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Examining the Impact of Foreign Direct Investment on Domestic Firm Innovation in Vietnam

Huynh Thi Ngoc Hien, Doan Thi Thu Uyen*
International University, Vietnam National University Ho Chi Minh City, Vietnam

KEYWORDS

Firm innovation, foreign direct investment, product innovation, process innovation, research and development.

ABSTRACT

The effect of foreign direct investment (FDI) on domestic firm innovation in Vietnam is aimed to explore by utilizing cross-sectional data published by the World Bank Enterprise Survey in 2023. Firm-level data are analyzed using ordinary least squares (OLS) regression and robust standard errors. The findings show that foreign direct investment has a significant negative impact on local firm innovation, which is measured by process innovation, product innovation, and research and development (R&D) activities. Other firm-related factors, such as firm sales, implementation of formal training, top managers' working experience, and presence of informal competition, have also been found to be positively correlated with domestic firm innovation. The moderating effects of formal training for employees and the presence of informal competition show that both these factors exert a negative influence on the connection of FDI and domestic firm innovation.

1. Introduction

Foreign Direct Investment (FDI) flows and trade liberalization are regarded as essential components of globalization. FDI provides the transfer of foreign enterprises' resources to domestic constructions, technology, managerial abilities, and organizations, emerging as a critical engine for prosperity and globalization in the 21st century. Vietnam, is reliant on these, have experienced significant economic development in several recent decades. Theoretically, FDI is frequently associated with positive spillover effects, in which foreign businesses bring advanced technologies, skills, and managerial techniques to host nations, which can spill over to domestic firms. As foreign direct investment (FDI) continues to expand in Vietnam across several industries, it is vital to assess how this injection of cash has benefited Vietnamese enterprises' innovative potential. Employing company-level data gathered from the World Bank Enterprise Survey (2023), the purpose is to determine what effects of FDI flows bring about towards local firm innovation in Vietnamese business landscapes.

The FSA/CSA theory mentions different findings of innovation outcomes, which are determined by how MNE's Firm-Specific Advantages (FSA) combine with host nation's Country-Specific Advantages (CSA) (Rugman, 2010). When both FSAs and CSAs are strong, innovation performance is more likely and restricted if weak elements are found in either part. Then, it can result in a variety of effects of FDI on domestic firm innovation observed across different contexts.

In the midst of Vietnamese economic expansion, innovation capability, particularly technological adoption by domestic enterprises, has gained greater

*Corresponding author. Email: *doanthuuyen134@gmail.com*
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recognition due to its motivations for productivity improvement. Furthermore, the extent to which FDI encourages domestic firms to innovate depends on several factors. Lasrado (2019) specifies some of these factors as the sectoral composition of FDI, the technological gap between the foreign and local firms, the capabilities of adapting of the local firms, and the spillover effects. Therefore, this study firstly assesses whether the impact of FDI on domestic firm innovation, including the development or introduction of products, services, advancement or creation of processes, and investment in research and development (R&D) activities. Secondly, the study aims at investigating the moderating effects of formal training and presence of informal competition on the relationship between FDI and firm innovation. Furthermore, the study also considers the role of firm-specific characteristics such as business size, firm sales, firm age, export, formal training, top managers' working experience as control variables which foster firm innovation.

2. Literature review

2.1. Concepts

2.1.1. Foreign direct investment

According to IMF Balance of Payments Manual (1977), Foreign Direct Investment (FDI) is a transnational investment undertaken to gain a durable interest in a business dwelling in a different economy than that of the investors. It represents the goal of obtaining a meaningful role in the enterprise's management from direct investors. Consequently, FDI is often associated with lasting relationships.

Foreign direct investment (FDI) flows serve as a critical function in globalization by facilitating direct, stable, and profound connections between countries. Moreover, it encourages the movement of expertise and technology between economies, enhancing the competitiveness of both the recipient and the investor country. Additionally, it facilitates the host economy to expand its product offerings in marketplaces worldwide. As a result, FDI promotes the growth of global trade. Plenty of countries throughout the globe have demonstrated their commitment to attracting FDI since it has a remarkable beneficial impact on the host countries. However, the advantages vary among countries, making accurate measurement difficult. It is critical to note that FDI has its own disadvantages and can become detrimental if governments count extensively on it.

2.1.2. Firm innovation

Firm innovation is a vital aspect in promoting corporate competitiveness and success, and its definition has varied over time based on numerous ideas. Joseph Schumpeter's theory of innovation is fundamental, positing innovation as the driver of prosperity through the process of inventive construction. Schumpeter argued that firms innovate by introducing new products, processes, or business models, thereby displacing outdated practices and technologies. This view emphasizes the firm's role as a driver of technological change, leading to broader economic development. Specifically, it is also defined that there are five elements of innovation, which are new goods, manufacturing processes, new marketplace, new sources of supply, and new organizational structures (Schumpeter, 1934).

2.2. Hypothesis development

2.2.1. Foreign direct investment and firm innovation

Over the period of 15 years in India, the same result with negative influence of FDI on innovation is also found by Majumdar & Shaw, which means this is not the best approach for nation's firms to internalize the knowledge spillover (2023). However, its impact on domestic firm innovation is suggested to hinder local innovation capacities, especially in developing economies like Vietnam. Based on a strong foundation of literature, especially in Vietnamese context, this following hypothesis is proposed.

H1: Foreign direct investment (FDI) has a negative impact on domestic firm innovation in Vietnam.

2.2.2. Formal training and firm innovation

Training will bring about additional knowledge and capability among employees, generating an innovative working environment for developing new goods or services. Companies that practice training are further involved in process innovation, imparting the requisite expertise to their employees on new technologies and new operational processes. Adaptation forms critical aspects for innovation of process, which turns out into increased efficiency at operations and cost savings.

Formal training upgrades the capabilities and skills of employees, which, in turn, will increase the absorptive capacity of the firm so that the firm might make better use of the technologies, processes, and competence that have been transferred to it through foreign investors. There is a study by Rao et al. (2024) arguing that human capital (like training and skill development) is a very important moderator that actualizes the beneficial influence of FDI on innovation, by enhancing the competence of firms to absorb and employ external know-how. However, while formal training is generally considered a positive determinant of firm innovation, it can also negatively moderate this relationship under specific circumstances. Formal

training may limit creativity by reinforcing inflexible processes. And when incorporating the innovative approaches or technologies brought by foreign sources, employees relying on standardized training programs may struggle. Besides, other allocation of resources, such as for R&D investment, might be fewer due to these training activities. Therefore, this study proposes.

H2: Firms that provide formal training have a positive impact on domestic firm innovation in Vietnam.

H3: Formal training has a negative moderating effect on the relationship between FDI and domestic firm innovation in Vietnam.

2.2.3. The presence of informal competition and firm innovation

The correlation between rivalry from informal firms and domestic firm innovation has recorded significant findings recently. Informal firms, prevalent in many emerging economies, often operate outside regulatory frameworks, enabling them to reduce costs. This creates an unfair playing field, posing challenges for formal firms striving to maintain market share and profitability. The impact of such rivalry on the innovation outcomes performed of formal companies is complex and multifaceted. In this study, the presence of informal competition is assessed to be the threats that top managers taking the survey recognize from unofficial components.

The impact of competition towards informal companies has been studied on the moderating effect of formal firm strategies on its performance, especially in terms of new product advancement (McCann and Bahl, 2017). The authors use econometric models such as hierarchical linear modeling (HLM) to test the moderating outcomes of the competition on the link and introduce the concept of informal competition as a new explanatory variable. Moreover, this undesirable existence may hinder FDI into host nations due to the investors' expectations of Vietnamese economic or policies. Besides, R&D or innovation activities can be restricted as the investment in these items is considered to not bring about significant improvement when recognizing challenges from the presence of informal competition. Then, following hypotheses related to competition are posed.

H4: The presence of informal competition has a positive impact on domestic firm innovation in Vietnam.

H5: The presence of informal competition has a negative moderating effect on the relationship between FDI and domestic firm innovation in Vietnam.

2.2.4. Export and firm innovation

An empirical study suggests that exporting not only forces organizations to innovate to achieve the global standards but also helps them to better absorb the advantages of FDI (Xie & Li, 2018). In particular, exporting firms often have better infrastructure and greater incentives to develop creative ideas in goods and manufacturing dimensions as a result of the higher performance requirements demanded in foreign markets. This may result in a stronger beneficial correlation between FDI and firm innovation for exporting enterprises compared to non-exporting firms. Then, this study proposes next hypothesis.

H6: Export is positively associated with domestic firm innovation in Vietnam.

2.2.5. Firm size and firm innovation

Generally, the larger firms have more financial resources, skilled labor, and more organized R&D departments, which allow them to direct investments towards developing new products or improving processes within the firm. Marom et al., (2019) examine the relationship of business innovation and the scale of the organization, considerably indicating that organizations with greater size tend to reach a higher degree of innovation due to greater access to financial capital, human, and technological resources. Following hypothesis is suggested.

H7: Firm size is positively associated with domestic firm innovation in Vietnam.

2.2.6. Firm age and firm innovation

According to research published in Research Policy by Coad and other authors (2016), organizations with fewer years of age are likely to participate in doing riskier innovation activities that possibly lead to larger performance gains. They are also agile enough to quickly adopt the latest technological breakthroughs and operational expertises or strategies, which could unlock considerable gains in productivity and market share. Therefore, this study forms the hypothesis.

H8: Firm age is negatively associated with domestic firm innovation in Vietnam.

2.2.7. Firm sales and firm innovation

The mutually supportive connection between sales and innovation is demonstrated in several studies. Higher revenue allows for increased R&D expenditure, that in turn stimulates innovation and continuously increases sales. This relationship is particularly relevant for firms that are part of larger business groups, which provide additional financial and strategic support for innovation activities. And only those companies having medium-to-low revenue expansion ratios benefit from continuing to invest in research and development operations (Altuzarra, 2024). Then, following hypothesis is posed.

H9: Firm sales is positively associated with

domestic firm innovation in Vietnam.

2.2.8. Top managers' work experience and firm innovation

Top management team characteristics in Chinese context, including tenure, are examined the influence on local firm innovation. It is found that longer top management team tenure correlates with firm innovation, due to managers' deeper industry knowledge and strategic insight, using methods of Ordinary Least Squares with robust standard errors (Zhao et al., 2021).

H10: Firms with higher top managers' periods of work experience have a positive impact on domestic firm innovation in Vietnam.

2.3. Research model

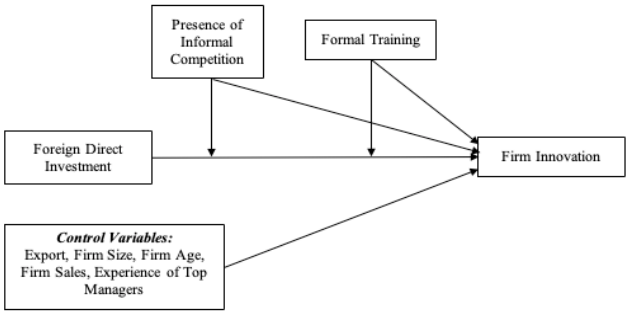

Figure 1. Proposed conceptual model

3. Methodology

3.1. Data collection

This research is established on the cross-sectional database in Vietnam in the year 2023. The data were gathered and calculated from the World Bank Enterprise Survey. The WBES are nationally representative surveys of private sector firms, providing a wealth of data on a variety of topics related to business. The WBES methodology involves face-to-face interviews, conducted following an independent sampling method to ensure consistency across all participating countries. The data includes both qualitative and quantitative responses by conducting methodology of face-to-face interviews, following a random sampling technique to ensure consistency across all participating countries. Data analysis tool utilized is STATA 14, a statistical software.

3.2. Variable description

Table 1. Variable Description

Variable	Definition
Domestic Firm Innovation	Dummy variable coded with one if a firm has any of 3 following categories: - Product Innovation: Dummy variable coded with one if a firm has proposed a new product or enhanced existing product. - Process Innovation: Dummy variable coded with one if a firm has proposed a new process or enhanced an existing process. - R&D: Dummy variable coded with one if a firm has invested in R&D activities.
Export	The ratio of sales made through exports
FDI	Dummy variable coded with one, at least, 10% of the firm is owned by private foreign individuals, companies or organizations.
Formal Training	Dummy variable coded with one if the firm conducts Formal Training programs for the employees
Experience	The number of working experience years that top manager of the firm works in the industry
Presence of Informal Competition	Dummy variable coded with one if the firm competes against unregistered or informal firm
Firm Age	The number of years since the firm has begun operations
Firm Sales	Firm's total annual sales
Firm Size	It refers to the number of employees in a firm and is categorized into four definitive groups i.e. micro = 1, small = 2, medium = 3, and large = 4.A micro firm has fewer than 10 employees. A small firm has between 10 and 50 employees, inclusive. A medium-sized firm has up to 100 employees, inclusive. Firms with more than 100 employees are classified as large. (*)

(*) According to Decree 80/2021/ND-CP guiding the Law on Support for Small- and Medium-Sized Enterprises by the Vietnamese Government.

3.3. Empirical method

The following model is embraced from previous research (Nyeadi & Adjasi, 2020) (1).

$$y_i = x_i \beta + \varepsilon_i$$

y_i represents the innovation index, and x_i represents the vector of independent variables.

The extended versions of the model will be presented in the following formats (2):

$Innovation_i = \beta_0 + \beta_1 FDI_i + \beta_2 Controls_i + \varepsilon_i$

Where $\varepsilon_i = \mu_i + v_i$

With v_i= individual firm effects

Innovation = Product Innovation/Process Innovation

FDI_i = Foreign Direct Investment for firm i

$Controls_i$= Vector of control variables

i=1,2,3,…,n (n= number of firms)

β is the regression coefficient and ε is the error term

3.4. Model estimation

This study delivers linear regression with a model of Ordinary Least Squares (OLS) to analyze correlation

between dependent and control variables. The method minimizes the total of the squared variances between the actual and expected values of the dependent variable, then leading to an optimal feasible fit for the gathered data. In fact, this approach is normally adopted due to its interpretability and flexibility when dealing with cross-sectional data. The effect that FDI exerting on domestic firm innovation is observed while accounting for various firm-specific characteristics and moderating determinants. The method approached assists in estimating the direct impact of FDI on innovation while simultaneously analyzing how other variables interact with FDI to influence innovation results.

Negash et al. (2020) utilized OLS to conduct a preliminary investigation into how Chinese inward FDI influences domestic labor productivity, which contributes to firm innovation. This approach allowed the authors to establish baseline correlations between FDI inflows and productivity before advancing to more complex methods, like the Generalized Method of Moments (GMM), to tackle potential endogeneity with dynamic panel problems. Nyadi and Adjasi (2020) also have the first stage of OLS in their approach, which is a method of two-stage least squares (IV2SLS) using several instrumental variables to study inward FDI and the innovation of companies in Nigeria and South Africa. This first-stage regression aids in distinguishing the consequences of instruments on the endogenous explanatory variables, contributing to construct a critical phase in the IV estimation procedure.

Besides, based on given methodologies, this research uses OLS with robust standard errors to evaluate how FDI influences the innovation of domestic enterprises in Vietnam. Robust standard errors are implemented to mitigate issues such as heteroskedasticity and omitted variable bias, making the estimation reliable and valid. Additionally, the concerns related to potential endogeneity can be handled by other more complex techniques, such as IV or GMM, OLS with using robust standard errors is believed to set a balance between methodological and practical ease for a more customized exploring phase of the analysis. Furthermore, this employed technique is also appropriately applied in analyzing cross-sectional data, and this is common research that attempts to target multiple independent variables including several predictors and controls. It would certainly be able to assess both firm characteristics and macroeconomic variables such as FDI as determinants of innovation between firms.

Furthermore, this employed technique is also appropriately applied in analyzing cross-sectional data, and this is common research that attempts to target multiple independent variables including several predictors and controls. It would certainly be able to assess both firm characteristics and macroeconomic variables such as FDI as determinants of innovation between firms. As implemented in the analysis, applicability of robust standard errors could make up for some modest breach of assumptions that might occur, such as heteroscedasticity, thus ensuring reliability of statistical inferences. The application of robust standard errors plays an important role when considering the variation in data characteristics, especially among firms with reference to size, industry, and region.

4. Results and discussion

The results confirm the robustness of the key findings from the model, with the negative and statistically meaningful effect of FDI on firm innovation (Coefficient = -0.118, p = 0.009) remaining consistent. This finding supports theoretical perspective such as Dunning's Pull Factor Theory, suggesting that FDI focused on cost-saving production rather than technology transfer can hinder local innovation. The results indicate that, in this context, FDI may not facilitate the expected spillover benefits but instead lead to dependency on foreign technologies or increased competition, reducing domestic firms' R&D capacity. This result is also correlated with the research investigating 49 economies over the period of 14 years from (Rao et al., 2024).

Positive drivers of innovation, such as Formal Training, Presence of Informal Competition, Firm Sales, and the Experience of Top Managers, also maintain their statistical significance after robust adjustments, further supporting their role as key determinants of firm innovation. The scale of revenue is also reported to be positive towards the innovation in recent research, facilitating the enterprises with higher sales to continuously invest in participating in R&D (Altuzarra, 2024). Formal Training (Coefficient = 0.193, p = 0.000) emerges as the strongest positive predictor, highlighting the importance of investing in employee development to foster innovation. Presence of Informal Competition (Coefficient = 0.132, p = 0.000) demonstrates a strong positive effect, indicating that competitive pressures drive local firms to innovate to stay competitive. Similarly, Firm Sales (Coefficient = 0.043, p = 0.012) and Managerial Experience (Coefficient = 0.007, p = 0.001) emphasize the importance of financial and managerial resources in promoting innovative activities in domestic firms. This argument is aligned with mostly recent studies in distinct economies, emphasizing the undeniable contribution of this part of human resources (Zhao et al., 2021).

The estimation results indicate that formal training significantly moderates the correlation of FDI and firm innovation. The interaction term has a coefficient of -0.2049603, with a significant p-value of 0.03, signifying that the effect is empirically substantial. Therefore, while formal training is beneficial on its own, its interaction with FDI seems to temper the otherwise beneficial association between FDI and innovation.

The regression statistics of the moderating impact of the presence of informal competition on the correlation of FDI and local innovation are provided. Specifically,

Table 2. Linear regression with robust standard errors

Firm Innovation	Coef.	St. Error	t	p-value	[95% Conf	Interval]	Sig
Export	.03	.016	1.81	.071	-.003	.062	*
FDI	-.118	.045	-2.62	.009	-.206	-.03	***
Formal Training	.193	.049	3.98	0	.098	.289	***
Firm Age	-.01	.014	-0.75	.453	-.037	.017	
Firm Sales	.043	.017	2.53	.012	.01	.077	**
Firm Size	-.006	.016	-0.36	.721	-.038	.026	
Top Managers' Experience	.007	.002	3.43	.001	.003	.011	***
Presence of Informal Competition	.132	.029	4.58	0	.076	.189	***
Constant	.02	.049	0.40	.686	-.077	.117	

Mean dependent var	0.177	S.D. dependent var	0.382
F-test	10.855	Number of observations	807
Akaike crit. (AIC)	657.965	Prob > F	0.000
		Bayesian crit. (BIC)	700.205

*** p<.01, ** p<.05, * p<.1

Table 3. Linear regression of moderating effect of formal training

Firm Innovation	Coef.	St. Error	t	p-value	[95% Conf	Interval]	Sig
FDI	-.0167146	.0522807	-0.32	.7492719	-.1193375	.0859083	
Formal Training	.2845841	.0416958	6.83	0	.2027384	.3664298	***
FDI & Formal Training	-.2049603	.094983	-2.16	.0312344	-.3914045	-.018516	**
Constant	.1439873	.0147926	9.73	0	.1149506	.173024	***

Mean dependent var	0.177	S.D. dependent var	0.382
F-test	15.932	Number of observations	807
Akaike crit. (AIC)	697.613	Prob > F	0.000
		Bayesian crit. (BIC)	716.386

*** p<.01, ** p<.05, * p<.1

Table 4. Linear regression of moderating effect of presence of informal competition

Firm Innovation	Coef.	St. Error	t	p-value	[95% Conf	Interval]	Sig
FDI	.0494589	.0485805	1.02	.3089457	-.0459008	.1448186	
Presence of Informal Competition	.1510175	.0290354	5.20	3.000e-07	.0940234	.2080117	***
FDI & Presence of Informal Competition	-.2582639	.111036	-2.33	.0202694	-.4762189	-.0403089	**
Constant	.1244541	.0175785	7.08	0	.089949	.1589593	***

Mean dependent var	0.177	S.D. dependent var	0.382
F-test	9.462	Number of observations	807
Akaike crit. (AIC)	716.236	Prob > F	0.000
		Bayesian crit. (BIC)	735.009

*** p<.01, ** p<.05, * p<.1

the interaction term of FDI and the presence of informal competition (coefficient = - 0.258, p = 0.020) is adverse and statistically meaningful at the 5% threshold, describing that competition negatively moderates how FDI affects local firm innovation. This finding shows that while FDI itself might not directly harm innovation, its impact becomes more adverse in highly competitive pressure against unregistered or informal firms.

5. Conclusion and implications

This finding aligns with theoretical perspectives such as the Schumpeterian hypothesis and Dunning's Pull Factor Theory, which highlight how dependency on foreign technologies and intensified competition from foreign firms can hinder domestic innovation. This negative relationship depicts the importance of ensuring that FDI contributes to, rather than disrupts, the innovation ecosystems in host countries, specifically in Vietnam, leading to generating or modifying suitable policies. Regarding moderating effects of formal training investigated, it is identified to may be due to an overemphasis on compliance or standardized practices introduced by foreign firms, restricting local firms' competence to explore more innovative advances. Therefore, considering Vietnamese context, conducting employee training can bring about unexpected, standardized practices, leading to reducing the benefits of FDI. Informal sectors are often notable in such developing economies like Vietnam, then causing potential systemic challenges for formal firms.

Moreover, the insignificant outcomes in driving innovation of certain relevant organization characteristics, such as firm size and firm age, also illustrate remarkable insights, contrary to traditional assumptions. Additionally, in this context, Vietnamese marketplaces are heavily influenced by competition and external pressures, other factors such as managerial expertise, formal training, and revenue may hold greater importance. These elements also explain the critical role of firm sales, top managers' experience that are observed. Regarding the working period of top managers, it is highlighted that their accumulated knowledge, strategic insight, and leadership skills can drive the implementation of innovative practices.

Some implications for policymakers can be delivered based on these findings. To maximize the benefits of FDI, policies should aim to diminish its negative effects on local innovation by fostering stronger linkages between foreign and domestic firms. Furthermore, leadership development initiatives, such as executive training and information exchange platforms, may assist top managers in developing the expertise required to promote innovation inside their organizations. Top managers of enterprises and business owners in Vietnam could concentrate on modifying formal training programs or handling the presence of competition from unofficial components. Specifically, investments in formal training should be carefully adapted to balance compliance with the promotion of creativity and adaptability in local firms in Vietnam. Besides, the competition challenge requires regulatory reforms to adjust the marketplace or sector and support the innovation capacity of domestic enterprises.

Future research should explore additional mechanisms through which FDI interacts with firm characteristics and external conditions, the moderating effects of the other factors as well as examine sector-specific drivers to develop more tailored policy recommendations. Regarding context, comparative studies between Vietnam and other developing economies or with estimating longer span time could further form novel and important recommendations and lessons.

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