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Main theories of Foreign Direct Investment in countries

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Ruben Molina Martinez[1]

Heinz Geovanny Mendez Ortiz[2]

Abstract

This article discusses and analyzes some of the main theories of Foreign Direct Investment (FDI), which are Internationalization or Foreign Direct Investment, Internalization, Transaction Costs and Dunning's Eclectic Paradigm. Each of these theories provides explanations and underlying reasons for the complexity of FDI from an economic, business and international perspective. The findings explain the rapid growth of theories of Foreign Direct Investment, in which each one provides new variables to understand the phenomenon, as well as criticisms or observations of other theories.

Keywords: theories of FDI, multinationals, competitiveness.

1. Introduction

This paper discusses and analyzes the main theories of Foreign Direct Investment (FDI), a key phenomenon in the global economy, which involves the establishment of business operations in foreign countries. FDI is fundamental in the globalized world, in which international economies are integrated, and understanding the theories on this phenomenon is relevant for various actors, such as companies, governments, international business analysts and academics.

To address this issue, the most influential theories within the areas of International Business Sciences and Economic Sciences have been identified and analyzed. The most important theories explored in this study include the Theory of Internationalization or

[1] Research professor affiliated with the Institute of Economic and Business Research of the Michoacana University of San Nicolás de Hidalgo, Mexico. ORCID: 0000-0002-9840-6441. Email: rmolina@umich.mx
[2] Michoacana University of San Nicolas de Hidalgo, Mexico. ORCID: 0009-0000-7846-3484. Email: 2251459c@umich.mx

Foreign Direct Investment, the Theory of Internalization, Dunning's Eclectic Paradigm or OLI, and the Theory of Transaction Costs.

The type of research applied in the development of this work is documentary, with a qualitative technique, with the purpose of analyzing each of the Theories of Foreign Direct Investment. In this sense, the present study is based on proposals and works carried out previously, with the objective of investigating, collecting and synthesizing relevant information on the theories of FDI.

The structure of the document includes four main sections. First, the Method established for the development of the research is addressed. Then, the Literature Review is introduced, in which the main theories of FDI are introduced. Next, the Analysis and Discussion with the results obtained is presented. Finally, conclusions are offered.

2. Method

The type of research used for this article is documentary, a qualitative research technique that involves searching and analyzing information in a set of scientific documents, including books, journals and academic articles. According to Tancara (1993), this approach allows for a deeper understanding of the topic of interest through the collection, synthesis and analysis of information from previous and systematized works. This method is particularly useful for exploring and understanding the evolution and current state of theories on Foreign Direct Investment, providing a solid basis for discussion and critical analysis of them.

3. Literature review

Before addressing the main theories of FDI, we will start with its definition: Foreign Direct Investment is a flow of capital from a parent company to a host country for the acquisition of productive assets or to create a new subsidiary from scratch, with the aim of creating a long-term economic and business link. Source: own definition.

3.1 Foreign Direct Investment Theory

Stephen Hymer, a pioneer in the theory of internationalization in international business with his thesis: "The International Operations of National Firms: A Study of Direct Foreign Investment" (1960), proposed the creation of compensatory advantages, understood as competitive advantages in the foreign market through multinational corporations (MNE) whose focus is on the control of the firm's assets and achieving monopolistic power, taking advantage of market imperfections.

Hymer's theory is based on the following positions: 1) multinational investment will achieve profitability, under the condition of having a compensatory advantage over companies in the destination country, 2) the market of the destination country should not be neoclassical, that is, it should be an imperfect market, 3) control the use of substantial assets abroad in order to reduce risks and achieve a monopolistic advantage, 4) multinationals have the ability to intervene in markets and eliminate competition (Dunning and Rugman, 1985; Rugman, et.al., 2011).

Kindleberger (1969) delved deeper into FDI by relying on market failures to develop his theory. Calvet (1981), on the other hand, analyzing Kindleberger, proposed a creative name for his market failures, which he called the “market imperfections paradigm.”

The imperfections paradigm expresses the following headings: 1) Deviation from perfect competitiveness in goods markets, at this point it refers to product differentiation and the ability expressed in marketing, 2) Imperfection in factor markets, it takes advantage of high management and combines with monopoly advantages, 3) Internal and external economies of scale, are exploited by vertical integration, 4) Government limitations on the entry or exit of FDI, in the attempt to reduce imports the government can increase taxes in defense of internal production, which can cause a counterproductive effect when discovering that it has given an opening to multinationals (Kindleberger, 1969).

Caves (1971) says that a company has no reason to invest in foreign markets, as long as there are profitable opportunities for the exploitation of economies of scale in the location of origin, by not having a high margin of opportunities, companies expand across geographic borders, betting on consolidating a small number of companies that offer products or services that are perceived as different by consumers, managing to take advantage of and exploit market imperfections.

3.2 Transaction Cost Theory (TCT)

In the Theory of Transaction Costs, Ronald Coase (1937) was a pioneer in his article "The Nature of the Firm", pointing out that, in the market, outside the firm, production depends on price movements; within a firm, market transactions are eliminated, and given the complex structure of the market, they can be replaced by the entrepreneur-coordinator, who directs production.

It is important to reflect on a point of the TCT, in itself it represents a criticism of the neoclassical theory, because it differs from the neoclassical assumption of perfect competition, that is, between suppliers and demanders they are price takers, causing the markets to empty and consequently there would be no room for transaction costs.

Oliver Williamson, in the 70s, deepened the TCT, establishing the key behavioral assumptions on which the TCT is based, the first is, limited rationality, and the second, opportunistic behavior (Williamson, 1981).

According to Cuypers et al. (2013), assumptions are the basis for understanding two phenomena that occur in the organization: Transaction Characteristics and Governance Mechanisms.

Based on Cuypers et al. (2013), they say that, in the case of Transaction Characteristics, it is mentioned that there are three elements:

(1) Asset specificity: This is considered a core factor and refers to the fact that its use value is highly specialized.

(2) Uncertainty: refers to the future behavior that may occur among any of the parties involved in the transaction or future events or behaviors.

(3) Frequency: The degree of recurrence in transactions between firms generates trust and credibility between the parties.

Likewise, in relation to the Governance Mechanisms, three different forms of governance can be analyzed (Cuypers, et.al, 2013):

(1) Hierarchy: Transactions are internalized within the organization

(2) Market: It is established through contracts, or they take prices from the neoclassical market.

(3) Hybrid: It is the combination between the Hierarchy and Market mechanism.

In this way, the Transaction Characteristics and the Governance Mechanisms are interrelated, to the point that considering both elements of the organization leads us to minimize transaction costs, achieving mitigation of limited rationality and the possibility of opportunistic behavior, and also contributing to the development of a sustained competitive advantage for the company through the internalization of some specific assets.

This perspective can be deepened by saying that the possibility of internalizing specific assets is substantial, because it would allow companies to develop a sustained competitive advantage, through the three different forms of governance (Rodríguez, et.al., 2015).

So, it is important to ask, if in the neoclassical theory a price system is established with the capacity to be efficient and the assumption of perfect competition is fulfilled, what is the purpose of the firm? To answer, the assumption is raised that the distinctive mark of the company is the overcoming of the price mechanism (referring to the neoclassical theory), even the organization of the firm can reduce costs, based on obtaining inputs at a lower cost, than by doing so through market transactions. Another advantage should be mentioned, that, if internalization fails, the firm can still return to the direct market (Coase, 1937).

Transaction costs can be linked to FDI through entry modes. Entry mode refers to the way in which the firm decides to enter foreign markets, even the border issue in international marketing is the appropriate choice of entry mode in foreign markets (Anderson and Gatignon, 1986).

It can be stated that the entry modes linked to TCT in Foreign Direct Investment are the following: Joint Ventures, Acquisition and/or Merger, Greenfield and Brownfield. It is important for companies to choose the governance mechanisms and transaction characteristics to enter a foreign market.

3.3 Internalization Theory

Internalization theory has convincingly demonstrated why neoclassical markets and the contracts linked to them have high transaction costs. It also explains why firms are more efficient internally in reducing transaction costs associated with the use of the market; the method of internalization is known as hierarchy (Hennart, 1986).

The Internalization Theory establishes that multinationals are characterized by being profit maximizers in imperfect markets; firms create an internal market controlled by a hierarchical governance mechanism, seeking to reduce transaction costs (Banalieva and Dhanaraj, 2019).

According to Rugman et al, (2011), the work of Buckley and Casson (1976), “The Future of the Multinational Enterprise”, identified the internalization of intermediate product markets, breaking with the tradition of monopolistic advantages linked to entry barriers, consumption or market imperfection in final production markets, which is the cornerstone of the theory of Hymer (1960), Kindleberger (1969) and Caves (1971).

The internalization theory adopts the ideas of Coase's transaction cost theory (1937), in addition to being in line and parallel with the innovative contribution of Williamson (1975), on the relative efficiency of the market and the different governance mechanisms (Hennart, 1986; Rugman et al, 2011).

Regarding internalization, Rugman (1981) speaks of the lubrication of the organization through internal prices, having the capacity to correct market failures, especially high transaction costs. Buckley (1983) has an opinion in tune with Rugman, saying that

internalization is being able to operate at the closest margins of a perfect internal market. While for Casson (1981), he defends that the central reason for multinationals is to integrate their operations under a single control unit (hierarchy), and that the internal market is adequate when the company is decentralized and has control powers over the managers who run the individual plants.

Rugman (1981) contributed to and extended the theory of internalization in a dynamic way, contrasting FDI with exporting and licensing [the three concepts considered by the author as entry modes for firms in foreign markets], and constructing potential points [control and resources, risk and costs, adaptation to the local market, available resources] of change for each of the three long-term entry modes. In addition, he investigated the implications of internalization theory in corporate finance (Rugman and Verbeke, 2008).

The theory of internalization is not a guarantee of supplying market failures, that is, firms cannot ensure their success in replacing it (Hennart, 1986). In this sense, we find ourselves at a point of contrast, because theoretically companies can be more efficient than markets, minimizing costs in intermediate markets, but they can still have errors or failures, and even in the worst case, worsen the internal market, increasing intermediate costs and having the need to resort to the external market (neoclassical).

3.4 Dunning's Eclectic Paradigm Theory or OLI

Dunning's eclectic paradigm is one of the most important theories in international business to explain Foreign Direct Investment, based on a simple but profound construct.

Dunning (2000) asserts that the extent, geography and structure of production carried out by multinationals in foreign markets are determined by the intrinsic association of three variables, which comprise the components of three subparadigms.

The variables or subparadigms have an integrative view of the competitive advantages in FDI, these are also known as ownership advantages (O), location advantages (L) and internal advantages of the firm or internalization (I). The acronyms in parentheses, when integrated, form OLI, the other way in which this paradigm is known.

Dunning carries out an exhaustive analysis of each of the subparadigms:

1) Ownership advantages: Refers to the company's own resources or specific assets. Multinationals have an advantage or set of advantages considered unique and sustainable that make the difference over their competition in foreign markets, which gives them a more consolidated competitive position, characterized by being difficult to replicate (Dunning, 2000). The differences can be explained through an analysis of the characteristics of the factor endowment of the countries in which the multinationals operate, and especially of the country where the multinational is from, which is where its ownership advantages arise (Dunning, 1980).

   Explicitly, the advantages of multinationals focus on their ability to produce internally, organize all their assets, patent technology, and adapt to foreign markets and innovation.
2) Location advantages: Refers to the location of countries or regions. The paradigm states that fixed assets plus property advantages increase the level of FDI utilization in the host country. In particular, the variable has new indicators such as the exchange rate, political risks and the implementation of supranational policies (Dunning, 2000).

3) Dunning (1995), delving into the locational advantages of countries, mentions that more weight should be given to the following factors: (1) the territorial embeddedness of interdependent real estate assets, particularly geographic areas; (2) the growing need for spatial integration of complex and rapidly changing economic activities; (3) the conditions under which alliances between companies that improve competitiveness can flourish; and (4) the role of national and regional authorities in influencing the scope and structure of localized centers of excellence.
   Advantages of internalization: The third subparadigm addresses the way in which multinationals take advantage of their core competencies, whether competitive or specific, through the exploitation of a foreign country's fixed assets (Dunning, 2000). A classic example of specific advantages is the possession of technology per se; the application of technology offers the producing company an advantage over global competition. Likewise, internalizing and patenting this technology provides additional benefits compared to selling it to a foreign producer for the manufacture of similar goods. Without these advantages of internalization, foreign direct investment (FDI) would be replaced by a simple market transaction based on a contract between buyer and seller (Dunning, 1980).
4) For the multinational, internalization has a set of advantages for the company, starting from the avoidance of search and negotiation costs, information asymmetries that generate moral risk and adverse selection in which the agent acquires more information than the principal. In addition, it avoids the costs of unfulfilled contracts and legal disputes due to this cause, and finally reduces uncertainty (Dunning, 2000).

4. Analysis and Discussion

The analysis and discussion focuses on the Theories of Internationalization or Foreign Direct Investment, Internalization, Transaction Costs and Dunning's Eclectic Paradigm or OLI, each of the theories explains the phenomenon of international economy, highlighting the main assumptions and factors that encourage FDI by multinational companies.

The theories mentioned in the previous paragraph share common factors because they focus on imperfect markets, that is, those that do not meet the assumption of perfect competition proposed by the neoclassicals . We can find the market imperfection from the Theory of Internationalization, by stating that a monopolistic power must be achieved (Hymer, 1960), the set of market imperfections (Kindleberger, 1969), and the commitment to the differentiated oligopoly of multinationals abroad (Caves, 1971).

According to TCT, imperfect markets are based on their main assumptions, limited rationality and opportunistic behavior, both considered market failures (Cuypers, et.al, 2013). The Internalization Theory is subject to imperfect markets, by not transacting in the market due to high transaction costs and changing it for internal prices, this is how it corrects market failures, that is, getting closer to a perfect internal market (Rugman 1981, Buckley 1983).

In the case of Dunning (1980, 2000), the imperfect market is seen in two of the proposed subparadigms. In the case of property advantages, it refers to maintaining unique advantages, that is, a case of information asymmetry is presented, in which the firm reserves specific assets such as patented technology. This information inequality is a clear example

of market failures. In addition, the author agrees with authors such as Coase (1937), Williamson (1981), Hennart (1986), Rugman (1981) and Buckley (1983), on the need to internalize specific assets, to reduce transaction costs, opportunism, unfinished contracts and reduction of uncertainty.

There are also factors that distinguish between theories, such as the Internationalization Theory that innovated in FDI, explained how or why companies expand, contributed to the change of focus, focusing on the individual company, and that moves between nations taking advantage of the use of its specific or monopolistic advantages. It is worth mentioning that the FDI theory is criticized by the rest of theories such as "Internalization", "TCT", "OLI", because this set of theories breaks with monopolistic advantages by focusing on intermediate markets in order to internalize certain activities, providing new theoretical frameworks to understand the way in which they minimize the transaction costs of multinationals.

The theories linked to Internalization, TCT, OLI are distinguished by intrinsic characteristics in each of them, for the Transaction Cost Theory, it explains the different forms of governance that a multinational can choose , which are hierarchy, market and hybrid, to reduce transaction costs; on the other hand, the case of Internalization delves into the advantages of internalizing certain transactions, in order to reduce costs through organization and market risks; and finally, the OLI Theory offers various subparadigms, location, ownership and internalization (the latter coincides with the ideas of TCT and Internalization), however, it explains the exploitation of advantages characterized by being unique and sustainable, as well as competitive or specific advantages by multinationals.

5. Conclusion

This paper concludes that the main theories on "Internationalization or Foreign Direct Investment", "Internalization", "Transaction Costs" and "Dunning's Eclectic Paradigm or OLI", provide a solid basis for understanding the different underlying approaches to the FDI phenomenon, in which they provide substantial analytical tools to explore the complexity of multinational companies at a global level.

The evolution of FDI theories has seen rapid growth in explaining how companies operate abroad, beginning with monopolistic advantages and barriers to entry, moving on to internalization and concern for the organization of the multinational, in addition to strategies for choosing a type of governance and exploiting additional factors such as location and ownership.

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