FOREIGN DIRECT INVESTMENT THEORIES: ANALYSIS OF MAIN FDI THEORIES

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ABSTRACT

The purpose of this study is to identify the main foreign direct investment theories. Although several researchers have tried to explain the phenomenon of FDI, it‘s not possible to say there is a generally accepted theory, every new evidence adding some new elements and criticism to the previous ones. This study attempted to explain the different foreign direct investment (FDI) theories by providing an analysis of the key theories in many scholarly works.

Key words: Foreign Direct Investment (FDI), OLI, Eclectic paradigm

IEVADS. ВВЕДЕНИЕ. INTRODUCTION

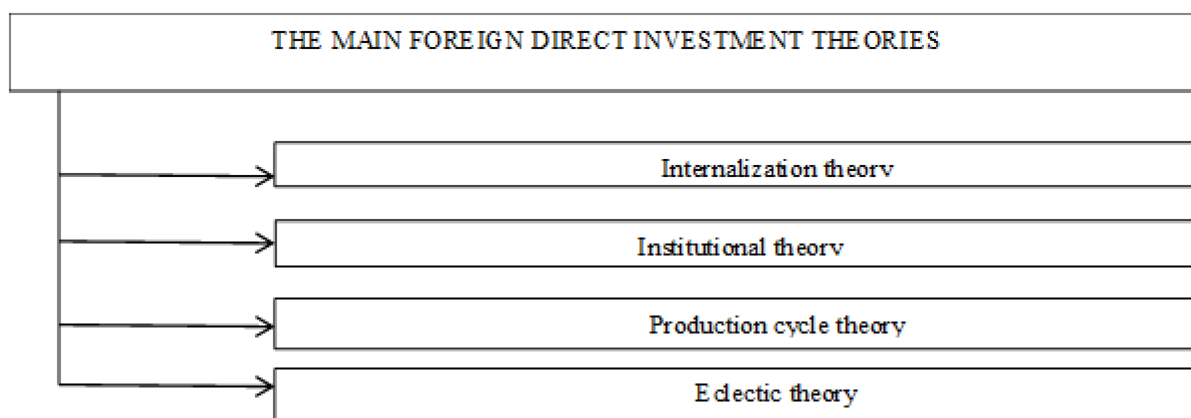
Foreign Direct Investment (FDI) acquired an important role in the international economy after the Second World War. This interest was driven by the rapid growth of US investment abroad at that time. Theoretical studies on FDI have led to a better understanding of the economic mechanism and the behavior of economic agents, both at micro and macro level allowing the opening of new areas of study in economic theory.

The objective is to explain the different FDI theories by providing an analysis of the key theories in many scholarly works.

Methods: the analysis and synthesis of scientific literature.

ANALYSIS OF MAIN FDI THEORIES

To understand foreign direct investment must first understand the basic motivations that cause a firm to invest abroad rather than export or outsource production to national firms. Picture 1 illustrates the theories that emerged in the second half of XX century and are considered as the main FDI theories.



Picture 1. The main foreign direct investment theories
Source: prepared by author

Many authors [12; 16; 11; 5] note that these theories explain only a certain group of foreign direct investment factors. Meanwhile, the decision to invest abroad is determined by a number of factors that can be explained not by a separate theory, but by various foreign direct investment theories together.

P. Zukauskas [17] notes that there are many international foreign investments, but often the main statements of these theories are repeated, several theories can be combined, or one theory is divided into more theories. The most popular FDI theories are: the internalization theory, production cycle theory, institutional theory, eclectic theory (OLI paradigm).

Some authors divide theories explaining FDI into microeconomic, macroeconomic, others distinguish the third group of theories - mixed theories of foreign direct investment. Czapor, [6] and Accoley [1] argue that microeconomic theories explain FDI from an enterprise perspective, macroeconomic theories relate to the country's perspective, and mixed theories combine microeconomic and macroeconomic aspects.

INSTITUTIONAL THEORY

The theory emphasizes the role of the institutions for attracting FDI. Bénassy-Quéré et al. [3] point to the increasing impact of institutions in attracting FDI, starting with the 1990. Assuncao [2] suggests that FDI are the result of the game or of the competition between governments. In this respect, institutions are seen as the ones that create the rules of the game. According to Popovic an Calin [15], a major importance for the appearance of this theory is due to the transition process in Central and Eastern European countries. The main characteristic of the transition process was to create institutions adapted to the market economy. Kinoshita and Campos [8] prove that neither market size, nor low labour cost are not significant determinants of FDI, once the quality of institutions and other variables related to policy formulation are taken into account.

INTERNALIZATION THEORY

The microeconomic theory of international production in 1960 was introduced by Stephen Herbert Hymer (1960 published in 1976). His work is considered to be a landmark in the study of FDI. According to Hymer the reasons for internationalization of companies are of two kinds: variables associated to the company's dimension and ownership of specific assets and variables resulting from the existence of market failures. Hymer demonstrated that FDI only takes place when the benefits of exploiting firm-specific advantages (FSAs) across borders allow overcoming the additional costs of doing business overseas.

This theory states that FDI from other alternative means of access to the foreign market is chosen because of the excessive costs of contracting and executing contracts and the higher risk of operating the company in a foreign market than owning and managing its own units abroad [12].

MNEs uses its internal organizational hierarchy as internal operations become cheaper than market operations [2]. Thus, the company seeks to maximize profits through internationalization. The theory of internationalization attempts to explain whether MNE uses leasing and licensing techniques to sell its products abroad, or whether it itself produces abroad using FDI [13]. In other words, it answers the question of why a company prefers foreign rather than producing domestically and then exporting. According to V. Kvainauskaitė [10], this theory is based on contract costs incurred in concluding contracts; this is the cost of negotiating, controlling, signing a contract. FDI against other alternatives is chosen because the costs of concluding and executing contracts (licenses, privileges, supplies, etc.) are too high and there is a higher risk of the company's operations abroad when it owns and manages its units abroad. This theory states that firms maximize their profits in imperfect competition, during this process if:

- • Shipping costs are high, there are trade barriers;
- • There is a problem with insufficient information on the foreign market;
- • There is information asymmetry between sellers and buyers;
- • There are conditions that increase costs, the company chooses internationalization and implements direct investment abroad.

In this way, firms can avoid delays, negotiations and customer uncertainty and take advantage of the opportunities to reduce the impact of adverse government regulation through transfer pricing and price differentiation across markets.

PRODUCTION CYCLE THEORY

The Product Life Cycle Theory was formulated by R. Vernon in 1966. According to this theory, some authors [16; 12] distinguish three stages of product life (innovation, maturity, standardization stages), while other authors [7] distinguish four stages (innovation, growth, maturity, decline). The international product life cycle theory states that the creation of a new product requires a highly skilled workforce and high capital investment associated with developed countries (the innovation phase in which the product is produced and exported from one country). At the maturity stage, where many competitive products are produced, the production of the product is transferred to developing countries, where the cost of production is reduced (the production and export of the product is linked to the developing countries, the original producer and exporter countries become importers) [10; 12]. Although the life cycle theory of an international product explains foreign investment, some authors emphasize the limitations of applying this theory. Buckley [4] and Navickas [12] point out that this theory can easily be applied to products based on technology or economies of scale and cheap labor, which cannot be said about service delivery.

ECLECTIC THEORY

The fundamental puzzle that started the three decade-old history of the OLI paradigm were questions such as: Why do firms invest overseas? What determines the amount and composition of international production? From the beginning, the eclectic paradigm has been preoccupied with explaining the origin, level, pattern and growth of firms’ offshore activities. The first condition – O – answered the ‘why go abroad’ or ‘how is it possible to go abroad’ question. O advantages (primarily from possession of intangible assets) were characteristics of MNEs that gave them a net competitive advantage over other firms supplying particular foreign markets. O advantages were broken into three types:

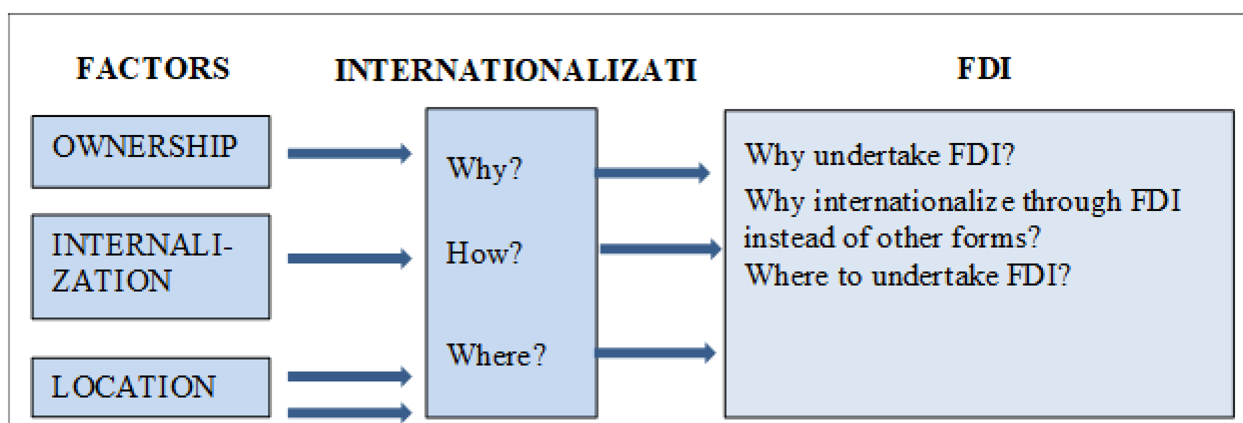
Type 1: advantages that do not arise from multinationality but are advantages that any firm may have over another producing in the same location; i.e., advantages stemming from size, monopoly power and better resource capability and usage. These enable the firm to achieve more technical or cost efficiency or more market power than another firm.

Type 2: advantages from being part of a multi-plant enterprise, such as economies of scale in non-production overheads (e.g., centralised accounting) and access to internal resources at lower cost than on the external market (e.g. internal borrowing).

Type 3: advantages that come specifically from multinationality, such as wider opportunities and the ability to exploit differences in factor endowments and markets across countries; such advantages increase along with the number of foreign countries in which the MNE has operations and the diversity of their economic environments.

Dunning presented the OLI paradigm, arguing that the decision to invest abroad is based on three groups of factors: the advantages of ownership, state and internationalization (OLI).

The factors determining the internationalization process in the Dunning model S. Kurtishi-Kastrati [9] depicted using the picture below.



Picture 2. Model of determinant factors in the key decision in the internationalization process [9]

It should be noted that local advantages have different effects on vertical and horizontal foreign direct investment. Foreign direct investment is one of the three main methods used by companies to start operating on a foreign market. The other two are export and licensing.

According to Pilinkienė [14], Navickas [12], Kvainauskaitė [10] eclectic theory combines the main statements of monopoly advantages and theories of internationalization. Meanwhile, Buckley [4] notes that eclectic theory combines not only the latter two theories, but also the theory of localization of foreign direct investment.

SECINĀJUMI. ВЫВОДЫ. CONCLUSIONS

The results of this study reveal that there is no a unified theoretical explanation, and it seems at this point very unlikely that such a unified theory will emerge.

Despite different approaches of FDI theories, they are unanimous in their view that a firm moves abroad to get the benefit of advantage enjoyed them in the form of location, firm – specific or internalization markets. These theories also proves the fact that government policies on the domestic economy play very important role in encouraging international investments by firms.

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