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FOREIGN DIRECT INVESTMENTS – THEORETICAL ASPECT

Summary: Theories of foreign direct investments try to explain the reasons of establishing international enterprises, understand their motives for making investments outside their native states as well as study factors affecting the selection of localization for their business activity. The goal of this article is the presentation of categorized theories, which are published in Polish subject-matter literature and in foreign literature, concerning direct foreign investments.

Key words: FDI, theory, foreign direct investment.

1. Introduction

Since the middle of the twentieth century foreign direct investments' increase in weight has been noticeable. A previous inflow of foreign capital inflow into third world states, in form of foreign direct investments, amounted to 15.210 billion USD[1]. Just in 2007 the world inflow of FDI amounted to 1.833 billion USD while the outflow to 1.996 billion USD. Growing dynamics of this phenomenon resulted in growing interest of this issue and the creation of theories explaining the foreign direct investments. It is worth mentioning that it is difficult to indicate one dominating theory in terms of this issue which would explain the phenomena as a whole. Moreover, it can be stated that theories, those already existing and those still being investigated, supplement each other and together explain the phenomena in a better way.

The goal of this article is the presentation of categorized theories for foreign direct investments which are published in Polish subject-matter literature and in foreign literature as well.

2. Division of theories for foreign direct investments expansion

The theories of foreign direct investments try to explain reasons for the establishment of international enterprises, understand their motives for making investments out of their genuine states as well as study factors affecting the selection of localization for a business activity.

[1] As of the end of December 2007.

In his book A. Stępniak[2] presents a division, so called Casson division, of direct investments theory into three groups. They are divided into:

- theories for international capital markets,
- theories for enterprises,
- theories for trade,

and at the same time there is an assumption stating that the direct investments theory is the theory integrated into the three above mentioned theories. According to A. Stępniak this division is logic, however, it contains many 'gaps' and it is not related to other theories of international trade, e.g. related to the know-how transfer.

In the subject-matter literature there are very different divisions of direct investments theories. The most common categorization is the one proposed by J. Misala[3] into microeconomic, macroeconomic and mixed theories for direct investments.

Among microeconomic theories there are:

- portfolio investments theory,
- theory of investment portfolio diversification,
- enterprises' behaviour theory,
- theory of reaction of enterprises to oligopolistic conditions for competition,
- theory of financial liquidity for a foreign subsidiary,
- theory of possession (related) advantage of an enterprise,
- theory of internal transactions,
- theory of appropriation (capability).

Among macroeconomic theories there are:

- theory of the capital profitability,
- theory of foreign manufacture volume and absorptivity of foreign markets,
- theory of monetary areas,
- theory of relative distribution of workforce and capital costs,
- theory of shaping investment advantage on foreign markets.

Mixed theories enumerated by J. Misala contain:

- localization theory for foreign direct investments,
- eclectic theory of international manufacture.

In the author's opinion the most reliable categorization of foreign direct investments has been presented by J. Stehn[4] since it is very legible, clear and consequently functional and logic. J. Stehn divides the theories for foreign direct investments into two sub-groups: theories resulting from conditions for localization and theories resulting from conditioning for a company. In the first group there are the following theories: profitability theory, 'output' and market volume theory, product's lifecycle

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[2] A. Stępniak, *Integracja regionalna i transfer kapitału. Inwestycje bezpośrednie w aspekcie klimatu inwestycyjnego w Unii Europejskiej,* Wyd. Uniwersytetu Gdańskiego, Gdańsk 1996, p. 51.

[3] J. Misala, *Współczesne teorie wymiany międzynarodowej i zagranicznej polityki ekonomicznej,* SGH, Warszawa 2001, p. 214-229.

[4] J. Stehn, *Ausländische Direktinvestitionen in Industrieländern,* Mohr Siebeck, 1992.

theory, monetary area theory and localization theory. The second group contains such theories as: portfolio diversification theory, company's behaviour theory, oligopolistic reaction theory, internalization theory and possession (related) advantage theory.

3. Selected theories in terms of foreign direct investments

One of the macroeconomic theories of foreign investments is capital localization profitability theory which is also called efficiency hypothesis. This theory assumes that investors head for profit maximizing and they develop their investment activity until the expected profitability of an additional investment is equal to the final costs of a particular investment project. This hypothesis is extended by a statement that capital flows are specified by so called relative profitability, which occurs between a localization state and the state 'sending' (transferring) the capital. It means that the capital flows from low capital profitability states into large capital profitability states[5].

Another macroeconomic theoretical construction in terms of foreign investments is so called 'output' and market volume theory, also called a theory for foreign manufacture and foreign markets' absorptivity. It assumes a relation among production volume, Gross Domestic Product (GDP) and the size of market and foreign direct investments. It is based on neo-classic investment theory and uses the theory of a multiplier as well as investment super-multiplier.

Next theory resulting from conditioning at a localization state is the product's lifecycle theory established by R. Vernon in 1966. The theory is most often used in the context of technology transfer and the technological 'gap'. The theory constitutes a modification and an extension of the Schumpeter theory. It is based on the assumption that technological knowledge and know-how are not equivalent goods and their flow is restricted. It is caused by unequal expansion of innovations. According to this model companies try to penetrate foreign markets in highly developed states through the following stages: export – licence sale – foreign investments, while in poorly developed states just by means of foreign investments. It concerns those fields of production within which enterprises have technological advantages or other sort of advantage. Such advantages result from the fact that products within particular branches occur on domestic market earlier than on other states' markets. According to this theory a product 'comes through' a few phases: a phase of innovation, maturity and standardization. At the first stage, when a company just starts manufacturing a product, its entering into foreign market is too risky. Foreign demand is limited to the wealthiest members of society only. However, as the time passes by and the quantity of manufactured goods grows, an enterprise obtains profits and makes the unit costs lower. Than the product is within the second stage. Stabilization on a domestic market enables the export of a product into foreign markets on which

[5] J. Misala, *Teorie międzynarodowej wymiany gospodarczej*, PWN, Warszawa 1990, s. 214; A. Stępniak, op. cit., p. 54.

the demand grows up significantly. At this moment other states also start up a manufacture process which results in more severe competition and the necessity of lower manufacture costs. It is possible only in case of transfer of the production process and this constitutes the third phase which means 'coupling of markets'. An international share of work within a company leads into a significant decrease in manufacture costs[6].

Other theoretical structure of macroeconomic character is the monetary area theory which assumes a division of the world economy into different currency zones. A starting point there is the growing dependency of cash & credits national systems' operations upon international conditions. In the opinion of the author of this theory – R.Z. Aliber – foreign investments result naturally from the difference of position of particular currencies on the international monetary market. Additionally, international investments' streams are affected by such factors as: the amounts of duties and sales, foreign market size as well as large value of monopolistic advantage. According to this concept every enterprise has its assets assigned to a currency which may be 'weak' or 'strong'. Investors from different states observe the position of currencies on the financial market and make investment decisions, giving consideration to the risk level for foreign direct investments or portfolio investments. Foreign investments' streams (also in case of portfolio investments) flow from states with 'strong' currency into states with 'weak' currency[7].

The last theory resulting from conditioning in a localization state is the localization theory for foreign direct investments which combines both micro and macroeconomic elements. It has been extended by many scientists, among others J.H. Dunning (1973), A.M. Rugman (1980) and P. Tesch (1980) Therefore, there occur differences in terms of this theory. A formalized version of this theory has never been established, however, when observing considerations made by the above indicated authors, one may notice similar core thoughts. All people dealing with this theory can see the reasons for the localization of foreign direct investments among common factors shaping the advantage of the host state (market). Localization theory assumes an optimal connection of a possession advantage of an enterprise and the localization advantage of the host state. These factors may be divided into four groups: 1) political factors, which include: stable political system, legal safety and attitude presented towards foreign investors, 2) costs factors, such as: the access to productive inputs and their prices, in these, among others, labour costs abroad, 3) market factors – market dynamics and size, competitors, export opportunities and external market

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[6] E. Czerwieniec, *Zagraniczne inwestycje bezpośrednie w gospodarce krajów wysoko rozwiniętych,* Wyd. Akademii Ekonomicznej, Poznań 1990, p. 28-32; A. Sokołowski, *Inwestycje niemieckie na Dolnym Śląsku,* Oficyna Wydawnicza Arboretum, Wrocław 2001, p. 35-36, A. Stępniak, op. cit., p. 55-57.

[7] J. Misala, *Teorie międzynarodowej…*, p. 216, 223-224, J. Rymarczyk, *Internacjonalizacja przedsiębiorstwa*, PWE, Warszawa 1996, p. 38-40, A. Stępniak, op. cit., p. 57-58.

security and 4) factors related to trade barriers, among them: licences, duties, contingents, codes and national grants for domestic enterprises[8].

A theory not mentioned by J. Stehn, while considered by J. Misala to be a macroeconomic theory, is the theory for investment position on foreign markets. The aim of this theory is the explanation of foreign direct investments on the basis of different economic development levels of particular states. To do this it uses a survey index specifying the investment level of states which is net value of an investment per one inhabitant. It distinguishes four groups of states, which respond to four stages of growth and at the same time to four stages of shaping an investment position on foreign markets. The first group is constituted by states with very low income per one inhabitant. In case of such states there is often 'zero' or negative net value of foreign investments. Another group of states is constituted by states with net income *per capita* from 400 to 1500 USD. These states host many foreign investors but they invest low amounts in themselves. Two last groups are constituted by states of the highest level of economic development. They invest abroad more than foreign investors invest in their territories[9].

The second group of theories in terms of foreign investments is constituted by theories resulting from the conditioning for a company – microeconomic theories, namely: the portfolio diversification theory, company's behaviour theory, oligopolistic reaction theory, internalization theory and possession advantage theory.

The first macroeconomic theory is the portfolio diversification theory which assumes that capital transfer streams are affected by different profit rates but also different risk rates for localization. Every investor who maximizes profits gives consideration to certainty and uncertainty in terms of localization. The larger expected profit the larger tolerance for uncertainty which is presented and vice versa. Therefore, the aim of an enterprise is the diversification of its portfolio since it needs stocks, shares and deposits of large and limited risk level in relation to the profit rate in different regions[10].

Next microeconomic theory there is the company's behaviour theory which states that a starting point for a decision on a foreign direct investment is the occurrence of some external and internal conditioning. Company's management is usually more prone to overestimate the risk related to the establishment of a foreign affiliate than to underestimate it. With reference to the above mentioned fact, it forces the expansion on foreign markets following its competitors. Consequently, a host-state for a capital investment is selected after accurate risk analysis has been completed. A. Stępniak considers this theory to be insignificant in terms of explanation of the reasons for direct investments since there are no reliable empirical surveys available[11].

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[8] J. Misala, *Teorie międzynarodowej...*, p. 231-233; E. Oziewicz, *Zagraniczne inwestycje bezpośrednie w rozwoju gospodarczym Azji Południowo-Wschodniej (ASEAN),* Wyd. Uniwersytetu Gdańskiego, Gdańsk 1998, p. 96-97; J. Rymarczyk, op. cit., p. 40-42; A. Stępniak, op. cit., p. 58-61.

[9] J. Misala, *Współczesne teorie*…, p. 217-218.

[10] A. Stępniak, op. cit., p. 61.

[11] J. Misala, *Współczesne teorie*…, p. 220; A. Stępniak, op. cit., p. 61-62.

Next theory is the oligopolistic reaction theory. This theory is based on a thesis stating that foreign investments made by some enterprises present tendencies to be 'concentrated' within time and particular economy fields in a host-state. Oligopoly is one of the market monopolization forms. It means the occurrence (on a market) of several competing or cooperating dealers – monopolies when a number of purchasers is unlimited. According to this theory, the establishment of a foreign affiliate by one of the enterprises of any field results in relation of other large companies following the pioneer and establishing their branches on a foreign market. This phenomena is determined to be a competitors' imitation effect and is based on the product's lifecycle theory established by Veblen[12].

The internalization theory has much in common with theories which result from the specificity of an enterprise. It is especially often associated with the oligopolistic reaction theory. It assumes that all foreign investments may be reduced to the issue of market imperfection and 'external effects' caused by such an imperfection. Specific advantages resulting from internalization appear when a market is not able to provide some kinds of transactions cheaply and effectively while transnational corporation may do this. The existence of such a type of advantage must be looked for in a theory of transactional costs, according to which a company's aim is to minimize transactional costs. Transnational enterprises try to maximize profits due to internalization, which means internal transactions within the same enterprise. It is possible when it controls a vendor or a recipient. Susceptibility of an enterprise to internalization depends on relations among the four groups of factors such as: factors specific for a branch, e.g. character of a product, market's structure, factors specific for a region, e.g. geographical distance, culture-related differences, factors specific for a nation, e.g. political system and tax system and factors specific for the enterprise, e.g. organization, management or marketing. On the basis of surveys' results the authors of the theory state that anytime, when basis for competitive advantage of an enterprise is constituted by technological innovation and related know-how, than a preferred form of foreign markets penetration is constituted by foreign direct investments[13].

The last theory, which results from conditioning for the company is the possession advantage theory. It assumes the existence of imperfect competition and puts pressure on the process of internationalization of enterprises' business activity, which appears under such circumstances. Researchers focus on a single company and its strategy within different fields. They notice that a significant premise for an enterprise to make a decision on foreign expansion is the certainty of an advantage and an opportunity for long-term use of this advantage. A possession advantage for an enterprise is constituted by the following factors: general factors not related to internationalization of the business activity, special factors shaping the advantage of

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[12] J. Rymarczyk, op. cit., p. 37-38; A. Sokołowski, op. cit., p. 36; J. Witkowska, *Bezpośrednie inwestycje zagraniczne w Europie Środkowo-Wschodniej,* Wyd. Uniwersytetu Gdańskiego, Gdańsk 1997, p. 42-43.

[13] J. Misala, *Współczesne teorie*…, p. 223-224; A. Stępniak, op. cit., p. 62-65.

foreign affiliates of a genuine enterprise over local companies and newly-established companies and factors related to the fact of internationalization of the enterprise. Among general factors there are, among others: size, scope of business activity and international position of an enterprise as well as specialization directions and production diversification rate, trade mark, efficiency in terms of organization and management, research & development potential, capabilities and achievements within marketing sphere. Among special factors shaping the advantage of foreign affiliates of a genuine enterprise over local companies and newly-established companies is the access to different types of resources of the genuine enterprise upon preferential terms and conditions, especially to technical and technological resources as well as marketing and administrative ones. A good example of factors resulting from the internationalization of an enterprise's business activity is the extension of the opportunity for making a choice as well as better access to information and opportunity for risk diversification[14].

The results and decisions of the internalization concept have been presented in the eclectic theory for international manufacture by J.H. Dunning, which describes the foreign direct investments theory in detail. Dunning, in his concept, apart from internalization takes the oligopolistic advantage theory and localization theory into consideration[15]. Dunning divides factors into three groups of variables (named advantages), which motivate companies to make expansion on foreign markets[16]:

- advantages relevant for a company (and for its affiliates) – monopoly stream,
- advantages resulting from internalization – efficiency stream,
- advantages related to localization.

This concept also specifies conditions which must be met in order to persuade a company to make direct investments on a foreign market. These criteria are as follow[17]:

1) an enterprise will reach net benefits resulting from an advantage over its competitors from a state offering a location in terms of supply for a market;

2) with an assumption of the first condition, a company should use obtained advantage undependably, while the profitability of an investment cannot be based only on its payable disclosure to other companies, e.g. in form of leasing of re-sale;

3) with an assumption of meeting the first and the second condition it is important to keep the made investment profitable.

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[14] J. Misala, *Teorie międzynarodowej…,* p. 221-222; A. Stępniak, op. cit. p. 65-66.

[15] T. Sporek, *Zagraniczne inwestycje bezpośrednie główną strategią korporacji transnarodowych*, Wyższa Szkoła Zarządzania Marketingowego i Języków Obcych w Katowicach, Katowice 1998, p. 30.

[16] M. Gorynia, R. Owczarzak, *Podstawy teorii internacjonalizacji i globalizacji działalności przedsiębiorstw*, "Gospodarka Narodowa" 2004, nr 1-2 (149-150), p. 17.

[17] T. Sporek, op. cit., p. 30.

Summing the Dunning theory up, foreign direct investments are constituted by a function of three variables: specificity of an enterprise, reason for actions heading for foreign market expansion and benefits which may be reached by a company as a result of such an initiative.

4. Conclusions

On the grounds of the above analysis one may state that still there is no coherent and complete theory which would describe the issue of expansion into foreign markets by enterprises in form of foreign direct investments. The establishment of one theory for business activity of enterprises in the international area is a serious challenge and it requires complicated surveys over enterprises, due to which there shall be specified reasons, barriers for investments but profits and costs as well. One should remember that the behaviour of enterprises is not the same and it depends on the series of factors, among them the origin state of an enterprise but also target localization for an investment. Therefore, one still may just discuss the division of already existing theories into micro and macroeconomic theories but – more and more often – mezzo-economic theories. However, when rating the above described theories, the author thinks that the one of most reliable is Dunning theory since it takes micro and macroeconomic level theories into consideration.

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BEZPOŚREDNIE INWESTYCJE ZAGRANICZNE – ASPEKT TEORETYCZNY

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