Chapter 2
THEORIES OF FDI: AN OVERVIEW

Among the various forms of international capital movements (e.g. loans, borrowings, portfolio investments, bank deposits, and long term direct investment), cross-border direct investment inflows were seen to increase rapidly in the years following the end of the Second World War. The impact of these inflows was felt not only on the growth and profitability of the investing companies, but also on the national economies of both the investing ('home') and recipient ('host') countries (Dunning, 1970). The growing significance of foreign direct investment (FDI) as a major international phenomenon motivated extensive theoretical and empirical research attempting to justify FDI, identify its determinants and assess the impact of FDI on 'home' and 'host' countries.

One of the salient features of the research on FDI has been its close association with the study of multinational enterprises. In their unique capacity as transporters of FDI, the functions, motives, and behaviours of multinational enterprises have been subjects of wide-ranging research. A review of the theoretical literature on FDI reveals that the organisational and operational characteristics of multinationals have often been studied together with the analysis of FDI.

Theories explaining FDI can be divided in two distinct groups. The first of these comprises theories that aim to justify FDI within the framework of the theory of international trade. The second group tries to explain FDI in terms of the theory of the firm and industrial organisation (IO) literature.
This chapter seeks to provide a brief review of the main theories of FDI. It is divided into four sections. The first section studies the various postulations of FDI under the theory of international trade. The second section discusses hypotheses derived from the theory of the firm and the IO literature. The third section focuses upon an eclectic theory of FDI and analyses its main features. Finally, section four provides a summary of the main theoretical explanations of FDI.

2.1 INTERNATIONAL TRADE THEORY

In its orthodox or 'pure' version, the theory of international trade attempts to explain trade between nations within a rigorous general equilibrium framework. The Heckscher-Ohlin-Samuelson (H-O-S) construct, which attributes trade to differences in factor endowments between nations, is central to the pure theory of trade. Beyond the orthodox version, however, there exists a large body of literature within the purview of the theory of international trade in the neo-classical tradition, which devotes significant attention to international capital movements, FDI flows and multinational firms (Posner, 1961; Hufbauer, 1965; and Vernon, 1966).

The rigid assumption of complete factor immobility between nations, central to the H-O-S model, eliminates the possibility of movement of capital between countries, and therefore, fails to accommodate the phenomenon of FDI and multinational enterprises. Indeed, other H-O-S assumptions, such as identical production functions across nations, perfect competition, and constant returns to scale, also directly contradict the economic framework characterising FDI.
However, within the format of neo-classical trade theory, if the assumption of factor immobility between nations is relaxed, then one arrives at the theory of capital arbitrage, explaining capital movements and FDI. The core assumption in this regard is the responsiveness of factors of production to international factor price differentials. Given the difference in factor endowments between nations, as proposed by the H-O-S model, marginal factor productivities and factor prices will be different among nations. The H-O-S construct suggests that nations will export commodities that utilise their abundant factors more intensively, leading to international factor price equalisation. But if factors of production are perfectly mobile, then international factor movements in response to price differentials can always occur, irrespective of trade in commodities. This implies that capital from the more capital-abundant nations can move to the relatively less capital-abundant countries, in response to higher rates of return in the latter, thereby equalising returns to capital in different countries (Corden, 1974a). Factor price equalisation, therefore, can actually be achieved without international trade.

Under strict assumptions (i.e. absence of transport costs, labour immobility, identical production functions for each good between nations and absence of factor intensity reversals), permitting capital mobility in the H-O-S framework leads to the extreme conclusion of capital movements being perfect substitutes for international trade (Mundell, 1957). Trade theorists, however, argue that given transport costs and differences in production functions between nations, trade and capital movements are not perfect substitutes (Corden, 1974a). Rather, in the familiar two-country, two-commodity general equilibrium framework, introducing assumptions of capital mobility and capital movements in response to relative returns between nations, gives rise to the
strong possibility of the capital-abundant country exporting both capital, as well as the capital-intensive commodity. In such situations, both international trade and capital movements will contribute to eventual factor price equalisation.

It is therefore evident that with modifications like presence of transport costs, differences in technologies between nations and dissimilar production functions, and economies of scale, the pure theory of trade can yield the distinct possibility of international capital movements even within its restrictive framework. Modern neo-classical trade theorists have attempted to explore the pure theory after introducing some of the above modifications (Kemp, 1969; Jones, 1970; Chipman, 1971). The endeavours have produced interesting results like the likelihood of capital moving on account of shifts in demand patterns in either country (Chipman, 1971) or in response to a more efficient environment for its utilisation (Jones, 1970).

Even after considerable modifications, the pure theory of trade remains limited to postulates that only identify circumstances likely to induce international capital movement. It is unable to provide a complete explanation of direct foreign investment, as distinct from foreign borrowing or portfolio investment (Lall and Streeten, 1977), on account of its failure to address an issue central to the concept of FDI and multinational enterprises: Why do firms invest in establishment of production facilities in foreign locations?

Within the overarching tradition of the theory of international trade, a particular theoretical strand, commonly referred to as the location theory (Losch, 1954), attempts to study the reasons responsible for choice of locations, as far as individual firms are concerned. The theory identifies geographical configurations of production locations
and markets representing an economic equilibrium in space (Vernon, 1974). Assuming
global cost minimisation as the main objective of producers, the theory expects
producing firms to assess the different types of production, transportation, and
transaction costs, associated with various locations (Kojima, 1978) and identify a least­
cost location for locating their manufacturing activities.
Given its assumptions of international factor immobility and perfect competition,
introduction of multinational firms within the purview of the location theory is likely to
yield choices, which are similar to those of independent national firms (Vernon, 1974),
arrived on the basis of cost considerations with regard to source of raw materials and
location of consumer markets. The theory also fails to account for the oligopolistic
features of multinational enterprises, and the impact, which such features are likely to
have on decisions to invest.
A substantive link between international trade and foreign direct investment is provided
by the product cycle hypothesis (Vernon, 1966, 1974). The hypothesis combines a
three-stage theory of innovation, growth, and maturing, with emphasis upon R&D
(research & development) as an independent input in the production process (Kojima,
1978), and identifies difference in technological endowments as the main source of
national comparative advantages.
The hypothesis argues that firms from technologically superior nations will initially
produce new hi-technology products for their domestic markets. Given the heavy capital
investments required for sustaining R&D and achieving technological superiority, only
the richer, capital-abundant nations can develop such capabilities. Since the demand for
the new products is highly income-elastic, high domestic incomes in the richer countries
lead to expression of new wants. The latter stimulate technological innovations, as does labour scarcity, which encourages production of commodities using labour-saving technology. Since communication costs tend to increase with distance, producers of the new products wish to be located close to the final markets. The new products are initially unstandardised, as they require continuous upgradation for suiting consumer needs.

In the second stage of the product cycle, which is the growth stage, the product specifications gradually stabilise and consumer information and knowledge about the products increase. Demand for the products becomes increasingly price-elastic and variable costs of production come up as significant factors in determining competitiveness of producers. Markets for the products also expand with increasing awareness. Foreign markets with broadly similar demand patterns surface as new destinations and are initially served through exports. Exports continue to take place, till the costs of producing at home and exporting overseas are lower than the costs of producing overseas. When the former become higher, firms decide to locate production overseas. Overseas investment initially takes place in countries having demand patterns similar to home markets, i.e. other advanced higher-income economies.

The third and final stage of the cycle is the mature product stage. With complete standardisation of the production process/ technique, the ‘new’ products imbibe similar characteristics with little to distinguish between them. Price becomes the sole determinant of competitiveness and accordingly, lowering production costs becomes the overriding objective. Availability of cheap labour becomes the most important factor behind location of production decisions. As a result, production gradually shifts to
developing country markets having abundant cheap labour. Over time, output from the subsidiaries replaces exports from the parents. At a later stage, the subsidiaries start exporting to their home countries, given the lower costs of production in host nations.

The main assumptions of the product cycle hypothesis (i.e. consumer tastes and preferences differ according to incomes, intra-firm communication costs and those between the firm and the market increase with distance, improvements in product technology and marketing methods are predictable, and significant imperfections exist in markets for technical know-how) entail significant departure from the rigid suppositions of the pure theory of trade and provide a more flexible framework for explaining FDI. At the same time, the relevance of the theory in explaining FDI and behaviour of multinational enterprises becomes evident from its identification of technological differences as the main source of national comparative advantages. Between nations, technological differences arise from their thrust on R&D and the ability to utilise effectively the output from R&D. Possession of superior R&D and commercial exploitation of the benefits arising from such possessions, are features commonly associated with multinationals.

The cyclical sequence of product evolution illustrated above was subsequently modified in a later version of the product cycle hypothesis (Vernon, 1974). Compared to the earlier version, the modified edition emphasises heavily upon oligopolistic behaviour of firms. The first stage, i.e. innovation-based oligopoly is broadly similar to that of the earlier one. However, innovations are suggested to be not only labour saving in nature, but also land-saving. The crucial difference between the two versions arises in the second stage. This stage in the modified version, mature oligopoly, assumes inter-
dependence between product and locational strategies of various firms. Markets for the innovated products created in the first stage are also assumed to have significant entry barriers, typical of oligopolistic market structures, manifesting in the form of economies of scale in production, marketing and research. Individual initiatives of firms are attempted to be nullified through counter-initiatives by rivals – a characteristic common to the entire industry. Firms establish production in rival markets for strengthening bargaining positions with the eventual objective of stabilising global market shares, which is achieved when each rival firm produces in all the major markets. In the final stage, senescent oligopoly, economies of scale no longer act as entry barriers. Efforts to create new entry barriers through product differentiation also do not succeed and the firms gradually reconcile to competitive pressures. Inter-regional cost considerations, rather than geographical proximity to markets, or oligopolistic reactions, become crucial in determining decisions for location of production.

The product cycle hypothesis offers an explanation for one of the key issues relating to FDI: Why certain firms prefer investing abroad, rather than exporting? The hypothesis establishes that FDI is justified if the costs involved in exporting and catering foreign markets are more than those of locating and producing overseas. The theory also draws attention to the importance of specific host-country factors, like cheap labour (the role of various host-country locational factors in determining FDI will be discussed in detail in section 3), in determining foreign investment. Further, the theory also identifies technological superiority, ability to innovate, and oligopolistic behaviour, as distinguishing features of multinational enterprises.
In spite of its seminal contribution to the theoretical insights on FDI and multinationals, the product cycle hypothesis has limitations, which restrict its acceptability as a self-contained theory for FDI. It has been pointed out (Buckley and Casson, 1976) that the theory fails to account for non-export substituting FDI and does not explain the tendency for non-standardised products to be produced abroad. Besides, while the theory throws light upon the factors that influence location decisions, it does not indicate the sources of ownership advantages for the investing firms.

2.2 THEORIES OF THE FIRM AND INDUSTRIAL ORGANISATION

Like the pure theory of trade, the theory of firm also fails to offer convincing explanations for FDI, mainly due to rigid assumptions like perfect competition, constant returns to scale etc. (Lall and Streeten, 1977). However, a section of the theories of the firm, emphasising upon assumptions of oligopolistic advantages and market imperfections, have exerted considerable influence upon economic research aiming to establish a theoretical foundation for FDI.

The main issue that the theories emphasising upon oligopolistic advantages aim to address is: How are foreign firms able to compete efficiently with their indigenous counterparts in host countries, despite the intrinsic advantages enjoyed by the latter? Between domestic and foreign firms, the formers have superior knowledge of local market conditions. Acquiring this knowledge entails significant costs on part of the foreign firms (Buckley and Casson, 1976). There are also heavy costs involved in establishing subsidiaries. Notwithstanding these disadvantages, if some firms decide to set up production facilities in overseas locations, then, according to the oligopolistic
theories of FDI, they must possess some sources of distinct oligopolistic advantages, which are sufficient to outweigh the disadvantages involved in competing with indigenous firms in host countries (Hymer, 1976).

Various sources of oligopolistic advantages have been identified by the theoretical literature on FDI. These advantages have been discussed in detail in Section 3. Broadly, the advantages arise from possession of specific intangible assets, like marketing expertise, patented technology, easy access to finance, managerial skills etc. (Kindleberger, 1969). It is obvious that ownership of these assets can not construe sources of special advantages for individual firms under perfectly competitive conditions. Due to imperfections existing in the international markets for these factors, firms owning these assets become endowed with distinct oligopolistic advantages, acquiring capabilities for competing efficiently with domestic firms in foreign locations.

Among various sources of oligopolistic advantages, the theories of the firm emphasise upon proprietary control over assets which have 'zero' or minimal marginal costs of usage (Dunning, 1977), and which can be easily transferred by parent firms across locations to subsidiaries without significant additional costs (Johnson, 1970). The advantages arising from owning these assets can be spread over more than one plant leading to creation of multi-plant economies of scale (Soci, 2002). Possession of special knowledge or skills has been identified as the most common firm-specific asset of the above kind (Buckley & Casson, 1976). In addition, ability to differentiate products (Caves, 1971) and knowledge obtained from previous R&D have been distinguished as assets enjoying similar properties.
By identifying FDI as an outcome of international market imperfections, it is possible to underline the benefits obtainable from exploitation of oligopolistic advantages as the driving forces behind FDI. However, these advantages are given and exogenous. Market imperfection theories do not explain how these advantages are generated, or why firms invest more in developing these advantages, as compared to other assets. Moreover, while possession of special advantages is a necessary condition for FDI, the market imperfection theories do not explain why firms decide to produce overseas, as against options like producing at home and exporting, or licensing production to local agents in foreign countries.

Ownership advantages, combined with location-specific cost reducing characteristics, (discussed in the earlier section) offer a convincing explanation for firms preferring to undertake FDI vis-à-vis exports. A theoretical construct aiming to conclusively justify FDI brings together these two groups of features (Hirsch, 1976). The model classifies firm-specific advantages (e.g. possession of superior technology, marketing skills, managerial techniques etc.) as revenue-earning factors and country-specific characteristics as cost factors. According to the formulation, FDI materialises if benefits arising from possession of ownership advantages outweigh costs of foreign operations and, if costs of foreign operations are lower than those of domestic production and exports. While the formulation is useful in explaining conditions determining the choice between FDI and exports, it does not justify firms with oligopolistic advantages preferring FDI against arm's-length arrangements like licensing.

The decision of foreign firms to exploit their advantages through FDI, rather than through alternative market-based arrangements, has been addressed by internalisation
theories (Buckley and Casson, 1976; Lundgren, 1977; Swedenborg, 1979). These theories argue that the economies obtained by firms by internalising operations outweigh the various transaction costs involved in external arm’s-length arrangements like licensing. Most of the transaction costs in trading through markets arise from product market imperfections in form of informational asymmetry between foreign firms (principal) and local vendors (agents). With potential licensees having better information regarding local market conditions, foreign firms are vulnerable to the classic principal-agent problem, on account of post-contract opportunistic behaviour by agents (Williamson, 1985; Ethier, 1986; Rugman, 1981; Hennart, 1982; Caves, 1982; Teece, 1986; Markusen, 1995). Given the difficulties in formulating effective contracts for preventing opportunistic behaviours, foreign firms, are inclined to exploit advantages through internal hierarchical structures.

One of the most common examples of market failures in arm’s-length arrangements relates to the market for know-how (Magee, 1977; Rugman, 1981; Caves, 1982). Informational asymmetries create problems of adverse selection, where the buyers of know-how (i.e. local licensees), are largely unaware of the intrinsic features of the technology being transacted, and the sellers (i.e. foreign firms) are unable to disclose the same to the former. Sellers, therefore, do not expect premium for quality and are inclined to transact inferior products, knowing which, the buyers tend to quote lower prices for the product. The eventual outcome is gradual withdrawal of sellers of quality products from the know-how market (Guha and Ray, 2001). Foreign firms are also reluctant to reveal much about the product being transacted, since greater disclosure can dissipate the benefits of possessing the technology. With knowledge enjoying ‘public
good' attributes, sharing knowledge always precludes the possibility of eroding the oligopolistic advantages of foreign firms.

Failures also arise from other imperfections like lack of adequate protection for proprietary rights over knowledge, enhancing possibilities of imitation. There are also uncertainties over the performance of technology in unfamiliar markets, particularly for new, complex products. Moreover, moral hazards, in form of shirking effort or diversion of selling effort by the licensees, are other sources of violation of agency contracts (Mathewson and Winter, 1985). All these instances of market failures reinforce the possibility of undertaking FDI (Ethier, 1986) despite the significant costs of internalising operations, like resource costs of establishing foreign operations, communication costs on account of co-ordinating various activities, and the costs involved in operating in alien cultures and systems.

It has also been argued by internalisation theories that it is difficult to realise the benefits of ownership advantages arising from possession of other intangible assets like managerial expertise and marketing skills, through arm’s-length markets (Nicholas and Maitland, 1998). Many of the assets construing sources of advantages for foreign firms are inseparable from their human capital and management systems. Transferring such assets at arm’s-length involves significant costs (Teece, 1986) and are prone to failures. Internalisation of operations through hierarchical structures, therefore, enables foreign firms to ensure full appropriability of returns on the investment made in creation of intangible assets (Buckley & Casson, 1976; Magee, 1977). Internalisation theories suggest that it is not the possession of intangible assets that is uniquely advantageous to multinational firms. Rather, it is the ability to efficiently internalise the use of these
assets, as opposed to selling them, which gives them the comparative advantage over domestic firms.

The internalisation theories provide explanations for FDI by identifying circumstances in which internalising operations is preferable to licensing. The identification of these circumstances has much to do with the incorporation of knowledge — a major firm-specific ownership advantage — as a key explanatory variable within the framework of the theories. Given the overall objective of profit maximisation and the oligopolistic advantages arising from possession of knowledge, internalising production across national borders by undertaking FDI, appears a logical conclusion on part of multinational firms.

2.3 TOWARDS AN ECLECTIC THEORY OF FDI

For analytical convenience, we divide this section in two parts. The first part discusses the eclectic theory of FDI. The second part discusses various sources of ownership advantages for foreign firms and different locational advantages in terms of host-country characteristics.

2.3.1 An Eclectic Theory of FDI

The earlier sections have discussed the core issues underlying the theories of FDI, summarised as follows.

Ownership advantages, arising from possession of various intangible assets (e.g. advanced technological know-how and superior production techniques, marketing and managerial expertise, access to cheaper sources of capital etc.) comprise sources of
oligopolistic advantages for foreign firms' vis-à-vis their local counterparts. Possession of ownership advantages, therefore, is a necessary condition for foreign direct investment. However, mere possession of ownership advantages does not guarantee establishment of production facilities in foreign locations, since the benefits of these advantages can be realised through exports, or through licensing arrangements with local agents. Firms would decide against exporting, if the costs of producing abroad were less than those of producing at home and exporting overseas. The costs of foreign operations will depend upon various host-country specific locational features (e.g. availability of cheap skilled labour, host country government policies, access to raw materials etc).

But even if firms decide not to export, they might still prefer licensing compared to FDI. The decision to license production, or not, will depend upon the costs and benefits associated with licensing in the light of various market imperfections and failures associated with arm's-length transactions of intangible assets. If the costs of licensing (arising from possible violations in principal-agent relationship, informational asymmetry etc.) are significant, then firms are likely to refrain from such arm’s-length transactions. Given the costs associated with licensing, if foreign firms feel that they will be able to utilise their ownership advantages more efficiently through internal networks, then it will be sufficient cause for establishment of local production bases.

The necessary and sufficient conditions for FDI find place within an eclectic framework commonly referred to as the O (Ownership)-L (Location)-I (Internalisation) construct (Dunning 1977, 1981, 1988). The framework puts together the main issues emerging from various explanations of FDI and suggests that at any given point of time presence
of ownership advantages, location advantages, and internalisation advantages, are essential for undertaking FDI. Accordingly, it emphasises upon fulfilment of three conditions:

1. Firms must have ownership advantages arising out of possession of intangible assets, which enable them to compete effectively with local firms by overcoming the costs of doing business abroad.

2. Foreign markets should offer some location advantages, which make foreign production more profitable than producing at home and exporting abroad.

3. There must be some internalisation advantages encouraging firms to transact their intangible assets through internal organisational networks, rather than through the market.

Though the O-L-I framework has been criticised on the grounds that it justifies only FDI that materialises through establishment of wholly owned subsidiaries, and is unable to explain other forms of FDI like joint ventures (Markusen, 1995), it still remains the most comprehensive theoretical framework for explaining FDI.

At this point, we would like to highlight the implications of the O-L-I framework for the present research. The eclectic paradigm indicates that determinants of FDI can be grouped into supply-side and demand-side factors. Supply-side factors comprise the ownership advantages enjoyed by foreign firms and their incentives and abilities to internalise the use of these advantages. Demand-side factors constitute location advantages possessed by host countries in terms of their specific characteristics. Due to differences in resource endowment, socio-economic factors, and government policies,
attractiveness to FDI varies considerably between nations. The thrust of this research is on the identification of demand-side determinants of FDI for India.

2.3.2 Sources of Ownership and Locational Advantages

2.3.2.1 Ownership advantages

Oligopolistic advantages enjoyed by multinational enterprises constitute the first component of the O-L-I framework explaining FDI. Possession of these advantages is considered a necessary condition for occurrence of FDI. Some of the major sources of oligopolistic advantages for foreign firms (Lall and Streeten, 1977) are discussed below.

1. Access to cheaper sources of capital has often been mentioned as a major source of oligopolistic advantage for foreign subsidiaries. This can arise from the parent firm’s possession of large internal resources; avenues open to the subsidiaries for approaching capital markets in other nations; and the possibility of being granted more favourable borrowing packages in local country markets on account of the higher credit ratings enjoyed globally by the parent enterprise. However, mere access to cheaper capital is unlikely to induce direct foreign investment in the absence of other oligopolistic advantages.

2. The theoretical literature on FDI and multinational enterprises has widely referred to superior management as a key source of oligopolistic advantage for multinational firms. Superior management implies either greater operational efficiency (compared to local firms) or better risk-taking abilities for furthering business interests (Ingham, 1976). Multinational firms acquire this advantage from various factors like presence of experienced managers trained in foreign operations, more educated
personnel and higher standards of recruitment. It may also arise from the complex organisational forms that multinational corporations often adopt for facilitating rapid and efficient decision-making across diverse and widespread units (Lall and Streeten, 1977).

3. Possession of superior technology by foreign firms as compared to domestic firms is perhaps the most vital ownership attribute and source of oligopolistic advantage identified by theoretical literature. ‘Technology’, in this context, broadly refers to the ability to translate knowledge of relevant sciences into commercial use (Lall and Streeten, 1977). ‘Applied’ R&D efforts in multinational enterprises aim to discover new processes and products. It also aims to achieve product differentiation through introduction of marginal variations in products manufactured by the firm and its rivals. R&D efforts, which are directed largely towards product differentiation (also referred to as ‘defensive’ R&D), tend to increase as industries become more oligopolistic and technologies increasingly standardised (Freeman, 1974; Gruebel and Lloyd, 1975). Given the high scale of R&D required for obtaining successful innovations, large multinational firms have undisputed advantages over their smaller, local counterparts. The extensive marketing networks of these firms enable them to sustain the profitability of innovations (Vernon, 1971; Brock, 1975). Large multinational corporations are also more capable of spending greater amounts on acquiring patents and defending them, which, in turn, makes them the largest beneficiaries of the international patent systems. It is evident that technological innovation and the size of the corporation are closely linked, thereby making
superior technology a key intangible asset and one of the ‘prime causal forces behind international production’ (Lall and Streeten, 1977).

4. It has been argued that the role of marketing is not only vital to direct foreign investment, but it is also probably a greater source of oligopolistic advantage than technology (Lall and Streeten, 1977). Marketing is a multi-dimensional phenomenon. Among its main functions is market research, which enables firms to appreciate the evolving needs of buyers. Advertising, another key component of marketing, is a significant tool in creating and maintaining market power (Comanor and Wilson, 1974; Cowling et al, 1975). The theoretical literature on FDI is unambiguous in pointing out that marketing plays a singularly important role in promoting brands irrespective of their technological intensity (Parker, 1974; Horst, 1974), thereby serving as a major motivator for international expansion (Lall, 1975). Like the level of R&D required for obtaining successful innovations, the scale of marketing essential for sustaining market power is beyond the reach of small firms, thereby making it a forte of large multinationals.

5. Control over the markets for final products, production processes, transportation, and production of raw materials required as inputs, often give multinationals privileged access to raw materials. This source of oligopolistic advantage can be traced to historical, technological, and financial or marketing factors, and is commonly noted in several manufacturing industries dominated by multinationals.

6. Theories of the firm have identified scale economies as an important ownership advantage for multinational firms. Large multinational corporations have a greater advantage in mobilising finance and expertise for setting up facilities that enjoy
economies of scale. However, it is mentionable in this context that economies of scale arising from plant size or longer production runs can be acquired by all firms upon attaining the required size. In this sense, scale economies can construe a source of oligopolistic advantage, only if the required size can be attained through other special advantages like technology, finance or marketing (Lall and Streeten, 1977).

In the final analysis, the ownership attributes of multinationals, which constitute various sources of oligopolistic advantages, have a cumulative effect upon expansion of multinationals and inflows of direct foreign investment. While there are several sources of oligopolistic advantages, superior technology and marketing are perhaps the most decisive ones.

2.3.2.2 Location advantages

While possession of ownership advantages enables multinational enterprises to exploit market imperfections in foreign locations, the decision to do so through direct investment, rather than exports, is determined by location-specific features. The literature on FDI has devoted considerable attention to recognition of host-country attributes and their impact on inward FDI. Much of this exercise has been attempted through empirical analysis. The findings of important empirical studies in this regard will be discussed in Chapter 3. Meanwhile, some of the main locational features, as identified by the theoretical literature on FDI, are discussed below.

1. Discussions on location theory and product cycle hypothesis in section 1 have underlined the importance that firms attach in choosing locations that have cost-
reducing characteristics. Assuming that rational cost assessments play a significant role in location decisions of multinational enterprises, the latter are expected to allocate their resources among various countries in a commercially efficient manner by choosing the most cost-efficient locations (Kindleberger, 1969; Corden, 1974a). Among various factors that are likely to influence cost calculations of multinationals, the theoretical literature has devoted particular attention to labour costs in different locations (Johnson, 1968a; Vernon, 1966, 1974). The relative differences in costs of labour between host countries has been identified as an important determinant of FDI, particularly for LDCs. Due to differences in endowments of labour, availability and cost of labour varies widely between nations. There are also considerable variations in availability of skilled labour between countries. Presence of low cost skilled labour in investment locations enables multinational enterprises to utilise their ownership advantages more efficiently by lowering variable costs of production. Apart from labour, the backward vertical integration of foreign firms in many countries has been traced to the availability of natural resources. It has been pointed out that the objective behind such integration is to gain access to cheap sources of raw material (Dunning and Narula, 1993).

2. Possession of superior technology is identified as an important source of oligopolistic advantage for multinational firms. However, the benefits realisable from this advantage depend significantly upon the host country’s technological capabilities. The availability of technically skilled manpower, familiarity with various technical processes and know-how, and the level of indigenous
technological development, determines technological capabilities of host countries. Higher technological capabilities of host nations are expected to encourage FDI, particularly in knowledge-intensive sectors.

3. The size of the host country market is an important factor behind the decisions of the multinationals to locate production overseas. Large markets enable foreign firms to lower costs of production through economies of scale. Countries with large markets are not only able to sustain more economic activities, but can also provide greater opportunities for economic diversification (Chen Chunlai, 1997). Large markets also help multinationals in exploiting to the full one of their core ownership advantages i.e. efficient marketing.

4. The theoretical literature on FDI has identified FDI of the ‘tariff-jumping’ variety, which is an outcome of restrictive import policies (e.g. imposition of tariffs and quotas) pursued by host nations. Host country government policies encouraging import-substitution have been found to be responsible for establishment of local manufacturing bases by foreign firms, which earlier used to serve the local markets through exports, in several LDCs (Lall and Streeten, 1977). In addition to government policies, the political, social, and economic environment of a country, are instrumental in determining the level of confidence of investors in an economy and shaping their risk perceptions (Hood and Young, 1978). Liberal fiscal incentives for foreign investors and easy norms for repatriation and remittances are expected to encourage inward FDI. The nature of intellectual property protection available for patented technologies, which is determined by host country patent
laws, is important in determining the choice between licensing and direct investment.

2.4 A SUMMARY OF THE MAIN THEORIES OF FDI

In this chapter we have tried to provide a brief review of the main theories of FDI. We pointed out that theoretical justifications of FDI could be broadly divided into two groups. The first group involves explanations relating to international trade theory and the second pertains to the theories of the firm and industrial organisation.

The pure theory of trade is unable to explain FDI on account of its rigid assumptions. Theoretical variations within the neo-classical trade theory, however, attempt to explain FDI according to the principle of capital arbitrage, after relaxing the assumption of factor immobility. Capital arbitrage attributes capital movement between nations to differential rates of return on capital between countries. Further research by neo-classical trade theorists indicate that it is possible to explain international capital movements within the framework of the pure theory of trade, after relaxing assumptions like absence of transport costs, constant returns to scale, and identical production functions between nations.

Despite considerable modifications, the pure theory of trade is unable to explain the decision of certain firms to locate production overseas. The location theory attempts to justify this decision by arguing that firms attempt to identify least-cost locations for their manufacturing bases, given the different transaction and transportation costs associated with various locations. However, the location theory fails to account for
many key characteristics of FDI, chief among which are oligopolistic features of multinational firms.

The product cycle hypothesis, which emphasises upon differences in technological endowments as the main source of national comparative advantages, provides a substantive link between international trade and FDI. The theory argues that technologically superior nations will initially produce high technology products for domestic markets. With gradual standardisation of technology, the products will be exported to countries with similar tastes and preferences. With complete maturing of technology, lower production costs will determine the competitiveness of producers, resulting in relocation of production in locations possessing abundant cheap labour. The theory explains the decision of certain firms to invest overseas, as opposed to exports, and also draws attention to the importance of host-country features in determining FDI. However, the main limitation of the theory is its inability to explain the sources of ownership advantages for foreign firms.

Theories of the firm and industrial organisation focus at length upon the sources of ownership advantages. According to these theories, foreign firms are able to overcome the costs of foreign operations and compete efficiently with domestic firms in host countries due to possession of intangible assets (e.g. advanced technology, know-how, managerial skills, marketing expertise etc.), which construe sources of oligopolistic advantages. Theories of firm emphasise upon imperfections in the international markets for these assets, which enable firms having proprietary control over them to enjoy oligopolistic market power. Among various assets conferring ownership advantages, those having zero or low marginal costs of usage, like special knowledge or skills, are
considered most vital, as they enable foreign firms to exploit multi-plant economies of scale across locations.

While possession of ownership advantages emerges as a necessary condition for FDI, it does not explain why foreign firms will necessarily undertake FDI, given the option of realising the benefits of these advantages through arm’s-length arrangements like licensing. In this regard, it has been pointed out by internalisation theories that arm’s-length arrangements are prone to market failures on account of informational asymmetries between foreign firms and their local agents, as well as other market imperfections like lack of adequate protection for proprietary knowledge. The heavy transaction costs involved in trading through external markets motivate foreign firms to exploit ownership advantages through internal networks by establishing local production facilities.

The core issues justifying FDI find place within the eclectic O-L-I paradigm. The O-L-I construct underlines three basic conditions for FDI. First, firms should possess distinct ownership advantages enabling them to compete efficiently with local counterparts. Second, host countries must possess locational advantages, which encourage foreign firms to serve local markets directly, rather than export. Finally, the firms must have internalisation advantages, which motivate them to exploit ownership advantages internally, rather than through the market. The O-L-I framework groups determinants of FDI into supply side (ownership and internalisation) and demand-side (locational) features, which has direct implications for our research.

We also discussed some of the main sources of ownership advantages for foreign firms, as well as the major locational advantages identified by theoretical research. Possession
of superior technology and marketing skills has been identified as key sources of firm-specific ownership advantages. Other intangible assets construing sources of advantages include managerial expertise and access to cheaper sources of capital and raw material. Among the host-country characteristics identified by theoretical literature as sources of locational advantages, cost of labour and availability of natural resources are the two most significant factors. Besides, size of the domestic market and host countries' government policies are also classified as significant determinants of FDI.