Chapter-2
THEORIES OF FOREIGN DIRECT INVESTMENT
AND MULTINATIONAL ENTERPRISES

1. Introduction

In order to conduct empirical investigations on the issues pertaining to comparative conducts and performance of FCFs and DFs as well as for efficiency and export spillovers from FCFs to DFs, we require a theoretical framework for deriving various hypotheses. In view of this, the objective of the present chapter is to review the major theories of FDI and MNEs which are generally used for deriving hypotheses in such types of empirical research. Thus, the plan of this chapter is as follow. Section-2 discusses the major characteristics of FDI/MNEs. Section-3 briefly reviews the select micro economic theories of FDI/MNEs, including industrial organisation (IO), transaction cost and internalization (TCI) and eclectic theory, and the resource-based view of the firm (RBV). These theories generally used for deriving hypothesis for conducting the empirical research. Section-4 presents a discussion on the comparative features of the theories of FDI and thereby selects the eclectic theory of FDI as the most suitable framework for deriving hypothesis for the empirical research to be taken up in the later chapter. Section-5 presents the conclusions and implications of the FDI theories for the development.

2. Characteristics of FDI/MNEs

Before reviewing the theories of FDI, it may be useful to discuss the major characteristics of FDI and its major vehicle MNEs. As discussed by many scholars, the major characteristics of FDI and MNEs are summarised in the following paragraphs.

First, FDI often contains a package of assets including equity capital, technology, management and marketing skill, etc. (Hymer 1976). However, FDI can occur even without the movement of funds from one country to another. For instances, MNEs, in many cases, exchange proprietary knowledge (technology, skills, etc.) or physical capital (machinery, equipment's, etc.) against equity claims on a host country firm, or FDI may occur through the reinvested earnings of existing affiliates of foreign firms.
Secondly, the MNEs directly control the firms in which FDIs are made while the firms offering credit or subscribing portfolio capital in another firms will not control the latter. MNEs mostly engage in value adding activities by controlling a foreign affiliate through FDI. In recent years, however, MNEs have been increasingly resorting to non-equity forms of involvements (viz. cooperative agreements and outsourcings) sometimes without legal ownership of assets but de facto controlling the operations of non-affiliated concerns (Narula and Dunning 2009). Thus, the hierarchical control and full internalisation no longer remains a first-best option to MNEs due to the improved enforceability of contracts and declining transaction and monitoring costs. The developments associated with the globalisation and the widespread application of information and communication technologies (ICTs) have made it easier for firms of all sizes to monitor, identify and establish collaborative ventures than what previously had been the case.

Thirdly, FDI normally originates from the select oligopolistic industries of the certain (home) countries and flows into the same industries belonging to the other (host) countries (Hymer 1976). The goods and services that MNEs produce overseas are overwhelmingly those that they produce at home (Hennart 2007). However, MNEs are increasingly engaging in the international production networks in which different stages of the production process of a good takes place in different countries.

Fourthly, the MNEs are more attracted towards industries with four characteristics, notably, high levels of R&D relative to sales; large share of professional and technical workers in their work forces; products that are new and/or technically complex; and products with high levels of differentiations created through advertising, marketing and other means (Markusen 1995, UNCTAD-WIR 2005). Further, MNEs tend to concentrate their activities in more competitive or dynamic sectors characterised by high growth rates and use of new and emerging technologies (e.g. electronics, communication equipments and industrial machinery). Furthermore, MNEs also concentrate in mature sectors where economies of scale, branding and advertising determine market share (petroleum products, chemicals, automobiles, food and beverages and consumer durables).

Fifth, in spite of recent increase in the share of R&D that MNEs do outside their own countries, the new products and processes are overwhelmingly created by
the R&D made at the firms’ headquarters (UNCTAD-WIR 2005). A large number of affiliates are still set up abroad to exploit new products or processes and reputation earned at home (Hennart 2007).

Sixth, the global operations of most of the MNEs are not geographically diversified. They are mostly concentrated in a group of wealthy industrialized countries, which have experienced a convergence in their income levels, consumption and technological capabilities (Narula and Dunning 2000) and another group of more advanced developing countries (e.g. newly industrializing east Asian countries and emerging economies like India, China, Brazil, South Africa, Russia).

Seventh, the quality of FDI differ due to the differing motives of MNEs’ cross-border operation, divergence in the competence and scope of FCFs, strategies and scope of MNE operations and differences in the nature of firm-specific assets accessed/possessed by the FCFs (Lall and Narula 2004). These points are elaborated in section-5 of this chapter.

Eighth, as opposed to the Greenfield FDI by which a new plant is set up from the scratch, the mergers and acquisitions account for a substantial share of the world FDI flows (UNCTAD 2009, Chapter-1)

An ideal theory of FDI should be able to explain causes of FDI and most of the above mentioned characteristics, activities and operations of MNEs—the main vehicle of FDI.

3. Theories of FDI/MNEs and Resources Based View of Firm

3.1 Industrial Organization Theory

During the decades of 1960s and 1970s, a search for the new theory of FDI/MNE resulted in the identification of FDI as a bundle of tangible and intangible resources created by oligopolistic firms. Based on the insight of theory of industrial organisation originally developed by Bain (1956, 1959), Hymer (1976) proposed a path breaking theory of FDI in his Ph. D. dissertation in the 1960 that was published posthumously in the year 1976. In the meantime, Kindleberger (1969) and Caves (1971, 1974) refined Hymer’s theory of FDI as proposed in his Ph. D. dissertation. We call this theory as industrial organisation (IO) theory of FDI/MNEs and review the same in this section.
Hymer's (1976) version of IO theory of FDI underlines two major factors causing the most common type of FDI. The first one relates to the chief motive of an oligopolistic firm to overcome competition or to eliminate conflicts, which arises due to the simultaneous operations of a few firms of different countries in same industry having high barriers to entry. As conflict erodes the profits of the individual firms, the firms may prefer to operate under a unified ownership (or common control). In this process, FDI occurs when an existing enterprise in country takeovers or colludes with an independent enterprise of another country, both operating in the similar industry.

The second factor relates to the possession of monopolistic advantages by the prospective foreign investor that overcomes the disadvantages of doing business abroad. Hymer (1976) articulates that a firm attempting to operate across national boundaries faces disadvantage in terms of additional costs arising from the lack of knowledge about alien economy, language, law and politics; discrimination by the foreign governments, consumers and suppliers; and exchange rate risk (Kindleberger 1969). Later, Zaheer (1995) describes these additional costs as the liability of foreignness, being faced by a prospective foreign investor, as a fundamental assumption driving theories of FDI. The sources of liability of foreignness are categorised into four major groups: (i) costs directly connected to the geographical distance-higher coordination, transportation and communication costs; (ii) lack of embeddedness in and unfamiliarity with the business networks of the prospective host country; (iii) differential treatment of domestic firms in comparison to the foreign firms in the prospective host country; (iv) restrictions imposed by the home country government to share the resources (viz. high technology or strategic resources) with its subsidiaries to be located in certain countries (Zaheer 1995).

The monopolistic advantages that could compensate for the liability of foreignness includes: the capability to obtain factors of production at lower prices than rival firms; possession of superior production technology; command over better distribution channels; superior organizational and marketing skills and economies of scale in production and distribution; product differentiation [Hymer (1976) Kindleberger (1969) Caves (1971, 1974)].

The possession of monopolistic advantages may enable a firm to exploit them through international business including exports, arm's length sale of technology or
international production (or FDI) but it does not ensure that the firm must undertake FDI. For FDI to take place, the following additional conditions should be met. First of all, the monopolistic advantages should provide higher rate of return to the prospective investors relative to their competitors at home as well as those based in the foreign market. Secondly, the relevant monopolistic advantages must be transferable abroad and capable of being used in conjunction with other resources available at foreign location. Thirdly, there should be enough imperfection in the market for products, factors and technology of the host country; otherwise the foreign affiliates of the investing firms would not be able to retain these advantages. (Hymer 1976).

In the presence of these conditions, a firm does prefer FDI in comparison to the exports and licensing of technology as two alternative forms of exploiting foreign market. The FDI is preferred as compared to exports because barriers to trade in the form of tariff and transport cost often prevent the firms from maximizing returns on exports. The firm's preference for FDI over licensing the technology for manufacturing of a product to an independent entity in the foreign market is based on the rationale that the latter may lead to several disadvantages to the investing firm. These disadvantages may include: (a) losing monopoly over the product to the rival firm and thereby face difficulty in controlling its price and output level; (b) not receiving due payment for the technology owing to the inability of the buyer to evaluate the worth of knowledge until the latter is in possession of the same; (c) it may be difficult to reach at a satisfactory contract between licensor and licensee due to the absence of regular market for trade in technology. (Hymer 1976).

3.2 Transaction Cost or Internalisation Theory of FDI

Internalisation is a process by which an arm's length transaction based contractual relationship in external market is replaced by internal transaction between a parent firm and its affiliates as well as among affiliates of the parent firm through managerial coordination and administrative fiat. When the cost of transaction is excessive due to imperfections in market for the products or factors or technology or when the market for a certain item (e.g. proprietary knowledge or technology) is completely absent, it is beneficial for a firm to enter into intra-firm trade at the transfer-prices set by administrative fiat of the management (Rugman 1980, 1981).
Relying on the concept of internalisation of market for goods and intangible assets including technology across national boundaries by a multi-locational firm, Buckley and Casson (1976) for the first time made a systematic attempt to develop a transaction cost or internalisation (TCI) theory of FDI. Subsequently, a number of scholars including Rugman (1980ab, 1981) and Hennart (1982, 2001) contributed to the development of a full-fledged theory of FDI or multinational enterprises (MNEs) based on the concept TCI. In fact, (Rugman 1980b) asserts that the TCI theory is a general theory of FDI and thereby considers the other existing theories of FDI as sub-cases of the same.

The TCI theory asserts that FDI occurs in the process of internalisation of imperfect (or non-existent) external market across national boundaries. Firms find it more efficient to trade through internal market than external market if the market for particular goods or services is either non-existent or imperfect. Rugman (1981) recognizes basically two kinds of market imperfections, which induce a firm to form an internal market across international boundaries. The first is the artificial market imperfection that is created mainly by the governments' restrictions on free trade of goods across national boundaries. One important example of this kind of restriction is the custom duties (or import tariffs) levied by a country for protecting its domestic industries from imports. To gain access to the domestic market of such countries, therefore, a foreign firm attempts to establish its FCFs.

The second type of imperfection is the natural market imperfection that exists on account of the public goods characteristic and intangible (and tacit) nature of the FSA (e.g. proprietary technology, organizational, managerial and marketing expertise). As a result of natural market imperfections, it is difficult (or impossible) to determine the market price of the firm-specific intangible assets, but the cost of generation (e.g. expenditures on R & D for creation of a new product or process) of such assets are to be fully borne by the licenser firm. In case of licensing of technology to an outside firm through contractual arrangements, for example, it is highly likely that: i) the incorrect prices for proprietary knowledge may get negotiated, and ii) the FSAs of the transferee firm may be lost in case of poorly conceived licensing agreement.
In order to avoid the above-mentioned risks, a firm undertakes FDI and creates internal market across its FCFs based in different countries. The internal market enables the firm to control and monitor the use of FSA transferred to its FCFs and at the same time earn a fair return (determined by transfer pricing mechanism) on the FSAs. In other words, the internalisation allows the MNEs not only to retain control over their monopolistic advantages but also to recoup the costs incurred on creation of FSAs. Against these benefits, there are certain costs attached to the internalisation process itself that include (Rugman 1980a): i) the cost of organizing an effective communication network within the MNEs, and ii) costs of social distance and political risk associated with entry to an alien country. A firm weighs the prospective cost of internalisation vis-à-vis costs of licensing before taking a decision about undertaking FDI. (Rugman 1980a)

The TCI theory favours the MNEs operations on the ground that the MNEs are the efficient instrument of overcoming imperfections in the market, whether the imperfections are created naturally or artificially. Moreover, the TCI theory also stresses on the gains accruing to the firms of host countries through the transfer of technology by the MNEs. The proponents of TCI theory argue that the host countries chiefly benefit from the transfer of technology by the MNEs as that would not otherwise take place owing to imperfection in the market for technology. They also suggest that since market imperfections are more pervasive in the developing countries than in the developed countries the former stands to gain more through the MNEs' activities.

In terms of prescribing policies for development through FDI, the TCI approach is very close to the neoclassical view. Its major recommendation is to remove all the obstacles to free trade and FDI. The attempts at regulation such as imposition of tariff for preventing imports, Rugman argues, gives rise to more FDI or joint ventures and technology licensing (an inferior alternative to FDI) in a host country (Rugman 1981, p. 36-7). Thus, strongly favouring the operations of MNEs Rugman says, "Regulation is always inefficient. Multinationals are always efficient" (Rugman 1981, p.156).
3.3 Resource-based View of Firm

With the rise of RBV in the 1990s, originally propounded by Wernerfelt (1984), Rumelt (1984) and Barney (1991), the focus regarding sources of sustainable competitive advantage and firm level performance (efficiency/profitability) has shifted from industry structure and firms' conducts to the quantity and nature of resources possessed of the firms within an industry. The researchers subscribing RBV look for possible causes of sustainable competitive advantage mostly within the resources and capabilities of a firm, holding constant all external environmental factors (Amit and Schoemaker 1993; Peteraf and Barney 2003).

The RBV divides resources into two major heads, namely tangible resources and intangible resources or assets. The tangible resources include financial, physical and human capital. These resources possess fixed long-run capacity and properties of ownership and are relatively easy to be measured, traded and duplicated (Amit and Schoemaker 1993 and Fahy and Smithee 1999).

Intangible resources (or assets) consist of intellectual property rights (e.g. trademarks, patents, copyrights, registered designs, and brands), contracts (viz. agency agreements, license agreements, property lease), organizational and marketing expertise, trade secrets, reputation or goodwill and networks with customers, suppliers, government organizations, research institutes, etc. (Grant 1991, Barney 1991, Amit and Schoemaker 1993 and Fahy and Smithee 1999). In comparison to tangible resources, intangible assets do not diminish by extra use; they are relatively resistant to duplication and difficult to be measured, valued and traded (Grant 1991, Barney 1991&2001, Amit and Schoemaker 1993 and Fahy and Smithee 1999). Thus, the intangible resources are more important source of heterogeneity and divergence in competitive advantage and performance across firms (Hall 1992).

The capability is defined as a capacity to perform some task or activity by effective cooperation and coordination of team of resources for maximizing efficiency (or profit). Examples of a firm's capability include highly reliable services, repeated process or product innovation, manufacturing flexibility, responsiveness to market trends, and short product development cycles [Grant (1991), Barney (1991, 2001), Amit and Schoemaker (1993) and Fahy and Smithee (1999)]. Capabilities can also be thought of as intermediate goods generated by a firm to provide enhanced...
productivity of its resources as well as flexibility and protection for its final product or service through information-based capabilities (e.g. brand names).

RBV is based on two major assumptions (Barney 1991, Peteraf and Barney 2003): First, firms are fundamentally heterogeneous in terms of their bundle of resources and capabilities within an industry. Second, resource heterogeneity may persist over time because the resources used for acquiring competitive advantages are rare, valuable, imperfectly imitable, imperfectly substitutable and imperfectly mobile in strategic factor markets. The RBV provides an efficiency based explanation of performance. Peteraf and Barney (2003) suggest that a firm builds competitive advantage only through efficiency or effectiveness in use of it resources, i.e., by producing more economically from the set of resources it holds and by delivering greater benefits to its customers at a given cost (or the same benefits at a lower cost).

The identification and evaluation of resources and capabilities has been the major contributions of the RBV. The eclectic theory of FDI discussed in the next subsection recognises the resources and capabilities as the ownership-specific competitive advantage that enables a firm holding them to undertake FDI.

3.4 Eclectic Theory of International Production

Combining the insights of IO, internalisation and location advantage theories, Dunning (1977, 1980) proposed an eclectic theory or paradigm of FDI. In view of many new developments including those on theoretical front, increasing globalisation of economies, integration of economic and financial activities, maturation of knowledge-based economies and liberalisation of cross-border trade and FDI, Dunning (2000) substantially updated the eclectic theory in a paper titled "The Eclectic Paradigm as an Envelope for Economic and Business Theories of MNE Activity". Based on this updated version we discuss the eclectic theory and each of its components in this sub-section. Dunning (2000) argues that the extent, geography and industrial composition of FDI undertaken by MNEs depends on the configuration of three sets of advantages: the (net) competitive advantages, which firms of one nationality possess vis-à-vis firms of other nationalities for serving that particular market, internalisation advantage and locational advantage. We explain these advantages in the following paragraphs of this section.
Net Competitive Advantages: Based on the developments in the FDI and related literature since the 1960s, Dunning (2000) categorises the net competitive advantages into three groups. The first one relates to the possession and exploitation of monopolistic advantages which arise from (or create) barriers to entry to final product markets for firms not possessing them. The second one stems from the ownership of a bundle of scarce, unique and sustainable resources and capabilities as identified by the RBV. These advantages stem from (or create) barriers to factors (or intermediate goods) market for firms not possessing them. The third one comes from the organisation theory of MNEs and includes "the competencies of the firms to identify, evaluate and harness resources and capabilities from throughout the world and to coordinate these with the existing resources and capabilities under their jurisdiction in a way which best advances the long term interest of the firms" (Dunning 2000, p. 169). The long term interest of the firm may include "minimizing transaction costs and maximising the benefits of innovations, learning and accumulated knowledge" (Dunning 2000, p. 169).

The relative significance of the three categories of net competitive advantages has changed over the decades. In the 1970s and 1980s, the unique ownership advantages of firms mainly reflected in their abilities to produce and organise proprietary assets and match the same to then existing market requirements. Since the 1990s, however, emphasis has shifted towards the firms' capability to access and organise knowledge intensive assets from throughout the world. As a result, the FDI is being undertaken not only to exploit, as in the 1970s and 1980s, but also to protect and augment the existing ownership advantages. Thus, the multinationality (i.e. the extent to which a firm undertakes value-adding activities in many different foreign countries) per se has also become an important intangible asset. (Dunning 2000).

The advantages of multinationality due to operation in many diverse countries may include: i) economies of scale arising from spreading of fixed costs over a larger market; ii) lowering of risk stemming from the change in a country's interest rates, wage rates, and commodity and raw material prices; iii) accessing to cheaper and idiosyncratic resources available in various countries such as the cheaper labour, better technology, or any country-specific resources; iv) global opportunities for
organisational learning or experience and for scanning rivals, markets and profitable ventures. (Dunning 2000).

Dunning (2000) also divides net competitive advantages between the static and dynamic advantages. He defines static competitive advantages as the income generating resources and capabilities possessed by a firm at a given point of time. On the other hand, he refers dynamic competitive advantages as the ability of a firm to sustain and increase its income generating assets over time. The significance of dynamic competitive advantages has increased in the last three decades. The competitive advantages based on industrial organisation and later on the RBV or organisation theory offer reasons for FCFs' competitive edge over their counterpart DFs in a host country.

Locational advantages: The eclectic paradigm recognises the locational advantages or the attractiveness of the countries as the key determinants of foreign production by MNEs. The location-specific advantages of a country may include cheaper availability of factor endowments like natural resources, labour, raw material; large domestic market, lower transport and communication cost; better physical infrastructure (e.g. power telecommunications, roads, seaports and airports); commercial, legal and financial infrastructure; favourable, transparent and non-discriminatory policy environment towards FDI; fiscal incentives, low tax rates, political stability and less government interventions and institutional set up; presence of DFs having distinctive and non-imitable set of location bound created assets with which MNEs could form alliance to complement their own core competencies. Provided that a firm has unique ownership or competitive advantages, it must be profitable for the firm to utilise these advantages in combination with location-specific advantages existing in a foreign country, otherwise, the foreign markets would be served by exports. The greater the net ownership advantage of the firms (net of any disadvantages of operating in a foreign location), the more the incentive they have to utilize these advantages among themselves. Thus, a firm's propensity to engage in foreign production is jointly determined by the country's locational advantages of immobile natural resources or created assets and its own ownership or competitive advantages which the firm needs to apply on the former.
**Internalisation advantage:** Given that a firm has a set of competitive or ownership-specific advantages and the immobile locational advantages of a foreign country are such as to warrant locating value adding or asset augmenting activities there, internalisation advantages, as discussed in TCI theory, will ensure the occurrence of FDI. Dunning (2000) extends the internalisation paradigm by integrating additional dimensions to it. He argues that the firms not only try to maximise profits by optimizing the use of existing assets internally through their foreign affiliates but they also undertake FDI, as in many cases of cross-border mergers and acquisitions, to acquire new resources and capabilities, or to acquire new markets, or to achieve lower unit costs of production, or to gain market power, or to forestall or thwart the competitions.

The eclectic paradigm further avers that the significance of each of these three advantages (i.e. the net competitive advantages, locational advantages and internalisation advantages), the precise configuration of these advantages applicable to a firm and the response of the firm to that configuration are likely to be the context specific. The context specific factors may include the following: a) the economic and political features of the country (or the regions) of the investing firms and the countries (or the regions) hosting FDI; b) the nature of industry and the types of value-added activities in which the firms are engaged; c) the characteristics of the individual investing firms, including their objectives and strategies in pursuing these objectives; d) the four motives of the FDI, namely, *natural resources seeking, market seeking, efficiency seeking* and *strategic asset seeking*; d) the extent of market failure influencing whether or not the market for technology is internalized across different industries; e) differences in the perceptions of different corporations about the comparative locational advantages of different countries as a manufacturing base.

Hence, there are likely to be country-specific and industry specific differences in FDI in terms quantity as well quality.

**4. Discussions on Theories of FDI**

Both, the IO and TCI theories of FDI, posit that some firms develop certain forms of ownership specific advantages. Hymer (1976) terms these advantages as *monopolistic advantages* while TCI names it as competitive advantages based on *firm specific assets or resources and capabilities*. When the firms armed with these
ownership-specific advantages intend to undertake FDI through their foreign affiliates, they face disadvantages of doing business abroad in terms of liability of foreignness. Therefore, the firm intending to undertake FDI must possess ownership specific advantages, which could overcome the liability of foreignness. Besides, the underlying assets providing ownership advantages must be readily transferable through the internal market of MNEs at no or nominal costs from the parent firm based in one country to its foreign affiliate based in another country.

The early theories of FDI (both TCI and IO) assume that the FSAs are created in the headquarters of MNEs and FCFs and thereby consider FCFs to be the mere recipient of firm-specific resources developed by the parent MNEs. As a consequence, they play an operational, rather than a strategic or innovative role. These theories reflected the reality prevailing at the early stages of internationalisation when MNEs expanded worldwide to exploit the monopolistic advantages created in the domestic market of the home country. In this framework, FCFs were tightly controlled and typically managed by home country personnel using vertical division of labour in which upstream activities in the value-chain were conducted at the centre, and downstream ones by the FCFs.

Despite the number of similarities, the IO and TCI theories of FDI differ in the following important aspects. First, the TCI theory views MNEs as the efficient organizers of inter-dependencies while IO theory emphasises on the MNEs as the oligopolistic firms which tries to eliminate conflict by taking over or colluding with rivals and thereby create or strengthen imperfection in the market.

Secondly, while IO theory stresses imperfections in markets for final goods, TCI sees MNEs as arising from inefficient coordination through intermediate input markets. TCI theory suggests that the MNEs do not need monopolistic advantages to expand abroad as inefficient intermediate input markets can exist even in competitive industries.

Thirdly, TCI theory advocates that having unique assets, such as new products and processes, do not necessarily confer monopolistic advantages, and thereby do not guarantee supernormal profits, since many of the "unique" products sold by MNEs will have close substitutes, especially in the long run. Moreover, if FSA are bought or rented at their capitalized value, the MNE will not earn any super-normal profits on
them. In other words, it is mistaken to assume that a firm that has made large investments in research and development or advertising is necessarily making super-normal profits. TCI theory believes in efficiency based explanation for earning super-normal profits. Only luck and/or superior management skills will make it possible for MNEs with superior resources and capabilities to extract more value from the factors of production and thereby earn super normal profit.

Dunning's (1977, 1980) eclectic theory of international production collectively explains the TNCs' rent-yielding advantages in terms of the configuration of three factors ownership advantages, efficiency advantages due to the internalization of transactions, and locational advantages. These advantages enable the investing firm to compete with incumbents in foreign markets, which requires increased costs of operations.

Things have changed substantially since the early theories of FDI were propounded. The waves of globalisation, added by the widespread implementation of information and communication technologies (ICTs) and substantial liberalisation of industrial, trade, investment regime and stronger intellectual property rights regimes world under WTO, have significantly influenced all the three determinants of FDI-ownership-specific, locational and internalisation advantages.

MNEs nowadays enjoy a degree of flexibility in moving production around, and in transferring know-how and knowledge from one location to another. They therefore are more aware of and often make use of the knowledge that exists in host economies. MNEs are actively seeking advantages originating in the global spread of the firm rather than just exploiting centrally created technological assets. As a consequence, MNEs have moved from being only technology creators to being also technology organizers within their networked corporate structures. These recognise varying forms of organisational flexibility and internal heterogeneity in the roles of technological activities in subsidiaries. Furthermore, within such a network each affiliate is recognized as being unique and is given a potentially important role in the process of creating FSA within the MNEs.

Recognising the changes brought about by the globalisation, Dunning (2000) in the revised version of eclectic theory offers a much broader analytical framework in which ownership-specific, locational and internalisation advantages are
complemented and extended to embrace new realities and context specific factors. For instances, eclectic theory adds in ownership specific advantages the competence of MNEs to scan, coordinate and access created asset from other firms. It also adds additional elements to internalisation advantage and locational advantage meant for explaining the attractiveness of a country for FDI. The revised version of eclectic theory, predict FCFs to be a group of firms with significant differences in terms of their resources and capabilities depending on the home countries in which they originate, host countries and industries in which they operate, type of MNE networks to which they belong and motives and strategies of MNEs. Besides, it also explains various non-equity forms of alliances between MNEs and host country firms. In the light of the above discussions, we feel that the eclectic theory can provide us the robust framework for examining comparative conducts and performance of FCFs and DFs as well as efficiency and export spillovers stemming from the presence of FCFs in the Indian non-electrical machinery industry.

5. Conclusions and Developmental Implications

The dominant view based on the micro economic theories of FDI is that the group of FCFs being affiliated to MNEs acts as the superior agents of development, particularly in raising the competitiveness of the host country industries, in comparison to DFs. Underlying assumptions justifying this view are the following. First, MNEs create and possess superior FSAs, which include technology, superior intra-firm hierarchies within and across national boundaries, advantages of common governance (Lall and Narula 2004). These assets are most important for a firm for maintaining competitive advantage/edge in an industry, particularly in technology and skill intensive industries.

Second, FCFs being part of MNEs system have privileged access to these FSAs, which are unavailable (notably to uni-national DFs in developing countries) or available in less quantities to DFs, despite the latter being better placed in terms of knowledge of local business practices, market and consumer preferences.

Third, the relative advantages of FCFs in terms of their asset bundle translate into their superior conducts and performance (viz. export behaviour, productivity/efficiency and profitability) of FCFs in comparisons to DFs. As a result, if the share of resource-rich and better performer FCFs increases in total population of
firms in an industry/economy, the average performance of the industry or economy also improves.

Fourth, the entry of FCFs increases competitive pressure in the concerned industry and FCFs coexistence with DFs for a reasonable period of time leads to spillover of FSAs of the former to the latter. The competitive pressures and spillovers initially cause DFs to improve their technology and methods of production, upgrade their skill levels and business practices (organisational, marketing, management, finance and accounting practices), augment their market intelligence and international contacts, enhance the quality of their products and services and improve their overall efficiency/productivity and export performance.

Thus, the simple policy prescription for the developing countries under “Washington Consensus” has been that these economies should increase the share of FCFs by promoting FDI so as to compensate for the weaknesses of the DFs, achieve competitiveness and growth in the economy (Williamson 2000).

The updated version of eclectic theory of international production emphasises that the extent, geography and industrial composition of FDI depends on the significance of each of the three advantages- net competitive advantages, locational advantages and internalisation advantages- and their configurations. Dunning (2000), however, states that all the three advantages and their precise configurations and the response of the firms to these advantages in terms of quantity and quality of FDI are strongly influenced by the global as well as local context in which firms operate or propose to operate.

The FDI literature suggests that the quantity of FDI flow is influenced in an important way by the outward-oriented macroeconomic policy framework and conducive business environment prevailing in the host country; liberal FDI policy including national treatment to FDI and absence of TRIMs; the consistency, fairness and transparency of legal system; protection of private property rights including intellectual property rights; overall state of development of the economy in terms of physical and social infrastructure, etc. (Kobrin 2005).

However, the beneficial effect of FDI on enterprise developments depends more on the quality than on its quantity of FDI. The quality of FDI in turn depends on the competence and scope of FCFs, strategies of MNEs, motives of FDI, relative
technological capabilities of home and host countries, nature of FSAs transmitted to FCFs by the MNEs, absorptive capacity of DFs and the stage of investment development path (IDP)\textsuperscript{24} to which a country belongs (Lall and Narula 2004; Narula and Dunning 2000b). At the same time, Narula and Dunning (2000b) also advocate that the FDI-assisted development strategy presents the most efficient option to the developing countries in the present context. They site four reasons for this. First, given the shortage of fund and the less ability to evaluate and bargain, it is not a viable option for many developing countries to obtain FSAs from the market. Secondly, following the import substitution strategy or developing new industries under the government protection are almost impossible in the post-WTO era. Thirdly, the MNEs are increasingly maintaining their competitive advantage by retaining control over their FSAs in the more liberal and competitive market place of today. Therefore, they like to operate more through majority owned foreign affiliates and unlikely to sell their valuable technologies in the external market. Finally, the FSAs available with MNEs are also the critical resources of the development.

In view of the above, it is suggested that the developing countries should not only direct their efforts towards attraction of more FDI but also develop their capabilities to attract right kind of FDI (Lall and Narula 2004).