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# Foreign Direct Investment and its Theoretical Approaches

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**ABSTRACT**

*Multinational Enterprises enter the host countries via FDI, portfolio investment, export or through leasing of technology and patents (Frank, 1980).While considering cross border investment, it is important to distinguish between FDI and Portfolio Investment. Portfolio Investment involves passive holding of securities and other financial assets, which does not reflect active management or control or both of the security's holders. High rates of return and reduction of risk through geographic diversification positively influence it. The management dimension is what distinguishes FDI from Portfolio Investment in foreign stocks, bonds and other financial instruments Several theories on FDI as envisaged above basically cover two distinct approaches: microeconomic approach approach (Buckley and Casson, 1976). While microeconomic approach to FDI flow attempts to explain why firms in one country are successful in penetrating into other markets, the macroeconomic approach (Buckley and Casson, 1976) tries to examine why firms look for international expansion.*

## 1. INTRODUCTION

Technological advancement is an important contributor to the economic growth. Amongst the developing and transition economies of both Europe and Asia, the fastest growing ones are the biggest recipients of foreign direct investment (FDI) (UNCTAD.2002).The developing countries are making transition from import substitution of the 1950s and 1960s towards structural adjustment and market economies with and increasing thrust on FDI .FDI takes place when an investor based in one country (the home country ) acquires an asset in another country (the host country)with an aim to manage that asset.

Multinational Enterprises enter the host countries via FDI, portfolio investment, export or through leasing of technology and patents (Frank, 1980).While considering cross border investment, it is important to distinguish between FDI and Portfolio Investment. Portfolio Investment involves passive holding of securities and other financial assets, which does not reflect active management or control or both of the security's holders. High rates of return and reduction of risk through geographic diversification positively influence it. The management dimension is what distinguishes FDI from Portfolio Investment in foreign stocks, bonds and other financial instruments (Krugman and Obstfeld, 1977; Yarbrough and Yarbrough, 1997; Salvatore, 2001).

On the contrary, FDI comprises of the acquisition of share and capital through mergers and takeovers, the establishment of new Greenfield subsidiaries, capital transfer from parents to subsidiaries and reinvestment of the profits earned buy subsidiaries. It is defined as net inflow of 'investment to acquire a lasting management interest (usually 10 percent of voting stock)' in and enterprises operation in a country other than that of an investor, the investor's purpose being an effective voice in the management of the enterprises. In most of the cases, both the investor and the asset it manages abroad are of foreign firms. In such cases, the investor is referred to as the "parent firm" and the asset as the 'affiliate' or 'subsidiary' (WTO, 1996).

## 2. THEORETICAL APPROACHES TO FOREIGN DIRECT INVESTMENT

There exist a number of theoretical approaches to FDI that tend to address why a country of a firm attracts foreign capital and who contributes to that, among them, the most widely used theories are Comparative Cost Advantage theory, Product Life Cycle theory, and Eclectic Theory.

**A. Comparative Cost Advantage Theory:** This theory, developed by Ricardo, while explaining the nature of imperfect markets suggests that a country should produce and export those goods and services which are relatively more productive than others and imports those goods and services for which other countries are relatively more productive than it is (Krugman and Obstfed,1997).Although this theory is an explanation on trade flow rather than a direct theory on FDI, it leaves room for explaining why firms want to enter a foreign market by way of direct investment instead of exporting their products to the foreign country.

With regard to above, there are four different cases having distinct implications. First, if there are both firm specific and national comparative advantages, barrier to entry and to direct investment would be costly and thus lead to a distinct deterioration in the efficiency of world resource allocation, the cost having to be borne by both investing and hosting countries. Second, if there were strong firm specific and weak national comparative advantage, some company other than the foreign investor would be expected to establish production. Third, if national comparative advantage is weaker, exports can fairly easily be substituted for foreign investment and the firm can expand production in its home country and export the product to the country that raises barrier for direct investment .

The last option that the comparative advantage is weak in both the respect, make the case most indeterminate. This case is often connected with increasing return to scale, where several firms are usually found to be competing with one another. The decision regarding the location of the production would depend upon the chance factor only (Sodersten, 1980).

Despite its wider implications as drawn above, the theory of comparative advantage limits its scope for general applications for the reason that it may not be appropriate to assume that cost is the sole driving factor for FDI flows. Factors like technology transfer, tax incentives, etc. are equally important (Giffin and Pustay,1999 ).

**B. Product Life Cycle Theory:** The product life cycle theory as developed by Vernon explains why firms tend to become multinational at a stake in its growth. it emphasizes that in the early stage of the product cycle, initial expansion into foreign takes place through exports. Once the product has evolved in a standard form and the competing product have been developed, the firm may decide to look overseas for the lower cost locations and new markets established by price reduction or typically by firms operating under oligopolistic situation (Vernon, 1966, 1979). This theory also suggests that FDI occurs when the foreign market is large enough to support production (Cullen, 1999; Griffin and Pustay, 1999).

However, Vernon's theory does not identify clearly the scale at which it is profitable to invest (Hill, 2001), and it also fails to explain why companies choose FDI over other forms of market entry, viz. direct export (wild etal.2000). it is also important to remember that 'the story of international oligopoly is not a story of aggressive expansion by giant multinational companies in a predatory effort to crows out small local firms', rather 'a preference for the status quo' (Hufbauer, 1975,p 273).Vernon's model is questioned for its over deterministic approach and want of explanations under current global conditions(Buckley and Casson, 1985).

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C. **Eclectic theory:** A more comprehensive theory on FDI has been developed by Dunning called 'Eclectic Theory' (Dunning, 1979, 1981).It is Dunning who has given a systematic and general explanation of different types of international operations. The Eclectic theory identifies three types of advantages, viz. ownership advantage, locational advantage and internalization advantage, which a firm or an industry of a country must possess to attract FDI.

a) Ownership advantage: These arise from the size of the firm and their access to markets and resource, as well as firms' ability to co-ordinate activities and exploit difference between countries. The firms of investing country must possess some ownership specific comparative advantages over their competitors in the host country, which may include intangible assets like technology, managerial and marketing skills, access to cheaper capital and raw materials, etc.

b) Locational advantage: The host country must possess some locational advantages for the investor country so that the latter undertakes investment rather than exporting to the host country. Locational advantage arise due to country's natural endowments, transportation costs, macroeconomic stability , cultural factors, government policies, tariff and quantitative restrictions imposed on imports by host country, as well as inter –country differences in input, factor prices and productivity.

c) Internalization advantage: It arises because of market failure and information failure. Hence, for the firms, it must be more profitable to internalize those advantages by means of FDI rather than exploiting them by licensing .The advantage of internalization arises from four factors: (1) the need to control production and to coordinate flow of inputs; (2) the need for discriminatory pricing in case of intermediate inputs; (3) it avoid uncertainties in transfer of knowledge; and (4) it allows the foreign firms to avoids government regulations like anti- dumping , taxation, etc. transfer pricing .

Dunning(1993) in one of his later studies identifies three forms of FDI – resource seeking ,market seeking and efficiency- seeking FDEI. According to him, the nature of FDI will affect the determinants of FDI in host countries .

In case of resource seeking FDI , access to raw material and cheap labour is the major factor behind the choice of location. Countries endowed with relative abundance of such factor will be the choice of location of the firm seeking to produce these resource-intensive products. This may be seen as the extension of comparative advantage theory of international trade.

For efficiency seeking FDI ,local condition and policies are more important. Exchange rate policies, fiscal and monetary policies, types of institutions, political stability are some of the determinants of FDI foe host countries. These policies constitute the risks that foreign investors have to take into account to invest in any particular country.

Market seeking FDI aims to set up production capacity in a particular country to supply goods and services to the local market. Such investments may seek to exploit existing markets of create new ones and are also likely to be found in industries with high capital costs, large economies of scale and those with high larger markets and faster rates of economic growth will give greater opportunity to foreign investors to exploit.

In somewhat similar line, Porter (1986) identifies four stages in the development of the nation, viz. factor-driven, investment-driven, innovation-driven and wealth-driven. While Porter does not clearly indicate the patterns of FDI at different stages, these can differ depending upon the stage of development (Kumar, 2002). Ozawa (1992) expects that a country at the beginning of the factor-driven stage will attract

resource-seeking or labour-seeking inward FDI. The next investment-driven stage attracts FDI in the capital and intermediate goods industry. Similarly, the transition from investment-driven to innovation-driven stage brings inward investment in technology-intensive industries.

D. **Other Approaches:** The writings of Coase (1937) and the literature on barriers to entry (Bain, 1956) emphasize the fact that foreign investors are at disadvantage due to lack of knowledge of the local condition. In order to offset this disadvantage, the translational corporations (TNC) must have a compensating advantage that should be internationally transferable. In perfectly competitive market, no foreign firms can exist, but this can exist in imperfect market conditions. For direct investment to thrive there must be some imperfections in markets for goods or factors, including better technology or some interference in competition by government or firms. Kindleberger (1969) emphasizes on four possible imperfections: product differentiation in goods market, internal and external economies of scale in factor market and government intervention. According to him, due to these imperfections, FDI may provide rents (including high wages, benefits, and profits), intangible assets (Including technology, marketing, better managerial skill), and potential spillovers and externalities that are highly beneficial to the host-country towards achieving higher economic growth.

Further, Hymer (1971) argues that the possessor of the advantage is unable to fully capture the returns because of the imperfections in the market in respect of knowledge. One source of imperfection is the buyers' uncertainty about the full potential of technology unless it is put to use. In other words, the preference of FDI arises due to the cost of property rights transferred through licensing (Davis, 1977). Thus, the barrier to entry to do export and the inability of the firm to duplicate proprietary knowledge are the motivating factors for FDI. This approach, however, explains only the initial FDI but not the existing FDI. This limits its applicability in the context of developing countries.

Another approach (Aliber, 1971) views FDI within a currency area i.e. investors value all the assets in terms of currency of the home country. Hence they would demand premium for bearing the exchange rate risk. This theory, however, fails to explain the industrial distribution of FDI and also cross-country distribution among the developing countries (Buckley and Casson, 1976 and Dunning, 1971).

Knickerbocker (1973) views foreign investment as a defensive oligopolistic reaction. In an empirical study on US multinationals, he establishes the fact that the greater the seller concentration, the quicker is the entry of a leader into a market followed by others.

Oscar Bajo-Rubio (2002) has developed a more specific approach to FDI at the country-level. Following the theory of Smith (1987), they explain as to why any country will take FDI route and not export. Their explanation goes as follows:

Assuming that MNEs face no threat of competition, its export level would be obtained from the maximization of

$P(X)X - (C+S+T)X$

Where, $P$ = price

$X$ = output level

$C$ = unit cost

$S$ = transport cost associated with exports

$T$ = tariff associated with exports

On the other hand, if MNEs produces abroad, the output level would maximize

$P(X)X - CX - G$

Where $G$ = plant specific cost incurred by MNEs in the host country.

Denoting $X_e$ and $X_h$ as maximization of output levels while exporting or producing

abroad respectively,

If $X_e < X_h$, the dfirm would choose to invest abroad rather than export.

i.e. $(X_h) X_h - C X_h - G > P(X_e) X_e - (C+S+T) X_e$

The sufficient condition for FDI to be preferred is:

$$G < (S+T) X_e$$

FDI is, thus, then outcome of three interacting conditions. First, the firm owns assets that can be profitably exploited on a comparatively larger scale, including intellectual property (viz. technology and brand name), organizational and managerial skills, and marketing networks. Second, it is more profitable for the firm to utilize these assets in different countries than to produce in and export from the home country. Third, the potential profits from "Internalizing" the exploitation of the assets are greater that that from licensing the assets to foreign firms and are sufficient to make it worthwhile for the firms to incur the added costs of managing a large and geographically dispersed organization.

## 3. CONCLUSION

All the above theories seek to explain FDI regardless of the country of origin. As Kojima (1973) argues in the context of Japan, there is inherent difference between FDI originating in the west and in Japan. He suggests that FDI in Japan be explained more by macro-economic factors as against the micro-economic models that explain FDI in the west. While market imperfections and micro models of monopolistic competition may explain western FDI, a general equilibrium model without market imperfections is needed to explain Japanese FDI. Western and eastern firms differ in a number of ways. First, their cultural and social values are different. Second, infrastructure is often deficient in the east. Third, governments in the east unlike the west are more committed to have control on business. Also, investment decisions in the east are, by their very nature, long run and investors are affected by uncertainty of the durability of duty drawback schemes and other incentive packages that can be withdrawn or altered at the decision of the government.

Several theories on FDI as envisaged above basically cover two distinct approaches: microeconomic approach approach (Buckley and Casson, 1976). While microeconomic approach to FDI flow attempts to explain why firms in one country are successful in penetrating into other markets, the macroeconomic approach (Buckley and Casson, 1976) tries to examine why firms look for international expansion.

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