Understanding the Foreign Direct Investment in Order to Benefit from Them: A Theoretical and Empirical Review

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Abstract

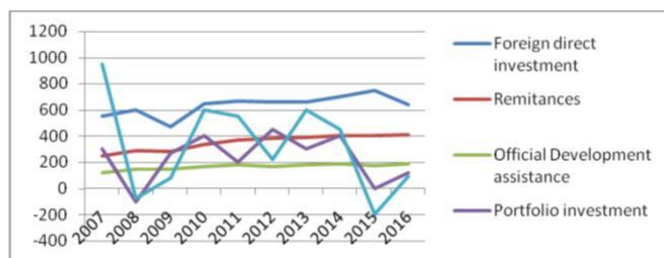
The attraction of foreign direct investment for years has been on focus of many governments around the world. These governments try to draft their policies in order to compete in attracting this important source to their development. The design of successful policies requires good understanding of the motives that a foreign investor would bring to the host country. Using different literature on Foreign Direct Investments, this paper analyzes multinational theories, which explain why a company decides to serve the foreign market and does not prefer export or licensing. The paper also reviews broad literature on the determining factors of host countries, which constitute an important moment in the decision of multinational companies for the host country of their direct investment.

Keywords: foreign direct investment; Economic Growth; Literature review, theories of MNC, country's absorption capacity

5. Introduction

Nowadays, foreign direct investments are being paid more attention. Different scholars highlight the importance of foreign direct investment as a source of funding. This feature of foreign direct investment is mainly important for so-called developing countries. These countries have major problems with needs of capital, which outweigh their domestic savings. Therefore, the main reason for the host country's efforts to attract foreign direct investment is to be able to access new funding sources for their economic development. At that moment, foreign capital is recognized as an important way to overcome this shortcoming (Liu and Agbola , 2014).

Financial inflows to emerging economies were estimated at $ 1.4 billion in 2016, down by more than $ 2 trillion compared to year 2010. These external sources consist of foreign direct investment flows, flows categorized as portfolio investment and other flows such as official development aid. Generally, their performance reflects the pace of economic growth and their impact depends precisely on the economic growth of different countries. An important feature of these flows is their instability, especially during the years of the world financial crisis, in the years 2008-2009. However, not all of their constituent elements represent the same behavior. Foreign investment flows represent a higher sustainability than other elements. This can be explained by the characteristics of this flow in contrast to portfolio investment and development aid.(Unctad 2017)



Graph 1: International financial flows in developing countries. **Source:** Unctad . Graphics processed by the author

As we can see from the above chart, foreign direct investment, besides taking the bulk of international financial flows, also represents a more stable performance.[1] They are therefore important for host countries.

6. Understanding Foreign Direct Investment

We see in two steps how a company chooses to invest a foreign direct investment in another country. The first step focuses on the motives of multinational companies. The motives of the multinational companies can be explained by theories of multinationals. The second step gives us an overview of the factors that the different countries of expectation exhibit and which play a major role in the investment decisions of the multinational companies. Both of these approaches are discussed in the following sections.

7. Theories of MNC to Explain Motives for Foreign Direct Investment

Through this section, we present briefly the various theories that explain the outcomes of companies to internationalize. These theories explain which factors determine the making of such a decision by a company.

7.1 Theories that suppose perfect markets

In this category we can group those theories that try to explain the investment behavior of different firms under the supposed conditions of perfect markets. The theories are explained as follows.

7.1.1 The Return Rate Theory

This is one of the earliest theories that explains the FDI flows. This theory explains the flows of foreign direct investments through the differences shown in different countries at rates of return from capital. The capital flow movement should according to this theory go from those countries with low rates to countries that have the higher returns from capital. But according to this assumption cannot be explained the phenomenon that in a given country there are also inflows and outflows of capital. This fact makes this theory unable to explain the movements of international capital flows in the form of foreign direct investment.

7.1.2 Market Size Theory

This theory points out that FDI inflows relate positively to the sales of foreign firms in the host country. The “Growth-driven FDI” theory focuses on domestic factors, such as market size (often defined by GDP) as one of the most important factors in attracting FDIs. (Demirhan and Masca, 2008; Economou, Hassapis, Philippas, Tsionas 2016).

Some foreign investors invest in developing countries mainly to serve the host market; these are the market-driven IHDs. Domestic market size may be the main determinans in attracting such a type of FDI (Unctad 2000). The size of the domestic market enables foreign investors to reduce production costs in order to supply the host market (Shatz and Venables, 2000, Lim, 2001).The size of a country's market grows with economic growth, encouraging foreign firms to increase their investment. The sooner the economy grows, the more demand for investment will be stimulated , also for foreign investment. High economic growth provides incentives for foreign investors because host countries can offer more facilities to investors (Zhang, 2001).

There are some disadvantages about this hypothesis. This theory explains the behavior of those types of foreign investment that are oriented towards market research, and cannot explain the behavior foreign direct investments that requires efficiency.

7.1.3 Portfolio diversification theory

This theory explains companies' decisions to become multinational through a simultaneous return and risk analysis. Investment has a positive relationship with the return rate and negative with the perceived risk. For this reason, investors try to diversify their investment portfolio in order to increase return on equity and reduce risk. This hypothesis also presents some shortcomings. It fails to explain the advantage of FDI to portfolio investment. Another disadvantage is the use of the use of an inadequate profit indicator in risk analysis .

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[1] *Kirabaeva and Razin 2010 in their paper show that foreign direct investment is more stable compared to other flows, because they also imply aspects of physical investment in host countries.*

7.2 Theories that suppose Imperfect Markets

These theories seek to explain company decisions about the alternatives they have to serve a foreign market, or the decision to become international, assuming markets are imperfect. Theories of this category are explained below.

7.2.1 Hymer-Kindleberger approach

This theory was created by Hymer and Kindleberger. CPKindleberger, the supervisor for Hymer theses, in expanding Hymer's work, introduced his theory of FDI and points out that "in a world of perfect competition in goods and markets, FDI cannot exist" (Kindleberger, 1969).

According to this theory, firms will choose to internationalize by taking a foreign investment in another country if they are already producing at minimal cost in the home country. The export alternative to serve the foreign market would cause increased spending as a result of the growth of production. According to this theory foreign direct investment enables the reduction of production costs by some advantages that these firms possess , as a consolidated distribution network, the most advanced management skills, the possession of a suitable technology, etc. Possessing these advantages made it possible for foreign firms to overcome some of the shortcomings they may face in the host country, such as the lack of knowledge of the domestic market, the necessary adaptation to the domestic legal and political framework etc.

Kindleberger in his theory showed why a foreign firm has advantages to firms in a host country, but the drawback of his theory lies in the fact that he did not show what advantages a firm should invest in a foreign country. Furthermore, it does not indicate what competitive advantages there is for a hosting country vis-à-vis another host country.

7.2.2 Vernon theory

Vernon (1966)[1] was the first to introduce the product life cycle theory in international trade. According to Vernon, a product cannot qualitatively develop into an underdeveloped or developing country, where per capita income is low. According to this theory, as the product develops qualitatively in a high-income country the demand for this product will grow in foreign markets. Through export, this product will penetrate the economies of developing countries. Consequently, following the securing of the market share in these foreign countries, the conditions for the opening of production lines will be created in foreign markets of developing economies, which have generally lower production costs. But Vernon's theory fails to explain the large flows of FDI between developed countrys.

7.2.3 The Internalization theory[2]

The main representatives of this theory are Buckley and Casson[3]. Their theory seeks to explain the reasons for a company to undertake a foreign investment in another country. According to them are the multinational companies themselves which enable a reorganization of their activities within the organization. This reorganization enables the companys to develop specific advantages. These specific advantages will enable them to be superior to domestic firms once in the host country. The basic idea of the internationalization theory emphasizes that the production and other processes of a company are more effectively dealt within the multinational enterprise to better exploit the knowledge-based assets of the company (Johansson, 2009).

This is especially true when the host countries have weak laws in the protection of intellectual property rights. But according to Buckley and Stranger (2011), the theory of internationalization focused heavily on the imperfections in external markets for the transfer of knowledge and not enough attention was paid to the nature and importance of transaction costs related to the internal transfer of knowledge."

Even the United Nations Conference on Trade and Development (UNCTAD) supports this theory when it intends to persuade developing countries to intensify their efforts for attracting foreign direct investment, seeing these investments as important sources for new technologies.

7.2.4 The OLI paradigm

[1] Vernon (1966) integrates trade and investment into a model
[2] The theory of internationalization was used by John Harry Dunning to build the OLI model.
[3] Buckley and Casson 1976

This theory has been described by many scholars as the theory that is able to explain more clearly the international behavior of multinational firms. This theory was formulated by Dunning. The theory itself embodies the combination of some of the theories discussed above. The novelty element that Dunning adds is that of the location. A firm would take production in a foreign country when three conditions are met, namely the advantages of ownership, the advantages of internationalization and the advantages of location, OLI paradigm (Denisia 2010.)

- Advantages of ownership relate to holding specific tangible and intangible assets, such as technology, specific knowledge, or management skills, which give multinational companies substantial advantages over local firms.

- Location advantages refer to all those factors that a location possesses and make it more attractive to foreign investment.

- Internalization advantages are those kinds of advantages that are more profitable for a firm to transact internally (ie through a wholly-owned subsidiary) than through licensing(Montolio , Camarero and Tamarit 2017).

7.3 Theories explaining foreign direct investment by international trade.

Another explanation for foreign direct investment focuses on the concept of international trade, supporting the idea that multinationals themselves realize a significant part of international trade.

Nayak and Choudhury, 2014 explained the Hirsch theory. Hirsch (1976) created an international theory of both elements of trade and investment, trying to clarify two moments. First, the theory explains the moment when a company decides to enter a foreign economyy and secondly, what are the factors that determine the form of entry, which means determining whether to decide to export to other countries or to produce directly in these countries . According to this foreign investment theory foreign direct investments enables the creation of competitive advantages. (Nayak and Choudhury, 2014).

Kojima also explained theories of trade and direct investment theories assembling them together. He concluded that foreign direct investment ëas needed to increase competitiveness and productivity, as ëell as to improve production processes (Chaëla, et al. 2015). Kojima identified the resources , labor force and market in host countries as the three main motives for international investment. But his theory fails to explain ëhy companies cannot increase competition in the domestic market (Nayak and Choudhury, 2014)

Other academics conclude that the creation of an integrated theory that explains foreign direct investment and international depends of FDI types, namely FDI classifications in horizontal or vertical FDI. Traditional FDI models claim that a parent company establishes a branch to replicate its business and sell products to the host country and the region, while vertical FDI models assume that a parent company creates an affiliate company in order to carry out several production stages in the host country. The incorporation of the concept of multinational companies into the standard of international trade theory shows that the link between capital movements and trade depends on whether multinational companies are horizontally integrated or vertically and types of integration are conditioned by factors such as transport costs and economies of scale(Carr et al, 2011).

8. Host Country Macroeconomic Determinants for Foreign Direct Investments

Different macroeconomic factors that represent the "health" of different host countries are defined as determining factors in attracting as much foreign direct investment flows as possible. These factors important in attracting foreign direct investors help us to understand FDIs, especially the relationship that exists between the economic, political, financial factors of the host countries and the inflows of foreign capital in the form of foreign direct investments in that economy.

A country's ability to benefit from FDI inflows is recognized as the absorption capacity of a host country.

Massoud (2008), in explaining absorption capacity, mainly identifies several key factors: the quality of human capital, technological development and more specifically what is called technological gap, financial development, trade openness, current account deficit and inflation.

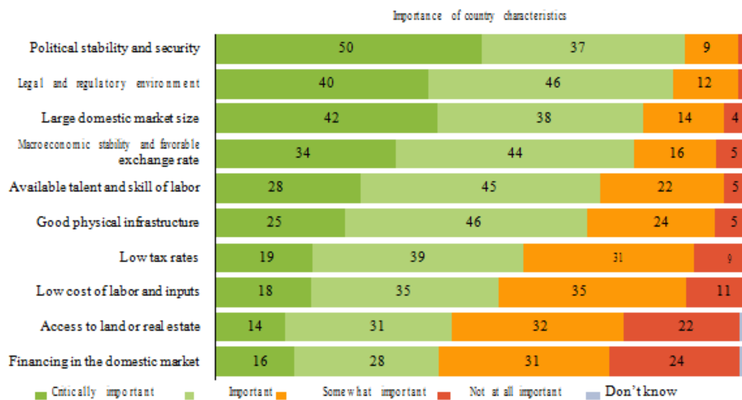
- Human capital in the host country is important. In order for the host country firms to implement the transfer of skills from the MNC to their employees, a certain level of development of this human capital is required in the host country (Michie, 2001, Dorozynska and Dorozynski, 2015).

• Different scholars have different views on the role of technological gap in the ability of the host country to benefit from foreign investment. Spreading externalities is conditioned by the size of this technological gap. Baltabaev 2014 thinks a major technological gap hurt the spread. An opposite view brings Xu, 2000. According to him, a big technological gap would be more productive.

• The significance of the financial system for the development of the financial system is attributed to the various functions it plays in the economy. A more developed financial system allows foreign investors to finance their activities through loans provided by the host country. An efficient financial system can alleviate the information's imperfections through providing systematic information on investment opportunities and capital returns, which are more important for foreign investors than for domestic investors. The more developed the financial system, the more it can help the business to develop. (Alfaro et al., 2009; Shah, 2016; Alfaro et al., 2017

• Trade openness is another element that affects the effect of FDI on economic growth. The strong positive impact of trade opening on FDI is evident in most empirical studies. These findings confirm that the foreign direct investments are strongly influenced by the degree of openness, with other unchanging factors. (Jadhav, 2012; Sala and Trivin, 2014, Shah and Khan, 2016).

In Global Competitiviness Investment Report 2017-2018 we see that investors consider a wide range of factors in their decision to invest in another country. All factors are of significant importance in the analysis to select a host country for their investment. According to this report, the most important element in decision-making is political stability and perceived security.



Source: Global Investment Competitiveness Report 2017/2018

Investment decision, whether they are in the form of foreign direct investment are based on a return and risk perceived investor analysis. One of the major risks of investment analysis are political risk. Governments can reduce this climate risk and ensure good governance. Political risks are numerous and include expropriation, transfer restrictions and convertibility, breach of contract, unpredictable arbitrary actions, discrimination, and lack of transparency. This could be due to the fact that many foreign direct investment fails, thus wiping the economic development of the country.[1]

Governments, like in developing countries and in developed countries, use tax incentives and other incentives to lower the relative cost or perceived risk by foreign investors in order to attract more FDIs. However, the effect of these incentives depends on the types different FDIs. When it comes to foreign direct investments that are looking for a market or are oriented towards the primary sectors, tax incentives are not very effective. If foreign direct investments are oriented towards efficiency-seeking, tax incentives may be relevant to investment decisions.[2]

[1] *Global Investment Competitiveness Report 2017/2018*
[2] *Global Investment Competitiveness Report 2017/2018*

Also another determinant of the decision of the host country selection by foreign investors directly is the country's infrastructure. A qualitative element of infrastructure becomes determinant in absorbing FDIs and prolonging their stay in time. Lack of a regular and quality infrastructure can present an obstacle for investors. Therefore, the governments of the host countries have begun to pay attention to improving the quality of infrastructure (Easterly 2001, Shah, 2014.)

9. Conclusion

Based on the literature examined in the paper, different theories point to the motives of the movement of international capital flows. The theories selected in this paper explain the motives that lead multinational companies towards direct investment in developing countries. These theories are based on the international business perspective. Through these theories we can understand the decisions of multinational companies to become part of a foreign market by deciding to export, licensing, or by undertaking a direct investment in the host country. We see that this decision is influenced by many factors such as the possession of some competitive advantages from multinational companies; the presence of transaction costs; the market size of the host country in the case of horizontal direct foreign investments: the lowest cost of resources in the host country if it is a direct foreign direct investment.

On the other hand, the business climate in the host country is important in absorbing foreign direct investment and may increase the impact on the development of this investment. An economy with a poor investment climate attracts less foreign direct investment and often it is useless. The size and potential of market growth - are so far the strongest determinants of FDI. But the investment climate characteristics such as strong institutions and friendly legislation for investors also matter to emerging and transition economies that seek to attract additional FDI. And other factors like human capital, a developed financial system, infrastructure quality and economic and political stability are an important element in the selection of the host country by foreign investors. Trade agreements and investment agreements also play an important role in absorbing FDI.

So we can conclude that there is no single theory that can fully explain the decisions to be internationalized for a company. This should be seen in two ways, distinguishing driving forces and attractive forces in this decision. Driving forces are those related to the specific advantages of the most productive companies, which are generally those that choose foreign direct investment as a form to serve in an external market. While attractive forces are the key policy makers of different countries in competition to attract as much foreign direct investment as possible.

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