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## A selective review of foreign direct investment theories

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A selective review of  
foreign direct investment  
theories



Dinkar Nayak  
Rahul N. Choudhury

ASIA-PACIFIC RESEARCH AND TRAINING NETWORK ON TRADE

# Working Paper

NO. 143 | MARCH 2014

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## **A selective review of foreign direct investment theories**

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**Abstract:** Several theories have been put forward by the researchers to explain foreign direct investment. However, no single theory fits the different types of direct investment or the investment made by a particular multinational corporation or country in any region. This paper traces the evolution of the theories of foreign direct investment (FDI) during the past few decades. An attempt is also made to explain the growth phenomenon of Third World multinational companies. The applicability of the theory differs with the type and origin of investment. Nevertheless, all these theories are unanimous in their view that a firm moves abroad to reap the benefits of the advantages in the form of location, firm-specific or internationalization of markets.

**JEL classification:** F21, F23, F36

**Keywords:** Foreign direct investment, internalization, MNCs, motivation, trade

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## Introduction

After the Second World War, when the forces of globalization emerged, expansion of foreign direct investment (FDI) really took off. The growing importance of multinational corporations (MNCs) and foreign investment during the 1950s and 1960s, particularly FDI flows from the United States of America to European countries, provided the impetus for many researchers to examine the issue of MNCs and the existence of international production.<sup>1</sup> As a corollary, many theories were formulated to explain the international movement of capital. It is in this context that an attempt is made in this paper to examine various theories that explain FDI.

Initially, the theories of capital market and portfolio investments were used to describe the initiation of FDI. Originally, direct investment was an international capital movement only (Kindleberger, 1969). In fact, prior to 1950, FDI was regarded as a subset of portfolio investment. Accordingly, it was asserted that the most important reason for capital flows lay in the differences in interest rates. This approach stated that when there were no uncertainties or risks, capital tended to flow to the regions where it gained the highest return. However, this context failed to incorporate the fundamental difference between portfolio and direct investment. Direct investment entails control. Thus, the important theoretical shortcoming of the interest rate theory is that it does not explain control. If interest rates are higher abroad, an investor will consider lending money abroad, but there is no logical necessity for that investor to control the enterprise to which he or she lends to the money (Hymer, 1976).

The formulation of a proper explanation of FDI was attempted in the 1960s. Further, with the increasing role of MNCs, academicians attempted to integrate their activities with the theories of FDI (Rayome and Baker, 1995). Since then, these theories have highlighted different factors governing the international movement of capital. Some theories have considered market imperfections as the reason for FDI flows while others have considered oligopolistic and monopolistic advantages. There are also FDI theories that relate FDI to international trade. In the following sections an attempt is made to examine these theories.

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<sup>1</sup> As FDI is primarily routed through multinational corporations, the terms FDI and MNCs are used interchangeably in this paper.

The objectives of this attempt are threefold: (a) first, to gain an understanding of the basic motivation for firms to go abroad; (b) to highlight the weaknesses of these theories;<sup>2</sup> and (c) to review the theories that provide explanations for FDI flows from developing countries.

Although literature reviews on FDI theories have been conducted from time to time, surveys of literature explaining the outflow of FDI from the so-called “Third World” are sparse. This paper attempts to bridge this gap. In section 1, theories of FDI based on the assumption of perfect competition are described. Section 2 examines the different theories against the backdrop of imperfect competition. Currency-based theories of FDI are reviewed in section 3. Section 4 examines the theories that have linked FDI with international trade and section 5 deals with the linkages between RIA and FDI. Section 6 considers theories that explain the outflow of FDI from developing countries. Section 7 concludes the paper.

## **1. Theories of FDI based on perfect competition**

The early works of FDI theory can be traced in the work by MacDougall (1958) who established his model based on the assumptions of perfectly competitive market. His theory was further elaborated by Kemp (1964). Assuming a two-country model and prices of capital being equal to its marginal productivity, MacDougall and Kemp both stated that when there was free movement of capital from an investing country to a host country, the marginal productivity of capital tended to be equalized between the two countries. They found that after investment, the output of the investing country fell without any decrease in the national income of the country. This is because in the long term the investing country gets higher income from its investment abroad.

Theories explaining international investment in a similar way can be found in the works by Simpson (1962), Frankel (1965), Pearce and Rowan (1966) and Caves (1971). However, the fact is that in a world characterized by perfect competition, FDI would not have existed (Kindleberger, 1969). In fact, some form of distortion must be there to enable the realization of direct investment. Hymer (1976), who was the first to point this out in 1960, developed his theory based on an imperfect market setup. Others followed suit. This is discussed in the next section.

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<sup>2</sup> Several previous reviewers did not consider this aspect.



Furthermore it is pertinent to note that during the interwar period of the twentieth century an important development was Britain's loss of its status as the major creditor, and the United States emerged as the major economic and financial power. In the post-Second World War period, there was significant FDI growth fuelled by: (a) the improvement in transport and communications, which facilitated exercising control from a distance; and (b) the need of Europe and Japan for United States capital to finance their reconstruction activities. However, by 1960, host countries started to recover and there was a slowdown in FDI outflow from the United States; at the same time, other countries initiated FDI in the United States. The 1980s witnessed two important developments. First, the United States became a net recipient of FDI. Second was the emergence of Japan as a major home country for FDI flows to the United States as well as Europe. The 1990s saw the decline in the importance of Japan as a source of FDI. Moreover, merger and acquisition became an important force behind FDI. Since 2000 there has been an increasing flow of FDI from the developing countries, not only to other developing countries but also to the developed world. It is against this changing scenario that FDI theories have evolved over time.

## **2. Theories of FDI based on imperfect markets**

### **2.1. Industrial organization approach**

Hymer was one of the pioneers who established a systematic approach towards the study of FDI. In his 1960 doctoral dissertation, Hymer (1976)<sup>3</sup> developed the FDI theory approach of industrial organization. His theory, which was one of the first works to explain international production in an imperfect market framework, was supported by Lemfalussy (1961), Kindleberger (1969), Knickerbocker (1973), Caves (1974), Dunning (1974), Vaitsos (1974) and Cohen (1975) among others.

The essence of Hymer's theory is that firms operating abroad have to compete with domestic firms that are in an advantageous position in terms of culture, language, legal system and consumer's preference. Furthermore, foreign firms are also exposed to foreign exchange risk. These disadvantages must be offset by some form of market power in order

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<sup>3</sup> Hymer's dissertation was subsequently published in book form in 1976.

to make international investment profitable.<sup>4</sup> The sources of market power – the firm-specific advantage in Hymer's terms or monopolistic advantage in Kindleberger's terms – are in the form of patent-protected superior technology, brand names, marketing and management skills, economies of scale and cheaper sources of finance. According to Hymer, technological superiority is the most important advantage as it facilitates the introduction of new products with new features. Moreover the possession of knowledge helps in developing other skills such as marketing and improved production process. A significant feature of this theory is that it articulates the point that the advantages are transmitted effectively from one unit of a firm to another unit of that firm, irrespective of the fact that they are either located in one country or in more than one country (Caves, 1971).

Since the market is imperfect, firms are able to take advantage of their market power to reap good profits by investing abroad. This argument was supported by some other researchers. For example, Graham and Krugman (1989) stated that in the past it was the technological advantage possessed by European firms that had led to them investing in the United States. Sodersten (1970) also argued that willingness to increase profits by taking advantage of technological superiority or superior organizational structure were the main reasons for direct investment. However, at the same time, critics such as Robock and Simmond (1983) argued that possessing firm-specific advantages did not necessarily mean investment abroad as firms might very well exploit their advantages through exporting or licensing.

However, a number of factors influence the choice between FDI and licensing/exports, including local government policy, local market conditions and size, the reaction of rival firms and the riskiness of investment. It is FDI that allows a firm to exploit its advantages to the full, so that it can capture all the rents provided by that control. Of further concern to the enterprise may be the fact that a lack of direct control will increase the likelihood of technology leaking to competitors (Sodersten and Reed, 1994). The foregone explanation transformed FDI theory from neoclassical trade theories into the industrial organization theory. However, Hymer's thesis does not form a complete explanation for FDI because it fails to explain where and when FDI takes place. This has been attempted by Vernon's (1966) PLC theory, the eclectic approach by Dunning (1977, 1979 and 1988) and the internalization theory by Buckley and Casson (1976).

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<sup>4</sup> Market power refers to the ability of firms, acting singly or in collusion, to dominate their respective market. Market power can be acquired only under conditions of imperfect competition (Lall, 1976).

## **2.2. FDI based on monopolistic power**

Kindleberger (1969), by extending the work of Hymer, put forward his theory of FDI on the basis of monopolistic power. Kindleberger argued that advantages enjoyed by MNCs could be useful only in the case of market imperfection. The advantages described by him might be in the form of superior technology, managerial expertise, patents etc. These advantages generally encourage a firm to invest in a foreign country in order to fully exploit them instead of sharing them with potential competitors in the foreign market. The greater the chances of earning monopoly profits, the higher will be the encouragement among firms to invest directly. Although, Kindleberger described various forms of advantages generally enjoyed by a firm over the host country firm, he failed to describe which advantage a firm should focus on. Further, a firm can exploit its monopolistic advantages abroad only if the host country's policy allows it to do so. Generally, in the name of national interest, the host Government would be unwilling to permit free entry of foreign firms into the country.<sup>5</sup>

## **2.3. Internalization theory of FDI**

Buckley and Casson (1976) provided another explanation of FDI by putting emphasis on intermediate inputs and technology. They shifted the focus of the international investment theory from country-specific towards industry-level and firm-level determinants of FDI (Henisz, 2003). Buckley and Casson analysed MNCs within a broad-based framework developed by Coase (1937).<sup>6</sup> Their theory came to be known as internalization theory as they stressed this fact with regard to the creation of MNCs. They articulated their theory based on three postulates:

- (a) Firms maximize profits in a market that is imperfect;

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<sup>5</sup> This type of fear dominated the attitude of the business class in India during the 1950s and early 1960s (Kidron, 1965)

<sup>6</sup> Coase offered an economic explanation of why individuals choose to form partnerships, companies and other business entities rather than carry out trading bilaterally through contracts in markets. He noted that there were a number of transaction costs to using a market. Therefore a firm will move to produce internally in order to avoid these costs.

(b) When markets in intermediate products are imperfect, there is an incentive to bypass them by creating internal markets.<sup>7</sup>

(c) Internalization of markets across the world leads to MNCs.

A firm that is engaged in research and development may develop a new technology or process, or inputs. It may be difficult to transfer technology or sell the inputs to other unrelated firms because those other firms may find the transaction costs to be too high.<sup>8</sup> Faced with this situation, a firm may choose to internalize by using backward and forward integration, i.e., the output of one subsidiary can be used as an input to the production of another, or technology developed by one subsidiary may be utilized in others.<sup>9</sup> When internalization involves operations in different countries then it necessarily means FDI.

Buckley and Casson (1976) identified five types of market imperfections that result in internalization: (a) the co-ordination of resources requires a long time lag; (b) the efficient exploitation of market power requires discriminatory pricing; (c) a bilateral monopoly produces unstable bargaining situations; (d) a buyer cannot correctly estimate the price of the goods on sale; and (e) government interventions in international markets creates an incentive for transfer pricing.

Although Buckley and Casson acknowledged the risk of host government intervention, they did not consider the difference in the magnitude of this risk across various industries. For example, industries such as power generation and telecommunications may face a greater risk of government intervention because societal considerations may require the balancing of private objectives with social objectives.<sup>10</sup>

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<sup>7</sup> This is known as the internalization of firms' activities.

<sup>8</sup> The transaction costs consist of the cost of acquiring a good or service via a market. Other costs, including those emanating from research and information, bargaining, retaining trade secrets and enforcement can add to the cost of procuring something through a market.

<sup>9</sup> The transaction costs between related firms may still be high, if the final product in the downstream production needs to be modified in order to cater to local market tastes and preferences.

<sup>10</sup> It implies a tradeoff between profit maximization and equity consideration.

## 2.4. Oligopolistic theory explaining FDI

Knickerbocker (1973) also formulated his theory based on market imperfections. It has been asserted in the economic literature that there two important motives for choosing a particular country as a location for setting up a new facility:<sup>11</sup> (a) firms seek increased access to the host country's market; and (b) firms want to utilize the relatively abundant factors available in that country. Knickerbocker also cited a third motivation for choosing a location – firms might invest in a country to match a rival's move (Head and others, 2002). In other words, firms often exhibit imitative behaviour, i.e., they follow the internationalization of competitors so that they will not lose their strategic advantage. In particular, Knickerbocker argued that in oligopolistic market conditions, firms in an industry tend to follow each other's location decision.<sup>12</sup> The idea is that firms, uncertain of production costs in the country to which they are currently exporting, run the risk of being undercut by a rival switching from exporting to setting up a manufacturing subsidiary in the host country. By imitating the rival's FDI, the firm can avoid being underpriced (Altomonte and Pennings, 2003).

Knickerbocker used data from a large number of United States MNCs to calculate an entry concentration index that showed the extent to which subsidiaries' entry dates were clustered over time. He suggested that oligopolistic reaction increased with the level of concentration and decreased with diversity of the product. His theory of oligopolistic reaction is exemplified by many of the world's industries, such as automotive, chemicals and electronics among others, which are dominated by a small number of very large corporations.<sup>13</sup> Within the oligopoly industries, firms are few enough in number to recognize the impact of their actions on their rivals and vice versa (Gwynne, 1979). However, Knickerbocker's proposition of oligopolistic reaction holds true only when uncertainty exists about costs in the host country; i.e., a sufficiently risk averse oligopolistic firm is more likely to set up a unit in a foreign country once one or more of its rivals invest there (Head and others, 2002). However, in the

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<sup>11</sup> The location advantages of a country are discussed in the following section.

<sup>12</sup> A firm may move abroad for variety of reasons, such as exploiting its ownership advantage or enhancing its market size.

<sup>13</sup> Examples of such reactions can be found in India where the initiation of economic reforms in the 1990s led to the setting up of a unit by Korean auto major Daewoo Motors, following which Hyundai Motors established their plant in that country.

case of certainty, the incentive to go abroad decreases with rival investment. Furthermore, this theory does not explain what motivated the first firm to undertake FDI.

## 2.5. Eclectic Paradigm to FDI

In the 1970s one of the most robust and comprehensive theories of FDI was developed by Dunning (Read, 2007). In his path breaking work, Dunning (1977 and 1979) amalgamated the major imperfect market-based theories discussed above – the oligopolistic and internalization theories – and added a third dimension in the form of location theory to explain why a firm opens a foreign subsidiary. Location theory addresses the important questions of who produces what goods or services in which locations, and why?<sup>14</sup> Location theory has also been frequently applied by researchers in attempting to understand the factors that influence locations of MNC units. Among others, they enumerated factors such as host country policies, economic fundamentals, firm strategy<sup>15</sup> and agglomeration economies.<sup>16</sup>

On the basis of the above, Dunning (1993) put forward his theory, which came to be known as the eclectic paradigm or OLI paradigm.<sup>17</sup> Dunning suggested that a firm would engage in FDI if three conditions were fulfilled:

- (i) It should have ownership advantages vis-à-vis other firms (O);
- (ii) It is beneficial to internalize these advantages rather than to use the market to transfer them to foreign firms (I);
- (iii) There are some location advantages in using a firm's ownership advantages in a foreign locale (L).

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<sup>14</sup> The location theory got underway with the publication of Johann Heinrich Von Thunen's first volume of *Der Isolierte Staat* (The Isolated State) in 1826 (Feinberg and Keane, 2001).

<sup>15</sup> Strategic factors include the need to locate near important clients; this is especially true for service firms like advertising agencies. See op. cit.

<sup>16</sup> It refers to the benefits that may accrue to firms that locate in clusters such Silicon Valley

<sup>17</sup> Dunning argued that "the eclectic (paradigm) is less an alternative theory of international production than one which pinpoints the essential and common characteristics of each of the mainstream explanations". That is the reason why he renamed it 'paradigm' instead of the original 'theory'.

Ownership advantages are those which are specific to a firm. These advantages, which may be enjoyed over domestic and foreign competitors, are in the form of both tangible and intangible assets.<sup>18</sup> These ownership advantages lead to reductions in a firm's production costs and allow it to compete with firms in a foreign country.

Location advantages of different countries play a significant role in determining which country will play host to the activities of multinational corporations.<sup>19</sup> As indicated above, a firm gains from avoiding market imperfections in terms of uncertainty, problems of control, lack of desirability of giving full information to potential buyers etc. The internalization gains make it more profitable to carry out transactions within the firm than to depend on external markets.

The essential feature in the eclectic theory is that all three types of conditions must be satisfied before FDI occurs. Dunning (1980) stated that the "OLI triad of variables determining FDI and MNCs activities may be likened to a three-legged stool; each leg is supportive of the others, and the stool is only functional if the three legs are evenly balanced". What this means is that a firm having ownership advantage, and where there are internationalization gains but no locational advantage is incurred by setting up a unit in a foreign country, will very likely choose to increase its production at home and export its product(s) abroad. In the same way, a firm having ownership and locational advantages will find it more profitable to produce abroad than to produce domestically and export its product(s); however, if there are no internalization gains then the firm will be better off licensing its ownership advantage to foreign firms.<sup>20</sup>

The major contribution by Dunning's eclectic paradigm to the existing literature on FDI was to combine several complementary theories, and identify a set of factors that influence the activities of MNCs.<sup>21</sup> For this reason his theory gained wider acceptance than other

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<sup>18</sup> These include patents, technical knowledge, management skills, access to or control over raw materials, superior technology, brand name, and marketing skills, and scale economies.

<sup>19</sup> Location advantages may be in the form of access to protected markets, favourable tax treatments, lower production and transportation costs, cheap inputs for production, lower risk, political, legal and cultural environments etc.

<sup>20</sup> There may be no internalization gains because the product could be produced by a firm abroad without harming the domestic firm's ownership advantage.

<sup>21</sup> The essence of this approach is the application of these variables to trade (exports), international production (FDI) and the international organization of production (licensing) (Letto-Gillies, 2005).

imperfect market-based theories. Dunning (1980) empirically tested his theory and obtained satisfactory results. However, one of the main criticisms of the eclectic paradigm is that it includes so many variables that it loses any operational practicality. Dunning himself accepted this fact and stated that it was an inevitable consequence of trying to incorporate the different motivations behind FDI into one general theory.

The result of this criticism was the “Investment Development Cycle or Path” (IDP) theory that proposes a link between a country’s level of economic development measured in GDP per capita and its international investment positions – the net outward FDI stock per capita. The basic hypothesis is that when a country develops, the conditions encountered by foreign and local firms will change. This will affect the flows of inward and outward FDI. This, in turn, will have an impact on the economic structure of the country. Thus, there is a dynamic interaction between the two. Unlike the earlier paradigm, the new theory accepts the fact that a Government can influence the country’s condition through its policies, thereby affecting FDI flows and domestic firms’ ownership advantages. In this way, IDP introduced a new notion of dynamic approach to the eclectic theory.<sup>22</sup>

### **3. FDI theory based on strength of currency**

Aliber (1970) made one of the early attempts to explain FDI on the basis of the strength of currency. He presented his theory of foreign investment on the basis of the relative strength of the various currencies. He forwarded his theory in terms of the differences in the strength of the currencies in host and source country. He postulated that weaker currencies compared with stronger investing country currencies had a higher capacity to attract FDI in order to take advantage of differences in the market capitalization rate. Aliber had tested his hypothesis and found the result to be consistent with FDI in the United States, the United Kingdom and Canada.

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<sup>22</sup> Dunning (1981) initially proposed four stages of the development path, starting with pre-industrialization without any FDI. In stage II, as a result of government intervention, some location-specific advantages are created and inward FDI begins to rise. In stage III, domestic firms gain ownership advantage, and with higher wages inward FDI falls at the same time outward FDI starts to rise. Countries in stage IV become net outward investors. In 1986, Dunning added stage V to explain the convergence and balancing of FDI stocks in most of the developed countries.



Although Aliber claimed that it was an alternative theory, and may be a valid explanation for direct investment in developed countries, it does not seem to be a particularly relevant to that in less developed countries with highly imperfect or non-existent capital markets and with heavily regulated foreign exchanges (Lall, 1976). Among other notable studies in the same genre are Caves (1988), Froot and Stein (1991) and De Mello (1997).

Even though Aliber's theory found wide support, the theory does not provide an explanation for investment between two developed countries that have currencies of equal strength. Furthermore, the relevance of the theory cannot explain the investment of a developing country's (weaker currency) MNCs in a developed country (stronger currency).<sup>23</sup> Recent investment in the United States and the United Kingdom by Indian and Chinese firms can be cited as examples.

Almost all the theories reviewed in the above sections are based on a Western developed world perception. Few theories have been formulated that explain FDI from developed Asian countries such as Japan.

One of the first theories on FDI from Asian developed countries was put forward by Kojima (1973, 1975, and 1985) mainly with regard to FDI outflow from Japan. He argued that the inability of firms to compete domestically in Japan had compelled them to look for investment opportunities abroad. He was of the opinion that the more efficient local firms were pushing the less competent firms out of the local market. As a result, the weaker firms were moving overseas, especially to other developing countries.<sup>24</sup> However, Kojima's hypothesis failed to explain the expansion of business activities in international markets by the domestically competent firms.<sup>25</sup>

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<sup>23</sup> The rise of Third World MNCs is discussed in section 8.

<sup>24</sup> This is exemplified by the example of Suzuki Motor Corporation of Japan which came to India as it was unable to face competition from other automobile firms such as Toyota Motors in the domestic market.

<sup>25</sup> For example, the well-entrenched Japanese automobile company, Toyota, had also set up its base in India to take advantage of liberal automobile and FDI policies.

#### 4. FDI theories related to international trade

The expansion of FDI in the past two decades and the continuous growth in output of multinational firms has changed the structure of international trade to a large extent. Foreign direct investment has, by some measures, become even more important than international trade (Graham, 1996; and Helpman and others, 2003). In fact, about one third of total international trade occurs between the intra-firms (UNCTAD, 2004). A number of attempts have been made to integrate FDI theory with the theory of international trade.

Smith (1776), followed by Ricardo (1817), pioneered the theory that provided explanations of trade flows between nations. Smith developed his theory based on absolute difference in costs. Trade will emerge if one country has an absolute advantage in the production of one commodity and disadvantage in the production of another commodity.<sup>26</sup> However his theory failed to explain trade between countries where one country had no line of production in which it was clearly superior. It was Ricardo who elaborated Smith's theory to fit in more general framework by formulating a theory based on comparative advantage. He asserted that a country will specialize and export that commodity in the production of which it has comparative cost advantage and import that commodity in which its cost advantage is the least. This theory was based on using one factor of production-labour and thus it is the difference in production technology that explains the different costs that provide incentive for trade. However, over and above such a general insight into international trade, the classical theories by assuming immobility of labour across the borders were not helpful in providing explanations for the international movements of capital. (Morgan and Katsikeas, 1997). In contrast to this theory, the factor proportion theory propounded by Heckscher (1919) and Ohlin (1933), explained the differences in advantages by relative endowments of factors of production (and implicitly their relative prices). They stated that countries would export goods and services that utilized greater quantities of their relatively abundant factors, and import other goods and services (that is, those that were relatively scarce factors).<sup>27</sup> However,

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<sup>26</sup> Absolute advantage means the exporting is able to produce, with given amount of capital and labour, a larger output than any rival.

<sup>27</sup> Bertil Ohlin wrote and published his book in 1933 which first explained the theory. He wrote the book alone, Heckscher was credited as co-developer of the model, because of his earlier work on the problem, and because many of the ideas in the final model came from Ohlin's doctoral thesis, supervised by Heckscher.

these theories do not explicitly answer the question concerning production outside national borders as they also based their theories on the assumption of international immobility of factors of production. Vernon (1966) assimilated international trade with international investment.

The 1960s saw significant technological change, which coincided with the rise of multinational corporations. The existing theories of international trade were found to be inadequate for explaining the changing pattern of trade. This resulted in a call for an alternative explanation of trade flows (Leontief, 1966). It was in response to this need that Vernon (1966), by using United States multinational data, explained the cycle of their expansion in the post-Second World War period. He contended that FDI was the reaction to the threat of losing markets as products matured as well as the need for cheaper factor costs in the face of competition (Latorre, 2008). This theory, popularly referred to as the “Product Life Cycle Theory”, provides an explanation of how factors such as the availability of larger and cheaper capital, superior management, discovery of new processes, product differentiation etc. interact over time to determine production, export and foreign investment patterns of oligopolistic enterprises (Lall, 1976).

The theory attempts to integrate three stages of production in order to explain the life cycle of a product. The first stage of this model deals with the introduction of innovation. It is argued that new products will be invented, produced and sold in countries with the highest incomes and skill.<sup>28</sup>

If the product meets with success in a wealthy market, production increases, new markets are explored and export develops. This marks the beginning of the second stage – maturity. In this stage the price elasticity of demand for the product is comparatively low. The demand for the product rises in the foreign market and competitors emerge. The original producer establishes a production unit in the foreign country to cater to the increased foreign demand as well as to compete with rivals. It is in the second stage that the firm goes international. The final stage is characterized by product standardization. The production technique becomes well-known and reaches its zenith. As a result, investment moves on further to any

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<sup>28</sup> Vernon (1966) contended that “the United States market offers certain unique kinds of opportunities to those who are in position to be aware of them. First the United States consists of consumers with average income that is higher than that in any other national market. Second, the United States market is characterized by high unit labour costs and relatively unrationed capital compared with practically all other markets”.

location in the world where costs are at the lowest possible level. Thereafter, the product is exported to the original country of innovation where the product is phased out in order to favour innovation of yet another product.

Thus, the exporter becomes an importer at this stage of production.<sup>29</sup> Production of personal computers (PCs) can be cited as a prime example of the production life cycle. They were first introduced in the United States followed by Japan and, ultimately, China, which has now become one of the world's largest exporters of PCs. Nevertheless, this theory fails to explain why it is profitable for a firm to undertake FDI rather than continuing to export from the home country or by licensing a foreign firm to produce its products. It simply argues that once a foreign market is large enough to support local production, FDI will take place. However, it fails to identify when it is profitable to invest internationally. Vernon (1979) recognized that the situation had changed rapidly since he had developed his theory and that this had considerably weakened its predictive power (Latorre, 2008). Despite this, the product-cycle theory has provided a framework under which other authors such as Hirsch (1976) and Helpman and others (1984 and 2004) have dealt with the question of whether to go the FDI route or to export.

Hirsch (1976) developed an international trade and investment theory by focusing on two aspects: (a) when a profit-maximizing firm chooses to serve a foreign market, and (b) the conditions under which foreign market servicing is carried out either through exporting or local manufacture as a result of direct investment. Hirsch asserted that FDI could be analysed within the framework of industrial organization and location theory models. However, it is not consistent with trade models that assume perfect markets, factor immobility, zero transportation costs, international identical production functions and constant returns to scale. FDI will also not take place even if it is assumed that international factor mobility is possible. For example, if it is assumed that capital is completely unhampered, capital costs between two nations will be equalized; hence, there is no incentive to undertake FDI. The relaxation of constant returns to scale also cannot explain FDI.

In the absence of transportation and marketing costs, an optimum sized plant will be less costly to operate in countries enjoying comparative advantage. Economies of scale are not

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<sup>29</sup> Freeman (1963) used a similar three-stage classification.

associated with the size of the domestic market; thus, they enhance rather than counteract comparative advantage. International direct investment takes place only in a world that admits revenue-producing factors that are firm-specific on the one hand, and information, communications and transaction costs, which increase with economic distance, on the other. He concluded his theory by noting that international investment facilitates specialization according to comparative advantage to a greater extent than trade, since firms that are purely exporters will incur differential export-marketing costs (M); in the case of MNCs, some exemptions from such costs are granted.<sup>30</sup> Furthermore, multinationals have an incentive to enhance the gains from trade by expanding output or setting up new units in least-cost locations and by supplying to all markets from that location.

Kojima (1973, 1975, and 1985) also integrated trade theories with direct investment theories. He strongly recommended that FDI was required in order to make factor markets more competitive and efficient internationally as well as to improve production processes in a country that is well-endowed with the given resource. Kojima identified resource, labour and market orientation as the three major motives behind international investment by a firm.<sup>31</sup> Kojima's theory mainly focused on Japanese investment. The other major Asian economies, such as China, India, the Republic of Korea and Taiwan Province of China, were not dealt with in his theory. Those countries have proven their potential in the international investment market in recent decades. Even though there are some examples of international investment that verify Kojima's assumption of inability of firms to compete domestically, which leads them to invest abroad, it is still not satisfactory to generalize this proposition.

One of the main limitations of the works cited above is that they have not taken into account the modes of FDI, i.e., vertical and horizontal.<sup>32</sup> It was Helpman (1984), and Helpman and

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<sup>30</sup> M is defined as the difference between export marketing costs per unit of sales and domestic marketing costs per unit of sales.

<sup>31</sup> When a firm invests with a view to increasing and securing imports of the goods that the home country lacks or produces at a higher cost, this is referred to as trade-oriented or resource-oriented FDI. If investment is made in order to benefit from cheaper labour costs it is known as labour-oriented FDI. Investments in order to capture a big market or to supersede the trade barriers are called market-oriented FDI.

<sup>32</sup> Vertical FDI refers to a situation where a parent firm invests in a production facility in another country in order to produce inputs that will be brought back to parent firm for further processing. Alternatively, the firm in the home country produces only inputs and ships them to its affiliates in another country in order to service that market.

others (2003 and 2004), among others, who related international trade to vertical as well as horizontal FDI. Helpman (1984), developed a general equilibrium model of international trade in which MNCs play an important role. He combined elements of ownership and locations in this model, and extended his earlier work that dealt with the firms producing a single product. He constructed his theory based on firms having a single production facility, which could be in a country other than where the headquarters were located. However, given the absence of tariffs and transportation costs means the firm will never open more than one production facility, so his model is really one of a vertically integrated firm.

Helpman's model is based on the differences in the factor endowments of different locations where a vertical MNC chooses to start its production centre. The model argues that firms like to choose cost-minimizing locations to maximize their profits. The differences in the factor endowments are associated with the relative size of the country. The theory explains the simultaneous existence of intersectoral trade, intra-industry trade and intra-firm trade. The theory also explains cross-country penetration by MNCs as a result of impediments to trade such as transportation cost and tariff.

In another article, Helpman and others (2004) focused on a firm's choice between exports and horizontal FDI. They developed a model of international trade in which firms choose to serve the domestic market, to export or to engage in FDI to cater to markets abroad. They contended that every industry was characterized by heterogeneity; therefore, the productivity of firms will differ. The consequence of this is that firms are organized on the basis of their productivity. The least productive firms shut down as they cannot generate a positive operating profit, no matter how they are organized. Other low-productivity firms sell only in the domestic market. The remainder of the heterogeneous firms will serve both domestic and foreign markets. However, the modes of operating in foreign markets will differ from firm to firm, depending on their productivity levels. The most productive firms will decide to serve the foreign market via FDI while less productive firms will sell in the foreign market through exports. The firms that invest abroad will do so when the gains from avoiding transportation costs are greater than the costs of maintaining facilities abroad. This is called the proximity-concentration tradeoff. Thus, by embodying elements of the proximity-concentration tradeoff

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(Hanson and others 2002). Horizontal FDI refers to investments in production abroad that are designed to serve foreign customers. (Helpman and others, 2003).

in the theory of horizontal FDI, the model predicts that foreign markets are better served by exports relative to FDI sales when trade frictions are lower or economies of scale are higher. Helpman and others (2004) tested their hypothesis with the help of export and FDI sales by United States firms in 38 countries and 52 industries; the results supported their theoretical predictions.

It is pertinent at this point to note that both horizontal and vertical FDI can also take two forms: (a) cross-border mergers and acquisitions or Greenfield FDI.<sup>33</sup> The former involves firms trading in heterogeneous corporate assets to take advantages of complementarities, while later involves setting up of new plants in the foreign market. This aspect of FDI was examined by Nocke and Yeaple (2004), who developed the “assignment theory of foreign direct investment” to explain a multinational’s FDI mode choice.

It is asserted in the business literature that mergers and acquisitions permit firms to exploit complementarities in their firm-specific assets (Maksimovic and Phillips, 2001). Thus, the merger and acquisition market allows heterogeneous firms to buy and sell corporate assets to exploit complementarities. In contrast, Greenfield FDI comprises the construction of production capacity abroad to permit a firm to deploy its assets in a foreign country. By assuming that two countries can freely trade with each one another, in their model they predicted that factor price differences between countries would lead to Greenfield FDI (from the high-cost to low-cost country) and to cross-border acquisitions (from each country to the other), while cross-country differences in entrepreneurial abilities (or some other corporate assets) would only give rise to mergers and acquisitions (from each country to the other). Thus, as per the model, the possibility exists for two-way FDI flows even in the absence of transportation costs and factor price differences between countries.

Furthermore, since Greenfield FDI requires incurring expenditure for building a new facility in a foreign country, such an expense will be worthwhile only if the gains from reassigning production are large enough. Following on from this, the model also predicts that firms engaging in Greenfield FDI are, on average, more efficient than those engaging in cross-border acquisitions. Their empirical testing supported the predictions of their model. Nevertheless, the theory fails to explain the recent phenomenon of the dramatic growth of

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<sup>33</sup> Mergers and acquisitions are often termed as Brownfield FDI.

Indian FDI (low-cost region) in developed regions (high-cost region). In addition to Greenfield investment, Indian outward FDI has taken the form of acquisition.<sup>34</sup>

## 5. Linkages between FDI and regional integration agreements

In the past few decades regional integration agreements (RIA) have proliferated throughout the world, leading to increasing flows of production factors across nations.<sup>35</sup> This has coincided with a dramatic surge in flows towards developed as well as developing countries. As a result, the role of RIA as a locational determinant of FDI has become a topic of intense debate in recent years. The relevant question is whether RIAs supplement or complement FDI. RIAs typically encompass reductions in regional trade barriers and investment restrictions. Hence, the impacts of RIAs on FDI flows will ultimately reflect the effects that investment and trade liberalization have on location and firm-specific advantages. The liberalization-induced changes in relative cost among member and non-member countries, changes in relative economic growth rates, altered investors' perceptions about country-specific political risks etc. will alter the location-specific advantages.<sup>36</sup>

RIAs also have the potential to change firm-specific advantages, thereby providing incentives for firms to undertake FDI. For example, an RIA may lead to a geographical concentration of specific industrial activities. If those activities involve significant agglomeration economies, then the firms with production facilities within the locations may enjoy increased efficiency advantages compared to other firms. Therefore, if these

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<sup>34</sup> The United Kingdom and the United States are the two main recipients of Indian FDI, thus defying the conventional wisdom that says developing country MNCs carrying out their external activities mostly in developing regions (Pradhan, 2008b).

<sup>35</sup> For example, the transformation of the European Economic Community into a single market (European Union) with a common currency. In the Americas, RIAs have been formed such as NAFTA, MERCOSUR and CUSTA. Similarly, in Asia and Africa many developing countries have entered, or are discussing, RIAs. (Salike, 2010, and Jaumotte, 2004).

<sup>36</sup> Some of these changes are a direct result of economic integration; for example, reductions in tariffs change the relative advantages of exporting versus setting up a unit abroad. Some changes are indirect consequence of RIAs; for example, the alteration of relative and absolute growth rates will have an impact on FDI flows (Blomstrom and others, 1998)



advantages are best exploited by establishing facilities abroad, FDI will increase to such regions. This fact was highlighted by Dunning (1997)

The earliest works that tested the linkages between RIAs and internal and external FDI flows focused on the experience of the European Community.<sup>37</sup> Among others, Yannopoulos (1990) concluded that the early phase of European integration witnessed a very large increase in both internal and external FDI as well as trade flows. However, the largest increase was from the United States.<sup>38</sup> Studies pertaining to the latter stages of European integration have provided mixed results. Some studies (e.g., Dunning, 1992) asserted that United States investment in the European Community recorded an upsurge, while other studies opined that it was relatively small (Lipsey, 1990). Studies that have paid attention to the impact of RIAs on FDI results for individual countries within the integrating regions have also produced mixed results (Mayes, 1983; Baldwin and others, 1996). In contrast to those studies, Blomstrom and others (1998) provided a different picture on the North American experiences under CUSTA and NAFTA. They suggested a substantially more modest impact of RIAs on extra-regional FDI stimulation. However, like the European findings, the study suggested that the investment impacts differed across countries within the integrated regions.

What could be the reasons for the different FDI outcomes of RIAs? This issue was looked at from a theoretical perspective by Salike (2010), who noted that to identify and assess the connections between RIAs and FDI it was essential to consider the motives and modes of FDI from the intraregional (external) and interregional (internal) perspectives. Salike identified two important motives of FDI (tariff jumping and internalization) and two channels of FDI (vertical and horizontal).<sup>39</sup> The two views of the motives for FDI will provide contradictive results regarding the effects of RIAs on intraregional flows of investment. If the motive for FDI is tariff jumping, horizontal FDI flows will decline because exporting from the home country will be relatively more attractive than FDI.<sup>40</sup> However, if internalization is the

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<sup>37</sup> Internal FDI flows are flows between individual member countries, while external FDI flows are between individual member countries and non-member countries.

<sup>38</sup> According to Dunning (1997), this was chiefly due to FDI determinants such as market size and growth, and agglomeration economies.

<sup>39</sup> Salike took into consideration the interpretations by Dunning (1971) and UNCTAD (1998).

<sup>40</sup> The theory of horizontal multinational firms assumes that the avoidance of tariff impediments and other barriers is a major reason for setting up plants abroad that serve that foreign location (Markusen, 1984)

motive, RIAs will create an incentive to increase investment as it will help to exploit the intangible assets of firms more efficiently. This is especially true for vertically integrated FDI, where the operations of MNCs are specialized according to the locational advantages of the host countries.<sup>41</sup> With regard to interregional investment FDI flows, both the two motives and the modes will lead to higher investment flows from outsiders into the region as a result of RIAs, either because of fears about future protection or the perception of an enlarged market.<sup>42</sup>

Salike theorized that the combined effects on FDI would depend on the intensity and mix of investment coming from inside and outside the region. In other words, if interregional investment is predominant RIAs will boost investment. But if intraregional FDI is dominant, the effect could be negative. It should be noted that even if the modes and motives are same for countries within the same RIAs, not all countries may benefit to the same extent as those from different RIAs. Countries with relatively higher education levels and financial stability have a tendency to attract a larger share of FDI at the cost of other RIA members.<sup>43</sup>

Although the various theories examined above have looked in detail at the economic factors affecting FDI, they have explored political factors to a much lesser degree (Buthe and Milner, 2008). Further, domestic political instability and political institutions have been explored in a systematic manner, whereas international political factors have not received due attention in the economic literature. Even studies linking RIAs with FDI have concentrated on the economic dimensions and not on the equally important political aspects.<sup>44</sup> For example, the signing of trade agreements indicates to potential investors that a more welcoming investment climate exists, as the commitment to liberal policy on trade increases the chances that the Government concerned will maintain liberal economic policies domestically

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<sup>41</sup> By way of contrast, vertical MNCs split up the production process across borders in order to exploit gains from comparative advantages within those firms (Helpman, 1984)

<sup>42</sup> A survey by the Working Group of the Capital Markets Consultative Group (2003) was found that RIAs increase regional demand and potential market size. This is very important in the context of analysing FDI prospects for number of countries in Africa and Asia that are too small to attract market-seeking FDI on their own.

<sup>43</sup> This has been confirmed by the estimates carried out on a sample of 71 developing countries during 1980-1999 by Jaumotte (2004).

<sup>44</sup> It can be argued that RIAs may affect FDI positively not only because they have economic effects but also political effects, in the sense that RIAs institutionalize the commitments to open markets and liberal economic policies (Chang and others, 2005).

to ensure maximum gains from such international agreements. It was these factors that boosted FDI from the United States to Viet Nam after the signing of the United States-Viet Nam Bilateral Trade Agreement. From 2001, this agreement extended most favoured nation status to Viet Nam. It also required Viet Nam to liberalize many laws, policies and procedures during a 10-year period. These obligations were expected to not only stimulate bilateral trade between the two countries but to also make Viet Nam attractive to the United States and many foreign investors (Foreign Investment Agency, 2005). In fact, the period after the signing of the treaty witnessed accelerated flows of FDI into Viet Nam.<sup>45</sup>

## **6. FDI theories explaining investment from developing countries**

The theories reviewed above have mainly explained the movement of investment from developed economies/regions to other economies/regions. The above discussion however, fails to capture the phenomenon of investment from developing countries to other countries. In more recent times, especially during the past two decades, a number of developing economies have emerged on the map of international investors. MNCs have not only emerged from newly industrialized economies such as the Republic of Korea and Taiwan Province of China but also from countries such as Argentina, Brazil, India, the Philippines among others (Kumar and McLeod, 1981). The so-called Third World MNCs (TWMNCs) have established themselves in every sphere of the global economy.<sup>46</sup>

Thus, it becomes necessary to explain the essence of TWMNCs in order to develop a theory consistent with their investment behaviour. At the outset, it must be noted that these firms have generally brought technology from the developed world. However, since such technology is more suitable for an area with a large market size, firms importing technology will export their products once local demand has been met. As the products become more familiar in foreign markets, and as the markets for such products gradually become established, the firms show a preference for setting up subsidiaries abroad rather than

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<sup>45</sup> The greatest increase was recorded from United States MNCs at a rate of 27 per cent annually (Foreign Investment Agency, 2005).

<sup>46</sup> Aggarwal and Weekly (1982) first coined this term.

exporting. Thus, in some cases the Product Life Cycle Theory is able to explain investment abroad by TWMNCs.<sup>47</sup>

In certain cases, a product is modified and the technology, which was originally imported, undergoes changes to suit the tastes of foreign consumers. The modification is either in the form of scaling-up (for consumers in developed countries) or scaling-down (for consumers in other developing countries).<sup>48</sup> During the product modification process, the technology also undergoes change.<sup>49</sup> In fact, modified foreign technologies that factor in local tastes and preferences have allowed innovating TWMNCs to gain a competitive edge in other developing countries that have similar socio-economic conditions.<sup>50</sup> In this way, TWMNCs have acquired the firm-specific ownership advantages highlighted by the Hymer (1976). Such firms find it more beneficial to internalize these advantages than to transfer them to other unrelated firms (Buckley and Casson, 1976).

Apart from the ownership advantage in the form of suitable technology, TWMNCs also enjoy other ownership advantages over the developed world's MNCs in the form of:

- (a) Lower overheads and expatriate costs. Unlike their western counterparts, Third World MNCs make minimum investments in their factory, office and work facilities. Although these firms pay higher wages to their staff as compared to

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<sup>47</sup> Ting (1982) highlighted the classic example of the unfolding of the international product lifecycle phenomenon in the case of subsidiaries of Taiwan Province of China's "Tatung Company" operating in Japan, Singapore and the United States, and primarily engaged in the production and assembly of household and electronic items using technology that had originally been imported. After gaining domestic success, these products were first exported to the countries from where the technology had been imported; finally the firm even invested in advanced markets and transferred the product technology. There are many such examples of products that have gone the full circle such as televisions, mobile telephones and automobiles,

<sup>48</sup> Scaling-up involves enhancing the features qualitatively while scaling-down refers to eliminating features in order to make the product simpler.

<sup>49</sup> The innovative process-developing activities of many Indian firms in a wide range of industrial activities ultimately led towards product development in the 1990s. For example, in the case of the Indian pharmaceutical sector, a number of Indian companies that started by out-licensing to MNCs in developed countries has allowed them to exploit their competitive advantage even in the developed countries (Pradhan, 2008a).

<sup>50</sup> According to UNCTAD (2004) one of the key drivers of the increasing number of home-grown Indian firms, such as the Tata Group, Infosys, Wipro and Ranbaxy, is the improvement of ownership-specific advantages, including financial capabilities.

what is paid in their home countries, it is still lower than the wages paid by MNCs from the developed countries. The resultant lower cost is then passed on to the consumers (Kumar and Kim, 1981);

- (b) Familiarity with local conditions. Third World firms are in an advantageous position in terms of their familiarity with developing countries. Most of the developing countries have a common socio-economic background, ethnic and cultural environment, infrastructural conditions and bureaucratic inefficiency. Although these are not conducive for development, indirectly it becomes an asset to the third world firms to operate in such environment;
- (c) Less-threatening position. Unlike their western counterparts these firms are perceived to be neither politically nor economically threatening by other developing host countries.<sup>51</sup> Consequently, they receive a considerably warmer welcome than would be accorded to investors from the developed countries.<sup>52</sup>

According to Dunning (1998), location-specific factors are also responsible for MNCs undertaking FDI. As pointed out by Kumar (1982) and Sharan (1995), the barriers imposed on imports by host countries constitute one of the main reasons behind FDI by Third World firms. In order to protect their foreign market positions that have been developed through exports, these firms often respond to protectionist measures by setting up subsidiaries and joint ventures in host countries. Thus, a part of overseas investment can be considered defensive in nature.<sup>53</sup> Another motive for FDI is a desire for reduced risk through diversification. This risk is related to political instability or the threats of adverse political developments at home.<sup>54</sup>

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<sup>51</sup> However, when a large and powerful country such as China is perceived to be dominant in a region, firms from such a country will sometimes be seen as a political and/or economic threat by the countries in which they are investing..

<sup>52</sup> The expectation that better rapport will be achieved between TWMNCs and host country Governments is, to a large extent, based on the perception of economic and cultural kinship that is assumed to exist between the parties who share a common Third World background (Aggarwal and Weekly,1982).

<sup>53</sup> For example, when textile exports by Hong Kong, China were threatened by import restrictions in Indonesia, the firms responded by setting up manufacturing units in the latter country (Chen, 1981).

<sup>54</sup> FDI is therefore also seen by TWMNCs as an outlet for decreasing their overall exposure to political risk (Lecraw, 1977).

In certain cases, political uncertainty due to industrial disputes may also have an effect on outward FDI. For example, the rapid increase in labour costs as a result of labour disputes and uncertainties in production in the 1990s resulted in firms in the Republic of Korea relocating to countries that had lower wage levels and which were free from labour disputes (Tcha, 1998).

Further, government policies at home have been identified as one of the common motives for Third World MNCs to invest abroad. Government measures are not only in the form of incentives offered by the host Government but also through the home Government exerting influence that is restrictive in nature. This has created pressure on Third World firms to invest abroad. For example, in the pre-1990s period, large privately-owned Indian firms that were desperate to expand their operations found themselves in a bind due to the disadvantageous situation created by a restrictive policy regime.<sup>55</sup>

Another driver of FDI has been the role of diaspora. Such ethnic networks play a transitional role in matching the right supplier and seller in international markets. They particularly enjoy a favourable position in their country of origin, which allows them to serve as bridges between the economies of the country of origin and the host country.<sup>56</sup> Anwar and Mughal (2013) found that investment by Indian MNCs have usually gone to countries and regions having sizeable Indian migrant communities. During 1999-2008, the leading recipients of Indian outward FDI in the OECD region were Canada, the United Kingdom and the United States. These countries happen to have the largest concentration of Indian diaspora

Furthermore, if the domestic currency is relatively stronger than foreign currency it will be advantageous for firms to go abroad.<sup>57</sup> In other words, the currency-based theory of FDI also provides an explanation for foreign investment by Third World countries.

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<sup>55</sup> The strictly regulated industrial licensing system that operated in India prior to the 1990s deterred the entry of new firms and prevented the expansion of output by existing competitors. This is because those firms that obtained an industrial licence did not put it into practice in order to pre-empt licensed capacity. This practice effectively forced rivals to seek investment opportunities abroad (Siddharthan and Pandit, 1998).

<sup>56</sup> It is interesting to note that a study conducted by Amendolagine and others (2012) in sub-Saharan Africa revealed that investment by diaspora members in their country of origin tends to generate larger backward linkages.

<sup>57</sup> For example, it was evident that FDI by the Republic of Korea during its transition phase increased significantly as its currency became stronger relative to the currency of the country in which it was investing. (Tcha 1998).

It is evident from the above discussion that many of the FDI theories explain the decision by TWMNCs to invest abroad. Nevertheless, there are certain motives that appear to be common to such firms and this sets them apart from those MNCs that have their headquarters in developed countries.

## **7. Conclusion**

It is obvious from the above review that in the economic literature a large number of theories exist that explain the reasons for the movement of international capital. The central concern of these theories is to provide an explanation of the reasons for a firm's decision to move abroad. Some of the theories are a corollary to trade theories under a perfect market set up, while other theories have been developed from the imperfect market conditions. However, no single theory can explain international investment.

Despite their different approaches, these theories are unanimous in their view that a firm moves abroad to reap the benefits of advantage enjoyed by them in the form of location, firm- specific or internationalization of markets. These theories also articulate the fact that government policies on the domestic economy also play a vital role in encouraging international investment by firms.

Some theories have also propounded a link between regional trade agreements and FDI. However, it is pertinent to the note here that the majority of theories are in the context of First World multinationals. In the recent past, the growing importance of Third World MNCs has necessitated the modification of these theories in order to incorporate such features as labour disputes in the home country, lower expatriate costs, familiarity with local conditions in other countries and the role of diaspora.

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