THE EVOLUTION OF FOREIGN DIRECT INVESMENT THEORIES: HOW CAN INSTUTIONS RELATE?

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Abstract:
Theories of Foreign Direct Investment (FDI) have evolved over the past few decades. There are theories which try to explain the motivation behind investments, and there are others to explain why companies go abroad. To understand the motivations of firms in today's economic environment, we have to trace the evolution of these theories. At first, researchers tried to explain capital movements with trade theories. However, because of the strict conditionality, they only explained a small part of FDI. To extend the validity of the models, researchers started to examine investments from the firms' point of view. The models evolved from Vernon's product life cycle model, through Hymer's monopolistic advantage model, to Dunning's eclectic theory. These firm-based theories highlighted the importance of entrepreneurs. Dunning's theory includes the statements which featured in previous models. We can find monopolistic advantage, localization and internalization models in this argument. This study is an attempt to relate the issue of FDI to institutions. There is a rapidly growing literature on the subject of new institutional economics, which indicates that the effect of institutions can appear in any economic situation. These effects can be shown in Dunning's theory, too. The consensus view seems to be that institutions play a significant role in ownership, in localization and in internalization advantages. Consequently, we can find them in the other models, too. The purpose of this paper is to identify the main trends in FDI theory and highlight how institutions can relate to them.

Keywords: Foreign Direct Investment, International Trade, Institutions

JEL classification: E02, F02

1. Introduction

In the last few decades, the issue of FDI has been receiving more attention. Since World War II, foreign direct investment has expanded rapidly, especially in the last few decades. The national barriers to capital movements were mostly removed after the war (Barrel and Pain, 1997), so free movement of capital could start. With this change, a new type of firm has emerged: the multinational enterprise (MNE). Since then, research in this field has multiplied. Researchers are interested in understanding the motivations behind this investment.
A consensus has emerged on the importance of FDI, especially on its effect on economic growth. The first attempts to explain FDI were related to already existing trade theories. In Section 2 we can see how these theories handled the mobility of capital. As time went by, the theories became more and more complex. The emergence of MNEs called for a new approach to this topic. This was the point at

which firm-based theories started to appear. These models will be presented in Section 3. There is also a rapidly growing literature on the subject of new institutional economics. According to North (1990:3), institutions are a "humanly devised constraint that shape human interactions". So it is argued that they also affect the investment decisions of the company. After a brief discussion of these theories we consider the possible relationship between the model and the institutions. In Section 4 we close the argument with conclusions and some further research questions.

2. International trade theories

In the last few decades, foreign direct investment has become more important than international trade. However, the origin of foreign direct investment theories lies in trade theories. These theories examine the macro level, arguing that FDI is simply an international capital movement. So the main question is where capital goes and why.

The first trade theories failed to explain international capital movements. *Ricardo (1817)* and *Smith (1776)* described international trade as the consequence of economic differences. These economic advantages may come from countries' differences in terms of factors (labour or capital). These theories are based on two countries, two products and the mobility of factors at a local level. Thus they do not even allow for FDI flows. Economists tried to extend these theories and explain FDI activity in its portfolio form (Hosseini, 2005). The portfolio theory still cannot capture the complexity of FDI and the production of MNEs (multinational enterprises).

The second trade related model was based on factor proportions and relative factor endowments. This theory extends the concept of comparative advantage with the costs of production (Morgan and Katsikeas, 2005). *Heckscher* and *Ohlin* argued that a country would export those goods and services that make use of their abundant factors. The model considers two countries, two products and three factors. The classical Heckscher-Ohlin theory was also unable to explain international investments because it assumed that factors are immobile. That assumption was relatively correct before World War II. However, in the new monetary system (the Bretton Woods system) the restrictions on capital flows were eliminated. The first attempt to expand the classic Heckscher-Ohlin model was the work of *Robert Mundell* (1957). The model stated that commodity movements are a substitute for factor movements. Mundell's theory suggests that capital flows out from countries which are relatively rich in capital to those that are relatively poor. If two countries have the same production function, then their returns of capital will be different. According to this theory, this was the only factor generating capital flows. When capital flows balance returns, they can substitute trade.

However, trends in investments showed a different pattern. Direct investment has mostly tended to take place within developed countries, from capital-rich countries to other capital-rich countries (Barrell and Pain, 1997). These trends called for an alternative explanation of trade and investment flows (Leontief, 1966).

Institutions have not appeared in the trade theories. As we can see, they are mainly based on two factors, capital and labour, and they have only explained

capital flows with factor endowments. When these models emerged, research into institutions was at a low level.

There was one more model related to trade theories. *Vernon* (1966) tried to solve the Leontief paradox by placing emphasis on the timing of innovation and the effects of scale economies. However, this theory approached the topic from the point of view of enterprises, so we cannot describe it simply as a trade theory. Vernon (1966) originally analysed the foreign direct investment from the United States to Western Europe after World War II, stating that there are four stages of the production cycle: innovation, growth, maturity and decline (Denisia, 2010). During the first stage American companies only served domestic markets, but after the War growing demand pushed the product cycle to the next stage. In the growth stage US companies began to export. They had the advantage of technology. The maturity phase started when manufacturers standardized their products, and EU firms began to imitate US products. US firms lost their technological advantage, so they had to relocate production to local markets to maintain their market share (Denisia, 2010). This theory successfully explained the production of some goods (such as PCs), but over the years it has lost its predictive power. There is another problem with this theory: it only argues that if the foreign market is large enough, FDI will replace exports (Nayak and Choudhury, 2014)

3. FDI theories based on firms

This group of theories concentrates on enterprises. These models differ from the previous ones in another respect. They highlight the differences between portfolio investments and FDI, recognizing that the role of the entrepreneur plays a large part in explaining international activities (Morgan and Katsikeas, 1997).
The first model was developed by Hymer (1976). This model proposed that foreign direct investments are associated with the international operations of firms. Hymer's *monopolistic advantages* theory suggests that MNEs have a specific advantage, which is indispensable for the performance of FDI. Foreign firms also suffer disadvantages compared to local firms, so they need this special advantage to compensate. Hymer has dealt with the problem of information cost for foreign firms, and the different treatment of government or currency risk (Denisia, 2010).
These advantages can be explained by market imperfections (Morgan and Katsikeas, 1997). Hymer stated that FDI means transferring knowledge and other firm assets, and not just capital mobility (Sethi et al, 2003). According to Hosseini (2005:532) the model argued that the firm has two motivations to invest abroad: to remove international competition and to increase the returns arising from the firm's special advantages. Although Hymer's model could not completely explain the operations of MMEs, his idea about market failure was formalized and developed in later models. Kindleberger (1969) and Caves (1971) extended Hymer's theory.
Kindleberger stated that a special advantage is useful in the case of market imperfection and it can include technology or management expertise (Nayak and Choudhury, 2014:6).

The second group of these theories are the *internalization theories*. The basis for these models was developed by Ronald Coase (1937). He argued that firms reduce transaction costs. If we extend this theory to the international operation of the firm, the question is why firms keep production internal.
Erdey (2005a) summarized emerging costs in international production. If we do not keep production inside the firm, we face two major problems: dissipation of knowledge and dissipation of goodwill. These costs are related to the intangible assets of the firm. There are some other problems with international production. The hold-up problem can occur if the parties behave in an opportunistic way. We may have to face the principal-agent problem if there is an information asymmetry strengthened by geographical and cultural distance.

Buckley and Casson (1976) argued that the firm will chose international production if the benefits compensate the costs. Their theory had three assumptions: firms maximize their profits in an imperfect market, when the market in intermediate productions is imperfect, there is an incentive to bypass them and create internal markets, and internalizations of markets leads to MNEs (Nayak and Choudhury, 2014:6). According to their theory, the following can result in internalization: a long time lag in the co-ordination of resources, discriminatory pricing to exploit market power, unstable bargaining situations, the buyer's inability to estimate the price, and government interventions. These problems are types of market imperfections (Nayak and Choudhury, 2014:7).

Theories based on *location choice*[1] separate vertical and horizontal foreign direct investments. Horizontal FDI means that the firm makes the same products in different countries. It is mainly the subsidiaries who supply the local market. Vertical FDI is when the firm locates the different stages of production in different countries. This occurs when the company is trying to maximize efficiency by utilizing the differences in relative factor endowments, government policies or regulation (Erdey, 2005b). Location theories attempt to explain why the firm chooses a foreign country for production (Helpman, 1984). The first models argued for the role of factor endowments. These vertical models separated the firm's operation into two parts: headquarter services and production. A horizontal model developed by Markusen (1984) concentrated on the multi-plant economies of scale. The knowledge-capital model combines horizontal FDI motivations with vertical FDI motivations. The theory developed by Markusen et al (1996) assumes two countries, two factors, and two goods. The model predicts that horizontal FDI occurs when countries are relatively similar in factor endowments and the cost of trade is high. However a significant difference in factor endowments leads to vertical FDI, because the factor price differentials stimulate fragmentation.

These are the three main types of firm-based FDI theories. They differ from the previous ones in several aspects; the main difference is that they concentrate not only on macroeconomic factors, but on microeconomic variables. This leads us to a complex theory, which incorporates the previous models' results. We will discuss the role of institutions in this theory, because it includes the three previous models.

[1] The discussion of the location choice theories is based on Erdey (2005b).

Dunning (1993) created a model to determine the necessary and sufficient conditions for foreign direct investment. The model - called *eclectic paradigm* - suggests that there are three essential conditions. FDI can only occur if the firm has all of these advantages.

The first is ownership advantage (O), which is basically similar to the previous concept of monopolistic advantage. It could be a product or a manufacturing process, or special know-how. Furthermore, the advantage could be reflected in skills (marketing, managerial etc.) or in the corporate culture. At this level we can easily recognize the importance of institutions. Formal institutions such as laws, regulations, patterns or trademarks have a significant effect on gaining an ownership advantage. Informal institutions, such as a well-functioning corporate culture, could be an advantage (Dunning and Lundan, 2008:583). The second necessary advantage is localization advantage (L). This reflects the firm's choice to go abroad. In the first theories the main localization advantages were natural resource endowments, the costs of the various factors, or the size of the market. According to Dunning (2001), any factor could be a locational advantage if it has an impact on the profitability of the firm in the foreign country. In the last few decades, with the growing literature of new institutional economics, it has become clear that institutions play a crucial role in this area. This role could include a wide range of relevant formal institutions such as laws, regulations, political institutions, and contract enforcement, but informal institutions matter, too. There is a slowly growing literature on the role of culture, traditions, and religion (Dunning and Lundan, 2008).

Dunning's third advantage is the internalization advantage. This is an answer to the question of why companies keep production internal. According to Dunning (1993), this means that firms try to avoid or reduce some transaction costs. This internalization advantage could occur because of the nature of the production. If there is a special knowledge, which is difficult to transfer, the firm could choose not to licence it. Or the firm could have concerns about its reputation, as was discussed earlier. As was argued by Dunning and Lundan (2008:587), "the institutions play a major role in determining the complementary or substitutability of the different organisational modes", which represent different combinations of market-led and hierarchical coordination. Institutions are major determinants in the transaction costs in or out of the company. These institutions could be formal (intra- and inter-firm contracts) or informal (codes, trust-based relationships).

The co-operation of the three advantages consists of the following: ownership advantage is needed to compete with local firms, internalization advantage must appear to keep this ownership advantage within the firm, and if these are both available, locational advantage helps to choose between exporting and FDI (Dunning 1993). The eclectic (OLI) paradigm is the most widely acknowledged theory of foreign direct investment. The acceptance and success of this model is based on its complexity, because this theory attempts to summarize the previous model's statements. Dunning also described the forms of foreign direct investment: it could be resource-seeking, market-seeking, efficiency-seeking or strategic asset-seeking (Sethi et al 2003).

4. Conclusions

The evolution of the foreign direct investment theory has not reached its conclusion. As new theories and new approaches arise we can observe the complexity of the topic. As new firm-based theories took the place of trade theories, the role of factor endowment declined. As we have seen, relative factor endowments and factor prices have a role in localization theories, but their importance has decreased. At the same time, researchers have discovered the significance of other factors, one of which is the institutional environment. The literature on the relationship between foreign direct investment and institutions is constantly growing. A further research question could involve informal institutions. This area offers some interesting ideas about the relationship between culture and investment.

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