FDI theories. A location-based approach

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Given the importance of FDI for the economic growth of both home and host countries, the aim of this paper is to assess the importance granted to location advantages during the development of FDI theory. We start with the earliest theoretical directions as regards FDI location issues and extend our study to describing less debated theories, but of a particular importance for this theme. In this way, we have the opportunity to emphasize the changes in FDI location determinants. We find that a direction of the FDI theories' expansion is due to the incorporation of new variables on location, although the location advantages are barely mentioned in the first explanations regarding the international activity of the firms.

Keywords: foreign direct investments, location, OLI paradigm, new economic geography, institutional theory

JEL Classifications: F23, F60, H10

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Introduction

The essential contribution of foreign direct investment (FDI) to the economic growth was empirically tested and represents one of the main motivations for the government efforts in attracting FDI. Why? The answer to this question is easily obtained by simply defining FDI as a flow of capital, technology and knowledge. Here we have the explanation for the race to attract FDI in which the economies are engaged. In this respect, each country can be proactively involved in attracting FDI by shaping and improving their location advantages.

Today, talking about FDI location-driven advantages is something common. FDI inflows are searching for locations abundant in natural resources or in created resources, such as better infrastructure, an attractive business environment, qualified employees and so on. The choice of a location is also influenced by the behaviour of the firm as regards its motivation – if it is resource-seeking, market-seeking, efficiency-seeking or strategic asset seeking. But at the beginning of FDI theories, location advantages were overlooked. The literature does not identify a starting point of FDI theories (Negritoiu, 1996) neither a theory that takes into account all the features that characterize FDI. This is why FDI theory is based on three integrative theories: the theory of the international capital market, the firm theory and the theory of international trade. It is the consequence of seeing FDI in terms of firm behaviour that decides to get involved in international activity. An important role in highlighting the location advantages in the foreign investors' decision-making process belongs to Raymond Vernon, in the 1960s, and to John Dunning a decade later. Starting with the 1990s, the MNEs activity starts to be explained by clearly taking into account the location theories and a special attention is directed to institutional variables. Currently, it is clear that the location advantages are at the core of the investment decision-making process, are subjected to permanently change and can be influenced by state policies. In the firm view, the location

characteristics of a country must transform in enhancers for the multinational companies' (MNC) competitiveness in the long run (Zvirgzde et al., 2013).

Still, why foreign investors choose one location at the expense of another? This is the question we try to answer in this paper, following the description of location advantages through the history of FDI theories. We try to identify the earliest theoretical directions as regards FDI location aspects. Also, we extend our study to describing one of the less debated theories, namely the theory of institutional FDI fitness.

2. Earlier approaches on FDI location

The location perspective in FDI theories was first extrapolated from the theories explaining domestic production (Kusluvan, 1998). The main two elements taken into account for deciding the location of domestic production were the production and transport costs (Weber, 1909, apud Popescu (Robu), 2012). It is the case for explaining the location of agricultural production based on the cost of the land and depending on the transport cost (Von Thunen, 1826, apud Popescu (Robu), 2012).

In the 1960, Raymond Vernon analyzes the US companies' incentives to invest in the developed countries. Several years later, in the 1973, Dunning has one of the first attempts to deepen the location advantages and makes a distinction between the supply oriented location theory (namely in the countries with low costs for production factors) and demand oriented theory (namely choosing the investment destination depending on the location of the markets and the competitors). In this respect, the existence of MNCs is explained through four location factors: the existence of raw materials, cheap labour force, unexploited and protected markets and transport costs (Kusluvan, 1998).

We can also see a change in the determinants shaping the attractiveness of a location. In the 1970s and 1980s, the main determinants were represented, firstly, by the cost and the quality of factors' endowment, and secondly, by the dimension, the character and the growth capacity of the national markets. The governmental policies of the host country, mainly the level of the taxes and the fiscal incentives, were considered important as long as they affected the two types of determinants mentioned above (Dunning și Lundan, 2008). Since 1990, the international production activity started to be explained through specific elements belonging to the location theories (Dunning, 2000). Previous location theories were extended for including the distinctive features of the cross border activities, such as the exchange rate, the political risk, regulations and politics at supranational level, cultural differences. The main processes that determined such substantial changes in the traditional determinants were the extension of the globalization process and the transition process in Central and Eastern Europe. If thus far the location decision was made on the cost of the traditional production factors or the dimension and structure of the demand, the new determinants are caused by the global dynamics: transaction costs imposed by the distance between the countries, technological and innovation standards, the necessity for concluding cross border alliances and so on (Dunning, 2000). The location advantages are therefore based on the created resources, such as the intellectual capital, the innovative systems, institutional and communication infrastructure. Due to the changes in society, "soft" location variables must be taken into account (Dunning, 2003) or those related to the life quality, such as minimising pollution, violence, corruption and other unacceptable social behaviours. The FDI determinants range toward those related to the economic morality. Dunning argues that location advantages are subject to constant changes.

3. Kindleberger's market imperfections' model

Kindleberger proposes the model of market imperfections as a reason for the FDI existence. The author finds four types of imperfections that generate FDI: imperfections on the goods market, due to product differences and different marketing techniques; imperfections on the factors market, due to different access to the capital market, the property over technology (patents, know-how) and differences relating to managerial expertise; the distortions caused by government intervention (tariff and non tariff barriers, taxes, price controls and profits, antitrust regulations, etc.) and economies of scale as they are contributing to increased production efficiency. In this way, Kindleberger emphasize important FDI determinants for host countries, such as the effect of the governmental intervention, the product differentiation, new technologies (Vasyechko, 2012).

4. The product life cycle theory

The theory starts from the comparative advantage of factor endowment (Vasyechko, 2012). In this context, FDI are seen as a reaction at the threat of losing the markets while the product matures, and the need for cheaper inputs to face competition. Although the scope of Vernon was not to emphasize the location advantages for FDI, the advantages and disadvantages of possible location for foreign investors began to have a greater importance at theoretical level.

There are three stages in the life cycle of a product. In the first stage, the new and innovative product is sold on the internal market. In the second stage, the product is exported due to standardization and scale economies. In the third stage, the company will decide to have subsidiaries in other counties in order to find cheaper inputs and lower production costs, as its objective is to reduce the costs. More specifically, Vernon analyses the evolution and the interactions from

three different views: the demand for the product, the competitive environment and the location of production.

Later, Vernon focuses his studies on the relationship between nation states and transnational companies (Eden, 2000). He identifies four areas of traditional frictions: employment, tax system, security and inter-jurisdictional conflicts. For attracting FDI, Vernon indicates several measures:

- as regards employment, according subsidies or reducing taxes;
- as regards the tax systems, regulating transfer prices and creating a vast network of bilateral tax treaties;
- as regards security, the access to technology and to the endowments with natural fuels;
- as regards inter-jurisdictional conflicts, Vernon considers that the interdependency between economies will eliminate these frictions.

5. The FSA-CSA matrix

Rugman develops the FSA-CSA matrix as a conceptual framework for explaining the FDI evolution at the beginning of the 1980. He has a dynamic approach, founding his analysis on the product life cycle stages. Still, the theory regards the behaviour of firm that choose external markets for taking advantage of its specific advantages (Rugman, 2007).

The Rugman's matrix has two axes: on the first one are the *firm specific advantages* (FSA) that form the competitive advantages of the firm. They consist in technological development, the know-how level, marketing capacities and managerial abilities. The second axis is represented by the *country specific advantages* (CSA), consisting of the natural resources endowment, the quality of labour market, institutional characteristics or public policies dedicated to an attractive business environment. The multinational firm will base its investment

decision after analysing the weak and the strong points of the two dimensions (Rugman și Verbeke, 2008).

Actually, the matrix is a comparative analysis between the strong or weak points of a host country against another one and of a firm against its competitors. The theory was firstly developed for the home country, considering CSA as the advantages of the origin country, but the theory also admits the assumption of CSA as being the advantages of the host countries.

The conceptual framework allows taking into account not only the classical location advantages, such as the resource endowment or the demand dimension, but also the factors that facilitates the potential development of a firm: the clusters' development or the ability to development intra and inter-firm relations. This is why the institutional regulations are also important as factors for attracting FDI (Rugman and Verbeke, 2008; Rugman, 2010).

For example, in a situation with weak FSA and strong CSA, the firms are having a product in the last stage of the life cycle; in this case, it counts less the specific advantages of the firm and more the advantages of the country, where the product will be sold. On the contrary, in a situation with strong FSA and weak CSA, it is possible that the firms have strong advantages as regards the marketing and the customization of the product; therefore the specific advantages of the host country are irrelevant.

The theory was shadowed by the appearance, about the same time, of the OLI paradigm, but its utility can be seen from three points of view (Rugman and Verbeke, 2001): as a tool for decision-making at the top management, as a tool of public policy in describing the comparative advantages of the state and the specific advantages of the firms and as an instrument allowing for analyses and comparisons between countries as regards the location parameters.

6. The OLI paradigm and Dunning's work on location determinants of FDI

The concept of the eclectic paradigm was presented for the first time in 1976, at the Nobel Prize Symposium on „International business location". The concept is seen as a benchmark for explaining the appearance, structure and location of FDI until today.

The eclectic character of the paradigm is given by the incorporation of elements from different previous theories: international trade, investment location, monopoly and internalization advantages and ownership advantages.

The internationalization of production emerges as a result of three factors: ownership advantages (O), location advantages (L) and internalization advantages (I). Dunning concludes, in this way, that all the three types of advantages are important for establishing the size and structure of FDI. To that point, each of these types of advantages was analyzed as isolated. While the O and I advantages are regarding the microeconomic theory of the firm, the L advantages can be encompassed by the macroeconomic theory.

The ownership advantage (O) regards both the tangible assets of a company (such as the natural resources at its disposal, the labour force and the available capital) and the intangible ones (information and technology, managerial and entrepreneurial skills, organizational systems, the brand awareness).

The internalization advantage (I) is represented by the ability of the company to produce and trade the goods through the network of subsidiaries.

The location advantage (L) is mainly due to the differences between the home and the host country as regards the factors' endowment, the market structure, legal system, political and cultural environment, market access and so on. The company will invest on a foreign market given that the attractions of the foreign market are higher than the ones of the home market (Dunning, 1980). In further

research, Dunning emphasize the need of permanently adapting the theory to the dynamics of globalization. The source of the L advantage is the classical theory of international trade, but Dunning sees the location advantage at the macroeconomic level, thus incorporating the assets of the host country, no matter their source (the free market or the government). Initially, Dunning considers that the location advantages are derived from the supply chain (the labour force qualification and the labour force cost, the taxation of the companies) and the demand chain (the market dimension and its growth), but afterwards he takes into consideration a third dimension, the one of political and social infrastructure (Pournarakis and Varsakelis, 2004).

Starting from this basis, Dunning (2004) proposes a scheme for the location determinants in the host country taking into account three dimensions: the framework outlined by the policies for attracting FDI, the economic determinants and the facilities for business development.

Another way of dealing with the location advantages is the conceptual framework of the matrix economic environment - economic system of the host country - governmental policies. The economic environment relates to the resources and capacities of a country, the economic system is the macro-organizational mechanism in which the resources and capabilities are allocated, while the governmental policies are the strategically objectives of the governments ant the measures taken at the micro and macro level (Dunning and Lundan, 2008). More recently, Dunning and Zhang (2008) deepen the research and distinguish between a physical environment, shaped by the resources, capacities and markets, and a human environment, including institutions and the system of values and beliefs. The physical environment is the one in which the companies are creating economic welfare. The rules of the game in creating welfare are established in the human environment.

The empiric analysis of the two authors points to the institutions advantages as the most attractive for FDI, exceeding the ones represented by the resources, capacities and markets. The most important contribution in attracting FDI is the market efficiency, followed by the structure of incentives, technological capacity, infrastructure and support services, innovation systems and market characteristics. The institutional development is seen by Dunning as a necessary condition if countries want to remain attractive for foreign investors. Its importance is growing due to the contribution and influence of institutions to the economic openness of a country, the state of economic and social development, the attitudes and policies regarding the creation of the value and entrepreneurship, the type of governance that affect the freedom of action of the main creators of value in the society (Dunning and Lundan, 2008). In this respect, Dunning concludes that the institutions and the institutional infrastructure should be taken into consideration when studying the determinants and the impact of the international business activity.

7. The new trade theory

The new trade theory is an alternative of the classical trade theories for explaining the real trade flows. Initially, the model was taking into account the scale returns, the market imperfections and the differences of the products. Markusen and Helpman are the ones that extend the model and include FDI and MNCs. The foreign investors decide their location based on a comparison between the advantage of concentrating the production in order to achieve economies of scale and the reduction in commercial costs resulting from the production of goods in different countries, close to the local market (Johnson, 2005). This idea was responsible for the classification of FDI into two types: horizontal FDI and vertical FDI and gave birth to two models explaining FDI determinants.

a) The horizontal FDI model

Markusen developed this model, stating that the main motivation for investors is the markets with growth potential in order to sell the products. FDI inflows are determined by the dimension and the growth potential of the host countries. These types of FDI are substitute for exports. Therefore, transport and commercial costs encourage horizontal FDI (Kinoshita and Campos, 2003).

Most empirical models indicate the prevalence of rather horizontal than vertical FDI (Johnson, 2005). Brenton, Di Mauro and Liicke (1998), Christie (2003) and Geishecker (2004) find evidence for horizontal FDI in Central and Eastern European countries – as these economies are targeted by market-seeking investments. Vasyechko (2012) argues that these types of investments are preferred by multinational companies investing in developing countries due to the high uncertainty of the host markets.

Markusen and Maskus (2002) conclude that the horizontal model is capable to explain FDI determinants, opposed to the vertical model, which is not supported by the econometric evaluations. Markusen et al. (1996) suggest that horizontal FDI are more likely to emerge as the countries are similar in terms of size and factor endowment. The foreign investment global pattern can be explained by applying horizontal model: the FDI flows from the developed and high income countries are also realised in the developed countries.

b) The vertical FDI model

Helpman states that FDI incentives are due to differences in factor prices. The ration of this model is embodied in the countries' different endowments with production factors (Markusen and Maskus, 2002; Markusen et al., 1996). Foreign investors will prefer the regions with the cheapest production factors. The model is more fitted for the investments in the development countries (Markusen et al., 1996). In this model, each stage of the production process is realised in different

geographical regions. Therefore, foreign investors are mainly attracted by the countries with low labour costs and generally with low factor costs, or in resource abundant countries. Zhang and Markusen (1999) complete the model with the transportation costs that must be supported in case that the output must be transported back to the home country if it is not sold. The model also includes the existence of a minimum share of skilled labour in the host country, without which investment cannot be made (Lattore, 2009).

In this context, Protsenko (2003) proposes the concept of FDI life cycle, sustaining that the percentage of vertical FDI in the total volume of FDI is decreasing over time, while the percentage of horizontal FDI is increasing. Under these circumstances, the author finds that, for the first period of transition, Central and Eastern European countries received vertical FDI, due to their cheap and educated workforce and proximity to major markets of Western Europe. As the market expands, vertical FDI are replaced by horizontal FDI in these countries.

c) The knowledge-capital model

The present model actually integrates the two previous models and was developed by Markusen (1996, 1997). This time, there are three factors computing the model: commercial costs, the absolute and relative differences between countries as regards the endowment with production factors and the obstacles for investments. The model points to a complete liberalization for trade and investments in order to increase the wealth of the host country.

The model includes the knowledge, as seen as an asset that can be easily provided to geographically separate production units, requires a highly skilled labour force and is highly mobile (Markusen şi Maskus, 2002).

Under these circumstances, one could ask how investments can be encouraged if, for example, an increase in commercial costs is

favourable for horizontal FDI, but are deterring vertical FDI. The answer resides in the commercial liberalization in a regional structure similar to the one offered by the European Union (EU). Theoretically, in this case the adhesion of new countries to the EU means less commercial obstacles, that should improve a decrease in horizontal FDI in the new member state, but an increase in vertical FDI and more FDI inflows from outside the EU, as a result of a larger and more homogeneous EU market. Empirical studies do not confirm this theoretical assumption. For Geishecker (2004), this is attributed to the absence of institutional and risk determinants in the model, also influencing the distribution of FDI.

8. The theory of the new economic geography

The theory was firstly developed by Krugman in 1991 and it is designed on two pillars. The first one is represented by the elements designating the agglomeration forces, while the second one consists in the elements composing the dispersion forces. The agglomeration zones are explained through a combination of scale economies and trade costs. More specifically, the location decision is influenced positively by the perceived demand and negatively by the production costs and the intensity of local competition (Disdier and Mayer 2004).

There are four elements and their interaction explaining the attraction and persistence of the economic activity: the increasing returns of scale, the monopolistic competition due to scale returns, transport costs and technological externalities between companies. As a result, we can discuss about core regions, where the production is accumulated, and periphery regions, where dispersion forces are acting. Kottaridi and Thomakos (2007) are concluding that these are regions creating virtuous cycles and vicious cycles respectively in attracting investors.

The theory of new economic geography is focused on the relation between the intermediate producers and the consumers

(upstream and downstream connections) (Hildebrandt and Worz, 2004). The theory emphasize the role of clusters as a region with the capacity of attracting new companies and qualified work force as a result of exploiting scale economies (Antonescu, 2011).

The market access and the production costs are the main determinants in making the location decision. Empirical studies regarding the benefits of being part of the EU as regards the FDI inflows for the CEE countries provide no clear conclusion. Claessens et al., 2000 and Globerman et al., 2006 find positive impact of the announcement of the adhesion of these countries to the UE for foreign investors, while Clausing and Dorobantu (2005) and Bockem and Tuschke (2010) find no significant impact. One explanation for this inconsistency is provided by Narula and Bellak (2009) who consider that the quality of national institutions prevails over the EU membership status. Also, Barell and Pain (1997) suggest that being a member of the EU will determine an increase in FDI; still, other studies refer to the stability of the economic environment as an outcome of EU adhesion as being the reason for such an increase in FDI.

Kottaridi and Thomakos (2007) evaluate the validity of the new economic geography theory by testing the convergence of FDI in 35 developing countries during 1980-2003. At the first sight, the authors do not find evidence of the "core-periphery" pattern in the FDI stocks per capita. Still, they recommend a careful evaluation of the theory when taking into account different groups of countries.

9. Institutional theory
The theory emphasizes the role of the institutions for attracting FDI. Assuncao (2011) suggests that FDI are the result of the game or of the competition between governments. In this respect, institutions are seen as the ones that create the rules of the game. Bénassy-Quéré et al. (2007) point to the increasing impact of institutions in attracting

FDI, starting with the 1990. A major importance for the appearance of this theory is due to the transition process in Central and Eastern European countries. The main characteristic of the transition process was to create institutions adapted to the market economy.

Kinoshita and Campos (2006) prove that neither market size, nor low labour cost are not significant determinants of FDI, once the quality of institutions and other variables related to policy formulation are taken into account. A similar result is provided in Popovici and Calin (2012, 2013).

9.1 The theory of institutional FDI fitness

A theory that is less debated when talking about FDI location factors is the institutional FDI fitness theory, developed by Saskia Wilhelms in 1998. The theory is actually pointing to the important and active role of the governments in taking economic measures and adapting their public policies in order to attract foreign investors. Taking into the account the case of African countries, the author considers that is not the traditional determinants of FDI that matters for increasing FDI inflows in a country (such as the size of the population or the socio-cultural characteristics), but the institutional variables that can be changed through the action of the governments (like the laws and their ways of implementation). The capacity of a country for attracting FDI resides in its ability to adapt – or to fit – to the internal and external demand of economic agents. In this way, the author emphasizes four types of institutions capable to adapt: the governments, the markets, the education system and the socio-cultural framework. There is a permanent connection between the four pillars (Wilhelms and Witter, 1998).

Government fitness is seen as the economic openness, a low degree of intervention on trade and exchange rates, low corruption and high transparency, while markets fitness is assumed to generate a high volume of trade, doubled by low fees and quick access to finance

or energy. The fitness of a country regards its capacity of not only attracting, but also absorbing and retaining FDI. Therefore, the most attractive countries for FDI will be those that are more capable to quickly adjust their environment: seizing the opportunities, responding to threats, enhancing their creativity, identifying niches for surviving in face of competition. The theory is applicable to all the economic levels that determine FDI: macro, meso and micro level.

The empirical analyses regarding this theory are mostly taking into account the African countries. Musonera et al. (2010) are testing the fitness model on four countries in the East African Community (Kenya, Tanzania and Uganda) between 1995 and 2007. They find that the model is suited for Tanzania and Uganda, as FDI inflows are determined by market, social, political, economical and financial factors. The main conclusion is that foreign investors are attracted by a stable environment; therefore the role of the government is important in ensuring this stability.

Muthoga (2003) investigates the FDI determinants in Kenya during 1967-1999 based on the institutional fitness theory. The author points to the impact of policy makers in making their country more attractive for FDI, as he finds that economic openness, the GDP growth rate, the domestic investment, the internal rate of return and the credit availability from the monetary authority are the main variables influencing foreign investors.

10. Conclusions

FDI theories started with studying the MNEs' behaviour; location issues were added as a result of economic dynamics and practical observations in the activities conducted between MNEs and host countries. Therefore, we find that an expansion direction of FDI theories is due to the incorporation of new variables on location, although the location advantages are barely mentioned in the first explanations regarding the international activity of the firms.

The role of governments also seems to be essential, as governments may become an active partner for foreign investors, having the possibility to create a favourable environment for investments and for doing business, especially in present, where more attention is given to created resources as determinants for FDI.

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