Chapter 5

Theoretical Framework

This chapter builds the theoretical framework which provides the methodological foundation for the thesis. Section II explains the locational factors. Section III discusses the theoretical framework based on John H. Dunning’s eclectic paradigm along with Mathews’ Linkage Learning and Leverage model and the Uppsala model and frames the relevant research questions to be tested in explaining the internationalisation strategies of the emerging Indian Pharmaceutical multinationals.

5.1 Introduction

Since the 1930s, various theories have been put forth to explain the geographical distribution of FDI and they include Vernon’s product cycle theory (Vernon, 1966), and that of Knickerbockers’ ‘follow my leader’ theory (Knickerbocker, 1973), which was one of the earliest attempts to explain the geographical clustering of FDI and Rugman’s risk diversification theory, which suggested that MNEs normally prefer to spread their foreign investments geographically than to concentrate them in a single location (Rugman, 1979).

The Classical and the Neo-classical theories of trade attributed changes in economic activity to variations in the availability of resources and the international division of labour was due to the geographical disposition of natural resources and the stock of capital. These theorists believed that there was no reason for FDI to exist as firms had no incentives to internalise cross-border markets as most of the trade in capital and intermediate products was assumed to be arm’s length with other assets being concentrated in particular locations. The role of technology in neo-classical theory was relegated to the background due to the assumption of its free accessibility to all firms which could be instantly transferred across borders. The neo-classical trade
economists, therefore, ignored the spatial distribution of international economic activity between countries and a country’s competitiveness lay in its ability to allocate resources in a manner that maximised its comparative advantage. These lacunae were taken up by the locational economists. The focus of the locational economists was not in determining the optimum mix of activities for a sub national location but in determining the optimum location for a particular mix of activities.

The last two decades has witnessed a growing interest by economists, (e.g. Audretsch, 1998; Krugman 1991, 1993) in the spatial concentration and clustering of some kinds of economic activity. Economists like (Cushman, 1985; Froot & Stein, 1991) have studied in detail the role of exchange rates in affecting the extent, geography and timing of FDI. Business scholars like (Porter 1994; Enright 1991, 1998), have suggested that an optimum locational portfolio of assets is a competitive advantage in its own right.

During the last few decades, the nature and spatial distribution of MNE activity has undergone drastic changes owing to a series of path breaking technological, political and economic events. Recent academic research too has begun to focus on the spatial aspects of FDI such as their mode of entry and expansion into foreign markets and the subsequent changes in the competitive advantages of firms.

Dunning (1998) attributes the international allocation of MNE activity to three major changes in the world economy. First, the growing prominence intellectual capital as wealth facilitators as seen in the case of services which are knowledge intensive. Such knowledge intensive activities are known to be dependent on its unique spatial needs, resources and MNE capabilities influencing the geographical distribution of FDI. The second important change is the rapid improvements in transport and communications technologies which has globalised economic activity besides lowering of trade and investment barriers throughout the world. The third significant feature of the global economy has been the emergence of “alliance capitalism” involving the collaboration of all stake holders in the form of intra-firm relationships and
inter-firm cooperative agreements to realise the economic goals of the economy at large. These three factors have necessitated firms to own and concentrate their activities within a limited number of locations (Dunning, 1998).

5.2 Explaining the Locational Factors

Extant literature has acknowledged that the locational preferences of MNEs depend on the structure of its domestic economy, the economic environment and of the international economy and their importance depends on four aspects of investment namely the motive for investment (e.g. resource-seeking or market seeking FDI), the type of investment (e.g. new or sequential FDI), the sector of investment (e.g. services or manufacturing) and the size of investors. UNCTAD (1998) lists out the key locational factors as detailed below.

a) Natural resources

Traditionally the availability of natural resources in the host country is regarded as an important determinant of FDI. Generally the resource-abundant countries lack the capital and the technical expertise needed to extract or sell raw materials to the rest of the world. The infrastructure facilities needed for transporting the raw materials out of the host country to its final destination is also a critical FDI determinant. Countries like India and China are increasingly undertaking natural resource seeking FDI especially in Africa owing to its rapid industrialisation and growing energy needs.

b) National markets

Large markets help firms in achieving scale and scope economies by accommodating both domestic and foreign firms and in helping them stay competitive. The high growth rate in a host country tends to stimulate investment by both domestic and foreign producers. National markets have been found to be important for many service TNCs, as most services are not tradable and therefore the only way to deliver them to foreign markets is through establishment abroad UNCTAD (1998).
c) Availability of low-cost labour

The availability of largely low-cost immobile unskilled labour is another location specific economic determinant of FDI and this FDI gained prominence under globalisation in the 1960s. Trans National Companies (TNCs) undertaking this type of FDI are firms from developing countries and those foreign affiliates who have moved up the value chain by organising and controlling networks of suppliers of various labour-intensive goods across several countries. MNCs that act as intermediaries between these suppliers and client firms in developed countries are also involved in this kind of FDI.

d) Macroeconomic policies

A host country’s macroeconomic policies reflect the openness of the country in question and include monetary and fiscal policies affecting taxes and exchange rates. Monetary and fiscal policies determine the parameters of economic stability such as the rate of inflation and the state of external and budgetary balances, and are therefore important in influencing all types of investment. As they determine interest rates and thus the cost of capital in a host country, they are significant in influencing investment decisions.

Fiscal policies determine general tax levels such as corporate and personal tax. Lower corporate tax rates in a country might attract an FDI project than a country with higher rates. Personal tax rates may affect the employee’s choice of a location of regional headquarters and may affect the hiring of foreign personnel. Exchange-rate policy affects the prices of host country assets, the value of transferred profits, and the competitiveness of foreign affiliate exports and hence may influence FDI decisions.

e) Business facilitation

Business facilitation involves proactive measures facilitating the business of foreign investors in a host country and includes promotion efforts, the provision of incentives to foreign investors, the reduction of the “hassle costs” of doing business in a host country (e.g. reducing or eliminating corruption and improving administrative efficiency).
f) Agglomeration economies

Such economies can be found in Knowledge-intensive industries seek such economies as they require created assets such as science and technology parks, R&D consortia and service-support centres (Dunning, 1998a) and therefore may be attracted to spatial clusters within a country or a region for knowledge creation.

g) Infrastructure facilities

Adequate infrastructure facilities such as high-quality telecommunication links and reliable transportation systems facilitates mutually supporting networks of activities and are therefore important for complex integration strategies.

h) A broad range of resources

The range of resources sought in host countries is diverse and these resources include not only inputs like natural resources, low-cost labour and engineering skills, but also functions like accountancy, legal services, purchasing and marketing, and finance and R&D capabilities. Therefore locations seeking to attract a wide range of value added TNC activities should be able to provide a correspondingly wide range of resources.

i) Specialised resources

Countries that are unable to provide a broad range of resources may still be able to attract specialized FDI, as long as they can provide specialized resources of high quality such as a workforce with technological sophistication and adaptability which can be matched with the needs of a firm that requires specific types of skills.
j) International policy frameworks

International policy frameworks involving international agreements among countries may influence significantly some of the FDI determinants and thereby impact FDI flows. The agreements may be bilateral, regional or multilateral.

Bilateral investment treaties (BITs) improve the investment climate by strengthening the bilateral standards of protection and treatment of foreign investors and establishing mechanisms for dispute settlement. All these help to reduce the risk of investing in countries party to these treaties.

Regional integration frameworks (RIFs) strengthen the links among members by reducing or abolishing tariff and non-tariff barriers. By virtue of being a member of a RIF, some country-specific location advantages may decrease in importance as FDI determinants, while region-specific location advantages may gain prominence.

5.3 Theoretical Framework

Having identified the importance of location as an important determinant for international investments, this section explains briefly three models on which the theoretical framework rests. The three models include John.H. Dunning’s the eclectic (OLI) paradigm, The linkage, Learning and Leverage model (Mathews 2002, 2006) and the Upssala Model (Johanson & Vahlne, 1977). Given below is a brief description of the three models and the corresponding research questions that the current empirical study attempts to address in order to gain insights about the relevance of these models in explaining the internationalisation strategies of the Indian Pharmaceutical firms.

5.3.1 The eclectic (OLI) Paradigm

The eclectic theory put forth by Dunning (1981) has provided the framework for a large number of studies on determinants of FDI on account of its applicability at both the micro and macroeconomic levels. It also brings
together the theories of industrial organization proposed by Hymer (1976) and Kindleberger (1969); the internalisation theory proposed by Coase (1937), Buckley and Casson (1976) and Rugman (1980); and the location theory of FDI. The principal hypothesis of the eclectic paradigm is that a firm will engage in foreign value-adding activities if and when three conditions are satisfied. These are:

1) Firms possess net $O$ (ownership) advantages in the form of intangible assets which are exclusive to the firm for a specific period of time compared to firms from other countries while serving overseas markets.

2) As firms possess these Ownership advantages, it is in their best interests to use them for themselves rather than to sell or lease them to foreign firms, which is done through an extension of its existing value added chains or the creation of new ones. These advantages are called internalisation ($I$) advantages.

As conditions (1) and (2) stated above are satisfied, it would be in the global interests of the enterprise to utilise these advantages outside its home country, failing which foreign markets would be serviced entirely by exports and domestic markets by domestic production. These advantages are termed the locational ($L$) advantages of countries. According to eclectic theory, the stronger the firm’s ownership advantages, greater is the firms propensity to invest overseas. Within the trinity of conditions for FDI to occur, locational determinants are the only ones that host governments can influence directly (UNCTAD, 2006).

Applying this model to the Indian Pharmaceutical industry, the current study attempts to address the following research questions.

1) Do Indian pharmaceutical firms possess unique Ownership advantages ($O$) to carry out cross border activities or does internationalisation contribute to the building of their ownership advantages?
2) How important have been the country specific Locational (L) factors in determining the spatial distribution of Indian pharmaceutical acquisitions?

3) What are main motives behind the internationalisation strategies of Indian pharmaceutical firms?

5.3.2 The Linkage-Leverage-Learning LLL Model

Researchers (Mathews 2002, 2006; Goldstein, 2007) have criticised Dunning’s OLI Paradigm calling it a static model as it accounts for a firm’s advantages at a particular point of time and does not capture the subsequent evolution and development in the firm’s capabilities given their accumulated experience in the international market. Mathews (2002a) therefore proposed an ad-hoc theoretical framework called the Linkage-Leverage-Learning (LLL) framework, based on a group of dynamic firms originating in the Asia-Pacific region, referred to as the “Dragon Multinationals”.

He pointed out that emerging MNEs can overcome their lack of resources by making use of Linkages, such as joint ventures, strategic alliances and other forms of collaboration with foreign companies for a faster and more efficient access to resources. Having linked themselves to developed country firms, these ‘latecomer’ firms use their global connections to leverage their resources and especially their cost advantages, while they learn about new sources of competitive advantage.

When firms repeatedly apply the linkage and leverage processes, it not only accelerates and facilitates greater learning for the firms but also enables them to perform more effectively resulting in their accelerated internationalisation. The variables considered under the LLL model in the empirical specification are the strategic assets proxied by Patents, trademarks and R&D expenditure. The empirical study also attempts to examine the role of economic, political and social linkages proxied by having membership in groups such as G 15, G 20 and Commonwealth countries on Indian pharmaceutical acquisitions to explain their internationalisation strategies.
The research questions testing this model are:

1) Have Indian pharmaceutical firms adopted the linkage, learning and leverage model to pursue their internationalisation strategies?

2) Which is the kind of linkages sought by Indian pharmaceutical firms in their cross border investments?

5.3.3 The Uppsala Model

According to the Uppsala Model, firms choose their mode of entry after factoring in their costs and evaluating the market risks and their own resources (Johanson & Vahlne, 1977). Firms are known to internationalise into foreign markets that are close to the domestic market in terms of psychic distance, defined as factors that make it difficult to understand foreign environments and eventually advance into markets further away in psychic distance terms as they evolve (Johanson & Wiedersheim-Paul, 1975). The Model explains that firms ought to possess a firm-specific advantage to offset their liability of foreignness (Hymer, 1976; Zaheer, 1995). The larger the psychic distance the greater is the liability of foreignness. The variable considered under this model in the empirical specification is the presence of a common language and the geographical distance between the home and host country. The research question testing this model is:

Does the presence of a common language and closer geographical proximity between India and other host countries reduce the liability of foreignness, thereby encouraging Indian overseas acquisitions in these locations?

Conclusion

The chapter built on the theoretical framework to provide the methodological foundation for the thesis. The framework incorporated three basic Models to include John H. Dunning’s eclectic paradigm along with Mathews’ Linkage Learning and Leverage model and the Uppsala Model which have been extensively used for a discussion on the motives for FDI. The research
questions pertaining to each of the Models have been stated to examine their relevance in explaining the motivations for overseas investments in the Indian Context. The various location specific (host country determinants) of FDI flows were also reviewed. The model specification on the basis of the foregoing theoretical framework as well as the formulation of hypothesis is discussed in the following chapter.