

# The Relationships Between National Intellectual Capital and Foreign Direct Investment

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**Abstract:** Foreign direct investment (FDI) has a significant influence on economic development, productivity and competitiveness in host countries. Policymakers are eager to attract FDI. With the importance of the knowledge economy, intellectual capital becomes a critical determinant of FDI location choice. Thus, the study tries to understand the relationships between national intellectual capital (NIC) and FDI in host countries and to compare the differences between developed countries and developing countries. The study hypothesizes that each component of NIC (human capital, market capital, process capital, renewal capital and financial capital) is positively related to FDI. Moreover, in developed countries, human capital and renewal capital has more influence on FDI while in developing countries, market capital and process capital have more influence on FDI. The study uses data from United Nations Conference on Trade and Development (UNCTAD) and Taiwan Intellectual Capital Research Center (TICRC). Because of data availability, the sample needs to be both included in the database of UNCTAD and TICRC during 2001 to 2018. The final sample consists of 59 countries which extends over the five continents. The study proceeds by using panel data, pooling 56 countries for the period from 2001 to 2019 after the Hausman test to determine whether there are fixed effects or random effects. A generalized least square (GLS) model is used to test the hypotheses with country-year data for FDI analysis. The results confirm that each dimension of NIC is positively related to inward FDI, indicating to the importance of NIC to attract inward FDI. In addition, national market capital, national process capital and national renewal capital have more influence on inward FDI in developing countries than in developed countries. Conclusions and practical suggestions are also provided.

**Keywords:** National intellectual capital. Foreign direct investment. Developed countries. Developing countries

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## 1. Introduction

For two decades, the global growth in foreign direct investment (FDI) has been remarkable (Villaaverde and Maza, 2015). Given FDI's significant impact on the host country's economic development and competitiveness, it has become a critical element of the economic strategies practiced by most countries (Villaverde and Maza, 2015). Determining the direction and destination of FDI has become a prominent research topic. Several frameworks and theories have been proposed to explain the determinants of FDI locations such as Product Life Cycle (Vernon, 1966), Internalization theory (Buckley & Casson, 1976), Ownership-Location-Internalization paradigm (Dunning, 1980), and institutional approach (North, 1990; Scott, 1995), etc., Based on Kim and Aguilera (2015), two perspectives exist on FDI activities: the economic tradition and institutional perspectives Among these several perspectives or theories, perspective of intellectual capital is neglected.

With the emergence of the knowledge economy, intellectual capital and intangible assets have been recognized as basic sources of wealth and national competitiveness (Lee, Lin and Lin, 2017). National intellectual capital (NIC) is important for creating national productivity and competitiveness (Edvinsson and Bounfour, 2004). It also facilitates economic growth, human development, and quality of life (Lin and Edvinsson, 2011; Lee, Lin and Lin, 2017). Foreign direct investment, which could influence the economy of a nation may be also influenced by the domestic intellectual capital.

Based on the OLI paradigm and institutional approach with the recognized importance of NIC, this study attempts to identify the determinants of FDI location choices from the perspective of NIC. The present study explores the national-level determinants of FDI based on NIC to understand which NIC component will attract FDI to the host country. Therefore, the research question is whether NIC in the host country attracts FDI. We hypothesize that all dimensions of NIC are positively related to FDI in host countries, although each dimension would facilitate FDI through different mechanisms. We hope that this study will provide a reference for policymakers facing fierce global competition. This study had two research questions: 1. Does the NIC in the host country help attract FDI? 2. Does each NIC component have different impacts on FDI in developing and developed countries? The study not only provides theoretical contributions to IB literature and intellectual capital literature by combining NIC and FDI together and finding the relationship between these two concepts

but also provide practical suggestions to policy makers in developing and developed countries by comparing the different effects of NIC in these two types of countries.

## **2. Literature review**

### **2.1 Locational determinants of FDI location choice**

Following Kim and Aguilera (2015), two perspectives exist on FDI activities: the economic tradition and institutional perspectives. The underlying assumption of the economic tradition perspective is that an MNC is eager to maximize returns on its rent-yielding proprietary assets in an imperfect world market (Kim and Aguilera, 2015). Extending internalization theory, the OLI paradigm proposes that MNC's location decisions are intertwined by the ownership, internalization, and location advantages of the host country (Dunning, 1980). According to the OLI paradigm, there are four major motives for FDI: market seeking, natural resource seeking, efficiency seeking, and strategic asset seeking. Market-seeking FDI aims to penetrate host countries' local markets. Natural resource-seeking FDI seeks and secures natural resources such as raw materials. Efficiency-seeking FDI attempts to pursue increasing efficiency, and it goes where the costs of production are lower. Strategic asset-seeking FDI focuses on attaining created assets such as technology, organizational abilities, and market information (Wadhwa and Reddy, 2011).

Another perspective comes from institutional theory. With the rising prominence of emerging economies, the integration of economic and sociological variants has made institutional theory one of the most robust topics in FDI research (Xu and Shenkar, 2002). There are two concepts in the institutional perspective: institutional quality and distance. Institutional theory argues that a nation's institutional framework influences its internal transactions, and thus, affects firm profitability (Khanna and Rivkin, 2001). Superior institutional quality in a country makes FDI more attractive, reduces investment risk, and facilitates processes involved in doing business (Uddin et al., 2019).

### **2.2 National intellectual capital**

National intellectual capital can be divided into five subcategories: human, market, process, renewal, and financial capital (Bontis, 2004; Lee, Lin and Lin, 2017). Human capital represents the knowledge, expertise, competencies, skills, intuition, wisdom, and ability of individuals in the country to achieve national tasks and goals, as well as national cultural values (Bontis, 2004; Lin and Edvinsson, 2011). Market capital refers to the assets in a nation's relationship with international markets (Lin and Edvinsson, 2011) and the capability to provide a desirable, competitive solution to its international clients' needs (Bontis, 2004). As a type of social intelligence in national intra/interrelationships, market capital entails legal relations, market mechanisms, and social networks (Lee, Lin and Lin, 2017). Process capital is the non-human reservoir of knowledge embodied in a nation's technological, information, and communication systems (Bontis, 2004) as well as the cooperation and flow of knowledge requiring structural intellectual assets (Lin and Edvinsson, 2011). Process capital is embedded in a country's science and technology, information, and communication systems that can be made tangible and materialized (Lee, Lin and Lin, 2017). Renewal capital refers to a nation's future intellectual wealth (Bontis, 2004). It is a nation's capability to increase its competitive advantage in future markets (Lin and Edvinsson, 2011). As a country's ability to create, sustain, and develop competitive strength, renewal capital includes investment in novel and innovative entrepreneurial activities (Lee, Lin and Lin, 2017). Financial capital is the financial capability of a nation and indicates its current national wealth (Lee, Lin and Lin, 2017). Financial capital refers to the ability to invest in other forms of capital and to build a foundation for the future.

### **2.3 Hypothesis development**

The relationship between national human capital and FDI has mostly been studied for all NIC dimensions. Human capital is recognized as a significant factor in inward FDI (Villaverde and Maza, 2014). By upgrading the skill level of the workforce, enhanced human resource development makes the investment environment attractive to foreign investors and increases incoming FDI (Majeed and Ahmad, 2008). Thus:

*Hypothesis 1: National human capital is positively related to the country's inward FDI.*

A desirable environment for international clients is an open culture, a global mindset, and tolerance of diversity (Lee, Lin and Lin, 2017). These factors imply a friendly and welcoming environment for MNCs, help to decrease the liabilities of foreignness, and increase host country attractiveness for MNC investment. Market capital also refers to investment and achievements in foreign relations as well as the social intelligence created by elements such as laws, market institutions, and social networks (Bontis, 2004). A higher level of market capital represents

stronger and more complete social institutions, such as corporate taxes and transparency, all of which decrease the liability of foreignness and facilitate FDI. Thus,

*Hypothesis 2: National market capital is positively related to the country's inward FDI.*

Process capital refers to organizational processes, activities, and related infrastructure for the creation, sharing, transmission, and dissemination of knowledge to contribute to individual knowledge worker productivity. National process capital can be seen as a country's infrastructure and institutions that create, share, store, transfer, and disseminate knowledge. From the perspective of institutional theory, which posits that the quality of institutions influences the location of FDI, countries with higher levels of process capital are more likely to become the destination of FDI because of their strong institutions. Thus,

*Hypothesis 3: National process capital is positively related to the country's inward FDI.*

Renewal capital is defined as a nation's future intellectual wealth and contains capabilities and actual investments in renewal and development to sustain competitive advantages (Bontis, 2004). All of these have drawn the interest of MNCs expanding abroad for resource exploration purposes or strategic asset seeking. Additionally, MNCs from developing countries are more prone to investing abroad for strategic asset-seeking motivations (Li, Li and Shapiro, 2012). They are more likely to be attracted to countries with abundant renewal capital, because of their high level of strategic assets. Thus,

*Hypothesis 4: National renewal capital is positively related to the country's inward FDI.*

Financial capital refers to a country's financial wealth. A higher level of financial capital represents greater national wealth and purchasing power. According to traditional economics, MNCs tend to be attracted by foreign market size with the motive of market-seeking. Past research provides much evidence about the impact of market seeking and factor endowment, such as the host country's market size (Emudainohwo, Boateng, Brahma and Ngwu, 2018). Thus,

*Hypothesis 5: National Financial capital is positively related to the country's inward FDI.*

Most advanced strategic assets and sophisticated customer knowledge are concentrated in developed countries (Dunning, 2006). Thus, developed countries have more strategic assets in terms of human capital and renewal capital. Due to the high quality of human and renewal capital that developed countries usually possess, MNCs are likely to invest in developed countries to seek strategic assets, rather than efficiency- or natural resource-seeking. Makino et al. (2002) propose that newly industrialized economic firms are more likely to invest in developed countries when they seek strategic assets in a host country. Hence, national human capital and renewed capital, which can be viewed as strategic assets in the host country, are especially important for attracting FDI in developed countries. Thus:

*Hypothesis 6: National human capital has more influence on FDI in developed countries compared to developing countries.*

*Hypothesis 7: National renewal capital has more influence on FDI in developed countries compared to developing countries.*

MNCs invest in developing countries because of cheap labor and abundant natural resources (Majeed and Ahmand, 2009). The motives for FDI in developing countries tend to be natural resource-seeking or efficiency-seeking. In addition to abundant natural resources and cheap labor, developing countries also share common characteristics, such as poor infrastructure, corruption at all government levels, political instability, government inefficiency, government intervention, and a lack of good governance ([https://en.wikipedia.org/wiki/Developing\\_country](https://en.wikipedia.org/wiki/Developing_country)). These characteristics not only increase FDI risk, but also increase its transaction costs in developing countries. Thus, MNCs are more likely to invest in host countries with a complete infrastructure, economic openness and freedom. Research also finds that weak infrastructure deters MNCs from investing in developing countries; therefore, developing countries are improving their infrastructure bases to attract FDI (Saini and Singhania, 2018). Hence, national market capital and national process capital, which refer to friendly relationships with international clients and the infrastructure in host countries, are more likely to attract FDI in developing countries. Thus,

*Hypothesis 8: National market capital has more influence on FDI in developing countries compared to developed countries.*

*Hypothesis 9: National process capital has more influence on FDI in developing countries compared to developed countries.*

### 3. Methodology

To examine the hypotheses, this study uses data from the United Nations Conference on Trade and Development (UNCTAD) and Taiwan Intellectual Capital Research Center (TICRC) at National Chengchi University, which have been used in several studies (Kostova, Beugelsdijk, Scott, Kunist, Chua., and Essen, 2019; Ståhle, Ståhle and Lin, 2015; Yoo and Reimann, 2017). The advantage of the databases is the wide coverage of FDI flows between country pairs and country-level variables. The study collected data on independent, dependent, and control variables from the two databases. Due to data availability, the sample needs to be included in both the UNCTAD and TICRC databases from 2001 to 2018. The final sample consisted of 59 countries that extend over five continents. This study follows Yoo and Reimann (2017), based on the United Nations classification, to classify developing and developed countries.

The independent variables in this study are the five NIC dimensions: national human capital, national market capital, national process capital, national renewal capital, and national financial capital. Following Ståhle, Ståhle, and Lin (2015), this study measures each capital type using 12 indicators, except for financial capital. Financial capital was measured by gross domestic product per capita (PPP). The TICRC collected panel data from 2001 to 2018 for 59 countries from the World Competitiveness Yearbook and other databases. The period of analysis is 2001-2018 for FDI data, with the independent and control variables lagged by one year.

The dependent variable in this study is the annual inward FDI flow in a specific country, measured in US dollars and obtained from the UNCTAD database. As with Kottaridi, Louloudi and Karkalakos (2019), this study employs the logarithm of FDI inflows to mitigate the effects of skewness on the data.

This study incorporates the log values of population and GDP growth to control for host country market size (Bailey and Li, 2015; Kottaridi, Louloudi and Karkalakos, 2019; Yoo and Reimann, 2017) as well as the ratio of ore and metal exports to the GDP of the host country (Ma, Xu, Zeng and Wang, 2020) to control for the motive of natural resource seeking.

This study uses ordinary least squares (OLS) regression models to test the hypotheses with country-year panel data, pooling 59 countries for the period from 2001 to 2018 after the Hausman test to determine whether there are fixed or random effects. To create interaction terms, the independent variables were mean-centered to avoid multicollinearity (Aiken and West, 1991).

**Table 1:** Descriptive table

	Mean	S.D.	1	2	3	4	5	6	7	8
FDI inflow	9.07	1.53								
Population	9.93	1.67	0.49**							
GDP growth	3.22	10.66	0.04	0.07*						
Ores and metals exporting	7.05	10.66	-0.08*	-0.05	0.04					
Human capital	6.71	0.91	0.09**	-0.46**	-0.30**	-0.15**				
Market capital	5.51	1.11	0.27**	-0.40**	0.02	-0.09**	0.57**			
Process capital	6.53	1.24	0.18**	-0.45**	-0.24**	-0.12**	0.83**	0.80**		
Renewal capital	3.95	1.55	0.27**	-0.26**	-0.18**	-0.20**	0.83**	0.74**	0.87**	
Financial capital	8.61	0.63	0.16**	-0.52**	-0.18**	-0.22**	0.68**	0.65**	0.81**	0.66**

**Table 2:** Regression model of direct effects

	1	2	3	4	5	6	7
Constant	4.77*** (18.87)	-2.22*** (-4.20)	-1.53*** (-4.50)	-2.01*** (-4.92)	1.81*** (6.47)	-12.60*** (-16.26)	-12.57*** (-13.85)
Ln Population	0.44*** (17.82)	0.62*** (24.28)	0.65*** (29.69)	0.67*** (27.79)	0.55*** (24.26)	0.77*** (31.54)	0.81*** (32.07)
GDP growth	-0.02 (-0.49)	0.06*** (4.39)	-0.02† (-1.87)	0.05*** (4.14)	0.03** (2.62)	0.03** (3.00)	0.00 (0.21)
Ores and metals exporting	-0.02* (-2.54)	0.00 (0.22)	-0.00 (-0.17)	0.00*** (0.22)	0.00 (0.93)	0.01*** (3.94)	0.01*** (4.06)
Human capital		0.73*** (14.64)					0.38*** (4.86)

	1	2	3	4	5	6	7
Market capital			0.76*** (23.05)				0.69*** (12.29)
Process capital				0.66*** (19.52)			-0.43*** (-5.19)
Renewal capital					0.44*** (17.34)		-0.05 (-0.96)
Financial Capital						1.61*** (23.22)	1.19*** (12.57)
Adjusted R <sup>2</sup>	0.28	0.41	0.54	0.48	0.45	0.54	0.61
F value	19.62***	32.57***	53.08***	43.36***	38.18***	53.60***	61.53***
Max VIF	<2	<2	<2	<2	<2	<2	11.24
t-statistics are in parenthesis; †, *, **, *** Significant at the 0.1, 0.05, 0.01, 0.001							

#### 4. Empirical results

Table 1 shows the descriptive statistics and correlation matrix of control variables, the five dimensions of NIC and the dependent variable, FDI inflow. Table 2 presents the results of OLS regression where FDI inflow is the dependent variable. Model 1 includes only control variables in the regression model, and thus preliminarily tests the effect of control variables on FDI inflow. H1, proposing that national human capital will be positively related to inward FDI, is supported ( $\beta=0.734$ ,  $p<0.001$ ), with an adjusted R<sup>2</sup> of 0.412 in Model 2. In Model 3, market capital is positive and significant at the 0.1 percent level ( $\beta=0.763$ ,  $p<0.001$ ) and adjusted R<sup>2</sup> is 0.536, thus supporting H2. H3 arguing that national process capital is positively related to inward FDI is supported with  $\beta=0.659$ ,  $p<0.001$ , and an overall adjusted R<sup>2</sup> of 0.484 in Model 4. H4 suggesting that national renewal capital will be positively related to inward FDI is supported in Model 5 with  $\beta=0.435$ ,  $p<0.001$ . H5 proposing that national financial capital will be positively related to inward FDI is also strongly supported in Model 6 ( $\beta=1.606$ ,  $p<0.001$ , adjusted R<sup>2</sup> =0.538).

**Table 3:** Regression model of moderating effects

	1	2	3	4
Constant	2.80*** (10.20)	-1.30 (-1.42)	2.22*** (8.60)	3.43*** (13.33)
Ln Population	0.62*** (23.51)	0.69*** (10.89)	0.69*** (27.30)	0.56*** (22.44)
GDP growth	0.05*** (3.85)	0.03*** (3.53)	0.04** (3.07)	0.03* (2.28)
Ores and metals exporting	0.00 (0.29)	0.01* (2.07)	0.00 (0.20)	0.01 (1.45)
Country type	-0.23* (-2.35)	0.50* (2.25)	-0.34*** (-3.82)	-0.07 (-0.79)
Human capital	0.78*** (13.74)			
Market capital		0.48*** (8.21)		
Process capital			0.72*** (19.73)	
Renewal capital				0.46*** (16.81)
HC*Country	-0.21† (-1.95)			
MC*Country		-0.49*** (-4.27)		
PC*Country			-0.360*** (-5.03)	
RC*Country				-0.15* (-2.57)
Adjusted R <sup>2</sup>	0.416	0.45	0.50	0.45***
F value	30.497***	31.68***	42.96***	35.46
Max VIF	<2	<2	<2	<2
t-statistics are in parenthesis; †, *, **, *** Significant at the 0.1, 0.05, 0.01, 0.001				

Table 3 shows the moderation effects of each national intellectual capital dimension on inward FDI and tests H6 to H9. H6 suggests that the positive relationship between human capital and inward FDI will be stronger in developed countries than in developing countries. This hypothesis is not supported ( $\beta=-0.212$ ,  $p<0.1$ ), with an adjusted R2 of 0.416 in Model 1. The coefficient is negative but not significant, indicating that human capital may not have significantly different effects on inward FDI in developing countries and developed countries. H7 argues that the positive relationship between renewal capital and inward FDI will be stronger in developed countries than in developing countries. This hypothesis is not supported because the coefficient for the interaction of renewal capital and inward FDI is significant but negative ( $\beta=-0.148$ ,  $p<0.05$ ) in Model 4. H8 predicts that market capital and inward FDI will be stronger in developing countries than in developed countries. This hypothesis is supported ( $\beta=-0.492$ ,  $p<0.001$ ), with an adjusted R2 of 0.452 in Model 2. H9 states that the positive links between process capital and inward FDI will be stronger in developing countries than in developed countries. This hypothesis is supported by the interaction coefficient in Model 3 which is negative and significant ( $\beta=-0.359$ ,  $p<0.001$ ) with an adjusted R2 of 0.504 in Table 3.

## 5. Discussion and conclusion

### 5.1 Discussion

The empirical results indicate that human, market, process, and financial capital are all positively related to inward FDI. Not surprisingly, human capital has always been considered a crucial factor in attracting FDI (Kottaridi, Louloudi and Karkalakos, 2019) and our results emphasize the importance of human capital. Additionally, human capital has a similar influence on inward FDI in both developed and developing countries. Human capital thus plays a crucial role in attracting inward FDI in all countries, and policymakers should emphasize increasing human capital.

Market and process capital have a positive influence on inward FDI. The results confirm the outcomes of several studies that argue that institutions attract inward FDI (such as, Sabir, Rafique and Abbas 2019; Abbas and El Mosallamy, 2016; Saini and Singhania, 2018). Moreover, market capital and process capital have more influence on inward FDI in developing countries than in developed countries. MNCs invest in developing countries mostly for large markets and natural resources rather than strategic assets (Saini and Singhania, 2018; Majeed and Ahmand, 2008). Compared to developed countries, developing countries with higher market and process capital tend to attract more attention and inward FDI. Therefore, it is important for developing countries to improve these two dimensions of the NIC to gain more inward FDI.

Renewal capital positively influences inward FDI. Interestingly, renewed capital has a greater influence on inward FDI in developing countries than in developed countries. Financial capital also has a positive relationship with inward FDI after controlling for the effects of population and economic growth. MNCs prefer to invest in destinations with large markets and higher potential growth (Li et al., 2018). Countries aiming to gain more inward FDI should increase their GDP and GDP per capita, which represent their national purchasing power.

### 5.2 Conclusion

This study finds that every dimension of intellectual capital has a positive influence on attracting FDI. Countries aiming to attract more inward FDI should focus on increasing the level of NIC. In addition, developing countries are not only preferred locations for MNC investment, but also have more advantages in increasing national intellectual capital to attract inward FDI. A higher level of NIC has more influence and draws more inward FDI in developing countries than in developed ones. Thus, policymakers in developing countries should emphasize increasing the level of national intellectual capital to attract the attention of MNCs and inward FDI.

This study has limitations that nevertheless provide for follow-up research in certain key directions. First, the measurement of NIC remains inconclusive, and several measurement models have been proposed. Further research should use other measures to capture NIC's different dimensions. Second, we attempted to reveal the different impacts of each NIC dimension on FDI. There are still some other possible impacts that need to be revealed. Future research should examine the relationship between each dimension and FDI.

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