CHAPTER 2
LITERATURE REVIEW

2.1 Literature review
The second chapter will consist about literature mainly focusing on the background and history of institutional theory and how it has been used in previous studies as well as how it has been applied by other researchers in their works. This chapter will also give information on FDI and what determines the FDI decision making on foreign countries based upon past literature by other researchers.

2.2 FDI
According to Kimura (2006), foreign direct investment (FDI) consists of 2 possible methods when an investor wants to invest in a new potential nation, the following passage below will give talk about the 2 methods:

1. Portfolio Investment: Financial investment that is performed in the capital market, an example of portfolio investment is purchasing securities like stocks on the stock market. Portfolio investment does not open the opportunity for jobs.

2. Direct Investment: These are mutual funds that are utilized to carry out service activities, procure devices or develop a production plant. These activities include purchasing land from either public or private landowners, excavating raw materials, harvesting agriculture, opening restaurants, bars and discotheques etc. These direct investment methods open up new jobs for locals and transfers management abilities (Kimura, F, 2006).
Foreign Direct Investment is carefully associated to international corporations such as a Multinational company (MNC). A multinational company is a company that operates in more than one nation, an example of an MNC is British petroleum, KFC, louis Vuitton etc. There are 2 primary qualities of an MNC, (a) how big is the company in terms of operations, usually an mnc is extremely large spreading its operations in many countries (b) its service operations are normally managed by its headquarters that is normally located at its country of origin. These multinational businesses are the primary force for the extension of rapid trade globalization. Generally, these multinational companies are international power houses that are capable and always interested in seeking financial chances in the world.

There are 3 primary intentions for an MNC to take interest into investing in other countries as FDI (kimura,2006), hence splitting up FDI into 3 classifications which are:

1. Market-seeking/ Horizontal FDI: This kind of FDI aim is to start a manufacturing plant or simply a factory to cater to the local market in the country of investment.
2. Resource-seeking/ Vertical FDI: This financial investment takes place when a company wished to get resource that is not offered in their origin nation, such as natural deposits, basic materials, or low-priced labor. This is usually done mostly in the production sector, such as in Vietnam, China and India where the accessibility of cheap labor is a prime factor for these kinds of FDI.
3. Efficiency-seeking FDI: These kind of FDI happens when a company derives gain from the centralization of business governance in a single location which will offer economies of scale and scope.

This type of FDI occurs for the business to able to do export-substituting or tariff-jumping. The factor for horizontal FDI is to much better serve a huge domestic market in a foreign nation by focusing production in that nation. This, a huge market size and market development of that nation is really essential.
2.3 FDI determinants

2.3.1 Market size

Market size can be specified as the variety of consumers who have a purchasing power in a potential market area. According to Resmini (2005), in a nation's economy, market size is typically evaluated by population, financial development, or nationwide earnings (Gross Domestic Profit per capita and development). According to previous analysis by past researchers, this is the primary factor of horizontal FDI, since financial investment tends to relocate to big establishing market where customers have acquiring power to make sure there are needs and will eventually increase financier's ROI. Huge market size likewise assists business to produce economies of scale, since it requires a huge market of specific size so that business can successfully make use of all company resources (Fountaura. M, 2007). Some research studies likewise support this discussion, such as Demirhan (2008), which specified there are substantial and favorable connection in between FDI and the marketplace size of a nation. GDP development likewise discovered to be among factor that may discuss a boost of FDI, however it has actually less importance compared to GDP.

A current example for this kind of FDI is Vietnam and India, which has the ability to bring in a great deal of FDI due to their capability to do production at low costs. Other nations like Vietnam and India just recently are likewise able to bring in FDI due to the fact that it is a transitioning nation from less established to establishing economies, which tend to influence FDI because of its inexpensive labor (Bevan and Eastrin, 2000).

2.3.2 Inflation

Inflation is specified as a sign in which the basic price level increases constantly (Nanga, 2001). Based upon this meaning, the boost in general price levels that happen just when, cannot be stated to be inflation. There are 3 parts that should be fulfilled in order to state that inflation has actually happened, the elements are:

a) There is a propensity for rates to increase, which implies that the rate Level that might take place at a particular time increases or falls compared to previously
still reveals the propensity boost.
b) That the boost in the price level happens continually, which implies it does not happen at any provided time, however on total level.
c) That the price level described here is the basic price level, which implies the price level experienced a boost not just in one or numerous products, but for the cost of products in general.

A cost boost in inflation can be determined utilizing a price index. There are a number of price indices that can be utilized to determine the rate of inflation, to name a few:
a) Consumer price index (CPI), an index utilized to determine home expenses or costs in purchasing a variety of products for needs of life.
b) Manufacturer of price index (PPI), an index that focuses more on big trade such as the cost of basic materials, basic materials, or semi-finished products.
c) Gross National Item (GNP) deflator, is a kind of index that is various from the CPI and PPI, where this index consists of the variety of products and services consisted of in the GNP estimation.

High inflation makes the cost of services and items end up being costly so that production input expenses increase. On the other hand, the inflation rate shows the stability of a nation's macroeconomic conditions. Getting more steady macroeconomic conditions of a nation, can lower unpredictability financial investment and increase financier self-confidence. This is likewise in line with what Mishkin (2001) stated, that the inflation rate can indirectly impact financial investment. Costs will increase consisting of elements of production when inflation happens. When aspect costs increase, business tend to lower their financial investment, which in turn triggers financial investment to decrease.
2.3.3 Rates of Interest

The rate of interest mentions the amount of payment for loans or other financial investments, above the payment arrangement, which is revealed in yearly portions (Mankiw, 2008). Rates of interest impact a person's choice on the option to invest in a particular nation or not. Just like other costs, the rates of interest is figured out by the interaction in between need and supply. For individuals who obtain cash, interest is a great paid to take in earnings prior to it is gotten, whereas for individuals who offer loans, interest is a benefit for postponing present intake up until the time of the receivable. The functions of rate of interest are as follows:

a) As a tourist attraction for savers both organizations, people and organizations that have more funds to invest their funds. Extreme funds in the hands of the neighborhood will in turn impact the development of an economy.

b) Can be utilized as a control tool for the federal government versus direct funds or financial investment in economic sectors. In case the federal government offers assistance to an economic sector, the federal government can make a lower rates of interest policy for the economic sector.

c) Can be utilized as a financial policy tool in order to manage the need and supply of cash distributing in an economy.

d) The federal government can control the rate of interest to increase production, as a result the rates of interest can be utilized to manage the inflation rate. This methods that the federal government can manage the flow of cash in an economy.

Rates of interest affects a business in 2 possible methods when practicing FDI, the following describes the methods:

a) Since interest is an expense, the greater the rates of interest the higher the company costs will be.

b) Rates of interest impact the level of financial activity so that it impacts business revenues.
Rates of interest are divided into 2, particularly small rates of interest and genuine rates of interest. The small rates of interest is the ratio in between the quantity of cash repaid to the amount of cash obtained, while the genuine rates of interest is the ratio of the buying power of cash paid to the acquiring power of the quantity of cash obtained, or the distinction in between the small interest rates and the inflation rate in the duration (Blonigen . B, 2005).

For financiers, the recommendation for conducting FDI is to take into considerations of interest rates. The high level of genuine interest rates will trigger high capital expenses so as to make the level of financial investment decrease. According to classical economic experts, the relationship in between interest rates and financial investment is unfavorable.

2.3.4 fluctuating currency

Currency exchange rate is the cost of the foreign currency compared to domestic currency (Zhang.Y, 2018). The boost in the currency exchange rate (currency exchange rate) of the domestic currency is called gratitude of the currency (foreign currency is less expensive; this implies that the worth of foreign currency in the nation boosts). A decline in the currency exchange rate (currency exchange rate) is called domestic currency devaluation (foreign currency ends up being more pricey, which suggests that the domestic currency is decreasing). The currency exchange rate or likewise called the currency exchange rate in different deals or buying and selling forex, is understood to have 4 types, specifically:

1. Offering rate, which is the rate identified by a bank for certain foreign exchange sales at particular times.
2. Middle rate, which is the rate in between the selling rate and the purchasing rate of forex versus the nationwide currency, which is figured out by the Bank Central at a particular time.
3. Purchasing rate, which is the rate figured out by a bank for certain foreign currency purchases at particular times.
4. Flat rate, which is the currency exchange rate that applies to offering and purchasing mayhem bank sale and purchase deals, in which the promo and other expenses have actually
been taken into consideration.

There is argument that weaker genuine currency exchange rate may increase vertical FDI since business will have the ability to quickly buy centers and boost production there and offer it to other nations. A more recent research study by Lily (2013) reveals that the gratitude, not devaluation of a host nation currency, is the one that will increase FDI inflows. Their research study likewise reveal that excessive change is unfavorable for foreign investors that wished to invest for a long period of time in a host nation.

The interest rate specifies the level of payment for loans or other financial investments, above the payment contract, which is revealed in yearly portions (Mankiw, 2008). Interest rates are likewise a rate that links the present with the future, as with other costs, the interest rate is figured out by the interaction in between need and supply.

The high level of genuine interest rates will trigger high capital expenses so as to make the level of financial investment decrease. The boost in the exchange rate (exchange rate) of the domestic currency is known as gratitude of the currency (foreign currency is more affordable; this implies that the worth of foreign currency in the nation boosts). A reduction in the exchange rate (exchange rate) is called domestic currency devaluation (foreign currency ends up being more costly, which indicates that the domestic currency is decreasing).

### 2.4 Institutional theory

Institutional theory is a theory that was first introduced in an article titled “The Iron Cage Revisited: Institutional Isomorphism and Collective Rationality in. Organizational Fields” by Paul J. DiMaggio & Walter W. Powell (1983). this theory at first was based on a philosophy that was initiated by Berger & Luckman (1967) and then was restructured by sociologists DiMaggio and Walter. Institutional theory has been revised by several sociologists after the coming years of DiMaggio and Powell’s article, other sociologists have their own views on institutional theory as well as their own definitions. According to Scott (2005) Institutional theory is the study of the processes and functions by which structures, schemas, rules, and routines become established as authoritative guidelines for social behavior. It asks how such systems come into existence, how they diffuse, and what role they play in supplying stability and
meaning to social behavior (Scott, 2005). A more simplified explanation of institutional theory is explained by DiMaggio and Powell (1983) as introduced earlier, institutional theory is basically a theory where companies and organizations who operate in the same industry will follow each other and eventually become the same over time. Institutional theory has been enhanced from a very early age to specify and observe the bigger scope of concerns connected to frameworks and also social actions.

Zucker (1987) Institutional theory derives of two defining characteristics that is bound by the theoretical proceedings for organizations to obtain a more institutional behavior through institutionalization (a) a rule-like, social reality high quality of the pattern of organized action (exterior), and also (b) an embedding in formal frameworks, such as official facets of companies that are not linked to certain actors or situations (non-personal/purpose) (Zucker, 1987). Institutional theory is established based upon social structure, nonetheless, the source of pressures cannot be seen plainly. Generally, in a company, high-level monitoring would certainly be taken into consideration to hold one of the most effective forces in shaping the company framework; however further research is needed to define the forces of the source.

Companies that follow each other to obtain the same goals are following a process known as homogeneity and the best concept to define this process is institutional isomorphism. To understand the concept and ideology of institutional isomorphism, one should thoroughly understand what isomorphism means, isomorphism is an influencing process that forces one body in a population to impersonate other body’s that face the same conditions of a specific environmental condition (Hawley. A, 1968). In an institutional point of view of isomorphism is a phenomenon where organizations will mimic each other not only for the gain of customers and resources but more towards the gain of political power and institutional legitimacy due to the pressure of other forces of politics and ceremony, this concept is a useful tool for understanding a country’s politics that gives a significance to a much more modern organizational life (Dimaggio.powell,1983). Watts and Mead (2005) study emphasis on the theoretical structure for benchmarking utilizing institutional theory and also discover institutional isomorphism which has actually come to be one of the most common for researchers to link judgment conformity with the problem they analyze by using institutional theory.
Institutional isomorphism derives of 3 mechanisms of isomorphic change as depicted from figure 2.0. the list bellow will give an explanation of the 3 mechanisms:

1. Coercive isomorphism: formal and informal tensions forced upon organizations by other organizations upon which they are dependable and rely on cultural expectations within the society which organizations function on (DiMaggio,1983). Actors that pressure in Coercive isomorphism are rules, laws and sanctions. DiMaggio (1983) gives A real-life example of this type of isomorphism manufacturers employ new pollution control technologies to conform towards environmental regulation to meet government rules and regulations.

2. Normative isomorphism: DiMaggio and Powell (1983) explained that pressure that is driven by professionalism and the introduction of 'legitimated expert practices' that lead to pressure for organizations to endure, companies might take on the methods required to conform that are imposed by professionals, caravella (2011) gives an example of this isomorphism as the authors example are instances of normative pressures are expert
networks or boards, at work socializing and also networking, training of workers and qualification processes recognized by expert bodies.

3. Mimetic isomorphism: The last institutional pressure illustrated by DiMaggio and Powell (1983) depicts uncertainty as an effective tool that requires imitation. This stress occurs in circumstances of uncertainty in which firms might take on referenced practices of other companies, markets or countries, reconstructing themselves on such behaviors. Its actors are innovation visibility by mimicking other bodies of institutional practices. DiMaggio (1983) supports the definition by providing an elaborate example as the initiative of Japan's modernizers during the late 19th century to adopt new governmental ways on apparently successful western models, Therefore, the royal federal government of Japan sent its police officers to research the courts, Military, as well as police in France, the Navy and also postal system in Great Britain, and banking as well as art education and learning in the United States.

The view and outlook of institutional theory mentioned on Amneta and Ramsey (2010) research study is argued with Chen and Robert (2010) as well as Scott (2005) monitoring that social habits has restricted the framework and also preserves the long-lasting stabilization of the company. Moreover, the understanding amongst the institutional concept could be made use of in numerous means, however, the typical understanding of the concept could be specified during the early stage of advancement of a business structure that produces a pattern based upon the normative as well as related systems to achieve established objectives (Scott, 2005).

The institutional theory concentrates on the organization in between as well as companies, specifically the stability as well as survival or organizations (Chen & Roberts, 2010). It focuses strongly that organizations can incorporate institutionalized norms and also guidelines to obtain stability and boost survival prospects. Institutional theory gives an extensive relation towards the connection between institutions and external factors that give tension on why organizations behave in a certain way in a specific environment based on behavioral core values, Institutional theory is used in this research paper to help give an explanation to define Indonesia’s business environment in multiple stand points.
2.5 Institutional theory applied on corruption

Shelfier and Vishny (1993) define corruption as the misuse of higher power for exclusive gain. Corruption is dishonest habits by those ready of power, such as supervisors or government authorities. Author Luo (2005) defines corruption as an unethical exchange of resources or practices involving the usage or misuse of public or cumulative services for personal gain.

Corruptions can come in many forms and it’s not always about “under-the-table transactions”, according to Heywood (2015) Corruption can consist of offering or approving allurements or unacceptable presents, double-dealing, controlling elections, diverting funds, money laundering, and also ripping off investors. Shelfier (1983) provides an example of act of corruption where for instance, government officials frequently gather under the table payments for offering permits as well as licenses, for offering easy flow with customs, or for derailing the entrance of competitors. Institutional theory can be used to explain corruption but before we get in that topic, we must first understand why corruption occurs. Corruption exists as weak task and institutional atmosphere that the representative has the ability to move his allegiance, corruption occurs because solid syndicate powers and control, info crookedness, absence of transparency as well as institutional intricacy permits the representative to exploit possibilities to go full potential on their very own interests and this is how corruption is allowed to be present. Institutional theory makes use of country as well as federal government institutional features, such as pre-existing policy of legislation, well-defined anti-corruption standards, and also independent anti-corruption establishments with enforcement powers, to explain corruption. Institutional theory generates the social context and also provides a taxonomy for comprehending just how corruption could end up being entrenched in organizations and also in society, in spite of the presence of an anti-corruption structure (Luo, 2005). Institutional theory considers that corruption affects the character, layout and transparency of the political system and also its institutions. At the same time, it recognizes that the partnership in between corruption, institutions, political systems, society as well as gender is very complex (Debski, 2018; Stensöta, Wängnerud, Svensson, 2015). Tolbert and Zucker (1996) discussed that based upon people’ interests, people would accept and follow social standards unquestioningly, with no vital reflection or resistance. Corrupt environment would lead
people to act corruptly as they considered it as a typical standard. Luo (2005) discovered that uncertain guidelines supply chances for government officials to take part in corrupt practices and make use of weak points of these guidelines. Fairness is referred to as guidelines that can be imposed and carried out relatively. Intricacy, on the other hand is a system of guidelines and sociocultural environments that are tough to comprehend, consequently, activates individuals to devote corrupt practices (Luo, 2005; Pillay and Kluvers, 2014).

Pillay and Kluvers (2014) supplied substantial evidence and proof of corruption at public industry organizations in South Africa which is an autonomous and an emerging nation. The authors managed to carry on defining corruption at an institutional level by including Luo's Version of institutional theory in their research resulting to conclude that institutional theory can help in giving an insight on how corruption can be incorporated in an organization.

Sudibyo (2015) conducted a research on identifying corruption in Indonesia and china in an organization level and concluded that Institutional theory can be used to describe the events of corruption at the organizational degree by stating the external pressures that causes corruption.

2.6 Institutional theory applied on nepotism

Nepotism is a practice and a type of favoritism revealed to colleagues as well as relatives, a more descriptive explanation on Nepotism is the act of misusing one’s power or main placement to offer a work or a support to a member of the family while neglecting their merit as well as credentials. (McLaughlin,1986) .Nepotism is seen as a form of corruption therefore nepotism is illegal in the public sector in some countries and therefore Nepotism is widespread in establishing nations where it affects and shapes organizational behaviors and service transactions (Hagen , 1978) Nepotism occurs where decisions are bound to be made derived by particularistic precepts of social range and reciprocity as well as the anticipated decision standards are utilitarian as well as universalistic. It indicates that tribal and peasant standards of in-group solidarity bypass the principles of the contemporary, industrial kind of institutions, which are either not accounted for, minimized or damaged. Nepotism occurs everywhere in the world, if it’s from a developed nation all the way to an emerging nation, it occurs from small family businesses to big MNC’s. Kim (2021) provided an example of a big case of nepotism as he said the global South Korean magnate Samsung,
which, considering that inception, was passed down from father to son. Samsung’s company eco at the time, Lee Jae-yong, specified that the recent corruption rumors that have actually engulfed his business because of the nepotistic method the firm had taken on over the decades.

Institutional theory can furthermore give an insight on nepotism. In a research paper titled “nepotism in an Arab world, an institutional theory perspective” written by authors Yusuf M, Sidandi and Jon Thornberry explain nepotism in the Arab world in an institutional theory perspective where they use Scott (2008) version of institutional theory and incorporate the 3 pillars. Sidandi and thornberry argue that legislation being an external pressure isn’t a significant factor in the diffusion of the institutional entrepreneurs as they do not anticipate regulative influence that would suppress nepotism. "Coercive pressures" (Scott, 2005) originate from MNCs where the HQ forces branches to follow a specific code of conduct (Guler, Guillen, Macpherson, 2002), however this will just encompass subsidiaries and not distribute to other companies. In a normative (referring to the normative isomorphism) context, Bamett & Kellermanns suggest that firms with some family influence might have a possible positive effect on firm efficiency if they have a "helping with family impact," a context where Human Resources aims to ensure fairness towards members outside of the family. While specific practices will still "consist of integrated benefits for household members" (Bamett & Kellermanns, 2006), they would likewise consist of mechanisms that secure the interest of non-family supervisors and employees. Non-family workers in a firm might allow themselves to accept nepotistic practices in succession preparation when they realize that the previous worker has actually taken interest in developing the chosen successor in regard to management skills and understanding transfer, both relevant to the presumed position (Cabrera-Suárez, 2005). Sidandi and thornberry explain that normative pressures in the Arab parts of the region is associated with efforts by international non-profit companies and capability building platforms for that reason institutions have actually embarked on initiatives that not just serve the needs of large companies, but more notably to the region, address problems of proper management for family-run startups. Guides and emails have been provided, forums have been made to talk about nepotistic practices and how to overcome them, and best practices have actually been reported to encourage a culture of reasonable employment (Sidandi and thornberry & 2006).
2.7 Conceptual framework

Figure 2.2: Conceptual framework

- Market size
- Rate of interests
- Inflation
- Exchange rate depreciation

Figure 2.2 is a diagram that depicts the main factors which affect FDI. Corruption, interest rates, inflation and exchange rate depreciation are some of the main reasons suggested by researchers that foreign investors take into consideration when deciding to invest in a particular country or not. There are many theories to explain FDI, but the author selects institutional Theory institutional theory can explain why these factors persist in a nation in a more environmental scenario, institutional theory explores the core behaviors and actors that affect or cause the situation of a specific nations business environment. In this research paper the authors main focus will be about Indonesia’s foreign business environment.

2.8 Institutional theory on FDI determinants

A foreign direct financial investment (FDI) is an investment made by a foreign firm or person in one nation into company interests situated in another nation usually occurs when a foreign investor practices business operation outside of the investors country of origin or acquires foreign company securities such as assets in a foreign business. Institutional theory can help explain determinants of FDI. Trevino, L. J., Thomas, D. E., & Cullen, J. (2008) state in their work that 7 institutional characteristics, particularly the academic system, political risk, privatization, tax reform, trade reform, bilateral investment treaties (BITs) and financial account liberalization that might impact
the possibility of inward FDI of a nation, the researchers also provided empirical evidence that the
constructs of Scott’s (1995) 3 pillars of institutional theory are intangible forces helped to understand factors that affect FDI focuses less on regulations lead to greater levels of inward FDI of a nation. Böckem, S., & Tuschke, A. (2010) research study derives that expanding degree of unpredictability enlarges a firm's propensity to participate in mimetic behavior towards FDI (DiMaggio & Powell, 1983). Oliver (1991) derives that the institutional point of view to put forward that firms can react differently to the exact same institutional pressures with measures ranging from consent or compromise, to avoidance, control and even straight-out defiance. Francis, J., Zheng, C., & Mukherji, A. (2009) argue that companies react precisely plus differentially to exterior impacts based upon the roots of institutional tension, the severity of the pressure put in, and their own prior experience concerning with prior pressures when considering FDI.