

## FLOW OF FDI TO DEVELOPING COUNTRIES — THE ISSUES INVOLVED

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**Abstract :** Foreign Direct Investment may take numerous forms including — (a) the establishment of a branch or subsidiary in a foreign country, (b) the expansion of an existing branch or subsidiary, and (c) the acquisition of an overseas business enterprise whether wholly or substantially. In addition to financial resources, FDI is regarded as promoting economic growth through the transfer of technology and various skills by effecting structural changes. This paper attempts to examine the factors, which mainly influence — (a) the flow of FDI in general and (b) the flow of FDI in developing countries in particular. The factors, which mainly influence the flow of FDI to developing countries are labour costs, quality of labour, infrastructure, incentives to investment including tax rates, government policy, market factors and foreign exchange rates.

**Key Words :** Foreign direct investment, disequilibrium conditions, government-imposed distortions, Product Life Cycle Theory of FDI, Eclectic Paradigm or OLI Paradigm, Location Theory, Kindleberger's Condition, Lenin's condition, Quality of Labour, Infrastructure

Many developing countries are in recent years introducing various policy measures to encourage foreign direct investment (FDI) in different sectors of the economy. Therefore, it would not be out of context to discuss the factors which induce the flow of FDI to developing countries. FDI refers to the acquisition abroad of plant and machinery and other physical assets with the operational control being in the hands of the parent company in the home country. It differs from portfolio investment, which is made with the intention of deriving a stream of investment income in the form of dividend, capital gains, etc., but without the intention of acquiring operational control. FDI may take numerous forms including —

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In addition to financial resources, FDI is regarded as promoting economic growth through the transfer of technology and various skills by effecting structural changes. This paper attempts to examine the factors, which mainly influence—(a) the flow of FDI in general and (b) the flow of FDI to developing countries in particular.

### Why FDI Flows to Other Countries — A Conceptual Discussion

The emergence of MNCs consequent upon the tremendous flow of FDI after World War II resulted in various studies relating to the international movement of capital. One of the earliest theories was developed by MacDougall (1960) and subsequently elaborated by Kemp (1964) and agreed to by Robson (1998). They assumed a two-country model — one being the investing country and the other the host country,

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and the price of capital being equal to its marginal productivity. They explained that, when capital moves freely from one country to another, capital movement would occur from the country where the marginal productivity of capital is lower towards the country where it is higher. This ultimately equalises the marginal productivity or profit rates between the two countries and benefits both the investing country and the host country. This theory is, however, appropriate when capital movement takes place between countries with the same level of development and similar production functions.

Hymer (1960) and Kindleberger (1969) have argued that imperfections in the national and international product and factor markets are the major determinants of FDI. Other major contributors in this field have been Caves (1971), Vernon (1966), Buckley and Casson (1976) and Dunning (1977). Various theories have been reviewed by Hood and Young (1979) and Calvet (1981). On the basis of varying degrees of market imperfections, Calvet has classified the determinants of FDI into the following four major classes :

1. market disequilibrium hypothesis
2. government-imposed distortions
3. market structure imperfections
4. market failure imperfections

In the first case, disequilibrium conditions give rise to profit opportunities. FDI flows occurs under such disequilibrium conditions and continues until equilibrium is restored. Actions of profit-seeking firms and arbitrageurs will soon restore equilibrium. FDI under such circumstances is considered to be transitory in nature.

In the second situation, government-imposed distortions like tariffs, import quotas and differences in national tax systems, may affect the market for real goods, raw materials, foreign exchange and domestic capital. These may make export less attractive and create incentives to invest abroad giving rise to FDI.

In the third case, large MNCs may deviate from perfectly competitive behaviour and resort to oligopolistic behaviour because of their superior power to manipulate market prices. On the one hand, such firms may create barriers to the entry of new firms by the creation of new products in the market place. On the other hand, they may indulge in the prediction and emulation of the actions of competitors. Such firms may thereafter make FDI.

According to the Product Life Cycle Theory of FDI developed by Vernon (1966), during the maturity stage, the well-established production technology creates opportunities for long production runs. But competition from similar products reduces profits and seems to affect production costs. As a consequence, production facilities abroad are sought to avail of lower costs there so as to ensure that positive domestic and overseas profit margins are maintained even during the decline of the product. This strategy is intended to prolong the profitable life of the product and is, therefore, a defensive strategy. This idea of defensive FDI has been extended by Knickerbocker

(1974) with the "follow the leader" behaviour of some firms. Thus, when a member of the oligopolistic group invests abroad, the others follow suit.

Caves (1971), has explained that the MNC has an immense capacity to differentiate its products in the domestic market by making small changes, whether real or imputed. This not only helps it to safeguard its products in the domestic market from imitation but also helps in keeping alive consumer interest in the product. However, this can be done only by making considerable investments in research and general marketing functions. This, in turn, enables it to continue producing new products more cheaply than its competitors. The successful MNC would then like to pass on this unique technology and marketing skill at little or no extra cost in overseas markets and to maximise profits on the heavy expenditure it has incurred on research and development. This will lead to FDI.

In the fourth situation, markets fail particularly due to departures from the perfect market assumption with respect to techniques of production and properties of commodities. The most important commodity involved here is technical and managerial knowledge. The characteristics of knowledge are such that make its production as well as transfer rather problematic. An unscrupulous licensee may steal the knowledge and use it for his own advantage. Hence it becomes desirable to transfer the 'knowledge' within a single firm justifying FDI over other alternatives of penetrating foreign markets. Hennart (1988) has argued that due to such reasons FDI can be expected to be more frequent in case of technology-based companies desiring to protect trade secrets.

### The Eclectic Paradigm or OLI Paradigm

Dunning (1979) has tried to integrate many of the FDI theories (viz., Industrial Organisation Theory, the Internal Organisation Theory and the Location Theory) into an 'eclectic paradigm' or 'OLI (ownership, location and internalisation) paradigm' of international production by MNCs. Dunning (1981) has clarified the role of the ownership, location and internalisation advantages in the context of international involvement of a firm. The possession of ownership-specific advantages alone will lead to licensing and contractual resource transfers. Export or licensing will be chosen if ownership and internalisation advantages are present. If all the three advantages of ownership, internalisation and location are present, the firm will prefer FDI to the other two kinds of foreign involvement, viz., export and licensing.

### Flow of FDI to Developing Countries

Of the three facets of the OLI paradigm, the Location Theory of Hood and Young (1979) is most appropriate in explaining why FDI flows from developed countries to less-developed ones. In this section, an attempt has been made to examine the factors, which mainly influence the flow of FDI to less-developed or developing countries in particular. The important determinants are labour costs, quality of labour, infrastructure, incentives to investment including tax rates, government policy, market factors and foreign exchange rates.

### Labour Costs

A cheaper labour force, in the host country as compared to the foreign country, is one of the factors influencing the flow of FDI from the foreign country to the host country. FDI will flow from high labour cost countries to low labour cost countries in pursuit of cost minimisation (Calvet 1981). According to Dunning (1988), locational advantages are the most important determinants of FDI flow to less developed areas where more inward FDI is received than outward. Dunning's model, however, cannot distinguish between locational variables. Sasaki (1994) revises the Ricardian theory by incorporating the difference in production functions, and points out two conditions of FDI—the first is the *Kindleberger's condition* (i.e., foreign capital must have a competitive advantage against local capital) and the second is the *Lenin's condition* (i.e., the host country must have the quality and quantity of labour and a developed infrastructure in order to operate with foreign capital).

But the question involved is why capital would move from an advanced country to a less-advanced country. If there are two countries — one advanced and the other less-advanced — producing tradable goods and employing the same quality of labour, then, if the cost of labour is cheaper in the less-advanced country, capital will move from the advanced country to the less-advanced foreign country in order to seek higher profit rates. In other words, cheaper labour costs in the less-advanced country would encourage an MNC in the advanced foreign country to invest as FDI in the less-advanced country. Again, if there are two or more countries competing as possible recipients of FDI, the country with the highest labour coefficient will be able to attract the FDI. It also follows that FDI will flow to the most advantageous sector of the less-developed country. However, it must be remembered that labour cost is only one of the factors for the flow of FDI.

### Quality of Labour

The quality of labour is a representative variable of the labour coefficient. It is an important factor in attracting FDI as it reflects on technology. It is one of the most important factors that determine whether or not the technology developed in the advanced country can be applied in the less advanced host country. Cheap labour by itself cannot attract FDI unless the requisite 'quality' of labour is available in the host country. The 'quality' of labour cannot be measured quantitatively. However, the level of education (including technical education) and labour productivity in the host country can be useful indicators.

### Infrastructure

The infrastructure in the host country must be sufficiently developed to attract FDI. This accords with *Lenin's condition* that a sufficiently developed infrastructure creates an environment conducive to investment. It influences productivity and also provides access to the market. The two most important indicators of infrastructure are transport (including passenger car, railway, maritime transport and airways) and communication (including telecommunications).

### **Investment Incentives**

Agarwal (1980) has pointed out that investment incentive is an important determinant of inward FDI. Various policy measures aimed at liberalizing capital movement, revised investment laws, and other incentives are introduced/offered by different developing countries for attracting FDI. Tax rate is also an important incentive/disincentive influencing the flow of FDI. If tax rates are different in different countries, MNCs may be tempted to invest in a low-tax country even though the cost of production may be higher there (Devereux and Pearson 1989). Tax here includes both the corporate tax and the withholding tax.

### **Government Policy**

Developing countries, in particular, often attempt, either directly or indirectly, to control imports in order to protect 'domestic industries'. To circumvent such barriers to entry in the form of exports, MNCs often resort to FDI.

### **Market Factors**

The market of a developing country is often expected to be less exploited/saturated than that of an advanced country. The potential size, type and inadequate nature of competition from domestic firms and other MNCs may provide impetus to FDI. FDI would be preferred to exports if cultural specialties require modifications in products to suit the tastes and budgets of the customers.

### **Foreign Exchange Rates**

Firms from strong-currency countries move out to weak-currency countries (Aliber, 1971). The income stream in a weak-currency country is associated with greater exchange rate risk. This enables a firm coming from a strong-currency country to capitalise its income at a higher rate. Aliber's hypothesis explains why FDI flows from a strong-currency (usually advanced) country to a weak-currency (usually less advanced) country.

Froot and Stein (1989) have pointed out that depreciation in the real value of currency of a country lowers the wealth of domestic residents in comparison to the wealth of foreign residents. This makes it cheaper for foreign firms to acquire assets of domestic firms and attracts FDI. Another theory has been developed by Caves (1988). He has explained how exchange rates influence FDI. Depreciation in the value of a currency, which is expected to be reversed in the near future, creates expectation of capital gains. This leads to inflow of FDI.

The recent increase in the flow of FDI particularly to developing countries has necessitated an in-depth understanding of the causal factors. This article is only a modest attempt to highlight and examine, in brief, the most important of such factors.

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