

TOPICS IN FOREIGN DIRECT INVESTMENT

Foundations of Foreign Direct Investment

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Introduction

To adequately understand foreign direct investment, one must trace the origins of international trade beginning with comparative advantage theory, which views trade from the standpoint of perfect competition, to the new classical theories that focus on imperfect markets. The debates that are raised in these theories touch on many issues, however, central to the underlying theme in all of these theories are the issues of efficiency and equity as they impact both the home and host countries. Understanding the theories in and of themselves is not enough to explain the concept of foreign direct investment. We need an instrument to tie the two together and that instrument or more preferably, institution, is the multinational corporation (MNC). The literature is inconclusive in providing a precise definition of the MNC. A generally accepted theorem is that MNC's are composed of a corporate structure where operations are in two or more countries on such a scale that growth and success depend on more than one nation, and where decisions are made on the basis of global alternatives (Parry 1973). For the basis of this paper, we shall also accept this premise.

This paper will examine how international trade theory impacts foreign direct investment decisions. We will investigate the idea of a MNC moving from the notion of perfect competition to the concept of dealing with market imperfections as well as follow the evolution to the "new paradigm" of international trade.

Understanding the Classical Theories of International Trade

Three theories have commonly been used to explain why corporations engage in international trade. These theories are comparative advantage, imperfect markets and product cycle. As we examine these theories we will see some overlap in their concepts, which creates some "harmonies" between the concepts, but we will also note some "distortions" that arise as well. We shall also begin to see how foreign direct investment impacts international trade.

Comparative advantage theory, developed by David Ricardo, explains what happens when one country can produce all products at an absolute advantage, but still engages in trade with another country. What occurs is specialization by countries, which promotes more efficiency in their production processes. Specialization can also lead to the absence of production in other products. In order to obtain essential products not produced in the home country, it is important to establish trade with other countries. This is the classical argument of comparative advantage (Madura 1998). From this we can begin to understand the basis of foreign market penetration.

Several assumptions are raised in regards to this theory, some with satisfactory explanations and some without. First, there is the assumption that resources are employed full time. If we assume that they are not, then the advantages of specialization tend to be less compelling. We mentioned earlier that efficiency in output was one of the objectives of this theory. Firms may decide to avoid overspecialization, especially in light of new directions in technology or price fluctuations (Daniels/Radebaugh, 1998). Second we note some areas such as the division of gains and the movement of goods, which are not adequately covered. When there is increased production due to specialization the decision as to what to do with the increased output is a critical issue. Firm owners as well as government officials of the nations will be concerned with their trading partner benefiting more greatly than they do. Since we are talking about production being shifted from one country to another, there must be some discussion of the cost of moving these goods. This appears to be one of the major weaknesses of comparative advantage theory, which is not adequately addressed in the literature. If it costs more to transport the goods, than what is saved through the process of specializing, then the benefits of trade are not realized. It was believed that there was greater mobility of resources domestically than internationally. This portion of the theory has been challenged over time and proven that resources are neither as mobile or immobile as once thought. While comparative advantage theory was primarily directed towards the production of goods, and not services, as world trade is increasing in the services sector this area of the theory needs more investigation.

If markets were perfect, factors of production would be extremely mobile and would transfer freely from country to country. But the real world is not perfect, and countries differ in the resources that are available for the production of goods. **Imperfect Market Theory** discusses the conditions where factors of production are somewhat immobile. There are costs and most often restrictions related to the transfer of labor and other resources used in production. Heckscher and Ohlin, two Swedish economists developed the theory which stated that differences in a country's endowments of labor relative to their endowments of land or capital, were used to explain the differences in factor costs. For example, if labor were abundant in relation to land and capital, labor costs would be low and land and capital costs would be high. If labor costs were high the reverse would be true. This scenario suggests that countries need to excel in the production and export of products that were in excess, leading to less expensive production factors. These imperfections in the market often allow MNC's to capitalize on a foreign country's resources, which create opportunities for foreign direct investment.

Raymond Vernon developed the **Product Life Cycle (PLC) Theory** to explain world trade in manufactured products based on the life cycle of the product. In general, the PLC theory states that the production location for many products moves from one country to another depending upon the stage in the product's life cycle. There are four stages in the life cycle: introduction, growth, maturity and decline. The key assumption underlying this theory is that the location of production will shift internationally depending on the stage of the cycle. It is in the introduction stage that the PLC theory is most commonly associated with classical international trade theory. Since information about markets and competition is more readily available at home, it is more common for a firm to establish itself in its home country. But as Vernon's theory progresses through the other stages of the PLC, it begins to take on a more neo-classical dimension. We shall discuss this further when we cover the evolution from classical to neo-classical theories.

What we can disseminate from these classical theories is the fact that at some point a firm makes the decision to move beyond their home country market. While international trade (exporting/importing) is one of the most common first mover strategies to penetrate foreign markets, we cannot overlook the fact that other options, such as licensing agreements, franchising, joint ventures, acquisition of existing operations and establishment of new foreign subsidiaries also exist (Madura, 1998). For the purpose of this paper we will examine only those options which deal with full control and ownership through foreign direct investment.

Foreign Direct Investment and the Decision Making Process

Multinational corporations see the main reason for foreign direct investment as particular responses to imperfect and distorted markets. These imperfections are closely associated with product and factor markets and financial markets. By understanding the type of imperfection that the investment is designed to overcome, multinationals are in a better position to determine how to pursue the investment. This analysis then leads to a decision of whether the proper approach is a vertical direct investment, across industries that relate to different stages of production, or horizontal direct investment, which is cross-border but within the same industry (Shapiro, 1992). Financial market imperfections that allow for greater cash flows, lower cost of funds and a reduction in risk via international diversification are key motivators for foreign direct investment. There are other motivations for engaging in foreign direct investment, such as, sales expansion, resource acquisition, diversification, competitive risk minimization and political objectives (Daniels/Radebaugh, 1998). We cannot ignore the effect of high transportation costs as an additional driving force in seeking foreign direct investment, specifically when high fixed costs are involved.

Yari Aharoni offers a slightly different model for decision making (Aharoni, 1966). Aharoni's focus is shifted inward to the internal environment of the organization, where relationship building is a key criteria in the process. His five-step process begins with an examination of the mechanisms that the company uses for conducting business; along with past experiences and the company's reaction to the external environment, which can include market imperfections. In addition to his consideration of the social system, he incorporates the element of time (which he ties together with the level of problem importance), uncertainty, which is the most critical of the elements, goal setting and constraints impacting the decision. The internal social system is usually driven by a key executive or high-powered client that has a desire to see a foreign investment occur for personal reasons, rather than for opportunity. The sheer suggestion of the level of problem importance indicates that someone is spending time investigating the opportunity. While a key executive or powerful client may have initiated the process, the decision process can be abandoned at this stage if it is deemed that there are obstacles that cannot be overcome. The element of uncertainty should signal that there are risks to be assessed before proceeding further in the process. This level of

uncertainty will require commitments from someone in the company to move the investment process forward. The caution that must be noted here is that if the sponsorship comes from a high ranking official, decisions may be made without full investigation of the opportunity, simply because of the status of the sponsor. Once the goal setting stage has been reached, it is critical that the internal groups move in sync to eliminate any uncertainty that exists. In the final stage of addressing constraints, the organization must align its resources to ensure operational control and growth of the investment.

Thus far we have looked at the decision making process from a variety of perspectives. However the question left unanswered is whether the decision making process is affected by the size of the organization? This question is addressed (Buckley, 1980), in the examination of small and medium sized enterprises.

The first clarification that is made in Buckley's work is the problem of defining what exactly is a small firm. Buckley chose to use criteria taken from the Bolton Report. Three key criterions were used: market share, independence and personalized management. Market share allowed the assessment of whether a firm was able to influence the prices or quantities of goods to any great extent. Independence addressed the level of control that the actual owner exerted over the organization. By use of this definition, subsidiaries of large organizations were excluded. And finally personalized management explains the level of participation and decision making that the owner displays. The normally requires that there is an avoidance of delegation of tasks from the owner to other in the firm. Other comparisons of use size of the economy, level of sales and even assets held by the organizations. Whatever measure that is decided upon to be used, the point is more to have a frame of reference regarding firm size when assessing the issue of foreign direct investment.

Aharoni made some key points about the role of management in the decision making process as it relates to foreign investment and Buckley has a similar, although more definitional role of management in the process. From his view management is central to the process not simple because of their status in the organization, but from the fact that they are critical to focusing on change. The faster the rate of change needed in an organization, the higher the demand for management involvement. Foreign direct investment is a highly intense and risky decision, which necessitates a high level of involvement by key decision-makers, usually the management of the organization. These are not decisions that can be made without the process of due diligence. The obstacle that smaller firms encounter is that they have constraints on resources and time in order to give the process the full attention that it needs.

Other constraints can plague smaller organizations as well. Product and technological changes can cause vulnerability in smaller firms. This occurs due to their lack of diversification. The technology constraint normally has an impact on the firm's ability to grow. There is also the possibility of financial constraints. Small firms may not be in the position to raise capital externally as larger firms can, therefore their investment dollars come from profits generated in the organization. To successfully compete for external funding, these firms must establish a track record of success or become exceptional at lobbying for needed capital. Buckley leaves us with the notion that managerial constraints are much worthier of attention than financial ones.

For many firms, the first entry into internationalization has come through exporting. This is also the first form of direct investment that the firm makes as well. This process is outlined through a series of intermediate steps, building towards the goal of establishing a subsidiary operation. This intermediate processing has two advantages; first it allows for systematic learning and secondly, it allow the firm a way to opt out of the process without making an extensive capital investment.

Once the decision has been made to invest in a foreign subsidiary; the firm must now fully understand the risks involved and identify ways of minimizing those risks. A "safe" avenue in expanding internationally is to expand into countries close by that are very similar in nature to the home country and its environment. It should be clearly noted that the safety of the investment is not simply due to proximity, but rather to conditions which most closely imitate the home country.

What we can extract from the information highlighted in the decision making process is the fact that it is based on three central principals: ownership, location and internationalization. But this leads us into another conceptual area as well. These elements are also basis for moving from the classical theory of international trade into the neo-

classical realm. We will now take a closer look at some of the new paradigms that are necessary to understand this broadening process of internationalization and foreign direct investment.

Moving from the Classical to the Neo-classical

As we move along in this process we carry forward the thought that world markets are no longer thought of in terms of perfect competition, but rather imperfect markets. This is a move to oligopoly, where decisions become more complex and entail consideration of multiple variables. With a more concentrated dose of uncertainty and risk involved, our decision making is more in the mode of gamesmanship, where each move is strategically thought out and the consequences of our actions more heavily weighed.

To bring perspective to this thinking (Dunning, 1981) designed the eclectic paradigm of international production. Here it ties together the three elements of location, ownership and internationalization and the economic rationale for doing business in foreign markets. To understand the eclectic paradigm, we must understand the factors, which affect each of these elements.

There is a magnitude of factors that affect location. We mentioned earlier the issue of psychic distance, however add to this the consideration of production costs, which are affected by economies of scale. If we can produce more at costs lower than in the home country then this helps to reduce an element of risk in making the foreign investment. What helps in this decision process is if we are able to secure resources outside of the home country, which can help to drive our production costs down. Transportation costs are another issue to consider. Moving a product from one location to another, depending upon the size and weight of the product can prove to be expensive. If the product can be made less expensively, then transportation costs may all but be eliminated from the process, with the exception of moving raw materials or partial parts to the new location. From the standpoint of the host country, if the product in question is one that can directly serve the new market, there may be some incentives offered to the home country to make the investment. While we have not touched upon it previously, we do have to recognize the impact of government intervention, which can come in the form of tariff barriers. If importing products would prove to be too costly, the strategy could quickly move to making the investment to avoid such costs.

As we look at the factor of ownership, several considerations come to mind. Technology is an essential part of most products and a critical component for a firm's ultimate success. When investment is made outside of the home country, it is imperative that patents and trademarks are initiated to protect the originator's ownership rights. Both the home and host countries are concerned about cross-cultural issues. From the host country perspective they will want to preserve their cultural values. Many host country governments are most concerned about the impact that foreign investments may have on issues of national importance that may not be critical agenda items for the home country management. Home country managers are concerned about maximizing their investments and often do not take the time to learn or understand the cultural norms of the countries in which they make investments. Cultural misunderstanding on either side can spell disaster for the organization. Market access is also an important issue. For the home country the attraction of foreign direct investment is the opportunity to have access to an untapped market. For the host country, this is an opportunity to establish a domestic market. Competition is a major factor to be dealt with.

We now turn our attention to the issue of internationalization. Management and the recruitment of management skills are essential to the decision making process. Both Aharoni and Buckley place a great amount of attention on the role of management in the internationalization process. Quality and prices go hand in hand with management capability. Individuals in foreign markets want and expect quality products and will pay fair prices to obtain them. This is especially true if the products are not readily available in the host country. If the management team has done a good job in assessing the international opportunity, then the level of uncertainty about the investment should have been greatly eliminated.

What Dunning is attempting to do with his eclectic paradigm theory is to develop a framework in which we can analyze and explain those determining factors of international production, and how this will vary between firms, industries and countries. As he looks at the influences from the standpoint of the country, his focus is on the stage of economic growth that the country is in, the relative size of the country in comparison to the home country and the degree of industrialization that the host country has achieved. When examining industry factors, it is important to

assess the level of sophistication for the technology being employed. Is the industry innovative or stagnant in its evolution? And finally from the standpoint of the firm, Dunning considers its financial strength, the strategy that it executes and its size in the market in determining its success. All of these factors make up the core competencies of the organization and they are the backbone to their success.

The eclectic paradigm does embrace concepts from both the Heckscher-Ohlin-Stevenson trade theory, which draws upon trade that is inter-industry in character and the theory of market failures, which focus on risk factors, information flow and trade barriers. Close examination however reveals that its theme centers on the identification and utilization of factor endowments, which ties it very closely to the classical theory.

Raymond Vernon has been critical of the eclectic paradigm in that he believes that the model is too static in nature. In his own PLC theory, Vernon tries to overcome this static element by showing the patterns of shift in the whole process. There is not only a shift in the location of the product, but also a shift in the location of the consumption. These shifts are explained over the life cycle of the product as it moves through the four stages that Vernon has outlined of introduction, growth, maturity and decline.

Several characteristics are revealed in each stage. In the introductory stage there is a great deal of flexibility as the product is being designed for the market. This requires a great deal of R&D effort in order to meet consumer tastes and preferences. At this stage value-added is extremely high. The products being developed are primarily for the home location and home consumption. As the product enters the growth stage, there is a better understanding of the product on the part of the consumers. It has been accepted and a certain degree of standardization begins to emerge. High growth and high demand for the product characterize this stage. The product is located in the US or another industrialized nation (Europe or Japan) and its consumption is in the US, Europe or other developing country. At the maturity stage for the product, cost and price are dominant factors. The product becomes highly standardized and little or no R&D is employed. It is most shifted to developing country and its consumption is world wide, with export opportunities to both the US and Europe. In the final stage, which is decline, cost is the only real factor. Its location is developing countries, as is its consumption, and it is being exported to the rest of the world.

One of the themes that we can walk away with from Vernon's model is that the more complicated it is to develop and market products, the greater the need for foreign direct investment. His primary focus puts less emphasis on the comparative cost doctrine and more on the timing of innovation, the effects of economies of scale, and the roles of ignorance and uncertainty in influencing trade patterns.

While Vernon seemingly presents a very rational model for foreign investment, he notes in his writing that not all decisions are purely rational. Any perceived threat to an established position of an enterprise may spark a call for action. In fact some studies actually cite threats as a more reliable stimulus to action than opportunity.

Vernon speculates about export opportunities that may arise from less developed countries. More often than not, it is expected that there would be a high requirement for labor inputs for this to occur. There is not much support or relevant evidence of this occurring, since it is difficult to imagine that manufacturers that made significant investments in less developed countries would consider exporting these products from those countries. More common to less developed countries would be investments in import replacing industries, which were made in the face of a threat of import restriction.

If we consider foreign trade patterns over foreign investment patterns to understand the competitive advantage of less developed countries, this brings about a more plausible rationale for why they are an attractive location for the output of standardized products.

As we have pointed out there are some striking differences in Dunning and Vernon's models however both allow us to consider options applicable to imperfect markets.

The Division of National Markets

We take a final look at theory issues by examining a framework of methods of market servicing (or sourcing policies) of multinational corporations.

A national market for a final product can be served in four main ways: by indigenous firms, subsidiaries of MNC's located in the market, by exports to the market from foreign locally owned firms and by export from foreign plants owned by MNC's. The first two methods are distinguished from the second two by the "location effect" (Buckley/Casson, 1979), the market is served by local production rather than export. We distinguish the first method from the second, and the third from the fourth by the "ownership effect", where production is owned and controlled by domestic nationals rather than by a foreign owned international corporation.

In order to service a final product market it may be advantageous to locate different stages of production in different locations. This seems to be somewhat of a shift from Vernon's philosophy. A firm chooses its optimal location for each stage of production by evaluating regional production costs and choosing the set of locations for which overall average cost of production is minimized. A number of factors can complicate this strategy. First, there are increasing returns to scale in a number of activities. Secondly, modern businesses perform many activities other than routine production; these activities require different inputs from production, but need to be integrated with the production process. The third factor is that in practice firms operate largely in imperfect competitive markets. Another factor is one of government intervention, which includes the impact of taxes, tariffs and other regulations. Finally location decisions will be influenced by the ownership effect.

Having considered location effects, let us now look at the issue of ownership effects. A major dynamic of the world economy is the changing ownership effects that influence the pattern of distribution of production between MNC's and national firms.

In a situation where firms are trying to maximize profits in a world of imperfect markets, there exists an incentive to bypass imperfect markets in intermediate products. Where markets are internalized across national boundaries, MNC's are created (Hymer, 1976).

Benefits from internalization arise from five types of market imperfection. First, production takes time. Second, market power may require discriminating pricing of a type not feasible in an external market. Third, internal markets remove or prevent growth of bilateral concentrations of market power, therefore reducing the likelihood of unstable bargaining situations. A fourth type of imperfection occurs when there is inequality between buyer and seller with respect to the evaluation of a product. And finally, internalization may be a way of avoiding government intervention.

Examining the division of national markets provides us with another perspective on the issue of location and ownership from what we have examined earlier in this paper.

Conclusion

This paper provides a foundation approach to understanding the relationship of foreign direct investment with the various theories of international trade. Our examination has allowed a comparison of classical theories with that of neo-classical theories. We have seen that the theories are a complex mix of harmonizing factors and market distortions.

As MNC's began responding to the imperfections in the market, they began making investment decisions based on a new realm of factors. Ownership, location and internationalization were the building blocks of the new paradigm. But even this model would appear too static for some theorists, and an understanding of the patterns of trade would become an emerging philosophy.

While the models that have been studied have been more aptly applied to developing nations, we see the need to understand the impact they have on less developed nations as well. As long as there are imperfect markets, foreign direct investment will continue to remain a dominant force in the process of internationalization.

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