Chapter 2

Literature Review

2.1. Introduction

The theory of capital movements had not been treated systematically until 1960s in the literature of Economics. Because, earlier, the classical theories of international trade based on the fundamental assumption that the factors of production, labor and capital are freely mobile inside a given country, but they are lacking freedom of external mobility (Nurkse, 1933). When the attention on the capital movements rises, the pattern of long-term capital flows including foreign direct investment was believed to be from capital-abundant to capital poor countries. In this view, scholars’ attention was focused primarily on the effect of capital flows rather than on the causes of FDI. In early periods, economists had not fully realized that the problem of foreign direct investment is one of capital accumulation in a foreign country and that the theory of domestic investment rather than the traditional theory of international trade and finance.

‘Pure orthodox theory of the firm’ assumes that firms are in perfect competition, and the firms have equal access to all productive factors, do not exercise market power, and reach an optimum size set by long-term diminishing returns to scale. It is not very useful in analyzing the behavior of TNCs, which grow in extremely imperfect markets.

Since the end of 1960s, the researchers interest was stimulated by the increasing of data on FDI and also by the rise to prominence of the multinational corporation. Hence
the most of studies in this area addressed to the problem of capital accumulation relying heavily on the theory of domestic investment.

Recent theories of foreign direct investment have turned to explanations based on imperfections, firm's oligopolistic interdependence, and the possession of monopolistic advantages. Such theories basically explain the monopolistic advantages of TNCs such as ‘superior management’, ‘superior technology’, ‘product differentiation’, access to market, access to raw materials, economies of scale, bargaining and political power, and cost of production etc.

A significant portion of the literature of foreign direct investment has dealt with the factors determining foreign direct investment. One of the most famous ideas in this aspect is Dunning’s (1988) ‘electic analytical framework’, which led to many studies on determinants of FDI. Most theories and studies on FDI are prevailing under the headings of capital movements, capital accumulation process, the theory of industrial organization of the firm, monopolistic or oligopolistic behaviour of the firm, cost and benefits of FDI, and the determinants of FDI. Some of theories and ideas under these categories are briefly reviewed in this chapter.

The area of foreign investment includes foreign direct investment, portfolio investment, and official development assistance. Literature on the subject of foreign investment has mainly devoted to foreign direct investment and portfolio investment. Both act a significant role in international capital flows at present.

Direct investment is taken to mean investment in operationally linked subsidiaries or affiliates as contrasted to portfolio investment, which is investment in equity and debt securities through the medium of an impersonal capital market. Direct investment
controls over the operations of the host country firm through the provision of capital, technology, entrepreneurship and access to market as a package instead of their being made available separately through the market place.

2.2. The theories of capital movements

In early periods, many economists explained foreign investment through the theory of capital movements between countries. Many theories, which explain capital movement generally, considered that foreign direct investment behaves essentially in the same manner as the rest of the long-term capital flows. The movement of capital represented merely "overseas loans" or "transfer of purchasing power". Some studies concerned the way in which the balance of payments mechanism adjusted to exogenous disturbance in the form of capital movements. Some groups of studies attempt to explain why and how capital moves internationally. This problem was examined in two different contexts. One is showing how the international flows of capital fluctuate in relatively short run period and the other is explaining the "structural pattern" of international capital movements. One possible reason for flowing of capital is the level of marginal productivity of factors countries according to Arndt (1954). Foreign investment inflows are low in under developed countries as the marginal productivity in those countries is lower.

2.3. Foreign direct investment as capital accumulation process

"Direct investment may thus be capital movement, but it is more than that. Direct investment has long been defined as a capital movement involving continuing control by
the investor" (Kindleberger, 1969). The theories of foreign direct investment as physical capital accumulation owe much of their development and success to the advance made in the study of domestic private investment. Theories of domestic investment, which can be categorized under various headings such as the neo-classical profit maximization model, the growth maximization model, accelerator model, the liquidity model, and the behavioral model, are applied to foreign investments in many of the studies.

In one survey, Mikesell (1962), reports that 20 of 72 companies replying to questionnaires gave “increased profits” as the primary objective of the firm, while almost as many firms reported having chosen “expanded foreign demand or markets” as their goal. A survey done by Brash (1966) revealed that the most important objective of the American manufacturing firms invested in Australia is “to take advantage of the expected growth of the Australian market”. These surveys reveal the relative importance of profit maximization and also the multiplicity of the purposes of foreign direct investment. The theory of profit maximization of domestic investment was successfully applied to the analysis of FDI by Johns (1967), Stevens (1967), Kwack (1972), and Abbot (1973).

The growth maximization theory of domestic investment was applied to FDI by Behrman (1969), Hymer and Rowthorn (1970) and justified the linear functional relation between the level of host nation’s income or GNP to the level of FDI in that nation.

Aharoni (1966), following Cyert and March (1963) advances a behavioral theory of FDI. Aharoni (1966) finds by interview that many firms do not look globally for that project, which maximizes profits, but that they would recognize a profit opportunity or potential loss of it only when it is presented as a new fact from outsiders.
2.4. The theories of industrial organization of the firm

Generally, industrial organization theories of FDI can be divided into two categories. One is that focus on internal characteristics of multinational firms. The other is that focus on rivalry among such firms.

Most of the theories and arguments under the first category are based on Hymer's (1976) valuable contribution. According to Hymer (1976), firms who operate cross-national boundaries face the certain costs, by which the firms who operate in one nation are not faced. To overcome the effects of these extra costs the firms should have internal firm-specific advantages over its rivals according to him. Further Hymer speculated that these advantages largely took the form of economies of scale or of superior product technology.

Dunning (1958) examined operations of US manufacturing firms in UK and found that these operations generally paid higher wages and were characterized by higher rates of labor productivity and new products innovation than their UK controlled rivals. Kindleberger (1969) tested the role of firm-specific advantages other than technology, such as organizational and marketing skills. Caves (1971) summarized these developments by noting that the advantages possessed by multinational enterprises can include any of a number of intangible assets including organizational and marketing skills and process technologies. Dunning (1988) emphasized that the advantages of internalization must interact with both firm-specific and locational advantages to explain FDI.

Some theoretical arguments have been presented under the second category related to rivalry among firms. Hymer (1976) and Hymer and Rowthrone (1970)
suggest that the possibility that rivalry among firms operating in the same country or countries can affect FDI behavior.

Knickerbocker (1973) noted a “follow the leader” pattern in the timing of FDI by US firms. He interpreted this phenomenon as a rational response to oligopolistic rivalry. Graham (1989) suggests that intra-industry FDI may take place as an “exchange of threat” in which firms invade each other’s home markets as part of an oligopolistic rivalry.

Within the total view that direct investment is a function of the growth of the firm are two strands. One emphasizes the market and other emphasizes the internal source of finance. First view implies that direct investment is stimulated not by profits but by markets. The second view connects direct investment not with markets but with the cost of capital to the firm. Many economists regard retained earnings as not only cheaper capital than borrowings or the sale of new equities but so cheap as to approach a negative cost.

Penrose (1956) explaining the growth of the firm in direct investment argues that once established, a new subsidiary has a life of its own and its growth will continue in response to the development of its own internal resources and the opportunities presented in its new environment. In time however the possibilities of expanding in other fields will appear attractive. Because expansion in the original lines at the same rates as before is no longer profitable, as new market opportunities have appeared or as the firm has itself developed. Thus the parent company can be drawn for productive services suitable for other types of products.
2.5. Monopolistic or oligopolistic behavior of the firm

The pure orthodox theory of the firm considers that the firms are in perfect competition. It further assumes that those have equal access to all productive factors, those do not exercise market power, and these reach an 'optimum' size set by long-term diminishing returns to scale. It was argued in later theories that these features are not applied to TNCs.

Many theories in the literature of FDI suggest that in a world of perfect competition for goods and factors, direct investment cannot exist. In these conditions, domestic firms would have an advantage over foreign firms in the proximity of their operations to their decision-making centers, so that no firm could survive in foreign operation. For direct investment to emerge there must be some imperfection in markets for goods or factors, including among the latter technology, or some interference in competition by governments or firms, which separates markets (Kindleberger, 1969). Kindleberger describes the nature of the monopolistic advantages, which produce direct investment under four headings, departures from perfect competition in goods markets, departures from perfect competition in factor markets, internal and external economies of scale, and government limitations on output or entry.

Sanjaya Lal and Streeten (1977) argue that if there is a situation of perfect competition, a local firm can simply borrow capital if it need to, at the same rate of interest as any other firms, and, since all other factors of production are equally distributed, there is no economic rationale for a foreign firm to invest in facilities, which it owns and has to run from abroad. It is, therefore, a necessary condition of direct
investment that the investing firm has same monopolistic or oligopolistic advantage not possessed by potential local competitors.

Hymer and others suggest that FDI occurs only when a firm has some major advantage over its competitors abroad. Since the major advantage often takes the form of some informational or technological assets, the firm would invest abroad only if the average fixed costs of these assets were expected to be lower than a certain threshold level.

2.6. Costs and benefits of foreign direct investment

Many theorists and researchers have contributed a large number of studies to the area of costs and benefits of FDI to host country and the home country. Some studies cover the impact of FDI on economic growth or on employment or domestic investment, and technological improvement in host countries and the economic development in home countries. Some studies have tried to examine the impact of FDI on trade and the balance of payments. And some studies have been done to investigate various other welfare effects of FDI on host nations in various aspects.

A regression analysis done for the advanced developed countries (ADCs) by Lee, Rana and Jawasaki (1986) found that foreign capital inflows had made a positive contribution to the growth of ADCs. According to this study, while foreign direct investment has contributed to growth both by augmenting resources available for capital formation and increasing the incremental capital output ratio, which in the annual change in GDP divided by the gross fixed capital formation. The evidence also implies it has tended to decrease incremental capital output ratio. Dunning (1970) evaluated the
relationship between US FDI and economic development gained through technology in Europe using data in 1950s and 1960s. His findings were positive. According to Dunning’s study, has leaned heavily on the US for technology in this period. US FDI in Europe were strongly concentrated in the research intensive and growth sectors. Hence strong technological impact caused to rapid growth in Europe faster than the US.

**Hagen (1962)** argues against FDI in developing nations. Hagen points out that multinational corporations can harm the host country by gaining excessive (more than the services are worth) profits through entering dubious cost items in its accounts and falsification of ‘transfer pricing’, siphoning from the country more foreign capital than they bring in, not providing as much employment as equivalent domestically controlled ventures do not revealing their technology freely to local firms and not licensing its use for a reasonable charge, in respect to MNCs subsidiaries, not importing much of their capital, and by their existence in the country, MNCs prompt opportunities for managerial and executive experience and that the MNCs deny these opportunities to the nationals.

**Lipsey (1991) and Graham and Krugman (1991)** pointed out that there is some evidence from the US to the effect that Japanese firms tend to have a higher import dependence than local firms. However Balasubramanyam (1989) among others has argued that this is in fact just a temporary phenomenon and once the foreign firm becomes established, it sets up local supply networks for sourcing inputs.

**Fry (1993)** investigated differential impacts of FDI in Southeast Asia. He concluded that FDI raises the rate of economic growth in the absence of financial repression and trade distortions in the sixteen sample developing countries taken together. He further stated that financial repression as measured by the real deposit rate of interest
and trade distortions as measured by the black market exchange rate premium can both cause FDI to immiserizing, when the domestic economy is distorted, FDI inflows are associated with a low or negative growth. When real interest rates are positive, however, FDI can accelerate the rate of economic growth more when restrictions on the sectoral location of this investment are relaxed.

Graham and Krugman (1991) argue that MNCs may be thought of as a facilitating device for trade in goods, services and knowledge and in some cases transactions costs may be reduced when international trade takes the form of intra-firm trade rather than arm’s length transactions between unrelated parties. FDI facilitates trade in goods, services and knowledge; it magnifies the gains from trade. Countries will be able to specialize more effectively in the production of intangibles such as knowledge as well as tangible goods to benefit from both comparative advantage and economies of scale. At the same time competition will be increased.

MacDougall (1960) studied on costs and benefits of FDI in Australia and concluded that the most important direct gains to Australia from more rather than less private investment from abroad seem likely to come through higher tax revenue from foreign profits through economies of scale and through external economies generally. This study further reveals that the effect on the balance of payments could be favorable, but the danger of future balance of payments crises might be increased.

Dunning (1970) studied US direct investments in Europe and showed that effects of changes in technology and changes in factor proportions as a result of US investments had worked together to yield not only convergence in pattern in production but also a higher growth rate in Europe along with the process of adapting to the borrowed
technology. Given that it is desired to attract technology by direct investment, the problem of European economies is to maximize the resulting technological multiplier and to minimize its costs.

*Johnson (1970)* presented ‘second-best arguments’ for protection of domestic firms of host countries against the intrusion of foreign direct investment such as balance of payments argument, monopoly argument etc. His view is foreign direct investment should be restricted as it affects domestic firms adversely.

*Sanjaya Lal and Streeten (1977)* evaluated balance of payments effect of FDI in developing countries and explained direct effects and the indirect effects. According to their findings, overall direct effect is negative for the reasons import dependence, technical payments, profit and transfer pricing etc.

2.7. **Determinants of foreign direct investment**

A significant portion of the foreign direct investment literature deals with the factors determining FDI, which is the subject of this study. Many empirical studies have been done on the private investments of advanced countries in less developed countries or regions or developed countries or regions or newly industrialized countries or regions to examine the factors served as determinants of FDI.

A recent study done by *Balasubramanyam and Greenaway (1994)* on East Asian FDI in European community (EC) concluded that the observed upsurge in such investment in the EC is largely due to the potential market size of the EC, although some of it might have been undertaken to word of threats of trade restrictions.
Kolde (1985) examined foreign direct investment activities and government policies towards FDI in four newly industrialized countries, Taiwan, Hong Kong, Singapore, and South Korea and showed that the government policies to grant incentives for foreign direct investments such as duty waivers on imports of capital goods, tax concessions, credit facilities, guarantee of profit remittance, and capital repatriation, subsidies for infrastructure facilities, free port facilities, subsidies for workers training, and reduction of foreign regulations are the main determinants of FDI attraction. He further shows infrastructure facilities have played critical role for attraction of FDI. Terpstra (1987) and You and Lim (1974) support to this view.

Many studies have been done to examine the factors that motivates FDI in various countries and regions using hypotheses that the FDI emerges due to ownership advantages, locational advantages and internalization advantages, following Hymer (1976) and Dunning (1977). Heitger and Stehn (1990), Balasubramanyam (1992) and Thomson and Nicolaides (1991) focused on the possible ‘protection-jumping’ incentive of increased, European integration and EC enlargement, emphasis on location-specific advantages that are predominantly fashioned by government policies is not however in line with the more eclectic ownership, location, and internalization paradigm. Baldwin (1979) reports evidence of US firms investing abroad in manufacturing in order to take advantage of relative abundance of unskilled labor.

The study done by Milner and Pentecost (1994) suggest that inter industry variations in industrial/market characteristics do systematically influence the extent of or scope for locational and internalization advantages for US investors in UK economy. They find empirical support for the hypothesis that US FDI is higher where there is
access to sources of UK comparative advantage in general, and specifically where it provide access to local endowments in the case of relatively capital and non-manual labor-intensive activities. The results also support a ‘restricted competitiveness’ hypothesis that US FDI is higher the lower is the scope for competition from other domestic firms and from imports. And FDI is shown to be ‘host’ market size with the EC being the relevant market.

According to some studies, some additional factors, which influenced to the relative cost of capital such as exchange rates, changes in taxation, and changes in trade policies effect foreign direct investment decisions. Froot and Stein (1991) suggest that if United States firms are cash constrained, a depreciation of the dollar relative to, for example, the Yen, leads to an increase of Japanese FDI to the United States. Krugman and Graham (1992) suggest that volatility of the exchange rate may serve to inhibit FDI.

2.8. Summary

Before 1960s, capital movements were not important area in the literature. When the attention on the capital movements rises, effects of capital flows became an important area of this subject in the literature in early periods. The reasons for moving capital between countries, the way of capital movements, and the structural pattern of capital movements were mainly covered under the theory of capital movements.

Initially foreign direct investment had not been realized as one of capital accumulations in a foreign country. After foreign direct investment was distinguished as a separate important area, importance of foreign direct investment as capital
accumulation process was risen. Economists viewed success of FDI in economic development similar to domestic investment through capital accumulation.

Many theories and studies on foreign direct investment were devoted to explain the nature and behavior of multinational corporations as their significant involvement in foreign direct investments. Theories of industrial organization based on microeconomic foundations were prominent in this area. Since the goods and factor markets of the world is nor perfectly competitive, and several MNCs have dominated FDI in the world, naturally MNCs exhibit monopolistic or oligopolistic characteristics. Many theories and empirical studies attempt to explain such behavior of the firms, which involve in FDI.

Some studies explain the costs and benefits of foreign direct investments to both host nations and home countries. Under this area, welfare effects of FDI, technological improvements in host countries, balance of payments effects of both host and home countries, effects on productivity and structural changes of the economies etc. have been discussed.

Many recent studies have focused on the area of determinants of FDI inflows. According to those studies, some major determinant factors are common to many countries or regions while some recognized factors differ from country to country or region to region. Such studies revealed the difficulty of measure many of the factors that serve as determinants of FDI. Hence in most cases, researchers have used only key factors, which cover many immeasurable factors in their empirical studies.