is the coefficient associated with the independent variable. If $\beta(1)=0$ or if $\beta(1)$ is found to be insignificantly different from zero, then there is no relationship between the

dependent and independent variables, i.e. the independent variable does not explain the dependent variable so we reject the model and accept the null H0, of no relationship between these variables; finally, $\varepsilon(i,t)$ is a regression error term.

The above equation is a simple static panel regression of Y on X at the same time, allowing for fixed effects. As mentioned earlier, the regression can be made dynamic by lagging X, allowing for lags of Y, and including additional factors that can potentially explain Y on the right-hand-side as independent variables. These are all variations which I will consider in the empirical work.

6.3 Estimating Goodwill for countries

Before moving to the panel regression estimation, the initial step of the analysis involves detecting Goodwill for each country in the sample. In order to detect this, the ratio developed in the previous chapter is used. For the countries sample and selected time span described above we calculate the following ratio:

$$\textbf{Goodwill (i,t) = Market Cap (i,t) / GDP (i,t)}$$

where the number of countries i goes from 1 to 80, and t denotes the time period from 1989 to 2012. Market Cap it is a proxy for the market value of country i on a given year t, and GDP in nominal terms is a proxy for fair value of country i on a given year t.

By estimating Goodwill for each country over the 24-year sample we build data on Goodwill necessary for the next steps of our analysis with 1610 observations. The data will be represented in the regression models as the Goodwill variable and therefore, is written with a capital letter, as are the other variables in the analysis.

6.4 Regression Model

Next, I estimate the relationship between FDI (depended variable) and Goodwill (independent variable) in order to test whether a country's Goodwill skews FDI inflows into the country. For this task a panel regression model (with fixed effects) is employed. [55] The tests start from a simple static regression on FDI and Goodwill, allowing for fixed effects:

$$FDI_{it} = \alpha_i + \beta GW_{it} + \varepsilon_{it} \qquad (1)$$

The test shows strong correlation between Goodwill and FDI variables, clearly illustrating that a country's Goodwill explains the amount of FDI inflows it receives.

However, correlation does not mean causation. In order to establish causation effect and the direction of the relationship; to test whether Goodwill generates (causes) FDI inflows or it is FDI that generates an increase in a country's Goodwill, the relationship between Goodwill of the previous year (Goodwill at t-1) and FDI at the current year t needs to be tested. Such a test makes it possible to establish if there is a causation effect between Goodwill and FDI – i.e. a country's Goodwill generates FDI inflows into the country and not otherwise. Thus, the initial model (1) is now transformed into:

$$FDI_{it} = \alpha_i + \beta GW_{it-1} + \varepsilon_{it} \qquad (1.1)$$

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[55] A large literature uses gravity models to explain FDI flows. Gravity models are also panel regressions and are commonly used to investigate the relationship between FDI inflows and various FDI determinants (Eaton and Tamura, 1994; Brainard, 1997; Blonigen and Davies ,2004; Egger and Pfaffermayr, 2004; Blonigen et al., 2007; Baltagi et al., 2007; Guerin, 2006).

This regression (1.1) is like the previous regression (1) in that both show that the estimated error term of the model is serially correlated, simply meaning that the FDI variable has correlation with its past, which, in fact, reflects reality; the FDI inflows of the previous years partly explain the current amount of FDI the country receives and such dynamics need to be reflected in the model in order to reduce the error term of the regression.

Allowing for dynamics in a simple way, by introducing lags of FDI (FDI at time t-1, t-2 and t-3), leads to the following regression, which is very useful in establishing one of the key empirical findings in the Thesis:

$$\mathbf{FDI_{it} = \alpha_i + \beta GW_{it\text{-}1} + \gamma_1\, FDI_{it\text{-}1} + \gamma_2\, FDI_{it\text{-}2} + \gamma_3\, FDI_{it\text{-}3} + \varepsilon_{it}} \qquad \mathbf{(2)}$$

where i = 1, 2, … 80 countries, is a country subscript; t is a time subscript, t=1, 2, … T, and T=24; the number of total observations in the model is 1429 − large enough to reduce sampling error to the minimum. FDI_{it} is the dependant variable and denotes inward FDI flows measured in million US dollars received by country i in year t. α_i is an intercept and I allow for panel fixed effects so that the intercept varies across countries and hence captures any systematic time-invariant differences across them (e.g. country-specific factors that account for cross-sectional differences in FDI inflows). $GW_{it\text{-}1}$ is the Goodwill of a country i for the previous year t-1, denoted as market capitalisation divided by GDP. The three lags of FDI ($\gamma_1\, FDI_{it\text{-}1} + \gamma_2\, FDI_{it\text{-}2} + \gamma_3\, FDI_{it\text{-}3}$) in the regression are needed in order to capture the fact that FDI tends to be serially correlated, i.e. positive (or negative) FDI in one year tends to be followed by positive (negative) FDI the following year; I experimented with various numbers of lags, and found that three were

statistically significantly different from zero. Also, allowing for lags of FDI in the regression raises the bar for Goodwill to be significant in the regression, so that finding a significant coefficient for beta is more robust if we allow for lags of FDI. More intuitively, FDI may have an 'accumulative' nature, especially if one thinks of the building of entities, as it takes time to build a plant or a factory or a chain of restaurants, hence the process may take several years to accomplish. Finally, ε_{it} is the regression error term, capturing the unexplained part of FDI in the model.

6.5 Larger regressions

The larger regression models are also considered in this Thesis in order to investigate the power of Goodwill to influence FDI, controlling for other already known FDI determinants proposed by the previous literature. This task will offer a different and even harder test of Goodwill; when other host countries' FDI determinants are included into our regression model (2), they may explain Goodwill partly or fully, thereby, diminishing or fully neutralising the power of Goodwill to explain FDI. Put another way, the ratio of Market Cap by GDP identifying Goodwill may capture information already present in other FDI determinants. Therefore, including them into regression (2) is a useful test for the robustness of the explanatory power of Goodwill to explain FDI, informing us whether Goodwill is:

1. distinctive from the other already known FDI determinants
2. significant in explaining FDI inflows when other FDI determinants are also included into the model.

According to the literature on host countries' FDI determinants, FDI inflows (the dependent variable in the regression model) are driven by a variety of a host country's factors - FDI determinants that will be included into our model as independent variables. The Goodwill of the country, as another proposed FDI determinant, will be another independent variable in this model in line with these FDI determinants. Proxies for the host country's FDI determinants are described in detail in section 6.6.3.

The third regression model (3) focuses on testing the "uniqueness" of Goodwill to explain FDI inflows relative to each of these FDI determinants.[56] If Goodwill is explained partly or fully by the FDI determinant then it will reflect in multi-collinearity between Goodwill and this determinant, which means that the same predictor was given twice (i.e. the FDI determinant explains Goodwill). The model will be run 8 times, testing Goodwill against each of the 8 factors one by one, separately. The model is run without fixed effects as the prime interest is to see the full power of our factors on FDI inflows.

Also, running this model will render it possible to make another important inference; whether the sign of the relationship between Goodwill and FDI inflows changes[57] when another FDI determinant is included. The model (3) is as follows:

$$\mathbf{FDI_{it} = \alpha_i + \beta GW_{it\text{-}1} + \gamma\ Factor + \varepsilon_{it}} \qquad \textbf{(3)}$$

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[56] The selection criteria for the host country FDI determinants for this analysis is presented in section 6.6.3

[57] from positive to negative; which challenges our H1 research hypothesis that the relationship between goodwill and FDI is positive: the more goodwill a country has the more FDI it is to receive.

where, the factor - is one of eight FDI selected determinants: Corruption, GDP growth (GDP), Political Risk, Financial Risk, Productivity, Internal Conflict, External Conflict, Government Stability.

The fourth panel regression model (4) focuses on testing Goodwill and its ability to explain FDI inflows when all the FDI determinants are included in line and is as follows:

$$FDI_{it} = \alpha_i + \beta GW_{it-1} + \gamma_1 Corruption + \gamma_2 GDP\ growth + \gamma_3 Political\ Risk +$$
$$\gamma_4 Financial\ Risk + \gamma_5 Productivity + \gamma_6 Internal\ Conflict + \gamma_7 External\ Conflict$$
$$+\gamma_8 Government\ Stability + \gamma_8\ FDI_{it-1} + \gamma_9\ FDI_{it-2} + \gamma_{10}\ FDI_{it-3} + \varepsilon_{it}$$

(4)

This test puts the post restrictions on Goodwill to explain FDI: the power of Goodwill to explain our dependant variable (FDI inflows) is likely to diminish when all other FDI determinants are included and would be shown in a smaller β coefficient compared to the results from previous regressions or may even become statistically insignificant. Moreover, the possibility of multi-collinearity among the independent variables (Goodwill and any or all FDI determinants) is much higher than in model (3) due to the cumulative effect.

This regression is going to be run with different variations, without fixed effects; to see the absolute power of the independent variables to explain the dependent variable, with fixed cross–section (country-specific) effects; with only fixed time-series effects (year-specific); with both fixed effects controlling the year and the country's specific residuals imposing restrictions on the explanatory power of Goodwill with all the tools and determinants available.

For the purpose of clarity, Table 4 below shows the expected, theory-consistent signs for all coefficients of regressions (3) and (4) between these FDI determinants and FDI inflows. It may be useful for the reader to refer back to this table later when interpreting results of the estimates of the regressions reported in Chapter 8.

Table 4. Expected sign on coefficients for FDI determinants in regression (3) and (4)

Corruption	+	Productivity	-
GDP growth	+	Internal Conflict	+
Political Risk	+	External Conflict	+
Financial Risk	+	Government Sustainability	+

6.6 Data description

The data source for the analysis is mainly from the World Bank because this is the largest data set available free of charge that has data for all the main indicators necessary for our analysis: FDI net inflows, data necessary to identify a country's Goodwill (Market cap and GDP) and also data for the majority of the proxies for FDI determinants. As mentioned earlier, having a single data source, where possible, for an empirical analysis enhances the consistency of results and their robustness and therefore, is preferable.

Although the great majority of studies on FDI determinants use bilateral data on FDI inflows from the OECD, OECD data sources do not have data on market capitalisation – one of the constituents of the formula to determine Goodwill. Combining data from different datasets to estimate Goodwill is likely

to increase the size of sample error and, therefore, avoided. Another disadvantage of OECD data, as a source for this analysis, is that it is available only for OECD countries, which is approximately 10% of all the countries in the world, whereas the World Bank dataset has data for all the countries in the world and therefore allows for testing a much larger sample of countries over a longer time period, thereby, increasing the robustness of results.

6.6.1. FDI data

Although there are different types of FDI depending on their purpose, type and entry mode[58], the mainstream research studies conducting statistical analysis on FDI patterns, as well as international institutions (e.g. IMF, World Bank), do not tend to differentiate FDI into particular types but usually conduct their analysis on total inward FDI (e.g. Buthe and Milner, 2008; Jensen, 2006; Morriset, 2003; Kinoshita and Campos, 2003) and this PhD thesis will follow this trend.

The data on FDI inflows is from World Bank dataset and represents the amount of total FDI received by each country on a yearly basis from all other countries in the world. The data is at annual frequency for a sample of 80 countries over the period of 1989-2012 measured in million US dollars, and for this analysis is converted in billions.

6.6.2 Goodwill data

Goodwill for each country is identified following the formula developed in section 6.4 and by using the data on Market Capitalisation and GDP from the

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[58] See section 2.3 on a host country's FDI determinants

World Bank dataset for the selected data sample of 80 countries, over the period 1989-2012.[59]

The data for Market Capitalisation was derived from the World Bank and is Market capitalisation of listed domestic companies (current US$). Market capitalisation is the share price times the number of shares outstanding (including their several classes) for listed domestic companies.[60] Investment funds, unit trusts, and companies whose only business goal is to hold shares of other listed companies are excluded. The data is annual and collected as end of year values converted to U.S. dollars using corresponding year-end foreign exchange rates. The aggregation method is a sum.

Data for GDP is GDP at purchaser's prices and is the sum of gross value added of all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources. Data are in current US dollars. Dollar figures for GDP are converted from domestic currencies using single year official exchange rates. For a small number of countries where the official exchange rate does not

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[59] The choice of countries for our sample also reflected the fact that countries need to have an established stock market – a necessary platform for purchasing the country's domestic companies' shares.

[60] Market capitalisation figures include: shares of listed domestic companies; shares of foreign companies which are exclusively listed on an exchange (i.e., the foreign company is not listed on any other exchange); common and preferred shares of domestic companies; and shares without voting rights. Market capitalisation figures exclude: collective investment funds; rights, warrants, ETFs, convertible instruments; options and futures; foreign listed shares other than exclusively listed ones; companies whose only business goal is to hold shares of other listed companies, such as holding companies and investment companies, regardless of their legal status; and companies admitted to trading (i.e., companies whose shares are traded at the exchange but not listed at the exchange).

reflect the rate effectively applied to actual foreign exchange transactions, an alternative conversion factor is used.[61]

6.6.3 Host country's FDI determinants data

Selection criteria

All the FDI determinants included into our quantitative analysis are discussed in section 2.3 "Theories on host country FDI determinants". The literature identifies an extensive list of host country FDI determinants as well as numerous empirical studies testing the validity and empirical evidence of such determinants to explain FDI inflows. In order to avoid the repetitive and time consuming work of testing all known host countries' FDI determinants, this Thesis, instead, builds on the study of Eicher, Helfman and Lenkoski (2011), which already identified the list of the most powerful host countries' FDI determinants. Their empirical study is the most recent, comprehensive, coherent and thorough study testing all known theories and FDI determinants, and found, when tested, only 9 host countries' FDI determinants to be statistically significant in explaining FDI inflows. These are: financial risk, a country's level of development, market size, productivity, religious tensions, taxes, GDP growth, internal conflict, corruption level and market potential.

This PhD Thesis adopts this list of the host countries' FDI determinants excluding those that are not appropriate for multilateral analysis or for which data is not freely available. In the meantime, this study adds to the list by including those FDI determinants that showed empirical evidence of being important

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[61] For a full description of the GDP World Bank data, see data.worldbank.org.

attractors of FDI inflows in other studies including Blonigen (2005), World Bank (2000), and Lucas (1990). These determinants are: political risk, risk of internal conflict, risk of external conflict and government stability.

Religious tensions as an FDI determinant, proposed by Eicher, Helfman and Lenkoski (2011), simply reflects the possibility of internal conflict in the country. It is included as a one of the components for the proxy for a Political risk factor. Also, internal conflict as an FDI determinant is included into our analysis thereby eliminating the need to test Religious tensions as a factor on its own.

To sum up, the host country FDI determinants included in this quantitative analysis are the following: corruption level, GDP growth, political risk that captures the religious tensions factor, financial risk, productivity, internal conflict, external conflict, and government stability.

1) *Corruption*

The importance of a corruption factor, also known as a proxy for measuring country's institutional quality, is heavily emphasised by Blonigen (2005) and Stein and Daude (2001) who claim that poor quality of institutions is likely to affect the efficiency and profits of MNCs.

Institutional quality is widely measured by a corruption proxy. In fact, Blonigen (2007) argues that corruption is the only robust proxy for institutional quality since any other composite indexes, that are trying to proxy the quality of institutions, are likely to be built by using surveys of different officials from different countries and may not respond to the current times and changes. They may also contain biasness in opinion and are, thus, questionable (Blonigen, 2005).

The relationship identified by Blonigen (2005) is negative (or inverse); the less corrupted the country is, the more FDI inflows should be attracted.

The data on corruption is ICRG data drawn from the PRS group. This is an ordinary variable, ranging from 6 to 0 with 6 for no corruption and 0 for corruption. The time period of the data is 1985-2011 and will be adjusted to our sample with missing values for 2012.

Please note, corruption is already included as one of the constituents of the political risk index which is one of the FDI determinants tested in our regression analysis. However, the main reason for including Corruption as a separate FDI determinant into our test, is that some might think that since Goodwill is an intangible incorporeal asset of a country it can be interpreted as or represented by a country's institutional quality. In order to test whether institutional quality and a county's Goodwill are two different indicators or the same thing, an empirical test is necessary.

Due to the way the proxy for institutional quality is constructed, the relationship between institutional quality (proxied by corruption) and FDI is expected to be positive: the higher the quality of institutions (the less corrupted a country is), represented by a higher value, the more FDI it should attract.

2)   GDP growth (%)

GDP growth is, typically, a significant FDI determinant in the vast majority of empirical studies on FDI determinants (e.g. Blonigen et al., 2004; Razin, A., E. Sadka, H. Tong, 2008; Eicher, Helfman and Lenkoski, 2011). Prospective growth, most commonly proxied by GDP growth, signals higher returns to MNCs due to expansion of the consumer market, thus attracting FDI

into those countries (see Rodrick, 1999 and Lim, 2001). GDP growth is often associated with a country's economic development and, therefore, it is logical to assume that a country with fast growing GDP growth would attract foreign firms to build their businesses and sell their goods to a growing population with an increasing purchasing capacity.

Another reason, perhaps even more important for this study, to include GDP growth into the regression models (2) and (3), in line with Goodwill, is because GDP growth is one of the components of the formula for identifying Goodwill. Therefore, in order to assess the robustness of a country's Goodwill as having power to predict and explain FDI over and above the power of GDP growth, GDP growth needs to be included into our test.

The variable is expected to have a positive effect on FDI inflows as GDP growth is associated with a country's economic development. GDP growth is calculated as:

$$\textbf{GDPt – GDPt-1/GDPt-1 *100,}$$

Data on GDP is the same data as the data on GDP for the formula identifying Goodwill and is in current U.S. dollars (The World Bank, 1989-2012). It is the sum of gross value added of all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. The time period of the data is 1985-2012, which is consistent with our sample.

The relationship between FDI and GDP growth is expected to be positive since GDP growth is associated with a country's economic development and, therefore, is expected to attract FDI.

3)   *Political Risk*

Lucas (1990) argues that only political risk is an important factor in limiting capital flows. Investments in many developing countries are exposed to large political risks, thus FDI inflows are large for politically stable countries rather than for countries that are not (Lucas, 1990). Singh and Jun (1995) also show that political risk and business operating conditions have been important determinants of FDI for countries that have historically attracted high FDI inflows. For countries with relatively low FDI, a key determinant was the degree of socio-political instability (La Porta et al., 1999).

The data for Political Risk variable is drawn from ICRG data obtained from the PRS group and represents the overall political risk a country faces. It is an aggregate measure of Government Stability, Socioeconomic Conditions, Investment Profile, Internal Conflict, External Conflict, Corruption, Military in Politics, Religious Tensions, Law and Order, Ethnic Tensions, Democratic Accountability, Quality of Bureaucracy and, therefore, an inclusive indicator of the overall political risk. This is an ordinary variable with the range from 0 to 100, representing Very High Risk (00.0 - 49.5) to Very Low Risk (80.0 - 100). The time period of the data is 1985 - 2011 and will be adjusted to our sample with missing values for 2012.

The relationship between FDI inflows and political risk of a country is expected to be positive: the higher the points, representing lower risk, the more investments the country is likely to receive.

4)   Financial risk

Financial risk is an empirically significant FDI determinant (e.g. Razin, A., E. Sadka, H. Tong, 2008; Eicher, Helfman and Lenkoski, 2011). Financial risk rating is defined by Razin, A., E. Sadka, H. Tong (2008) as an index of five components: 1) foreign debt as a percentage of GDP, 2) foreign debt service as a percentage of exports of goods and services, 3) current account as a percentage of exports of goods and services, 4) net international liquidity as months of import cover, and 5) exchange rate stability. The relationship between financial risk rating and FDI is claimed to be negative by Eicher, Helfman and Lenkoski (2011): the lower the financial risk a country is associated with, the higher the amount of FDI it is likely to receive.

The dataset on this determinant is Financial Risk rating data drawn from the ICRG PRS group, and is the same as that used by Razin, A., E. Sadka, H. Tong (2008) and Eicher, Helfman and Lenkoski (2011) for this factor. The ICRG data is constructed as;

> "...a means of assessing a country's ability to pay its way by financing its official, commercial and trade debt obligations. To ensure comparability between countries, risk components are based on accepted ratios between the measured data within the national economic or financial structure, and then the ratios are compared. Risk points are assessed for each of the component factors of foreign debt as a percentage of GDP, foreign debt service as a percentage of exports of

goods and services (XGS), current account as a percentage of XGS, net liquidity as months of import cover, and exchange rate stability" (ICRG methodology).

Risk ratings range from 50 = least risk to 0 = highest risk. Lowest de facto ratings are near 20. The time period of the data is 1985-2011 and will be adjusted to our sample with missing values for 2012.

Taking into account the construction of the data, the relationship between FDI and financial risk rating is expected to be positive: a higher value of the financial risk rating indicates lower risk and, therefore, is expected to be associated with higher FDI inflows.

5)   *Productivity*

A country's productivity, as a factor, is shown to exert significant influence on FDI returns (Eicher, Helfman and Lenkoski, 2011; Razin, Rubenstein, and Sadka 2004, and Razin, Sadka, and Tong, 2008). Razin, Sadka, and Tong (2008) have developed a theory on productivity whereby an increase in the country's productivity reduces the likelihood of new FDI, but increases FDI outflows to existing subsidiaries.

Productivity is proxied as real GDP per worker which is the most common and widely used measure (e.g. Eicher, Helfman and Lenkoski, 2011). The data is derived from the World Bank dataset and is gross domestic product (GDP) divided by total employment in the economy, adjusted by inflation (converted to 1990 constant international dollars using PPP rates).

According to Razin, Sadka, and Tong (2008), the expected relationship between productivity of the country and FDI inflows is negative meaning the more productive a recipient country the less FDI it is likely to receive.

6)   *Internal conflict*

Such factors as Religious, Socio-Economic and Ethnic tensions in a host country all influence amounts of FDI inflows (Eicher, Helfman and Lenkoski, 2011).

Since this Thesis is primarily interested in understanding the power of Goodwill to explain FDI inflows, it will not test the relationship of each of these subcomponents on the power of Goodwill to explain FDI but rather test their cumulative effect. For this purpose an aggregate measure "Internal Conflict" will be used to represent the power of internal tensions to affect foreign investments. The data for "Internal Conflict" is from ICRG and is constructed as "an assessment of political violence in the country and its actual or potential impact on governance" (PRS group). The highest rating is given to those countries where there is no armed or civil opposition to the government and the government does not engage in arbitrary violence, direct or indirect, against its own people. The lowest rating is given to a country embroiled in an on-going civil war. The risk rating assigned is the sum of three subcomponents: Civil War/Coup Threat; Terrorism/Political Violence; Civil Disorder each with a maximum score 4 and a minimum score of 0. A score ranges from 0 to 12 with 12 points for lowest risk of internal conflict and 0 to the highest.

The relationship is expected to be negative: absence of internal tensions should result in a higher volume of FDI inflows. However, taking into account how the data is constructed, the relationship is expected to be positive: higher score (representing low risk) should be associated with higher amount of foreign investment.

7)   *External conflict*

External conflict is defined as "a measure of the risk to the incumbent government and to inward investment, ranging from trade restrictions and embargoes through geopolitical disputes, armed threats, border incursions and full-scale warfare" (ICRG PRS group). The external conflict measure is an assessment both of the risk to the incumbent government from foreign action, ranging from non-violent external pressure (diplomatic pressures, withholding of aid, trade restrictions, territorial disputes, sanctions, etc.) to violent external pressure (cross-border conflicts to all-out war). External conflicts can adversely affect foreign business in many ways, ranging from restrictions on operations to trade and investment sanctions, to distortions in the allocation of economic resources, and to violent change in the structure of society.

The risk rating assigned is the sum of three subcomponents, each with a maximum score of 4 points and a minimum score of 0 points. A score of 4 points equates to very low risk and a score of 0 points to very high risk. The subcomponents are: war, cross-border conflict, foreign pressures.

The relationship is expected to be positive: a lower score indicates high risk and leads to less FDI.

8) *Government stability*

Empirical studies (World Bank, 2000, Alesina and Dollar, 2000) suggest that political stability has a quantitatively important impact on a country's ability to attract foreign investors, who prefer to invest in countries with good governance. One representation of this is stable and reliable government which is able to carry out its declared programs.

The ICRG data on government stability represents an assessment both of the government's ability to carry out its declared program(s) and its ability to stay in office. The risk rating assigned is the sum of three subcomponents: government unity, legislative strength and popular support, each with a maximum score of four, and a minimum score of 0, points. This is a scale variable with a maximum of 12 indicating very low risk and the minimum value of 0 indicating very high risk.

The relationship is expected to be positive: the higher the value, which represents low risk, the more likely the country is to receive foreign investments.

CHAPTER 7. EMPIRICAL RESULTS

7.1 Analysis

The data from the various sources collected and described are to be merged into one data set in order to carry out the quantitative analysis, executed using the statistical software EViews.

The data are first examined using descriptive statistical tests designed to analyse the basic properties of the data and identify potential data errors. This includes examining the correlation between the dependent variable that this study aims to explain (FDI) and the various independent variables in all the regression models (the potential determinants of FDI, including Goodwill).

Using ordinary least squares (OLS) estimation, I then turn to the main empirical analysis, based on the estimation of panel regressions. More precisely, I will assess the goodness-of-fit of the regression models and the statistical significance of the coefficients. Since the variables are a mix of indicator variables (in most cases using a scale ranging from 0 to 80 or similar) and variables expressed in units such as billions of dollars (e.g. FDI), the interpretation of the estimated coefficients will not always be meaningful. Therefore, I will rely on the assessment of the statistical significance of the coefficients to establish the statistical importance of the independent variables, and on their contribution to the goodness-of-fit, i.e. their explanatory power over FDI. I will then summarise all the relevant outputs for each regression in suitably constructed tables of results.

The (adjusted) R-square will be assessed, to evaluate the ability of the regression to explain FDI flows, along with the statistical significance of the

coefficients for each individual factor (FDI determinant). As it is standard practice, I will generally consider the 5% nominal level of statistical significance, i.e. I will consider a variable to be statistically significant when the analysis gives at least 95% confidence.[62]

Statistical significance highlights that the relationship between the dependent variable and independent variables in the regression is not due to sampling error or chance alone (Agresti and Finlay, 2008). The probability that the results in the sample examined appear in the population is more likely when the sample is larger than 100 observations (Agresti and Finlay, 2008). The regressions considered here have well over 1000 observations, and hence, the probability of making sampling errors such as rejecting incorrectly, the null hypothesis H_0, is very low. Put another way, the estimates of the coefficients can be expected to be quite precise and any hypothesis test is expected to be very powerful (Allison, 1999).

Estimation of the panel regressions and their analysis will make it possible to reach conclusions with respect to the ability of Goodwill to explain FDI on its own and jointly with other FDI determinants (by analysing the R-squared of the regressions and the statistical significance of their coefficients). Of particular interest is the sign of the relationship between FDI and Goodwill to understand the nature of the relationship: our conjecture is that there should be a positive relation between a country's Goodwill and its FDI inflows. Also, though of

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[62] Since the variables are defined in different units of measurement, the interpretation of the magnitude of the coefficients is not meaningful. Therefore, I will also rely on the estimate of the standardized coefficients to establish the importance of the variables and their contribution to explaining FDI flows, if multiple variables enter the regression significantly.

secondary importance, since there is a large literature already available on this, the relationship between each of the FDI determinants proposed by the literature and FDI is also examined in the regressions by looking at the sign of the estimate coefficients of these variables. Finally, it is important to understand whether Goodwill remains significant after controlling for other FDI determinants to establish whether (or not) any explanatory power of Goodwill for FDI is simply due to it capturing information already embedded in other FDI determinants.

Overall therefore, using the results from the regressions I will make an inference on whether Goodwill explains FDI inflows: whether the information in Goodwill contributes over and above other FDI determinants already known, and on the sign of the relationship between FDI inflows and each of the regressors in the models. However, to be clear, the main objective of the estimation is to test empirically whether Goodwill is a statistically significant determinant of FDI inflows and the nature of this relationship.

7.2 Regression model (1)

The empirical analysis begins with the estimation of the following panel regression, designed to test whether there is a relationship between Goodwill and FDI:

$$\textbf{FDI}_{it} = \boldsymbol{\alpha}_i + \boldsymbol{\beta}\textbf{GW}_{it} + \boldsymbol{\varepsilon}_{it} \qquad \textbf{(1)}$$

where FDI_{it} and GW_{it} denote FDI and Goodwill for country i at time t; α_i - is the regression constant; the term ε_{it} is the regression error , which captures the part of FDI which the model is unable to explain.

If the model is correctly specified this error term ε_{it} should be "well-behaved" and in particular it is important to check that it is not serially correlated.[63]

Table 5. Model summary for regression (1).

Total pool (unbalanced) observations: 1610

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	4.589260	1.005765	4.562954	0.0000
Goodwill	15.56188	1.249670	12.45279	0.0000

R-squared	0.087956	Mean dependent var	12.50757
Adjusted R-squared	0.087388	S.D. dependent var	32.73026
S.E. of regression	31.26745	Akaike info criterion	9.724274
Sum squared resid	1572067.	Schwarz criterion	9.730962
Log likelihood	-7826.040	Hannan-Quinn criter.	9.726756
F-statistic	155.0720	Durbin-Watson stat	0.388254
Prob(F-statistic)	0.000000		

Note that the number of observations for the Goodwill variable is 1610, which determines the number of observations available in the regression. If data were available for all 80 countries for the full 24 year period for all the countries under observation, the number of observations would have been 1920. Unfortunately for several countries there was no stock market data or the state itself did not exist at the beginning of our sample (1989-2012).[64] A number of post-soviet countries (e.g. Kazakhstan, Ukraine, Georgia) became independent only during the 90s. MCP data is missing for a number of countries during the

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[63] Serial correlation means there is variation in FDI which can be explained or predicted but that the model fails to do so, which would, in turn, indicate that the model has to be improved. And vice versa, the absence of serial correlation (the error term ε_{it} is not correlated with FDI_{it} variable) highlights the model being precise.

[64] Notably, Bolivia's stock market data only starts in 1994, Bulgaria in 1995, El Salvador in 1996, Kazakhstan in 1997, Tanzania in 1997.

years of inter or intra (civil) wars in some African countries.[65] Also, note that the number of observations may be further reduced in regressions estimated later in the Thesis when additional control variables are included in the models estimated, if these control variables are not available for all countries and years examined.

Overall, given the long sample period and the large cross-section of countries, the number of missing observations should not pose any problem in undermining the representativeness of the data and, therefore, the robustness of the conclusions reached in the empirical work.

The results from estimating regression (1) by OLS, reported in Table 5, clearly show that Goodwill is indeed a statistically significant determinant of FDI. The coefficient on Goodwill (β) has a positive sign (meaning a positive relationship between Goodwill and FDI; the higher the Goodwill of a country the larger the FDI it receives) and is statistically significant at a very high level with t-statistic = 12.45 given that the p-value is virtually zero. However, the estimated error term (the residual) is serially correlated, shown by the Durbin-Watson test which shows a value of 0.809. A well-specified model should have a Durbin-Watson statistic around 2 in order to be confident that there is no first-order serial correlation in the residual. A logical reason why serial correlation is present in the residual is that the panel regression (1) does not take into account the influence of FDI of the past years (t-1, t-2, t-3) on the current inflows of FDI (at time t). It seems reasonable that a dynamic model is needed in order to fix the problem of

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[65] For example, Uganda's data on Market Cap are missing for 2001 due to the Second Congo War; for Tanzania data are missing for Market Cap for 2009 due to 2008 Invasion of Ajouan.

serial correlation which simply implies that investments into the country are not random but depend on the past FDI inflows received by that country. Thus, lags of FDI are added into regression model (1) to test whether they are statistically significant in explaining current levels of FDI and whether the residual autocorrelation problem can now be resolved by virtue of these lags. In addition, country-fixed effects α_i and time-fixed effects are introduced to improve the model. Country-fixed effects capture any systematic time-invariant differences across countries and time-fixed effects capture any cross-country variation in FDI which is due to cross-country invariant differences across time. For example, if a major economic crisis hits all countries at the same time and generally reduces FDI inflows, such an effect, which is absolutely unrelated to Goodwill, needs to be captured in order for the model to be as precise as possible. The joint use of both country-fixed and time-fixed effects with lags of FDI substantially raises the hurdle to find statistical significance of Goodwill, as it is often the case that a variable that is found to be statistically significantly different from zero, without allowing for any of these effects, becomes insignificant after allowing for them. Therefore, regression (1) is augmented by introducing lags of FDI up to 3 years and fixed effects:

$$\mathbf{FDI_{it} = c + \alpha_i + \beta GW_{it} + \gamma_1 FDI_{it\text{-}1} + \gamma_2 FDI_{it\text{-}2} + \gamma_3 FDI_{it\text{-}3} + time\ effects + \varepsilon_{it}}$$

The above regression is estimated both for GW_{it} and $GW_{it\text{-}1}$ to test whether the relationship between FDI and Goodwill is purely contemporaneous or also predictive (i.e. Goodwill generates FDI inflows).

In statistics, correlation effect simply means some sort of a relationship between two different variables: as the value of one variable increases or decreases so does the value of another variable. However, correlation does not necessarily imply or demonstrate causation: the change in one variable is not necessarily the result of the change in the values of the other variable. Two different variables can be correlated but there may not be a causation effect between them. One possible way of testing for no reverse causality in the regression analysis – the independent variable causing the change in the dependent variable and not vice versa – is using the lag of the independent variable (in this case it is lag of Goodwill).

7.3 Regression model (2)

When I consider that Goodwill lagged by one year (GW_{it-1}), in essence I test whether Goodwill not only explains FDI but also predicts FDI flows – that is, the causation effect of Goodwill on FDI. This is useful to know since a contemporaneous relationship reveals correlation but not necessarily causation in the sense that it could be that FDI flows and Goodwill are jointly determined and influence each other when they are both used at time t. However, when using past Goodwill to predict FDI flows this is more likely to reveal a causation effect from Goodwill to *future* FDI flows.

Thus, when using lagged Goodwill (GW_{it-1}) the regression is as follows:

$$\textbf{FDI}_{it} = \textbf{c} + \boldsymbol{\alpha}_i + \boldsymbol{\beta}\textbf{GW}_{it-1} + \boldsymbol{\gamma}_1\textbf{FDI}_{it-1} + \boldsymbol{\gamma}_2\textbf{FDI}_{it-2} + \boldsymbol{\gamma}_3\textbf{FDI}_{it-3} + \textbf{time effects} + \boldsymbol{\varepsilon}_{it}$$

$$\textbf{(2)}$$

where again α_i is a country-specific constant (country-fixed effects), FDI_{it} denotes inward direct investments into a country i in the year t, GW_{it-1} is Goodwill for a country i in the previous year t-1 defined as (MKC(t-1)/GDP(t-1)), and FDI_{it-1}, FDI_{it-2}, FDI_{it-3} are the lags of inward FDI for the previous 3 years. The estimation of this regression will show the central empirical finding in this study, which will then be found to be robust against a number of sensitivity checks.

Before showing the results for the estimation of regression (2), some descriptive statistics for the variables used in this regression are presented in Table 6. I will note a number of basic points to aid understanding of the data.

Table 6. Descriptive statistics for variables used in regression (2)

	Number of observations	Mean	Maximum	Minimum	Std. Dev.
FDI	1429	13.60337	340.065	-25.3042	34.41504
GW	1429	0.518153	6.06001	0.000199	0.631697

The number of observations (cross sectional and time series) is 1429 for each variable, which is very large and allows us to be confident that the estimation of any regression produces accurate results. The mean of FDI (defined in billion US dollars) is 13.6 with a maximum of 340.6 and a minimum of -25.3, and with standard deviation of 34.42. This suggests the potential for large differences in the distribution of FDI among countries and over time, which is quite understandable given the variance in economic size among countries.

Goodwill has a mean of 0.52 so one could interpret 0.52 as the figure indicating fair value of a country over our sample, although clearly this is an

average across countries and time and therefore it could be that the mean differs somewhat, across countries for example. The standard deviation of 0.6 of the Goodwill variable indicates that the observations in the Goodwill variable can vary to generate substantial deviations from the mean of 0.52, and indeed we can see that the minimum is essentially zero and the maximum can be over 6.

I now report the results for the estimation of regression (2) in Table 7 below:

Table 7. Model summary for regression (2)

Fixed effects: cross-section fixed (dummy variables) and period fixed (dummy variables)

Total pool (unbalanced) observations: 1429

Variable	Coefficient	t-Statistic	Prob.
C	2.578655	2.493062	0.0128
Goodwill (t-1)	6.756847	3.946763	0.0001
FDI (t-1)	0.549528	19.97339	0.0000
FDI (t-2)	0.143618	4.517201	0.0000
FDI (t-3)	-0.110188	-3.826260	0.0001
R-squared	0.766968	S.E. of regression	17.24694
Adjusted R-squared	0.748853	Durbin-Watson stat	2.123436

The R-square of the model is 0.77, which seems very satisfactory given that the model is relatively simple. The adjusted R-square, that takes into account the number of parameters estimated and penalises for overfitting (i.e. use of unnecessary independent variables) remains very high and close to the R-square, being equal to 0.75. This is comforting since it suggests that indeed the independent variables do explain the dependent variable, FDI, and that the model is unlikely to be improved by making it simpler and more parsimonious.

The Durbin-Watson statistic, at 2.12, is now very close to 2, which suggests the residual displays no serial correlation. Recall that if the Durbin –Watson is close to 0 it suggests negative autocorrelation, whereas when it is close to 4 it indicates positive correlation; when the statistic is close to 2 it indicates absence of residual autocorrelation, i.e. the regression is free from the autocorrelation problem. Therefore, taking into account the lags improves the model.

Looking at the estimated coefficients of the independent variables in regression (2), it is clear that they are all strongly, statistically significantly different from zero in that all of the t-statistics are well above 2. It is not surprising of course to find a significant constant and that the lags of FDI are all statistically significant; the latter result simply confirms that FDI is path-dependent and therefore past FDI influences current FDI and, although it is statistically important, it does not tell us anything about the nature of the drivers of FDI. The result we are interested in, however, is that Goodwill has a large and positive coefficient estimate ($\beta = 6.76$) which is estimated very precisely with a relatively large t-statistic of 3.94. This clearly suggests the central conjecture of this study, that the higher the Goodwill a country has, the more FDI it is likely to receive. The statistical significance of lagged Goodwill is obtained even controlling for both country - and time-fixed effects which are both restraining factors for Goodwill, and for 3 lags of FDI.

Since Goodwill meets the two criteria proposed by the research hypothesis H_1 (β must be statistically significant and different from zero; β must be positive) we can reject the H_0 hypothesis, that there is no relationship between Goodwill and FDI inflows, and accept our research hypothesis H1,

that there is a positive relationship between FDI inflows and Goodwill, and that Goodwill generates FDI flows.

To conclude, the results show the theoretical predictions of Goodwill influencing FDI inflows, which inspired this regression are generally speaking, empirically valid. What is more, not only does a country's Goodwill have *explanatory* power over FDI inflows (in the contemporaneous regression (1)) but it also has a *predictive* power (in the dynamic regression (2)). The fact that Goodwill of the previous year for a country is statistically significant in explaining FDI flows in the current year and the relationship between Goodwill and FDI is positive, allows us, cautiously, to infer a causation effect: Goodwill drives FDI inflows.

7.4 Regression model (3) and its variations

I now turn to a larger model where regression (2) is augmented in various ways and I explore the role of some of the standard determinants of FDI proposed in the literature (regression model 3). It is important to understand whether Goodwill contains different information explaining FDI, from the information captured by other FDI determinants or whether Goodwill simply repeats the information that has been already defined by previously discovered FDI determinants. This test will make it possible to infer whether Goodwill contains "unique" information that cannot be captured by other FDI determinants or whether, perhaps, Goodwill is just a cumulative factor combining information from one or more FDI determinants already identified in the previous literature.

If Goodwill contains information that has already been captured by the other FDI determinants, then it should become insignificant after we include other FDI determinants into the regression. If, however, Goodwill remains statistically significant even after controlling for other determinants, this would indicate that the information embedded in Goodwill is unique or at least partly different from what can be identified and captured by the other determinants.

Before analysing the results from regression model (3), it is useful to discuss the descriptive statistics for the models (3) and (4), since the variables used in both of these regressions are the same. This is done below in Table 8.

Table 8. Descriptive statistics for regressions from the model (3) and (4)

	Observations	Mean	Maximum	Minimum	Std. Dev.
FDI	1337	13.62692	340.065	-25.3042	34.28457
Goodwill	1337	0.534233	6.06001	0.00004	0.646128
Institutional Quality	1337	3.26739	6	0	1.350498
GDP growth	1337	3.706608	33.73578	-17.669	3.924835
Financial Risk	1337	37.9282	50	14	6.338541
Political Risk	1337	-1.55984	17	-20.5	5.137606
Productivity	1337	23510.47	68039	1081	16535.19
Internal Conflict	1337	9.544877	12	2	2.000338
External Conflict	1337	10.33358	12	4	1.472228
Government Stability	1337	8.147345	12	1	1.968021

Again, the number of observations is very large, giving us confidence about the estimation accuracy as sample error reduces dramatically after a sample has over 100 observations. Since our samples are all far above 1000 observations

(1337) for the next regressions the possibility of sample error occurring is very low. The descriptive statistics of the dependant variable FDI and Goodwill were discussed in the previous subchapter already (Table 6), and therefore, the next variable to discuss is the Institutional Quality variable. Since this is an ordinal variable ranging from 6 to 0 it is reasonable to suggest that the mean is around 3; its standard deviation is 1.35.   GDP growth is defined as the annual percentage growth rate of a country; the mean is 3.71 and the standard deviation 3.92, which are reasonable numbers given the broad set of countries examined in this sample. The Financial Risk variable is in the range of 14 to 50. Although the variation of the scale of this variable is from 0 to 50, the lowest rating, de facto, is 14 in this sample. The Political Risk variable is on a scale from -25 to +25, and we observe almost all of that variation in this sample given that the minimum is lower than -20 and the maximum is 17. Productivity (output per labour employed) is measured in US dollars per worker and varies from $1081 to $68039 in some countries with an average of $ 23510.47 for most of the countries and a standard deviation of $16535.19. The next three variables come from the same data source and are relatively similar, built using the same principle. These are score variables ranging from 0 to 12. Internal Conflict is a variable with the minimum and maximum value of 2 to 12 respectively. Obviously, score 0 theoretically represents the highest risk but since the risk rating score is the sum of three subcomponents each with a maximum score of 4 and a minimum score of 0, none of the countries was given 0 for all the three subcomponents and 2 was the lowest score given to any country. The External Conflict variable is slightly less varied with a minimum of 4 and maximum of 12; the mean is 10.3 with a standard

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deviation of 1.47. Government stability ranges from 1 to 12 for minimum and maximum, with a mean of 10.33 and a standard deviation of 1.97.

Before starting to analyse the results from further panel regressions it is important to note that the coefficients on the regressors are unstandardized (raw estimates), just as for the previous regressions (1) and (2). In statistics, standardized coefficients are beta coefficients that have been standardized in order to establish which of the regressors has a greater effect on the dependent variable if the units of analysis of these regressors are different. In other words standardisation (basically dividing the variables by their respective standard deviation or variance) makes the coefficients comparable to each other across variables, to decide which ones have a bigger impact on the dependent variable. Standardized coefficients then refer to how many standard deviations the dependent variable moves per standard deviation increase in the independent variable.

In this study the units of analysis of the independent variables are different but they will not be standardized for the following reasons. Firstly, since statistical significance of the relationship between the independent and dependent variable is not affected by standardisation, i.e. the t-statistics are identical whether one standardises the coefficients or not, there is no need for standardisation of the coefficients to assess statistical significance. The main purpose of this analysis is decide if we can reject the null hypothesis of this study and prove the research hypothesis, which requires that Goodwill is statistically significantly different from zero (with a t-statistic around 2 or greater). However, since statistical

significance is not affected by standardization of the coefficients, there is no need for undertaking such an exercise.

Secondly, as is clear from the set of results reported in the analysis below, Goodwill is the only variable which is always and consistently statistically significant in all the regressions, so that the question of which variable is more important or has a bigger impact on FDI is not relevant in this case: it is clearly Goodwill, and there is no need to compare, therefore, the coefficient on Goodwill to the coefficients of other variables.

Thirdly, Goodwill is statistically significant with a lag, i.e. current Goodwill predicts future FDI, which means the relationship is not just contemporaneous but predictive. If the coefficient on Goodwill is standardised, it is necessary to use the sample standard deviation of Goodwill. Since the standard deviation is calculated for the full sample, one would then use full sample information in the regression (needed to calculate the full sample standard deviation), which makes the predictive interpretation of the regressions invalid.

Fourthly, the unstandardized coefficient beta on Goodwill can be interpreted as follows: for a 1% increase in Goodwill one expects an increase of beta billion US dollars in FDI inflows. This natural interpretation is of course not possible in terms of standardised coefficients.

Therefore, the results reported below are from the analysis with unstandardized coefficients.

I now report results for the estimation of model (3) where we regress FDI on lagged Goodwill, country-fixed effects, and a number of other candidate variables, one by one. At this stage we want to understand whether these

variables, taken one by one, are statistically significant and whether they affect the statistical significance of Goodwill. If we find that any of these variables makes Goodwill insignificant, that would indicate that the information in Goodwill is simply replicating the information in that FDI determinant which is already known. We start with Institutional Quality as an FDI determinant:

$$\text{FDI}_{it} = c + \alpha_i + \beta\text{GW}_{it-1} + \gamma\text{Institutional Quality}_{it} + \varepsilon_{it} \quad (3.1)$$

Table 9. Model summary for regression 3.1

Total pool (unbalanced) observations: 1415

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	0.160552	2.203584	0.072859	0.9419
Goodwill$_{(t-1)}$	15.82975	1.372385	11.53448	0.0000
Institutional Quality	1.427502	0.640922	2.227264	0.0261

R-squared	0.103056	Adjusted R-squared		0.101785
S.E. of regression	31.73216	Durbin-Watson stat		0.394608

The results show that the relationship between Goodwill and FDI is positive and strongly statistically significant. The coefficient $\gamma = 1.43$ of Institutional Quality is also statistically significant but with a much lower t-statistic of just over 2 relative to over 11 (for Goodwill). These results indicate that the information in the Goodwill variable is not captured by the Institutional Quality variable. The positive sign of the relationship between Institutional Quality and FDI is intuitively correct and consistent with the theoretical proposition that the higher institutional quality of a country the more FDI it is likely to attract.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ GDP growth}_{it} + \varepsilon_{it} \quad (3.2)$$

Table 10. Model summary for regression 3.2

Total pool (unbalanced) observations: 1520

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	4.470649	1.297091	3.446672	0.0006
Goodwill$_{(t-1)}$	16.91980	1.298220	13.03308	0.0000
GDP growth	0.000970	0.210958	0.004598	0.9963
R-squared	0.100714	Adjusted R-squared		0.099528
S.E. of regression	31.81431	Durbin-Watson stat		0.378247

Again, as in the previous regression Goodwill is statistically significant with a very large t-statistic. Here, GDP growth is not found to be statistically significant although the positive coefficient is signed correctly indicating that the direction of the relationship between FDI and GDP growth in this analysis is consistent with the theoretical proposition that a country having higher GDP growth attracts FDI inflows into its economy. However, GDP growth information is not statistically important in the regression, possibly because Goodwill already contains that information.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ Financial Risk}_{it} + \varepsilon_{it} \quad (3.3)$$

Table 11. Model summary for regression 3.3

Total pool (unbalanced) observations: 1392

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	1.780792	5.326217	0.334345	0.7382
Goodwill$_{(t-1)}$	16.31846	1.396268	11.68720	0.0000
Financial Risk	0.076801	0.142624	0.538488	0.5903
R-squared	0.098617	Adjusted R-squared		0.097319
S.E. of regression	32.03411	Durbin-Watson stat		0.392830

Turning to a regression where we include Financial Risk variable, I again find that Goodwill is strongly statistically significant. Financial Risk has the correct sign of the relationship but is statistically insignificantly different from zero. From this result it is evident that inclusion of the Financial Risk variable, as a regressor, does not change or add to the power of Goodwill to explain FDI.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ Political Risk}_{it} + \varepsilon_{it} \quad (3.4)$$

Table 12. Model summary for regression 3.4

Total pool (unbalanced) observations: 1392

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	5.689512	1.160100	4.904327	0.0000
Goodwill$_{(t-1)}$	16.05681	1.344462	11.94293	0.0000
Political Risk	0.549548	0.167296	3.284884	0.0010
R-squared	0.105379	Adjusted R-squared		0.10409
S.E. of regression	31.91373	Durbin-Watson stat		0.393270

The relationship between Goodwill and FDI is positive and statistically significant, which is consistent with the previous tests. The Political Risk variable is statistically significant as well at the 1% level with the correct sign consistent with the theory: the lower the political risk of the country the more FDI it attracts. This illustrates that indeed, Political Risk is a determinant of FDI. However, the coefficient of the Political Risk variable $\gamma = 0.55$ is much smaller than of Goodwill $\beta = 16.06$ showing that Goodwill is a more powerful FDI determinant compared to Political Risk. The results indicate that the information in the Goodwill variable is not a repeat of the Political Risk variable.

$$FDI_{it} = c + \alpha_i + \beta GW_{it\text{-}1} + \gamma Productivity + \varepsilon_{it} \quad (3.5)$$

Table 13. Model summary for regression 3.5

Total pool (unbalanced) observations: 1443

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-6.419659	1.424940	-4.505214	0.0000
Goodwill$_{(t\text{-}1)}$	9.280830	1.431692	6.482423	0.0000
Productivity	0.000651	0.00006	11.82829	0.0000
R-squared	0.176919	Adjusted R-squared		0.175775
S.E. of regression	31.10607	Durbin-Watson stat		0.403949

The model containing Productivity as a second regressor also illustrates a positive and statistically significant relationship between Goodwill and FDI at the highest level of significance (p-value = 0.000). Productivity variable is also statistically significant at the highest significance level, illustrating that productivity is indeed an empirically useful FDI determinant although the power

to influence FDI illustrated by the coefficient ($\gamma = 0.000651$) is much smaller than that of Goodwill ($\beta = 9.2808$). The sign of the relationship between Productivity and FDI is positive, which is consistent with the neoclassical notion that more productive countries enjoy more FDI inflows.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ Internal Conflict}_{it} + \varepsilon_{it} \quad (3.6)$$

Table 14. Model summary for regression 3.6

Total pool (unbalanced) observations: 1415

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-5.214397	3.868390	-1.347950	0.1779
Goodwill$_{(t-1)}$	15.88010	1.355099	11.71877	0.0000
Internal Conflict	1.058365	0.407552	2.596885	0.0095
R-squared	0.104183	Adjusted R-squared		0.102914
S.E. of regression	31.71222	Durbin-Watson stat		0.394441

Analysing results from the regression that includes the International Conflict variable, the relationship between Goodwill and FDI is again positive and statistically significant at the highest level of significance (p-value = 0.000). The Internal Conflict variable is also statistically significant at 1% level with p-value = 0.0095, illustrating that Internal Conflict is indeed a determinant of FDI. The sign of the relationship between Internal Conflict and FDI is positive, which is consistent with the theory and previous studies; countries dragged into internal conflicts are less attractive for FDI investments.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ External Conflict}_{it} + \varepsilon_{it} \quad (3.7)$$

Table 15. Model summary for regression 3.7

Total pool (unbalanced) observations: 1393

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	32.38405	6.126602	5.285810	0.0000
Goodwill$_{(t-1)}$	16.62596	1.331232	12.48915	0.0000
External Conflict	-2.685803	0.582133	-4.613730	0.0000
R-squared	0.112103	Adjusted R-squared		0.110826
S.E. of regression	31.78362	Durbin-Watson stat		0.403540

As for External Conflict, Goodwill remains strongly statistically significant and the External Conflict variable is also statistically significant at the highest level of significance (p=0.0000), meaning that external conflict is indeed an FDI determinant. The coefficient is negative, however, which seems counterintuitive. In any case, from these results it is clear that inclusion of the External Conflict variable does not affect the power or significance of Goodwill to explain FDI.

$$FDI_{it} = c + \alpha_i + \beta GW_{it-1} + \gamma \text{ Government Stability}_{it} + \varepsilon_{it} \quad (3.8)$$

Table 16. Model summary for regression 3.8

Total pool (unbalanced) observations: 1415

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-3.130559	3.586890	-0.872778	0.3829
Goodwill$_{(t-1)}$	15.93798	1.361142	11.70927	0.0000
Government Stability	0.974780	0.440893	2.210921	0.0272

R-squared	0.103010	Adjusted R-squared	0.101739
S.E. of regression	31.73298	Durbin-Watson stat	0.398886

Finally, I control for the Government Stability variable. The results show that the relationship between Goodwill and FDI is positive and statistically significant at the highest level of significance 1% (p-value = 0.000). Government Stability is also significant at 5% level with positive $\gamma = 0.97$ versus $\beta = 15.94$ of Goodwill illustrating that government stability is, indeed, an FDI determinant albeit much less powerful, compared to Goodwill. The results indicate that the information in the Goodwill variable is not identical to or repeated in the Government Stability variable. The positive sign of the relationship between the Government Stability variable and FDI is consistent with the theory and previous studies: the more stable the government of the recipient country is, the more FDI it receives.

To sum up, Goodwill is consistently statistically significant at the highest level of significance of 1% in all of the regressions estimated; none of the other determinants affect its significance or explanatory, and indeed, predicting power (or the sign of the relationship) to explain FDI - its beta coefficient - is consistently large and hugely statistically significant. The majority of the FDI determinants tested in this study have the theoretically correct sign of the relationship consistent with the theory and previous studies, though some of them are not found to be statistically significant, e.g. GDP growth and Financial Risk. It is important to note, however, that the Durbin-Watson statistic consistently highlights that there is a residual autocorrelation problem in all the regressions,

which we are aware of but, nevertheless, we decided not to include the lags of FDI, as the main purpose of this model is not to explain FDI inflows as well as possible but to test whether the FDI determinants contain information identical to the one in Goodwill. In other words, these models test whether there is something unique in the information in the Goodwill variable and its ability to explain FDI. Note also that the R-square and adjusted R-square are approximately 10% which also points to the fact that some other factors influencing FDI flows exist and that lags of FDI have to be added to improve the explanatory dynamics in the model. The next regression model (4) will address these points but the current model (3) met the main purpose: testing the "uniqueness" of Goodwill as an FDI determinant and predictor, showing that Goodwill contains information that cannot be captured by any of the FDI determinants tested.

7.5 Regression model (4)

The next regression model uses all of the FDI determinants together, jointly. This will tell whether the marginal explanatory power of Goodwill remains after we control for all of these standard FDI determinants combined. I can also inspect the R-squared to see what is the contribution to explanatory power of a larger model, while assessing whether, when other FDI determinants are included into the model as independent variables, Goodwill remains significant. I also assess what happens if, in addition to the eight FDI determinants included, I also allow for fixed cross-section and fixed time-series effects, and finally also allow for lags of FDI (later in regression 4.2). Would Goodwill stay significant when all such restrictions are imposed or would its explanatory power

simply be absorbed and replaced by the gravity of all other explanatory factors: fixed effects, FDI determinants and FDI lags? I start from regression (4.1).

$$FDI_{it} = c + \alpha_i + \beta GW_{it\text{-}1} + \gamma_1 \textbf{Institutional Quality}_{it} + \gamma_2 \textbf{GDP growth}_{it} +$$
$$\gamma_3 \textbf{Political Risk}_{it} + \gamma_4 \textbf{Financial Risk}_{it} + \gamma_5 \textbf{Productivity}_{it} + \gamma_6 \textbf{Internal Conflict}_{it} +$$
$$\gamma_7 \textbf{External Conflict}_{it} + \gamma_8 \textbf{Government Stability}_{it} + \textbf{time effects} + \varepsilon_{it} \qquad (4.1)$$

Table 17. Model summary for regression 4.1

Regression (4.1) without fixed effects
Total pool (unbalanced) observations: 1337

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	38.42960	8.448014	4.548951	0.0000
Goodwill$_{(t\text{-}1)}$	8.417717	1.476101	5.702670	0.0000
Institutional Quality	-3.121727	0.872935	-3.576128	0.0004
GDP growth	0.688038	0.227361	3.026198	0.0025
Political Risk	-0.189301	0.225000	-0.841337	0.4003
Financial Risk	-0.737624	0.215491	-3.422987	0.0006
Productivity	0.000964	8.04E-05	11.98372	0.0000
Internal Conflict	1.059435	0.590420	1.794375	0.0730
External Conflict	-3.148393	0.696300	-4.521606	0.0000
Government Stability	0.711349	0.451974	1.573871	0.1158
R-squared	0.225796	Adjusted R-squared		0.220545
S.E. of regression	30.26873	Durbin-Watson stat		0.463604

I first estimated regression (4.1) without fixed effects (so α_i is not included and neither are the time effects). The results show that when all the FDI determinants are included into the model their behaviour changes: some of them such as Political Risk, become insignificant, whereas others, such as GDP growth and Financial Risk, which were earlier insignificant, in contrast, now become,

significant. Some of them, such as Institutional Quality, Financial Risk and External Conflict, also change the sign of their relationship with FDI. Clearly, when estimating a multiple regression, results will be different from simpler regressions because the covariance between regressors plays a role, and this is what happens. However, and most importantly for the purposes of this study, the only variable that is consistently statistically significant throughout the tests with a large t-statistic of 5.7 is Goodwill, which also displays the usual positive coefficient estimate. It is also clear that with the inclusion of all the determinants the R-squared, as well as adjusted R-squared, of the model has improved to 22.6% which means that the cumulative power of the regressors, to explain the variance in the dependent variable, has increased.

7.6 Time series and cross-sectional tests

I now also include country-fixed effects on top of the eight FDI determinants.

Table 18. Model summary for regression 4.1

Effects Specification: Cross-section fixed (dummy variables)
Total pool (unbalanced) observations: 1337

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-25.34640	11.05575	-2.292600	0.0220
Goodwill$_{(t-1)}$	11.45597	1.991947	5.751144	0.0000
Institutional Quality	0.533696	0.906506	0.588740	0.5561
GDP growth	0.186273	0.180070	1.034450	0.3011
Political Risk	0.296258	0.189952	1.559646	0.1191
Financial Risk	-0.159903	0.204313	-0.782638	0.4340
Productivity	0.002242	0.000224	10.02561	0.0000
Internal Conflict	-0.170452	0.556286	-0.306410	0.7593
External Conflict	-1.262811	0.628754	-2.008436	0.0448
Governmental Stability	-0.133781	0.356106	-0.375677	0.7072
R-squared	0.626801	Adjusted R-squared		0.603346
S.E. of regression	21.59259	Durbin-Watson stat		0.918987

With the inclusion of fixed cross-section effects, the R-squared of the regression increases from 22.6% to 62.7%, and the adjusted R-square from 22.1% to 60.3%. The Standard Error of the regression dropped from 30.1% to 21.6% indicating that country-specific factors do capture some important information that explains the variation in the amount of FDI the country receives. These are not captured by the country's FDI determinants and Goodwill. However, in this richer model only Goodwill, Productivity and External Conflict appear to be statistically significant. Nevertheless, we can also see that the Durbin-Watson statistic indicates the presence of residual serial correlation, which will need to be addressed eventually, by introducing lags of FDI.

Next I remove country-fixed effects and introduce time-fixed effects to see if they play a role.

Table 19. Model summary for regression 4.1

Effects Specification: Period fixed (dummy variables)
Total pool (unbalanced) observations: 1337

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	39.71679	8.953608	4.435842	0.0000
Goodwill$_{(t-1)}$	6.781994	1.494146	4.539043	0.0000
Institutional Quality	-2.329186	0.992672	-2.346380	0.0191
GDP growth	0.714710	0.244674	2.921072	0.0035
Political Risk	-0.306827	0.244909	-1.252820	0.2105
Financial Risk	-0.939544	0.224582	-4.183515	0.0000
Productivity	0.000965	8.44E-05	11.42753	0.0000
Internal Conflict	0.980557	0.609682	1.608308	0.1080
External Conflict	-2.950812	0.706893	-4.174341	0.0000
Government Stability	1.086150	0.575026	1.888872	0.0591
R-squared	0.252513	Adjusted R-squared		0.235343
S.E. of regression	29.98003	Durbin-Watson stat		0.460806

The impact of fixed period effects does not strongly affect the results of the regression (4.1): the R-squared has only increased by 3 % from 22.5 to 25.2%, the Standard Error of the regression improved by less than 1% (from 30.3% to 29.9%). The Durbin-Watson statistics remains very far from the desired value of 2. Overall, time-fixed effects appear to be less important than cross-section fixed effects, and they capture less information.

In terms of the sign of the relationship between Goodwill and FDI and its significance, the relationship remains very strong and positive, with a t-statistic of

4.53 and p-value of zero. Political Risk and Internal Conflict become insignificant compared to the results of the initial regression (4.1) without fixed effects. The rest of the variables remain rather similar. The next step is to allow for both country- and time-fixed effects, and the results are given in Table 20.

Table 20. Model summary for regression 4.1

Effects Specification: Cross-section fixed (dummy variables) Period fixed (dummy variables)
Total pool (unbalanced) observations: 1337

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-19.38558	13.41242	-1.445345	0.1486
Goodwill$_{(t-1)}$	8.129613	2.089382	3.890917	0.0001
Institutional Quality	0.030194	1.030360	0.029305	0.9766
GDP growth	0.161786	0.196500	0.823338	0.4105
Political Risk	0.314468	0.213042	1.476085	0.1402
Financial Risk	-0.277136	0.226750	-1.222207	0.2219
Productivity	0.001947	0.000300	6.483909	0.0000
Internal Conflict	0.198541	0.599346	0.331263	0.7405
External Conflict	-0.805696	0.658528	-1.223481	0.2214
Government Stability	-0.045503	0.486501	-0.093532	0.9255
R-squared	0.640756	Adjusted R-squared		0.611691
S.E. of regression	21.36424	Durbin-Watson stat		0.908891

Controlling for both country specific and time specific fixed effects changed the quality of the model and the predictive power of the majority of the variables quite dramatically. The quality of the model has improved impressively: R-squared rose from 22.6% to 64%, adjusted R-squared from 22% up to 61.2%, while Standard Error dropped from 30.3% to 21.4%. However, as is clear from the previous Table 14, this change is mainly due to the control for cross-section

effects. The model still has one problem, namely residual autocorrelation, indicated by a Durbin-Watson statistic well below 2.

With regards to the significance of the variables, controlling for both types of fixed effects raises the hurdle for statistical significance of all variables. Indeed, in this regression none of the variables is significant, except Productivity and Goodwill. This suggests that country-specific and year-specific factors explain quite a lot of FDI variation and capture information embedded in some of the standard FDI determinants. What seems remarkable, however, is that Goodwill remains strongly statistically significant and positive. The fact that Goodwill is not captured by fixed effects could only be explained by the fact that it not only has explanatory power but also predictive power over FDI inflows (i.e. Goodwill generates FDI); Goodwill for the year t will not only generate FDI inflows in the same year but high Goodwill in the current year for country A will generate high FDI inflows in the following year. Conversely, low Goodwill will have the opposite effect. This supports the theoretical concept that a country's Goodwill is a concept of futurity, it is an asset for the recipient country that generates future investment flows. In other words, if a country succeeds in generating highly positive Goodwill so investors are willing to buy shares in its domestic companies or make direct investments in the form of building plants and factories on its territory, then, this country will receive these FDI investments in the following year, which is quite reasonable as it takes time for the capital to flow from one country to another. Moreover, the statistical significance and a rather high coefficient of FDI inflows for the previous year shows that FDI has a cumulative

effect and that FDI in the current year will most likely generate FDI in the next 2 years.

The final model of the quantitative analysis estimates the model 4.1 (above) with the inclusion of lags of the dependent variable, which should mitigate the issue of the residual autocorrelation problem, thereby yielding a statistically satisfying empirical model in all respects:

$$\textbf{FDI}_{it} = \alpha_i + \beta\textbf{GW}_{it-1} + \gamma_1\textbf{FDI}_{it-1} + \gamma_2\textbf{FDI}_{it-2} + \gamma_3\textbf{Institutional Quality}_{it} + \gamma_4\textbf{GDP growth}_{it} + \gamma_5\textbf{Political Risk}_{it} + \gamma_6\textbf{Financial Risk}_{it} + \gamma_7\textbf{Productivity}_{it} + \gamma_8\textbf{Internal Conflict}_{it} + \gamma_9\textbf{External Conflict}_{it} + \gamma_{10}\textbf{Government Stability}_{it} + \textbf{time effects} + \varepsilon_{it}$$

$$\textbf{(4.2)}$$

Please note that since the model shows that only the first two lags of the dependent variable are needed in this case to resolve the problem of residual autocorrelation, only two lags are included into the model (4.2).

Table 21. Model summary for regression 4.2

Effects Specification: Cross-section fixed (dummy variables) Period fixed (dummy variables)

Total pool (unbalanced) observations: 1285

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-14.01856	11.74955	-1.193115	0.2331
Goodwill$_{(t-1)}$	5.509150	1.819596	3.027678	0.0025
FDI(-1)	0.534604	0.029386	18.19240	0.0000
FDI(-2)	0.071072	0.030267	2.348200	0.0190
Institutional Quality	0.085751	0.898201	0.095470	0.9240
GDP growth	0.223310	0.168422	1.325897	0.1851
Political Risk	0.333109	0.183057	1.819705	0.0691
Financial Risk	0.076289	0.198227	0.384858	0.7004
Productivity	0.000903	0.000267	3.383205	0.0007
Internal Conflict	-0.116542	0.522698	-0.222963	0.8236
External Conflict	-0.334757	0.577428	-0.579738	0.5622
Government Stability	-0.349535	0.418630	-0.834949	0.4039
R-squared	0.758721	Adjusted R-squared		0.738121
S.E. of regression	17.84639	Durbin-Watson stat		2.076373

The inclusion of the FDI lags for the two previous years has fully solved the problem of autocorrelation, as can be seen from the Durbin-Watson test, which is now close to 2.0. The Standard Error of the regression is now low, around 17. The R-squared has improved and reached 76%, confirming the importance of taking into account the cumulative effect (lagged dynamics) of FDI. These indicators also suggest that there are, of course, other factors (FDI determinants) influencing FDI inflows that are not included in this model, as

about 24% of FDI variation is not explained by the model; but 76% of the variation is, which is highly respectable.

Again, in this general model, the hurdle for statistical significance of any variable is high as the model controls for two types of fixed effects, lags of FDI, and all FDI determinants entered jointly. As a consequence, only the variables that really matter for FDI determination survive; the model suggests these variables are Goodwill and Productivity. Expressed another way, having done everything I could to probe the statistical significance of Goodwill and to check whether its information can be replicated by other FDI determinants, Goodwill has survived all tests and has remained very strongly significant in all of the regressions estimated here. In the final, richer model reported in Table 21, none of the other FDI determinants pass the hurdle of statistical significance I have set for them, with the exception of Productivity. Given that some of the previous smaller regressions showed that some of the FDI determinants were significant, these results imply that different FDI determinants often include overlapping or common information and hence, when included into a regression jointly, only some of them remain statistically significant. Moreover, it is very likely that Goodwill captures some of the information in other FDI determinants. Ultimately, with the exception of Productivity, which remains significant in the final regression model and hence adds some information for FDI not captured by Goodwill or other controls in the model, all other candidate FDI determinants appear to be statistically redundant. The importance of productivity is not novel and confirms previous research on FDI determination, but the importance of Goodwill for FDI determination, recorded here, is a novel and important stylized

fact. Finally, the coefficient estimate of about 5.5 on Goodwill can be interpreted as meaning that for an increase in Goodwill of 1% one can expect an increase of 5.5 billion US dollars in FDI inflows.[66]

At this point, given that only two independent variables are found to be statistically significantly different from zero and hence needed in the regression to explain FDI (in addition to the lags of FDI and the fixed effects), I also estimate a parsimonious regression which only includes the significant variables – namely Goodwill and Productivity – and I standardise the coefficients on these variables (by dividing them by their respective standard deviations) so that we can make a comparison about which one has a stronger impact on FDI inflows. Therefore the regression estimate involves fixed effects (both time and country), two lags of FDI, Goodwill and Productivity. The results are given in Table 22 below.

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[66] It is important to note that I also ran a number of other regressions which are not reported, to conserve space, and because they do not add to or change, qualitatively, the above results. For example, using Goodwill at time t rather than lagged Goodwill at time t-1 always shows that Goodwill is statistically significant, but it is of course more interesting to use Goodwill lagged because of the predictive interpretation that this allows. Also, I ran regressions using 2 or 3 of the regressors in various combinations, and in no case did this change the fact that goodwill is strongly statistically significant.

Table 22. Model summary

Effects Specification: Cross-section fixed (dummy variables) Period fixed (dummy variables)

Total pool (unbalanced) observations: 1388

Variable	Coefficient	Std. Error	t-Statistic	Prob.
Constant	-17.18257	9.165442	-1.874713	0.0611
Goodwill$_{(t-1)}$	2.455166	0.742860	3.305016	0.0010
FDI(-1)	0.553635	0.028000	19.77296	0.0000
FDI(-2)	0.429145	0.026524	16.17932	0.0000
Productivity	2.125527	1.048093	2.028994	0.0428
R-squared	0.750231	Adjusted R-squared		0.744378
S.E. of regression	17.85863	Durbin-Watson stat		2.078182

The results confirm that this parsimonious model is adequate in that the adjusted R-squared is slightly higher than the one reported in Table 21 (73.8% versus 74.4% respectively), suggesting that the other variables included in the more general regression reported in Table 21 can be dropped. Also, the Durbin-Watson statistics confirm that there is no residual autocorrelation. With standardised coefficients on Goodwill and Productivity, I can now compare the relative importance of these two variables as drivers of FDI inflows: Goodwill displays a higher estimated coefficient of about 2.45 compared to 2.12 for Productivity, although they are clearly not very different from each other. Overall, while Goodwill appears to be dominant driver of FDI inflows in this regression and also throughout the analysis carried out in this chapter, Productivity appears also to be very important.

7.7 Summary

On the basis of the results above I reject H_0 hypothesis that there is no relationship between Goodwill and FDI inflows and support, instead, the research hypothesis H_1 that there is a relationship between Goodwill and FDI inflows. The fact that the Goodwill variable tested was lagged by one year and found to be statistically significant illustrates that Goodwill is a property of futurity, having a possible causation effect: Goodwill not only explains but also predicts FDI, in the sense that the more Goodwill a country has in the current year the more FDI it will receive in the following year.

The various tests on the robustness of Goodwill (the ratio of Market Cap by GDP) show that the information captured by this variable cannot be captured by any other FDI determinants tested. The information in Goodwill cannot even be captured by fixed effects or lags of FDI, unlike other FDI determinants that become insignificant when such controls are introduced. All of this highlights the distinctiveness of Goodwill from other FDI determinants. This, perhaps, can be explained by the fact that Goodwill has predictive power over FDI inflows, unlike other determinants, and proves the theoretical idea that Goodwill is a concept of futurity; it is an asset for the recipient country that generates future investment inflows. In other words, if a country succeeds in generating positive Goodwill and investors are positive about the country, then this country will receive FDI in the following year, which is quite reasonable, as it takes time for capital to flow from one country to another, especially if it comes in the form of building plants, factories or shops.

CHAPTER 8. CONCLUSION

The literature on FDI determinants, based on academic research and analysis carried out by various policy institutions, including the United Nations, identifies a wide range of host country FDI determinants that should attract FDI. These determinants have implications for key policy choices, including accepting or establishing democracy or improving certain types of countries' infrastructure and macroeconomic policies. However, there are several examples of countries that have attracted or continue to attract large amounts of FDI even though they do not score highly in the ratings of standard FDI determinants suggested by this literature. Indeed, the menu of FDI determinants available is not able to explain much of the uneven allocation of FDI flows across the world. This requires us to think differently and consider alternative determinants of FDI and mechanisms to attract them. One of these alternative mechanisms, to which this PhD Thesis is devoted, is for a country to build and accumulate Goodwill – an intangible asset that is reflected in investors' positive perceptions about a country's earning capacity and relative stability. The obvious success stories that adopted this strategy include Indonesia, a country with an authoritarian regime and poor infrastructure which, nevertheless, has become one of the "MINT" countries and is perceived as having great potential for economic growth. Indonesia has benefitted from high levels of FDI in the last few years. China is another example of a country that has built huge Goodwill despite having an authoritarian regime and poor rule of law.

A country's reputation and trust of investors in the country's ability to deliver returns on their capital is an important asset which is able to attract investment flows into its economy. This is because trust and being positively regarded is fundamental in business; FDI is a long term investment requiring long term commitment. Since investors cannot foresee the future of a country with great accuracy, due to the many unforeseeable internal and external factors that may intervene and change the trajectory of a country's circumstances (e.g. international crisis, outbreak of civil or international war, change of the government, etc.), and since FDI is a long-term, largely irreversible type of capital, the investment decision-making process is largely based on trust and belief in the country's stable and prosperous future. Positive expectations of the country's future and its trustworthiness are important (if not decisive) factors for investors that drive current FDI flows across countries. Thus, if a country has a reputation for being or becoming relatively stable, has gained the trust of investors and has the basic prerequisites for positive economic changes in the future, such a country is most likely to stand out among its competitors in the race for FDI capital.

Positive perceptions and expectations held by investors about the country, a country's Goodwill, is the country's valuable intangible asset that raises its investment attractiveness, thus helping to gain more FDI than it would otherwise receive. National Goodwill consists of various factors (discussed in Section 5.3) which can be positively influenced and managed if certain methods and policies are applied. As the data demonstrates, Goodwill of a country can fluctuate over time, which is consistent with the theory that Goodwill is a changing attribute that

requires a constant upkeep in order to deliver results which will meet investors' expectations. It can be accumulated or improved, even for those countries that have negative Goodwill, that is, a bad reputation in the international investment community which results in the country being undervalued and receiving less FDI than it would be expected to receive, given its economic and other FDI indicators.

This Thesis tests, empirically, the power of Goodwill to influence FDI inflows into countries. For this reason it developed a simple method[67] that makes it possible to identify a country's Goodwill (or its "bad will" in some cases) and estimated it for a sample of 80 countries for a long period, of over 20 years, in order to establish if there is a relationship between Goodwill and FDI. The regression analysis allows to make several inferences and explore whether the underlying theoretical predictions of Goodwill driving and explaining FDI inflows have solid empirical evidence supporting their conceptual underpinnings. In addition, this study also tested whether Goodwill is different from other FDI determinants; the empirical results suggest this is the case as the Goodwill measure contains unique information that cannot be explained and captured by other, previously studied FDI determinants. In other words, Goodwill is a missing determinant in the prior extant literature on this subject.

The results from the various tests in the empirical analysis support the central theoretical prediction of the Goodwill Model: Goodwill is a determinant of FDI that not only explains FDI but also generates it. The fact that the Goodwill variable is always statistically significant in all regression models, estimated in

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The ratio of Market Cap to GDP

different model specifications, illustrates that Goodwill is clearly a robust FDI determinant. To establish whether there is a one-way causation effect (Goodwill drives FDI inflows and not vice versa), the Goodwill variable was lagged by one year and also found to be very statistically significant, having strong power to predict FDI. These results allow to draw the conclusion that the greater the Goodwill a country has in the current year, the more FDI it will receive in the following year.

In conclusion, investors' good will is an independent component of a country's intangible assets and cannot be captured and explained by other FDI determinants. Consistent with the basic intuition behind the Goodwill Model, countries that are positively perceived by the investment community receive more FDI than those that are not.

This PhD Thesis is the first study that attempts to understand the puzzle of uneven allocation of FDI across countries by looking at the valuation methods of goodwill. For this reason, it is likely and desirable that future research will build on these results to test their robustness and to provide other measures of Goodwill. Several aspects of the research can be built upon and improved, and warrant further research. Most importantly, while this study is based on a specific measure of Goodwill, it is clear that by its very nature Goodwill is unobservable; it comprises a number of intangible, invisible factors that have to do with investors' perceptions. It is hoped that further, more refined measures of Goodwill can be proposed and tested in future research. A deeper understanding of how to measure national Goodwill and its components can then be fed into policy discussions and strategies for countries desiring to receive investment capital.

In conclusion, the evidence reported in this Thesis illustrates the important role that Goodwill plays for FDI allocation across countries and over time. A logical next step is to refine our understanding of the specific factors forming a country's Goodwill and, more generally, what makes Goodwill vary both across countries and over time. These issues remain important avenues for further research.

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Appendix 1
Graph 1

Host country determinants of FDI
World Investment Report, 1998

Host country determinants
1. Policy framework • economic, political and social stability • rules regarding entry and operations • standards of treatment of foreign affiliates • policies on functioning and structure of markets (especially competition and M&A policies) • international agreements on FDI • privatization policy • trade policy (tariffs and NTBs) and coherence of FDI and trade policies • tax policy   I. Economic determinants   II. Business facilitation • investment promotion (including image-building and investment generating activities and investment-facilitation services) • hassle costs (related to corruption, administrative efficiency, etc.) • social amenities (bilingual schools, quality of life, etc) • after-investment services

Type of FDI classified by motives of TNCs	Principal economic determinants in host countries
A. Market-seeking	• market size and per capita income • market growth • access to regional and global markets • country-specific consumer preferences • structure of markets
B. Recourse/ asset-seeking	• raw materials • low-cost unskilled labour • skilled labour • technological, innovatory and other created assets (e.g. brand names), including as embodied in individuals, firms and clusters • physical infrastructure (ports, roads, power, telecommunication)
C. Efficiency-seeking	• cost of recourses and assets listed under B, adjusted for productivity for labour resources • other input costs, e.g. transport and communication costs to/from and within host economy and costs of other intermediate products • membership of a regional integration agreement conductive to the establishment of regional corporate networks

Appendix 2

The full list of the countries included into the sample

Country Name
Argentina
Australia
Austria
Azerbaijan
Bangladesh
Belgium
Bolivia
Brazil
Bulgaria
Canada
Chile
China
Colombia
Cote d'Ivoire
Czech Republic
Denmark
Dominican Republic
Ecuador
Egypt
El Salvador
Finland
France
Georgia
Germany
Ghana
Greece
Guatemala
Honduras
Hong Kong
Hungary
India
Indonesia
Iran, Islamic Rep.
Ireland
Israel
Italy
Japan
Jordan

Kazakhstan
Kenya
Kyrgyz Republic
Malawi
Malaysia
Mexico
Morocco
Nepal
Netherlands
Nigeria
Norway
Pakistan
Paraguay
Peru
Philippines
Poland
Portugal
Romania
Russian Federation
Saudi Arabia
Singapore
Slovak Republic
South Africa
South Korea
Spain
Sri Lanka
Sweden
Switzerland
Tanzania
Thailand
Tunisia
Turkey
Uganda
Ukraine
United Arab Emirates
United Kingdom
United States
Uzbekistan
Venezuela
Vietnam
Zambia
Zimbabwe