



VAASAN YLIOPISTO

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Foreign Direct Investment Behavior

An Analysis of the Determinants and Motivations  
of Finnish Direct Manufacturing Investment  
in Asian Countries

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TABLE OF CONTENTS

	Page
<b>LIST OF TABLES</b> .....	<b>8</b>
<b>LIST OF FIGURES</b> .....	<b>9</b>
<b>ABSTRACT</b> .....	<b>10</b>
<b>1. INTRODUCTION</b> .....	<b>11</b>
1.1. Background.....	11
1.2. General trends related to foreign direct investments in Asian countries .....	13
1.3. The approach of the present study .....	16
1.4. The purposes of the present study .....	18
1.5. The objectives of the present study .....	20
1.6. The contributions of the present study .....	21
1.7. The structure of the present study .....	22
<b>2. FOREIGN DIRECT INVESTMENT: A REVIEW OF THEORIES</b> .....	<b>26</b>
2.1. Introduction .....	26
2.2. Market imperfection paradigm .....	27
2.2.1. Hymer's theory of international production .....	28
2.2.2. Product life cycle theory .....	30
2.3. Behavior paradigm .....	33
2.3.1. Internationalization theory.....	33
2.4. Environment paradigm .....	35
2.4.1. Location theories .....	35
2.5. Market failure paradigm .....	39
2.5.1. Internalization theory.....	39
2.5.2. Transaction cost theory.....	42
2.5.3. Eclectic theory .....	44
2.6. Summary.....	46
<b>3. THE MAIN FEATURES OF THE ECLECTIC MODEL</b> .....	<b>50</b>
3.1. Introduction .....	50
3.2. Features of the eclectic paradigm .....	52
3.2.1. Ownership-specific advantages .....	53
3.2.2. Location-specific advantages .....	55
3.2.3. Internalization advantages .....	58
3.3. Criticism of the eclectic paradigm.....	59
3.4. Summary.....	63
<b>4. STRATEGIC MOTIVES OF FOREIGN DIRECT INVESTMENT</b> .....	<b>65</b>
4.1. Introduction .....	65
4.2. Market seeking FDI's .....	66
4.3. Efficiency seeking FDI's .....	69

4.4. Risk-reduction seeking FDI	71
4.5. Knowledge seeking FDI	72
4.6. Summary	74
<b>5. DETERMINANTS OF LOCATION STRATEGIES IN FOREIGN DIRECT INVESTMENTS</b>	<b>76</b>
5.1. Introduction	76
5.2. The Framework	77
5.3. Ownership-specific advantages	79
5.3.1. R&D Intensity	79
5.3.2. Firm's size	80
5.3.3. Firm's international experience	81
5.4. Location-specific advantages	82
5.4.1. Cultural distance	83
5.4.2. Market potential	84
5.4.3. Wage rate	85
5.4.4. Corporate tax rates	86
5.4.5. Inflation	87
5.5. Internalization advantages	88
5.5.1. Country risks	89
5.5.2. Exchange rate fluctuations	90
5.6. Summary	92
<b>6. DETERMINANTS OF OWNERSHIP STRATEGIES IN FOREIGN DIRECT INVESTMENTS</b>	<b>95</b>
6.1. Introduction	95
6.2. The Framework	96
6.3. Ownership-specific advantages	98
6.3.1. R&D Intensity	98
6.3.2. Firm's size	99
6.3.3. International experience	101
6.3.4. Industry experience	102
6.4. Location-specific advantages	103
6.4.1. Cultural distance	104
6.4.2. Market potential	105
6.4.3. Economic welfare	106
6.5. Internalization advantages	107
6.5.1. Country risks	107
6.5.2. Scale economies	109
6.6. Summary	110
<b>7. METHODOLOGY AND CHARACTERISTICS OF THE SAMPLE OF THE PRESENT STUDY</b>	<b>114</b>
7.1. The Sample	114
7.2. The methodology of the present study	116
7.3. Operationalization of the variables used in this study	117

## ACTA WASAENSIA

7.3.1. Dependent variables .....	117
7.3.2 Independent variables related to location aspects.....	119
7.3.2.1.Ownership-specific advantages .....	119
7.3.2.2.Location-specific advantages .....	121
7.3.2.3.Internalization advantages .....	123
7.3.3 Control variable related to ownership aspects.....	125
7.3.4. Independent variables related to ownership aspects.....	125
7.3.4.1.Ownership-specific advantages .....	125
7.3.4.2.Location-specific advantages .....	126
7.3.4.3.Internalization advantages .....	127
<b>8. EMPIRICAL FINDINGS OF THE PRESENT STUDY .....</b>	<b>130</b>
8.1. Empirical results related to location strategies of Finnish firms in Asian countries. ....	130
8.2. Empirical results related to ownership strategies of Finnish firms in Asian countries. ....	134
8.3. Summary.....	138
<b>9. SUMMARY, CONCLUSIONS AND IMPLICATIONS OF THE PRESENT STUDY .....</b>	<b>141</b>
9.1. Summary and conclusions.....	141
9.2. Scientific and managerial implications of the present study .....	148
9.3. Limitations of the present study .....	151
9.4. Implications for future research.....	152
<b>REFERENCES .....</b>	<b>155</b>

**LIST OF TABLES**

	<b>Page</b>
Table 1. FDI net inflows in Asia (millions of dollars) (based on World Development Indicators Online by the World Bank Group) .....	14
Table 2. Studies using the OLI framework .....	17
Table 3. Classification of FDI-related theories .....	27
Table 4. Studies using Hymer's theory .....	29
Table 5. Studies using PLC approach .....	32
Table 6. Studies using Internationalization approach.....	34
Table 7. Studies using Location theories.....	37
Table 8. Studies using transaction cost approach.....	43
Table 9. Important FDI theories.....	48
Table 10. Strategic motives affecting the FDI choices.....	75
Table 11. Summary of the results obtained on the impact of OLI related variables on FDI choices in previous studies.....	92
Table 12. Types of international production (related to location aspects): some determining factors .....	94
Table 13. Summary of the results obtained on the impact of OLI related variables on the ownership-strategy-related choices in previous studies.....	111
Table 14. Types of international production (related to ownership aspects): some determining factors .....	112
Table 15. Description of dependent variables of the present study.....	118
Table 16. Description of independent variables related to location strategies.....	120
Table 17. Expected results for each independent variable related to location strategies.....	121
Table 18. Cultural distance between Finland and different target countries of FDIs.....	122
Table 19. Summary of operationalization of variables related to location aspects .....	124
Table 20. Description of independent variables related to ownership strategies.....	126
Table 21. Expected results for each independent variable related to ownership strategies.....	127
Table 22. Summary of operationalization of variables related to ownership aspects.....	128
Table 23. Parameter estimates for the binomial logit models related to location strategies.....	131
Table 24. Parameter estimates for the binomial logit models related to ownership strategies.....	136
Table 25. Types of international production (related to location aspects): some empirical evidence.....	138
Table 26. Types of international production (related to ownership aspects): some empirical evidences.....	139
Table 27. Summary of the results related to location strategies of Finnish firms in Asian countries.....	146
Table 28. Summary of the results related to ownership strategies of Finnish firms in Asian markets.....	147



**LIST OF FIGURES**

	<b>Page</b>
Figure 1. The structure of the present study .....	24
Figure 2. The eclectic framework.....	53
Figure 3. The strategic advantages of foreign production .....	66
Figure 4. The framework related to location aspects.....	78
Figure 5. The framework related to ownership aspects.....	97
Figure 6. Modified version of eclectic framework .....	149

**ABSTRACT**

Muhammad Rizwan Tahir (2003). Foreign direct investment behavior – An analysis of the determinants and motivations of Finnish direct manufacturing investment in Asian countries. *Acta Wasaensia* No. 115, 182 p.

Foreign direct investment (FDI) continues to expand rapidly, enlarging the role of the international production in the world economy. FDI grew by 18 percent in 2000, faster than other economic aggregates like world production, capital formation and trade, reaching a record \$1.3 trillion. In Asia, FDI inflows reached a record level of \$143 billion in 2000. The greatest increase took place in East Asia; Hong Kong (China), in particular, experienced an unprecedented FDI boom, with inflows amounting to \$64 billion, making it the top FDI recipient in Asia as well as in developing countries. Most of the countries and particularly Asian countries now also see FDI as an essential element in promoting growth and development. There is thus all the more reason to identify the variables as well as motivations of FDI in those countries.

The purpose of this study is to empirically investigate how different ownership-specific (O), location-specific (L), internalization (I) and strategic advantages have influenced the location and ownership strategies of Finnish firms in ten South and Southeast Asian countries from 1980 to 2000. Dunning (1993:56) identifies four main strategic advantages of FDI: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. Despite increased interest in FDI, very few studies (e.g. Kim & Hwang, 1992; Chandrapalert, 2000; Vyas, 2000) have been undertaken so far to empirically analyze the influential ownership-specific, location-specific and internalization variables together with the strategic motives in order to analyze the FDI choices of foreign investors. To the best of our knowledge, particularly these strategic motives have remained primarily anecdotal. This is apparently the first study to empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI behavior of the Finnish manufacturing firms in Asian countries.

The empirical part of this study is based on 136 FDI made by Finnish firms in ten South and Southeast Asian countries between 1980 and 2000. The preliminary research findings provide useful insights into the location and ownership strategies of Finnish firms in Asian markets. Of the reviewed FDI 33% were in China, 18.4% were in Malaysia and 14.7% were in Singapore. FDI flows by the Finnish firms to Asian countries were rather modest until the late 1980s, but especially in the early 1990s there has been clear growth in the number of FDI made by Finnish firms in Asia. The data analysis used a binomial logistic model to analyze the data and test the hypotheses. Related to location aspects, the results indicated that large firm size, larger international experience large size of the target market, low cultural distance and low wage rate had increased the probability of undertaking *MS* and *ES* FDI. Secondly, high R&D intensity of the investing firm has increased the probability of undertaking *KS* FDI. Finally, low inflation rate, a low level of risks and a high level of exchange rate fluctuations in the target country have increased the probability of undertaking *RRS* FDI. The results related to ownership aspects indicated that large firm size, larger international experience, low cultural distance, large size of the target market, and high level of economic welfare have increased the probability of choosing wholly-owned subsidiaries (WOSs) in order to undertake *MS* and *ES* FDI. Likewise, low levels of risks in the target Asian country have also increased the probability of choosing wholly-owned subsidiaries WOSs in order to undertake *RRS* FDI.

Further, with reference to the eclectic approach, in the whole sample ownership-specific (O), location-specific (L) internalization (I) and *strategic advantages* have influenced the location and ownership strategies of the Finnish firms in Asian markets. The individual *strategic motivations* listed above should not be seen as mutually exclusive. FDI projects may be driven by several ownership-specific, location-specific and internalization (OLI) advantages and strategic motives simultaneously and in various combinations. Conceptually, however, distinguishing between different types of *strategic motivations* facilitates a better understanding of the strategic motives underlying different FDI decisions and key ownership-specific, location-specific and internalization (OLI) advantages influencing the different types of FDI.

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**Key words** Foreign direct investments, eclectic paradigm, strategic motivations, location strategies, ownership strategies, Finnish firms and Asian countries.

## 1. INTRODUCTION

### 1.1. Background

Foreign direct investment (FDI) has become extremely important as the extent of international commerce grew steadily during the last two decades. This growth has occurred for several reasons, including the transition and development of free market economies around the world, the growth of international financial markets, the proliferation of regional integration between nations, and the numerous communications and technological developments that make managing far flung businesses easier. However, foreign direct investment (FDI) possesses some characteristics that make it highly sought-after on one hand, and the most controversial on the other (Barlett & Ghosal 1989; Dunning, 1992).

According to Buckley and Casson's (1985) typology, "foreign direct investment is an equity-based, internal transfer of resources and rights, that is unlimited in time." Dunning (1993:5) refers to FDI as investments "outside the home country of the investing company, but inside the investing company." He also emphasizes that FDI consists of a "package of assets and intermediate products, such as capital, technology, management skills, access to markets and entrepreneurship." This definition suggests that typical sales subsidiaries are something less than FDI. The IMF (1993) defines FDI as "investments that involve a long-term relationship reflecting a lasting interest of a resident entity in an economy (direct investor) in an entity resident in an economy other than that of the investor. The direct investor's purpose is to exert an influence on the management of the enterprise resident in the other economy." FDI is closely related to the concept of multinational corporations<sup>1</sup> although the two may not be the same thing. A multinational company (MNCs) refers to a corporation operating in more than two foreign countries. Multinational corporations are the conduits for the flow of FDI. FDI constitute not only flow of new funds from abroad but also the reinvested earnings of multinationals already doing business in the country and the sale of non-financial assets to the foreign subsidiary by the parent company. Interestingly, FDI may not essentially relate to capital flows. Since the financial markets around the globe are well connected, a subsidiary may raise funds locally and the headquarter may only provide management and technical

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<sup>1</sup> The terms "multinational corporations" and "firms" are equivalent and can be used interchangeably.

expertise. Commonly, investments with a minimum of ten percent of the total equity<sup>2</sup> of a foreign entity are classified as foreign direct investments. Foreign investments with an ownership below ten percent are classified as portfolio investments. In other words, FDI is a long-term commitment by foreign firms and tends to hold up better during periods of economic crisis in the host countries. Thus, another common cited advantage of FDI as compared with other forms of capital flows is its greater stability.

The growing propensity of firms to engage in cross-border alliances has implications not just for the modality by which knowledge and other intangible assets are transferred across national boundaries, but for the location of value-added activities – especially high value asset augmenting activities (Dunning 1998). Underpinning and reinforcing each of the events just described were two other factors that also have a profound effect on both the micro and macro-geography of MNCs (Dunning 1998). The first was the advent, in the 1980s, of a new generation of technological advances that were even in the late 1990s fully bearing fruit. The second factor was the renaissance of the market economy, and the consequential changes in the macro-economic policies and macro-organizational strategies of many national governments. This was most vividly demonstrated by the happenings in China and Central and Eastern Europe, but almost as far reaching, was the reappraisal of the role of the state and markets in economic development being played out in India, and in several African and Latin American economies (World Bank 1997). Both these factors have resulted in a major impact on the economic and political risk assessment of FDI by firms.

Several factors explain the wide spread in the flow of foreign direct investment (FDI). The most obvious is the outstanding economic performance by the Southeast Asian countries that adopted export-enhancing and FDI-friendly environment strategies early in their development process (World Development Report 2001). Strong economic growth in Southeast Asian countries that encouraged FDI flows led to the re-evaluation of FDI policies by other countries that had hitherto been ambiguous about the role of FDI in development. Secondly, economic development has come to be increasingly linked to new technologies. Production has become more knowledgeable, skilled and technology-intensive than ever

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<sup>2</sup> Bank of Finland requires at-least 10 % at stake

before. The share of world innovation, production and trade accounted for by multinational corporations (MNCs) has grown steadily making it imperative particularly for the developing countries to establish closer contacts with them. Thirdly, in the eighties the international debt crisis altered the composition of capital flows, away from debt creating private loans towards non-debt creating flows such as portfolio and direct investments.

## **1.2. General trends related to foreign direct investments in Asian countries**

In Asia, foreign direct investment has increased significantly over the past four decades. The awakening of South Korea and Taiwan, which further accelerated the growth of entire region, followed by Japan's transformation from post-war ruin into an economic superpower. In the 1970s and early 1980s rising foreign investment and deregulation in Indonesia, Malaysia and Thailand spurred this momentum, with the entrepreneurial city-states of Singapore and Hong Kong acting as the region's growth poles. China's tentative opening to the West in 1979, followed by its bold free market reforms in the late 1980s, led to unprecedented economic growth rates in the 1990s. According to the World Bank, by 2020 seven out of the ten largest economies on the planet will be in Asia, compared with only three out of ten in 1997. Together these countries form the Asian region, a formidable force that is drawing in the residual non-capitalist economies of Vietnam and Laos. In 1990s, the Asian region becomes increasingly self-sufficient in terms of intra-regional trade and investment (Lasserre & Schutte 1999: 21).

The prevailing view in Asia is that FDI constitutes a resource flow beneficial to economic and industrial development. It provides a combination of resources much needed in developing countries such as technology, capital, management and marketing techniques. Asian countries have increasingly recognized these advantages and a number of countries has either reviewed the existing policies or introduced new policies to create favorable investment environment and thus attract FDI.

However, in Asian countries, FDI has been concentrated in a few countries. In the early 1990s, seven East Asian countries – China, Korea, Singapore, Indonesia, Malaysia, The

Philippines and Thailand – received more than sixty percent of the FDI inflows to the all-Asian countries (see Table 1). During that time, most of the foreign companies in Asian

**Table 1.** FDI net inflows in Asia (millions of dollars) (based on World Development Indicators Online by the World Bank Group)

Host country	1980	1985	1990	1995	1998	1999	2000
Asia	1,503	3,447	11,599	56,070	66,545	58,972	55,223
China	430	1,659	3,487	35,849	43,751	38,753	38,399
India	79	106	162	2,144	2,635	2,169	2,315
Indonesia	180	310	1,093	4,346	-356	-2,745	-4,550
Japan	280	638	1,777	39	3,268	12,308	8,227
Korea, Republic	6	234	788	1,776	5,413	9,333	9,283
Malaysia	934	695	2,333	4,178	2,163	1,553	1,660
Pakistan	63	131	244	723	506	532	308
The Philippines	-106	12	530	1,478	2,287	573	2,029
Singapore	1,236	1,047	5,575	8,788	6,316	7,197	6,390
Thailand	190	163	2,444	2,068	7,315	6,213	3,366

countries had been able to capitalize on their inexpensive labor, huge market potential and tariff protection. Despite the Asian crisis of 1997, the flow of FDI in the region does not appear to be deterred. The reason is that, although the currency depreciation decreases the stream of dividends from the subsidiary back to the home country, this effect is offset by gains in terms of ability to acquire local assets more cheaply and to a greater advantage for exports. Indeed, a survey by the United Nations of 198 multinational corporations (MNCs) shows that the turmoil in East and Southeast Asia has had minimal effect on the flow of FDI in the region (Business World 1998). On the contrary, World Investment Report (2000) have indicated that firms have increased their FDI because of lower costs in the region, increased competitiveness of Asian exports due to currency depreciation and more liberal attitudes that includes the use of various incentives in attracting FDI.

Despite its long history in Asian countries, FDI has fluctuated over time to respond to changes in the environment for investment. The trend or flows of FDI have reflected changes in industrial and development policies, including import-substitution in the 1950s and 1960s, resource based-led development in the 1970s, and structural reforms and export-orientation in the 1980s and 1990s. FDI is sometimes perceived as interference in the host country's domestic affairs by the home country through subsidiaries operating in the host country. The

perception of interference is intensified when it is observed that corporations operating in the host country quite often undertake direct investments in oligopolistic markets. They possess intangible assets like managerial skills, trademarks, patents and managerial ability. These corporations sometimes earn more profits compared with those of competitive firms, and generate considerable funds that allow them to take the risk of venturing into foreign markets through direct investment.

First in the 1970s, many Asian countries relied on borrowing from international commercial banks (which they perceive as having less or no interference with the running of domestic affairs) to finance development projects. However, the oil shock triggered a drastic increase in interest rates and created a debt burden for these countries, consequently drying up the flow of loans. The increasing preference for FDI over borrowing from commercial sources became significant in late 1980s. FDIs were perceived to have several advantages over commercial bank borrowings. Equity financing requires payment to be made only when investment projects are successful and profitable, whereas debt payments are subject to the interest rate in the world markets. Also, only a certain percentage of FDI is repatriated back to the source country in a given period compared with the requirement to repay in full for the commercial loans. Furthermore, FDI allows a better match between the structure of earning from an investment and that of required payments to the capital used in financing. This means that in a period of depression the host country will face certain difficulties in meeting the contractual obligations, while in the case of direct investments, this will mean that the subsidiary makes either little or no profits, and therefore, there will be no profits to remit to the home country. This also prevents problems caused by Asian countries undertaking short-term loans to finance long-term investments.

As a result, the Asian countries and especially Southeast Asian countries became the major destinations for investment by the western firms in the years leading upto the financial crisis, which erupted in 1997. International capital flow caused growth and financial crisis in these economies. Since these Asian countries could borrow money at low interest rate overseas, in dollars, more cheaply than they could at home, in their local currencies. By late 1996, foreign investors began to move their money out of Asian countries because they worried

about their ability to repay. Lately, foreign and local companies rushed to convert their local currencies into dollars. The central banks in the region responded by buying local currencies with their dollar reserves and raising interest rates. This rise in interest rates drove down the prices for stocks and land. This dynamic situation drew attention to serious problems in the Asian economies: huge foreign debt, trade deficits and a banking system weakened by a heavy burden of unpaid loans. The central banks ran out of dollars to support their respective local currencies. That is precisely why the Asian crisis started.

Finally, these problems have arisen from the shifts in local attractiveness, which means that structural adjustments can occur rapidly within the region in the face of rising labor costs and currency appreciation occurring in one country after another (Chandrapalert 1999:40). At the same time, this fact suggests that now Asian governments can not afford to let the level of foreign direct investment drop further, given the pressing need to finance their chronic current account deficit and, more importantly, to revive the momentum of economic growth and industrialization. Thus emerged an increasing acknowledgement of the importance of FDI in accelerating economic growth and as a source of employment. Also most of the Asian countries are not only more receptive to FDI but are also competing to attract long-term capital inflows. There is thus all the more reason to identify the determinants of FDI in Asia in particular.

### **1.3. The approach of the present study**

The eclectic paradigm<sup>3</sup> developed by Dunning (1980, 1988, 1993) integrates several strands of international business theories on cross-border activities. It proposes that three types of advantages/ variables influence cross-border business activities: ownership-specific advantages, location-specific advantages and internalization advantages. Ownership advantage includes various tangible and intangible assets owned by the investing firm. Location-specific advantages (L) are essential in determining where firms will engage in cross-border value-adding activities. The level of location-specific advantages may also be expected to influence the ownership strategies chosen. The last strand of the eclectic approach comprises internalization advantages (I) that the company has in transferring assets

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<sup>3</sup> The terms "eclectic paradigm," "eclectic theory" and "OLI framework" are equivalent.



within its organizations instead of via the market, because of market failures. The greater the perceived costs of transactional market failure – and the greater the benefits of circumventing market failure – the more likely the company is to exploit its ownership-specific advantages within the firm and the greater the degree of ownership they will prefer in their FDIs.

**Table 2.** Studies using the OLI framework

Researcher	Industry
Dunning (1980)	US manufacturing industries
Dunning & McQueen (1981)	Hotel Industry
Yu & Ito (1988)	Tire Industry
Sabi (1988)	Banking industry
Agarwal & Ramaswami (1992)	Leasing Industry
Chandprapalert (1999)	US manufacturing FDIs in Thailand

Dunning (1980) analyzed the foreign operations of fourteen U.S. manufacturing industries in seven countries. The study suggested that the competitive advantage of a U.S. firm consisted of a combination of ownership-specific and location-specific advantages. Similarly Chandprapalert (1999) examined the determinants of US FDIs in Thailand. The results of the study confirmed the validity of eclectic paradigm as a useful framework to explain the activities of international operations. More empirical support for the eclectic theory can be found in Dunning and McQueen's (1981) study of the hotel industry, Sabi (1988) in the banking industry and Yu and Ito (1988) in the tire industry. A study conducted by Agarwal and Ramaswami (1992) tested the impact of interactions between ownership-specific advantages of firms in the leasing industry using both internalization advantages and location-specific advantages. The results of the study reported that large, diversified, more internationally experienced firms chose ownership-based market entry modes rather than licensing or joint venture modes. This held true for firms with higher ability to adopt and develop differentiated products in markets with higher contractual risks, they also chose ownership-based entry modes rather than contractual-types modes. In countries with higher investment risks, firms choose a lower investment mode such as export.

The eclectic theory provides a multi-theoretical approach for studying the FDI choices: international trade theory, resource-based theory and transaction-cost theory are the basic theories used. It is an overall organizing paradigm for identifying the variables from each approach that are most relevant in explaining a wide range of different environments affecting the FDI choices of the investing firms. The eclectic theory permits researchers to create determinants in order to predict FDI choices. The strengths of the theory could be characterized by its richness (several explanations) and its creativity (generations of new determinants and combinations of these and the existing ones). The strengths involve, however, also potential weaknesses (Anderson 1997). The strongest criticism of the theory has come from Itaki (1991). Itaki (1991) claimed that an ownership-specific advantage actually comes from an internalization advantage. Therefore, it is redundant to consider these two as separate determinants. Dunning's theory has also been called ambiguous regarding the sources of location-specific advantages. Despite these shortcomings, Dunning's theory is considered by many as one of the more comprehensive frameworks of FDIs. Thus, the eclectic approach has been selected as the framework in this study because of the above-mentioned integrative nature of the approach.

#### **1.4. The purposes of the present study**

The purpose of this study is to empirically investigate how the different ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI behavior of Finnish manufacturing firms in ten South and Southeast Asian countries from 1980 to 2000. Dunning (1993:56) identifies four main strategic advantages<sup>4</sup> of FDIs: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. Despite the increased interest in FDI, very few studies (e.g. Kim & Hwang 1992; Chandprapalert 1999; Vyas 2000) have been undertaken so far to empirically analyze the influential ownership-specific, location-specific and internalization variables together with the strategic motives in order to analyze the FDI choices of the foreign investors. To the best of our knowledge, particularly these strategic motives have remained primarily anecdotal. Empirical analysis of strategic motives along with the ownership-specific, location-specific

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<sup>4</sup> The terms "strategic advantages" and "strategic motives" are equivalent and can be used interchangeably.

and internalization variables<sup>5</sup> can not only add to our understanding of eclectic paradigm but also enrich our knowledge of FDI in general.

In past studies analyzing FDI behavior the focus has been on FDI made in Western Europe and in the USA (for a review of earlier studies see e.g. Bell 1996 and Larimo 2000). When the FDI behavior in other geographic areas has been analyzed, the focus has usually been on non-OECD countries in general or the focus has been on FDI made in a single country (mainly China). A review of previous studies seems to indicate that in fact the study made by Delios and Beamish (1999) focusing on FDI behavior of Japanese firms in various Asian countries is the only one giving some basis for comparisons (sample 1424 FDI in nine Asian countries). But still there is so far very limited information on the FDI behavior of non-Asian firms in different Asian countries.

Foreign direct investment flows by Finnish firms to Asian countries were rather modest until late 1980s, but especially in the 1990s there has been clear growth in the number of FDI made by Finnish firms in Asia. This study therefore contributes to the literature of international business by focusing on firms based in Finland, a small - industrialized country, where the domestic-market conditions are very different from those of the multinationals from the USA or Japan that have dominated past research attention. Moreover, studies on the determinants of FDI rarely combine ownership-specific, location-specific, and internalization advantages with strategic motivations of firms in Asian markets. This is apparently the first study trying to analyze how different ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI behavior of Finnish manufacturing firms in Asian countries. It therefore presents new data on and new empirical insights into the determinants of the Finnish manufacturing firms to engage in FDI ventures in Asia.

This study empirically analyzes the Finnish manufacturing FDI based in China, India, Indonesia, Japan, South Korea, Malaysia, Pakistan, The Philippines, Singapore and Thailand. These Asian countries are chosen since they have earned remarkable reputations for strong economic performance through their well-sustained growth rates in the last

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<sup>5</sup> The terms "variable" and "advantages" are equivalent and can be used interchangeably.

decades (see Table 1). Also, in the coming years these countries are considered as a potential recipient of inward FDI by Finnish firms. Hence, an effort to determine influencing ownership-specific, location-specific and internalization and strategic advantages of FDIs in these Asian countries will not only be informative to the managers of Finnish firms, but also valuable to the officials of Asian governments in order to formulate a strategy to attract more investments.

### **1.5. The objectives of the present study**

The objectives of the present study is to obtain more knowledge regarding the foreign direct investment behavior of Finnish manufacturing firms in ten South and Southeast Asian countries from 1980 to 2000. More precisely, this study attempts to empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages influence the FDI choices of manufacturing firms in order to contribute to and develop the existing eclectic paradigm of international production. Thus the first objective of the present study will be:

I To contribute to the extension of the OLI framework of international production.

In recent years, Asian countries have played a major role in international trade and they have also become a major player with respect to FDIs (Vyas 2000). The newly industrialized countries (NICs), newly industrialized economies (NIEs) and China in Asia have emerged as among the most attractive investment locations and absorbed rising proportions of worldwide FDI outflows. The present study attempts to investigate how the different ownership-specific, location-specific, internalization and strategic advantages have influenced the location strategies of Finnish firms in South and Southeast Asian countries. Thus the second objective of the present study will be:

II To empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI location strategies of the Finnish manufacturing firms in Asian countries.

Once a foreign market is targeted, the expanding firm has to design an appropriate ownership strategies that will function successfully in a new business environment. The

present study attempts to investigate how the different ownership-specific, location-specific, internalization and strategic advantages have influenced the ownership strategies of Finnish firms in South and Southeast Asian countries. Thus the third objective of the present study will be:

- III To empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages influence the FDI ownership strategies of the Finnish manufacturing firms in Asian countries.

The above mentioned objectives will allow us to have a direct comparison between ownership-specific, location-specific, internalization and strategic advantages in order to explore the FDI behavior of the Finnish manufacturing firms in Asian countries. This study attempts to find new relationships and provide some extensions to the existing theoretical explanations of eclectic paradigms. However, there is no denying the fact that a large number of ownership-specific, location-specific, internalization and strategic advantages could and indeed do have the potential to affect FDI. A study of this nature cannot possibly include all of them. For this reason, this study selects ownership-specific, location-specific, internalization and strategic advantages that are considered to have the greatest influence on FDI, from the point of view of the host and home countries.

## **1.6. The contributions of the present study**

This study empirically analyzes the ownership-specific, location-specific, internalization and strategic advantages of Finnish firms in Asian markets in order to modify and extend the existing eclectic paradigm. This extended version of the eclectic paradigm will provide the researcher with better understanding of the importance of each ownership-specific, location-specific and internalization advantages and their clear relationship with the strategic motives in influencing the location as well as the ownership strategies of the Finnish firms in Asian countries. More precisely, this study will help us to further understand that the ownership-specific, location-specific and internalization advantages shouldn't be considered in isolation, but with reference to their strategic impact upon a firm's global strategic objectives.

Practically identifying ownership-specific, location-specific and internalization advantages and strategic motives influencing the FDI choices can also help the host governments particularly in Asia to design specific investment policies to attract FDI. As most of the Asian countries have recently been pursuing vigorous policies towards attracting foreign investments, they need to understand the importance of conditions in influencing the inflow of FDI from a western country like Finland.

To managers, such a modified and extended version of the eclectic paradigm will offer several advantages. This study will help them to identify the probable and possible contradictions that exist when diverse variables and strategic motives are considered collectively. It is often an unfortunate fact of corporate life that a particular FDI choice is rarely an unmixed blessing. This study will help the managers in the important and difficult task of prioritizing FDI considerations, and thus to be able to better focus their time and resources – which are often limited – on those variables most likely to lead to success in a given situation.

Finally, this study will demonstrate how conditional logic can be used to examine the location and ownership structure choices of FDI in other cases as well. As FDI continues to grow, the method could prove to be useful in examining the location and ownership structure decisions of firms in Africa, Eastern Europe, and other regions of the world.

### **1.7. The structure of the present study**

The goal of this study is to undertake the empirical analysis of the ownership-specific, location-specific, internalization and strategic advantages influencing Finnish manufacturing FDI's from 1980 to 2000 in ten South and Southeast Asian countries.

**Chapter 1** gives the introduction and outlines the background, objectives, contributions and scope of the study. The structure of the study is presented in Figure 1.

**Chapter 2** reviews some of the leading FDI theories explaining the growth of the firm and the foreign value-added activities they own or control. It can be said that due to the diversity of the theoretical explanations there is no unanimously accepted FDI theory. However all

those theories share one common feature – nearly all of them are related to outward foreign direct investment. This chapter ends with the argumentation for choosing the eclectic paradigm as the framework of the present study.

**Chapter 3** gives detailed explanations of the eclectic model. It is important to clarify the perspective taken in the present study on the ownership-specific, location-specific and internalization advantages and the detailed relationships between them, especially since the eclectic framework has been developed over time. The mainstream criticism has also been included those theories share one common feature – nearly all of them are related to outward foreign.

**Chapter 4** presents the four main strategic motives for investment. By identifying the strategic objectives underlying FDI projects, it becomes possible to analyze directly and explicitly the role of strategies in determining the propensity of the firms to undertake FDI projects. The chapter ends with some concluding remarks.

**Chapter 5** concentrates on the theoretical and empirical literature on the location strategies and discusses the crucial ownership-specific, location-specific, internalization and strategic advantages of the investing firm. It also presents the hypotheses measuring the FDI choices of Finnish firms in Asian countries. The chapter ends with some concluding remarks.

**Chapter 6** presents a detailed literature review of the ownership-specific, location-specific, internalization and strategic advantages influencing ownership strategies of investing firms and the hypotheses measuring the FDI choices of Finnish manufacturing firms in the Asian markets. The chapter ends with some concluding remarks.

**Chapter 7** provides a bridge between the objectives, theoretical and empirical setting related to the FDI choices of the Finnish manufacturing firms in Asian countries. In this chapter research methodology and the sample and characteristics of the participating firms are discussed. It also provides an overview of the statistical procedure used and the operationalization of the dependent, independent and control variables related to location and ownership choices of Finnish firms in Asian countries.

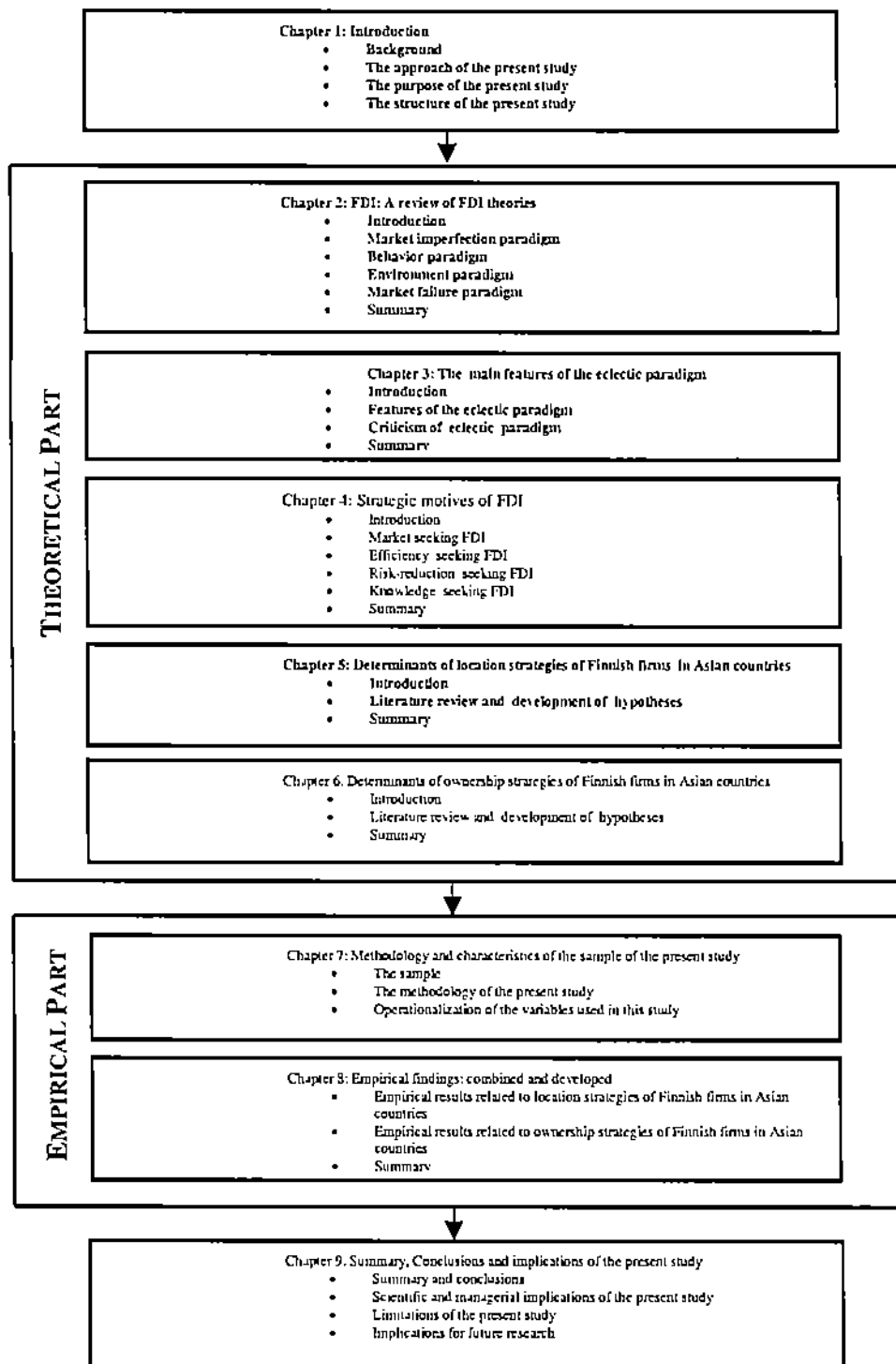


Figure 1. The structure of the present study



**Chapter 8** provides the results of the present study. The first part of this chapter deals with the testing of hypotheses and the model related to the location aspects of the Finnish firms in Asian countries. The second part of this chapter deals with the hypotheses and model related to the ownership strategies choices of the Finnish firms in Asian countries. Based on the empirical results, a summary and some concluding remarks are presented in the final part of this chapter.

**Chapter 9** discusses the contributions and implications of this study. The first subchapter provides a summary of the previous chapters of the present study. The second subchapter reviews the scientific and managerial implications of this research. Finally the thesis ends with a subchapter that contains suggestions for future research.

## **2. FOREIGN DIRECT INVESTMENT: A REVIEW OF THEORIES**

This chapter reviews some of the leading foreign direct investment (FDI) theories and explanations of the growth of the multinational firms. More precisely, this chapter attempts to discuss the strength and weaknesses of different conceptual frameworks. These theories and frameworks can be broadly divided into four paradigms: 1. Market imperfection paradigm, 2. Behavior paradigm, 3. Environment paradigm and 4. Market failure paradigm. There is a large diversity in theoretical explanations of international production and there is no unanimously accepted FDI theory. However, all these theories share one common feature – nearly all of them are primarily related to outward foreign investment. Rather, the use of particular paradigms and theories often reflects the issues addressed and questions asked. In addition to the general review of the FDI theories in the whole chapter, argumentations have been made for selecting the eclectic theory as the framework of this study. The chapter ends in a summary of all the reviewed FDI theories and arguments for choosing an eclectic theory as the framework of the present study.

### **2.1. Introduction**

There have been at least seven main theories that have proposed a way to analyze how firms choose between different FDI alternatives. These include Hymer's theory (1976), PLC theory (1966), Internationalization theory (1975), Location theory (1985), Internalization theory (1976), transaction cost theory (1986) and Dunning's eclectic theory (1980). However, in the field of international business, there is no general agreement on what should be labeled as theory, conceptual framework or paradigm. For instance, while Dunning (1988) regards the eclectic theory as a (general) theory, Cantwell (1989) suggests that it is a paradigm while Itaki (1991) describes it as a taxonomy of various determinants of foreign direct investment. As will be argued below, Dunning eclectic framework which is based on several theories, describes what factors influence FDI choices and could according to our conceptualization be characterized as a paradigm.

There are basically four specific paradigms in which all the theories and frameworks mentioned are grounded. The four different paradigms are market imperfection paradigm, behavioral paradigm, the environment paradigm and finally market failure paradigms. It is

crucial to first identify these four paradigms in order to further understand where the base of the theories has been born. Hymer's theory and the PLC theory belong to the Industrial Organization based market imperfection paradigm, which evolved from Bain's (1956) Industrial Organizational (IO) theory of the firm. The Internationalization theory belongs to the behavioral paradigm due to its foundation in Cyert and March's (1963) behavioral theory of the firm. Three of the more popular theories have their roots in Coase's (1937) theory of the firm. They are Dunning's eclectic theory, the internalization theory, and the transaction cost theory. These three comprise the market failure paradigm. The location theories finally belong to the environment paradigm.

**Table 3.** Classification of FDI-related theories

<b>Market Imperfection Paradigm</b> Hymer's theory Product life cycle theory	<b>Behavior Paradigm</b> Internationalization theory
<b>Market Imperfection Paradigm</b> Location theories	<b>Market Failure Paradigm</b> Internalization theory Transaction cost theory Eclectic theory

The market imperfection paradigm was the dominant paradigm of the sixties and early seventies when the behavioral paradigm took over and appeared to dominate till the latter part of the 1970's. The market failure paradigm appears to have dominated from the late 1970's through the present.

The rest of the chapter is organized in the following way. Section 2.1 discusses the market imperfection paradigm. The Behavior paradigm is discussed in section 2.2. The Environment and Market-failure paradigms are elaborated in sections 2.3 and 2.4. Finally section 2.5 provides concluding remarks and precisely the arguments for selecting the eclectic theory as the framework of the present study.

## 2.2. Market imperfection paradigm

Basically, the market-imperfection paradigm as described earlier comes from Bain's theory of the firm. Bain's (1956) theory assumes that (1) competition among firms in an industry is imperfect and (2) the maintenance of such competition is essential for continuous above-normal returns on investment (ROI). Industries with fewer competitors and higher entry

barriers reap above normal returns (Porter 1980). Therefore firms create imperfect markets by controlling the number of existing and potential customers. This can be accomplished in two ways. First, firms reduce the number of competitors by engaging in mergers or acquisitions or by forming strategic alliances. Firms can also reduce the number of potential customers by building higher entry barriers to the industry through heavy investment in capital-intensive production or in differentiation of products (Caves 1980; Porter 1980). By these means, firms can create a less certain environment, lessen competition, enjoy increased market share, control output and prices and achieve an above - normal ROI (Bain 1956). Under the imperfect-market paradigm firms attempt to control markets by reducing rivals. Within this framework fall both the PLC theory and Hymer's theory. The tendency of a firm to close markets at home is carried to foreign markets as well (Vernon 1966; Hymer 1976; Datson 2000). When deciding the entry-mode choice, the firm chooses the mode that removes existing competition or minimizes the possibility of new competition entering the market.

### **2.2.1. Hymer's theory of international production**

This theory emerged from Hymer's doctoral dissertation (written in 1960, published in 1976). The study focused on FDI operations of U.S. firms. Hymer showed that the orthodox theory of international trade and capital movement did not explain the foreign operations of the firms. In particular, it did not explain two-way flows of FDI between countries, and still less between countries with similar factor proportions. His explanation of why firms move abroad and establish international production was based on a theory of the firm and industrial organization. Hymer viewed the firm as an agent for market power and collusion. It comes in both Marxist and non-Marxist versions, the latter dating back to Baran and Sweezy (1966). Two of the clearest recent statements of this framework can be found in Newfarmer (1985) and Cowling and Sugden (1987).

Hymer argued that a firm having a monopolistic advantage in a product market or factor market have an added incentive to engage in international operations. The advantage creates a certain degree of market imperfection in a host country (Kindleberger 1969). Therefore, an entry mode that allows a firm to completely appropriate rent on its advantage

is chosen. Rent is defined here as Return on Investment. Some key studies published on Hymer's theory are those of Gruber, Mehta and Vernon (1967), Horst (1972b), Kim and Lyn (1990), Kindleberger (1969), Knickerbocker (1973), and Lall (1980a). There are three main assumptions to Hymer's theory: (1) The possession of a monopolistic advantage is a prerequisite for a firm's foreign operations. (2) A market for a firm's advantage is imperfect. (3) An above normal return on a firm's investment depends upon reduction of its competition.

**Table 4.** Studies using Hymer's theory

Researcher	Focus of the study
Gruber, Mehta & Vernon (1967)	FDI by US firms
Miller & Weigh (1972)	US investment in Brazil
Lall (1980)	FDI by US firms

The two main constructs of the theory are the "monopolistic advantage" of the firm and the degree of "market imperfection". "Monopolistic Advantage" of the firm relates to an advantage that no host country firm has or can acquire transferability from the home to the host country (Kindleberger 1969). The advantage should be sufficient enough to outweigh any potential disadvantage arising from the host country operation (Hymer 1976). This advantage could lie in production or distribution (Hymer 1976; Kindleberger 1969). "Market Imperfection" stands for a limited number of buyers to its advantage. This could be attributed to conditions like a small number of buyers, difficulty in the advantage evaluation, or the inability to get parties to arrive at a satisfactory contract. The higher the degree of market imperfection, the lower the probability that the firm may be able to receive a higher return on investment (ROI) from its advantage by licensing it. Therefore, internalizing a firm's own operation would be most efficient. However, if there are a lot of buyers, there should be fewer monopoly problems, a better evaluation of advantage, and a potentially higher ROI.

Hymer's theory has found considerable empirical support. Hymer's contention that a firm's possession of a competitive advantage is necessary for it to successfully enter an international market has found empirical support in numerous studies. These include,

Miller and Weigel (1972), who studied U.S. firms investment into Brazil and found that investing firms had an advantage over local firms in the form of R&D intensity or capital intensity prior to entry. Lall (1980a) found that a product differentiation advantage helped U.S. industries promote foreign direct investments.

Before Hymer's theory (1976), FDI was considered as a firm's investment in a portfolio of assets. Hymer argued to treat FDI as an industrial phenomenon rather than as a portfolio of assets. Following Hymer's work, FDI theories no longer paid tribute to FDI as a portfolio of assets. He set the stage for Dunning (1980) and Vernon (1966). Hymer's theory has also made contributions to the entry mode literature initiating other theories like Knickerbocker's (1973) and Vernon's (1966). Furthermore the terms "advantage" and "market imperfection" have continually been important tools for other researchers through the years. The key limitation of this theory is that it assumes a complete static view of firms' advantage along with a limited range of applicability in today's context.

### **2.2.2. Product life cycle theory**

Until the early of 1960s it was assumed that international trade and investments were mainly driven by economic factors (Chadprapalert 2000). Technological changes and the rapid growth of multinational corporations (MNCs) made it soon apparent that the traditional theories based on economic advantage were no longer useful in explaining trade patterns. Raymond Vernon (1966) used a micro-economic concept – the product cycle - to help explain a macro-economic phenomenon, viz. the foreign activities of US firms in the post-war period. His starting point was that in addition to immobile natural endowments and human resources, the propensity of countries to engage in trade also depended on their capability to upgrade these assets or to create new ones, notably technology capacity. He also hypothesized that the efficiency of firms in organizing these human and physical assets was, in part at least, of country-specific origin.

During earlier stages of a products life cycle exporting to target country's markets in order to satisfy demands is appropriate. This initially establishes a competitive position, which may deteriorate as a product reaches later stages in its life cycle. When the deterioration process starts the firm should shift from export to FDI to maintain a position in that market.

Therefore, the PLC theory suggests that the FDI choices should correlate with the life cycle stage of the product. There are three key assumptions to the PLC theory: (1) Products continually undergo changes over their life cycles; (2) Firms adopt FDI operations in foreign markets when their competitive positions appear to be eroding (Vernon, 1966); (3) Home country firms have an advantage over other firms in their own country because the information flow across borders is not cost-free.

In the innovation stage, manufacturers locate production facilities in their home country for a number of reasons: (1) Greater awareness of the market; (2) A greater awareness of feedback to product performance; (3) They have a monopolistic price advantage due to low price elasticity; (4) They have fewer degrees of freedom in the choice of location of production, processes of production and inputs due to lack of standardization (Vernon 1966). Here firms will satisfy any foreign demands by exporting. According to the PLC theory, as the product enters the maturity stage of the life cycle competitive firms start producing substitutes of the innovative firm's product. Therefore, the exporting firm now feels threatened and is forced to locate a production facility in the host market.

This approach to explaining foreign production was essentially an extension of the neo-classical theory of the spatial distribution of factor endowments to embrace intermediate products, together with an acknowledgement that strategic factors, arising from an oligopolistic market structure in which firms were observed to compete, influenced the response of firms to these endowments. It also introduced some novel hypotheses regarding demand stimuli, technology leads and lags, and information and communication costs, which have subsequently proved useful tools in the study of foreign production and exchange (Dunning 1993:71).

Most empirical studies demonstrate that the exports of products tend to be greater in the early stage as opposed to the later stage of the product life cycle. Horst (1972b) observed that exports of U.S electronic products are more competitive in the growth than the maturity stage. Possibly the most detailed study by Wells (1969) found that the exports of U.S. made consumer durables for a higher income consumer was higher in the newer than the older version. Poh's (1987) study examined performance of the UK electronics industry

and found a similar result as Wells. These studies fail to document any correlation between sales volume and the movement of exports through FDI.

The PLC theory recognizes the continual advances against a firm's competitive advantage due to new and continually improved competition. It is considered an important advancement over Hymer's theory about the static nature of a firm's advantage. However, inside the market imperfection paradigm a firm reacts to maintain competition when its advantage is threatened. A firm enters a market through FDI to be able to compete more effectively from inside.

**Table 5.** Studies using PLC approach

Researcher	Focus of the study
Wells (1969)	US made consumer durables
Hirsch (1972)	US electronics products
Poh (1987)	UK electronics industry

However although, the theory has made some crucial contribution to the FDI theories and the nature of a firms' competitive advantage. There are a number of constraints on the theory. Firstly it is no longer considered useful in explaining FDI. Its applicability appears to be limited to highly innovative industries. Buckley and Casson (1976) even argued that the theory is an over-simplification of the firm's decision-making process. They further pointed out that it was originally based on US experiences. Vernon (1971a) also admitted that the PLC theory did not capture the complex sociological, political and idiosyncratic factors influencing investment behavior. The PLC theory has been used by Knickerbocker (1973) to explain the framework of the oligopolistic structure of certain U.S. industries engaged in FDI operations. It has been found that US technological leadership is no longer a significant factor and many product innovations come from newly emerging countries like Japan and South Korea.

Secondly, the theory is also criticized for not addressing strategic organizational issues. Since the competitive advantages of firms were assumed to be country-specific, little attention was paid to the kinds of advantages that arose specifically from internalization of cross-border markets. In a later contribution, however, Vernon (1983) did explicitly



identify the reduction of organizational risk as a motive for, and determinant of, FDI (Dunning 1993:71). Thirdly, PLC theory also fails to meet testability and the empirical verifiability is made very difficult by correlating the stage of the product with the marketing efforts of the firm. Finally, the PLC theory may be outdated today due to increased information and technology that plays an ever-increasing role in the marketing.

### **2.3. Behavior paradigm**

In this paradigm, a firm operates in imperfect markets (Cyert & March 1963) mainly because of a lack of information about the specific market. The knowledge of a firm grows gradually over time and therefore it should also gradually increase its resource commitment. Initially it should be concerned with satisfying rather than maximizing profits. Inside this framework lies the Internationalization theory.

#### **2.3.1. Internationalization theory**

The internationalization theory argues a gradual pattern of expansion into international markets. Get your toe wet first and see how cold the water is. This theory originated in the 1970's at the Uppsala School (Johanson & Weidersheim-Paul 1975; Johanson & Vahlne, 1977). The theory proposed to explain how firms get initially involved in foreign market entry and how they determine resource commitments. The theory has been used to explain market selection (Luostarinen 1970 & 1979, Johanson and Vahlne 1977; Davidson 1980; Erramilli 1991), and the role in explaining other FDI choices as well.

The Internationalization theory has two constructs "market commitment" and "market uncertainty." Market uncertainty refers to the lack of ability to estimate the present and future market factors due to lack of experience, demand, competition and the market itself. This "market uncertainty" should lead a firm to take a more conservative, learning approach. The internationalization theory argued that initially a firm makes no resource commitment to any market. A firm sells its products into international markets through exporting mainly through trading companies. When a firm initially enters an international market it lacks adequate market-specific knowledge and therefore has a high degree of market uncertainty. With a high degree of market uncertainty the firm makes a minimum

degree of market commitment. Initial operations in a foreign market enable a firm to gain knowledge, which can lead to a decrease in market uncertainty. If market uncertainty declines to a low point and a firm sees an opportunity to expand further into the market then the firm increases its market commitment gradually. This movement could in turn lead to a lower level of market uncertainty and higher market commitment. The market entry mode along with the commitment continues in this manner. The firm may choose higher market commitment modes at the time of entry if the host market appears very attractive since lower commitment modes may be insufficient to meet market demands (Johanson & Wiedersheim-Paul 1975).

**Table 6.** Studies using Internationalization approach

<b>Researcher</b>	<b>Focus of the study</b>
Johanson & Wiedersheim-Paul (1975)	Swedish firm
Erramilli (1991)	US service firms
Sharma & Johanson (1987)	Swedish Technical Consultancy firms

Firms are also assumed to enter markets successfully at an increasing distance from the home country, not only in terms of physical distance but also in terms of difference of economic development, culture, political system and so on. Luostarinen (1979) refers to the so-called physical, cultural and economic distance that together is referred to as the "business distance." In other studies, Nordic researchers have only used cultural and geographical parameters and they are referred to as "psychic distance." In short, firms prefer to first enter markets they know best, which hence are "closer" than more "distant" markets, which are entered at a later stage.

Johanson and Wiedersheim-Paul (1975) found significant support for the theory while studying Swedish firms. While studying U.S. exporters, Bilkey and Tesar (1977) and Cavusgil (1984) also found support for a multi-stage commitment. In a study of UK manufacturing firms, Millington and Bayliss (1991) reported that firms rely on market experience and staged adjustment to their internationalization process especially in the early stages. There has also been some resistance to the theory. More specifically, Erramilli (1991) reported that as the experience of service firms increased, their desire for control

followed a U-shaped pattern rather than an upward sloping curve as expected in internationalization theory. Also, Sharma and Johanson (1987) reported that international patterns of Swedish Technical Consultancy (TC) firms do not follow the Internationalization model.

The internationalization process model has been criticized as being deterministic. This theory claims that the firm will start at stage a), then it will go to stage b) etc. The firm's ability to make strategic choices regarding appropriate modes of entry into overseas markets is denied (Root 1987; Anderson 1997). Furthermore, the internationalization process model is also considered as primarily suitable for firms at an early stage of internalization. Also, the relative importance of psychic and business distance has decreased since the 1970s after the advances in information technology tools. It is found in many studies that now firms move faster in this internationalization path and may by-pass some stages of the model (Nordström 1991; Luostarinen / UN-Wider 1994; Boros-Torstila 1999:45). Therefore time, increased technology and today's globalization might have turned the internationalization theory into an ineffective model for most of the firms today.

## **2.4. Environment paradigm**

This paradigm covers a body of literature that sees foreign operations of a firm as a function of location-specific factors. The majority of work under this paradigm analyzes host country factors against the operation of a firm. The more common factors have included economic, cultural, infrastructural and social factors. Most studies implied that firm's enter foreign markets through foreign direct investment (FDI) to carry out host country production and marketing operations (Root 1987). FDI choices range from larger to less resource commitment to host operations.

### **2.4.1. Location theories**

These theories attempt to explain the impact of host-country location-specific factors on a firm's FDI choices (Davidson & McFetridge 1985). The specific factors can be classified as Ricardian endowments or environmental variables. Ricardian endowments include raw materials, population, potential markets, etc. The environmental variables consist of

political, cultural, legal and infrastructural factors of a host country market. According to Korbin (1976) these variables are crucial to a firm as they affect the success of the operations and the achievement of its goals. A number of studies have analyzed the relationship between host country location-specific variables and a firm's FDI choices.

Ricardian Endowments of a specific country market consist of any natural resources that exist inside the country. The majority of studies have analyzed the effect of the market size (demand size) variables on a firm's entry mode choice. There have been very few studies that explore the impact of host country raw materials and labor force (supply side) variables on a firm's entry-mode choices.

The market size of a country indicates the industry size of a market inside the country or the potential to absorb a firm's production output (Agodo 1978). According to Aharoni (1966), the host market size is a key determinant of the FDIs. The studies that have found a strong relationship between market size and the potential of FDI operations include Aharoni (1966), Korbin (1976), Green and Cunningham (1975), Agodo (1978), Davidson (1980), Sullivan (1985) and Sabi (1988). The empirical evidence consistently suggests that the market size of a host country is a key component of FDI behavior of a firm in a particular country market. The larger the market, the better potential exists to conduct FDI to carry out production or marketing. Licensing or other less resource commitment modes would be more ideally suited for smaller markets (Davidson and McFetridge 1985).

A large population size coupled with availability of raw materials was considered a key determinant of success for U.S. FDI in Africa (Agodo 1978). Bass, McGregor and Walters, (1977) and Moxon (1975) argued that the size and local skilled labor force were to be considered key determinants of success for U.S. firm's foreign plant location decision. The correlation of these studies therefore shows the importance of raw materials and skilled work force to the success of production and marketing operations. The four most frequently studied environmental areas include political, cultural distance, host government policies and host country infrastructure factors.

The relationship between entry-mode choices and the environmental profiles of various countries was also analyzed by Goodnow and Hansz (1972). They concluded that U.S. firms use lesser control modes while moving from “hot” to “cold” countries, the lesser control modes referring to overseas agents and distributors while moving to higher control modes such as wholly owned subsidiaries (WOS). In their sample, they profiled each country within a construction of fifty-nine variables. The variables were representative of seven environmental segments: (1) economic development, (2) cultural unity, (3) legal barriers, (4) physiographic barriers, (5) geo-cultural distance, (6) market opportunity and (7) political stability. They further defined “hot” countries as countries that scored high on political stability, market opportunity, economic development and cultural unity and scored low on legal barriers, physiographic barriers and geo-cultural distance. They defined “cold” countries as exactly the opposite while defining a moderate country as anything falling in between.

**Table 7.** Studies using Location theories

<b>Researcher</b>	<b>Focus of the study</b>
Bass, McGergor & Walters (1977)	US firms in Asia, Latin America and Europe
Root & Ahmed (1978)	US FDIs
Davidson (1980)	FDI by the US firms
Anderson & Coughlan (1987)	US electronic firms

A number of studies have analyzed the impact of a host country’s political environment on the FDI decision of U.S. firms. The literature appears to be fragmented and split down the middle on the question of whether or not the political environment and conditions of a host country significantly affect the FDI decision. The studies of Aharoni (1966), Goodnow and Hansz (1972), Agodo (1978), Root and Ahmed (1978), Korbin (1978), Root (1987), and Fatehi-Sedeh and Safizadeh (1989) support the significance of impact of host country’s political stability, while Bennett and Green (1972), Cunningham (1975) and Korbin (1976) found no significant impact.

Root and Ahmed (1978) discovered that a host country’s tax policy (corporate) does affect the attractiveness of the country market for U.S. FDI. On a similar note, Bass, McGregor

and Walters (1977) found that managers consider a host government's attitude to and cooperation with foreign investors as an attraction to locate FDI within a country market. Other determinants formed by a host government have also constituted similar FDI attractions to a market. The effects of a screening process and government restrictions on equity holdings in a country's market could be viewed as a deterrent to a market as well (Davidson & McFetridge 1985). A firm's decision to locate its production or marketing operations in a host country market can be significantly influenced by various determinants of host governmental policy. When viewing economic, political or social variables government policy is likely to be a decisive factor or determinant of FDI in a country (Root & Ahmed 1978).

Infrastructure is another important factor or variable in determining a market's attractiveness. The infrastructure is necessary for smooth and efficient performance (Agodo 1978). Infrastructure can include roads, railways, airports, telecommunication lines, information access, banking facilities. Agodo (1978) studied U.S. firm's FDI in African nations. He found a significant relationship between FDI and the quality of business infrastructure of some African regions. Bass, McGregor and Walters (1977) studied plant location decisions of U.S. firms in Asia, Latin America and Europe. Their study suggested that four infrastructural factors were extremely important: (1) cost of site development, (2) land and construction costs, (3) level of industrialization and (4) potential growth. The presence of an efficient infrastructure should be an important variable in the host country production or the marketing operations of a firm in today's information related world.

Davidson's (1980) study suggested that U.S. firms use FDI operations in similar cultural markets. Other studies followed the same empirical findings as Maclayton, Smith and Hair (1980) who suggested that U.S. healthcare firms stay in similar cultural markets, while Anderson and Coughlan (1987) found that U.S. electronic firms chose less integrated channels when entering Japan and Asian markets when compared with market entry into Western European markets where they chose fully integrated channels. The theoretical work covering the impact of cultural distance on entry-mode choice is fragmented at best. The real variables of a host country that can be measured are economic and political. It

could be inferred that a firm would ideally locate production or marketing facilities in a culturally similar market but sometimes opportunities behavior justifies rational decisions.

As discussed, location theories can be effectively used to analyze an impact of host country factors on FDI choices of the investing firm. The real contributions of location theories to date is the increasing economic understanding related to host country market factors and their overall impact on FDI choices. It does not, however, generate other attributes associated with the firms. Hence location theories have been criticized for only providing a partial explanation of FDI.

## **2.5. Market failure paradigm**

This paradigm evolved from Coase's (1937) theory of the firm in which the firm and the market are two alternative modes that can be used to accomplish an economic function at a specified location. The choice of mode depends upon the most efficient mode and the type of competition. The theory has two types of competitive environments: (1) perfect competition and (2) imperfect competition. In perfect competition the market mode is more efficient than the firm. When the market becomes imperfect the cost of transactions becomes high. The market is said to have failed to efficiently perform economic activities for the firm. Here, a firm is better off in performing the function by itself .

There are three theories that are based on Coase's (1937) theory of the firm: the internalization theory, the transaction cost theory and the eclectic theory. These three theories together comprise the full market failure paradigm. There is a slight mechanism difference of market failure in the three theories. In the transaction cost theory (TC), market failure could occur after the commencement of a transaction with an agent. The agent could prove to be valuable over time because of the build up of transaction-specific assets. However, in the internalization theory market failure should occur prior to a transaction between a firm and an agent.

### **2.5.1. Internalization theory**

In this theory, firms grow by internalizing international markets for intermediate products. The product markets include firm-specific knowledge, skills and technology among other

things. This theory was launched by Buckley and Casson (1976), who attempted to explain a growth of multinational corporation phenomenon in U.S. and British multinationals after the World-War II era. The theory sets conditions that create a need to keep knowledge in-house. This makes a wholly-owned subsidiary (WOS) more attractive than licensing. Furthermore this theory also argued that firms grow and expand their operations internationally due to a lack of markets for firm-specific assets, i.e., the markets for key intermediate products such as human capital, technology, management expertise, and the like, are considered imperfect. Most of the literature contribution has been from Buckley and Casson (1976), Calvet (1981), and Rugman (1982).

The two main constructs of the internalization theory are the degree of “market failure” and “firm-specific knowledge.” To further define the constructs, firm-specific knowledge refers to skills and technology that are unique to the firm and market failure occurs when there are a limited number of buyers for the firm-specific knowledge (Datson 2000). Internalization theory is primarily concerned with identifying the situations in which markets for intermediate products are likely to be internalized, and hence those in which firms own and control value-adding activities outside their natural boundaries. Like earlier attempts to explain the growth of domestic firms (Penrose 1959), it seeks to explain the international horizontal and vertical integration of value-added activities in terms of relative costs and benefits of this form of organization relative to market transactions. Buckley & Casson (1988) argued that multinational hierarchies represent an alternative mechanism for arranging value-added activities across national boundaries to that of the market, and that firms are likely to engage in FDI whenever they perceive that the net benefits of joint ownership of domestic and foreign activities, and the transaction arising from them, are likely to exceed those offered by an external trading relationship. The core prediction of internalization theory is that, given a particular distribution of factor endowments, firm activity will be positively related to the costs of organizing cross-border markets in intermediate products.

The foreign market entry mode choice is the most efficient mode of a set under perfect market conditions. The failure of the market could arise from factors such as buyer uncertainty, less availability of buyers or difficulties in having the most effective contract.



If a firm decides to license out its own knowledge, market failure conditions can decrease the probability of full returns on its knowledge (Datson 2000). For example, buyers would be uncertain about estimates of a firm's knowledge because of the inability to assess others in a market as a result of market failure. Buckley and Casson (1976) contend it is difficult and expensive to write and police contracts. Therefore, the theory contends that the costs outweigh the benefits to the market costs. The higher the degree of market failure for a firm's knowledge, the greater the incentive to choose wholly-owned subsidiary (WOS) over licensing. The theory has limitations in only explaining the decision between WOS and licensing.

Datson (2000) argued that the lack of empirical support for its predictions is a key limitation of the internalization theory. The reason may be the difficulty of operationalization to the extent of market failure for intermediate products. This theory differs from the traditional perfect competition theory of the firm mainly due to the assessment of competition. The internalization theory assumes that markets are imperfect for certain types of firm-specific knowledge. The difference was an important inference over the traditional view of the firm. The main assumptions of the theory are: (1) The firm and the market are two alternative modes of performing an economic function; (2) The goal of the firm is to maximize long-term profits; (3) Certain intermediate products are imperfect. The theory fails to provide any means of operationalizing in a given host country.

The mode-choice mechanism in the theory is too general to operationalize. It is too difficult to estimate a cost-benefit point to understand. This makes the testability of the models uncertain. Buckley (1988) expressed similar reservations about the testability of the theory. Casson (1987), Kumar (1987) and Dotson (2000) further argued that the internalization idea is useful only if these costs are not more than the benefits of internationalization arising from reducing time, avoidance of bargaining and buyer uncertainty and minimization of the impact of governmental intervention, the benefit being transfer pricing or discriminatory pricing. Therefore, this theory has failed to attract the interest of U.S. researchers. The majority of work on the internalization theory has remained confined to British academics and economists. The internalization theory is important because of its

advantage over the perfect competition theory of the firm but it suffers from testability problems.

### **2.5.2. Transaction cost theory**

The transaction cost (TC) theory of entry mode choice was originated by Williamson (1975). Among the first to apply the TC theory to analyze entry mode choice were Anderson and Gatignon (1986). Most studies in this framework have followed the original framework and include the works of Anderson and Gatignon (1986), Anderson and Coughlan (1987), Erramilli and Rao (1993), Anderson and Gatignon (1988), Hennart (1988, 1989), Klein (1989), and Klein, Frazier and Roth (1990).

The main constructs of the TC theory of entry mode choice is “transaction-specificity”. The transaction-specificity of an asset refers to a firm’s investment that is required to facilitate or complete a transaction. An investment can be made in physical hard assets, human assets or tangible assets. It is argued that when specificity is high, the specific assets in question cannot be easily redeployed in other usages. However, if specificity is low, assets could be deployed in the other beneficial means (Datson 2000).

Williamson (1985) proposed that transaction cost occurs when a product is transferred across sequential stages of a production process under alternative governance structures. The most critical dimension is asset specificity. In addition, transaction cost economies maintain that cost occurs due to the combined ramification of the latter coupled with bounded rationality and opportunism. Williamson (1987) refers to “the world of governance,” in which firms seek to “organize transactions so as to economize on bounded rationality while simultaneously safeguarding them against the hazards of opportunism.” Two other factors affect the nature of these transactions; namely, uncertainty related to the completion of the contract and the frequency of these transactions. Hence, incentives for other operation modes than FDI through vertical integration become weaker as transactions become progressively more idiosyncratic, due to the less transferable nature of both human and physical assets, which become more specialized to a single use (Williamson 1987). In this way vertical integration brings the liberty to make adaptations in a sequential way and a presumption of joint profit maximization brought by single ownership. Furthermore,

adjustments are implemented at whatever frequency in order to maximize the joint gain to the transaction (Williamson 1987). Efficiency through proper matching of governance structures to the attributes of transaction is the central advantage of bypassing intermediate markets in the Williamsonian framework (Borsos-Torstila 1999:36).

**Table 8.** Studies using transaction cost approach

Researcher	Focus of the study
Anderson & Gatignon (1988)	Entry mode choices by US firms
Klein, Frazier & Roth (1990)	Entry modes
Erramilli & Rao (1993)	Entry decisions of the service firms

In the last decade applications of TCA have become fairly common in entry-mode investigations (Anderson & Gatignon 1986; Anderson & Coughlan 1987; Anderson & Gatignon 1988; Klein et al. 1990). The TCA seems to be especially effective in explaining vertical integration decisions, and has been used to predict entry modes for manufacturing firms as well as for service firms (Erramilli & Rao 1993). Most of the studies of foreign market entry modes have, however, made some modifications of the transaction cost theory (Erramilli & Rao 1993). The most important motivations for these modifications are to include non-transaction cost benefits flowing from increased control or integration, such as co-ordination of strategies in multinational corporations (Kobrin 1988), to extend market power (Teece 1981), and to obtain a larger share of the foreign enterprise's profit (Anderson & Gatignon 1986). The modified TCA predicts a positive relationship between asset specificity and propensity for high-control entry modes. The strength of this relationship is, however, contingent upon the influence of moderating factors such as external uncertainty (Anderson & Gatignon 1986; Kogut & Singh 1988a; Erramilli & Rao 1993), internal uncertainty (Anderson & Gatignon 1986) and firm size (Erramilli & Rao 1993).

It must be noted here that Erramilli and Rao (1993) questioned the general nature of contention for lower assets-specificity conditions. Their argument states that when the cost of integration is low and the ability of a firm to integrate is high, the firm is more likely to choose a higher control mode than a market mode because integration provides a firm with

non-transaction cost benefits like extension of market power, larger share of profits and execution of global strategies. Therefore, this argument restricts the TC framework in explaining entry mode choice under low assets specificity conditions.

The TC theory provides an effective framework for analyzing decisions that are important to the strategic operations of a firm. The theory can be used to choose wholly owned subsidiary or joint ventures (Hennart 1988), make or buy components (Walker & Weber 1984), or hire sales personnel or use independent representatives (Anderson & Weitz 1986).

### **2.5.3. Eclectic theory**

The eclectic theory consists of firm-specific advantages (ownership-specific advantage), location-specific advantage, and Buckley and Casson's (1976) internalization concepts as an internalization advantage. The theory blends the traditional trade theory with the internalization theory. It covers trade as well as foreign production operations of the firm and the combination of theories allows it more explanatory power than the theories in which it blends. The eclectic theory is not an alternative framework in the same sense, since it incorporates elements from different approaches and can be applied equally well at the micro or macro levels. It is rather an overall organizing paradigm for identifying the elements from each approach which are most relevant in explaining a wide range of various kinds of international production, and the wide range of different environments in which international production has been established (Cantwell 1991).

The eclectic theory generates a set of conditions of ownership-specific, internalization and location-specific advantages that explain a firm's choice of an entry mode for a set of export, licensing and ownership-based modes such as wholly owned subsidiary (WOS). Important contributions to the theory are Dunning (1980), Sabi (1988), Yu and Ito (1988), Agarwal and Ramaswami (1992).

The three key constructs that explain FDI choices are "ownership-specific", "location-specific" and "internalization" advantages. Ownership-specific advantages are firm-specific assets. Assets are reflected by the firm's size; multinational experience and skill by the firms' ability to develop differentiated products (Dunning 1993). Ownership-specific

advantages need to be both unique and sustainable in order to provide the firm with a competitive advantage in the FDI choices (Brouthers et al. 1999). Location-specific advantages reflect how attractive the specific country is, and the attractiveness of a country has been characterized in terms of its market potential and investment risk (Root 1987). In addition, measures of location advantages include similarity in culture, market infrastructures and the availability of lower production costs (Dunning 1993). Finally, the internalization advantage is concerned with the cost of choosing a hierarchical mode of operation over an external mode (Dunning 1988 & 1993). The eclectic framework has been further developed by Hill et al. (1990) and by Kim & Hwang (1992), who include strategic variables, and by Woodcock et al. (1994) where choice of entry mode is based on the contingency characteristics of resource requirements and organizational control factors. The eclectic theory has also been applied to analyze entry modes for small and medium-sized enterprises and in the service sector (Brouthers et al. 1999).

The eclectic framework further argues that the significance of each of these advantages and the configuration between them will vary among industries (or types of value-added activities), regions or countries (the geographical dimension) and among firms. Thus there are likely to be country-specific differences in the ownership-specific advantages of (say) Korean firms compared with (say) Canadian firms. The extent of market failure influencing whether or not the market for the technology is internalized is likely to be different in (say) the semi-conductor industry; while the relationship to the comparative location-specific advantage of Thailand and Taiwan as a manufacturing base for motor vehicle may be differently regarded by (say) the Toyota than (say) the Honda Corporations (Dunning, 1990).

The eclectic theory provides a multi-theoretical approach for studying the FDI choices: internalization theory, resource-based theory and transaction cost theory are the basic theories used. It is rather an overall organizing paradigm for identifying the variables from each approach that are most relevant in explaining a wide range of different environments affecting the entry mode choices of the investing firms. The eclectic theory claims that the FDI occurs when all three types of advantages are beneficial. The eclectic theory permits researchers to create determinants in order to predict FDI choices. The strengths of the

theory could be characterized by its richness (several explanations) and its creativity (generations of new determinants and combinations of these and the existing determinants). The strengths represents, however, also potential weaknesses (Anderson 1997). The strongest criticism of the theory has been derived from Itaki (1991). Itaki (1991) claimed that an ownership-specific advantage actually comes from an internalization advantage. Therefore, it is redundant to consider these as two separate determinants. Also, Dunning's theory has been called ambiguous about the sources of location-specific advantages. Despite these shortcomings, Dunning's theory is considered by many as one of the more comprehensive frameworks for FDI choices. Thus, the OLI approach has been selected as the framework in this study because of the above-mentioned integrative nature of the approach.

## **2.6. Summary**

The main goal of this chapter was to analyze the strengths and weaknesses of different conceptual frameworks based on the principles of theory evaluation. More precisely, the purpose was to find arguments for selecting the eclectic paradigm as the framework of the present study. Theoretical diversity (see Table 9) is expected in the field of economics of international production as much as in any other areas of economics. It is therefore difficult to formulate a single theory that can explain all forms of foreign trade and production. It is also fully accepted in the literature (e.g. Dunning 1993:74) as well that inter industry trade needs different explanations than intra industry trade, and that any theory of the firm critically depends on the assumed motivations of the firm.

There are basically four specific paradigms in which all of the seven theories and frameworks described earlier in the chapter are grounded. Firstly, the market imperfection paradigm describes that imperfect competition and monopolistic advantage. Under the imperfect market paradigm firms attempt to control markets by eliminating rivals. Secondly, the behavioral paradigm argues about market commitment and market uncertainty. The knowledge of a firm grows over time and therefore it should also gradually increase its commitment. Thirdly, by focusing on the host country factors against the operations of a firm environment paradigm introduces a dynamic view of the FDI

choices. The most common factors have included economic, cultural, infrastructural and social factors. Finally the market failure paradigm explains that the choice of entry mode depends upon the most efficient mode and the type of competition.

Over the last decade most empirical research on entry modes have used either transaction cost approach or an eclectic framework. However, a number of the predictor variables are difficult to measure, and different operationalizations have been suggested. For instance, asset specificity has usually operationalized this construct at the tactical (i.e. product and process) levels, while Aulakh and Kotabe (1997) have operationalized this construct at a strategic (i.e. investment and technology) level. Most of the studies have found a positive relationship between asset specificity and high-control entry modes. However, the latter study found a weak negative relationship. Operationalization, which Aulakh and Kotabe (1997) characterize as being at a tactical level could be closer to the transaction level than measures at the strategic level. When measuring at the level of firms, it could be more difficult to separate the effects of internal uncertainty from the effects of asset specificity. Therefore it has been argued (e.g. Andersen 1997) that the relationships between the explaining factors and entry modes are still unclear. Furthermore, future studies based on transaction cost approach should pay more attention to increasing our understanding of the nature of these relationships.

Dunning's eclectic theory is criticized for not sufficiently theorizing the relations between the three advantages, particularly for not making a clear distinction between the internalization and ownership-specific advantages. Aliber (1983) also criticizes Dunning for a narrow focus on firm-level strategies that fail to recognize market imperfection caused by variation in currency values. However, Dunning later re-appraises his model to incorporate inter-firm relationships and strategic alliances (Dunning 1995 & 1998). Dunning (1995) argues that because of the emergence of "alliance capital" (based on flexible inter-firm transactions and arrangements) over "hierarchical capital" (based on traditional arms-length arrangements), the eclectic paradigm needs modification in explaining FDI. More specifically, Dunning (1995) suggests that the organization-specific advantages should be broadened to take explicit account of costs and benefits derived from inter-firm relationships and transactions, particularly costs and benefits that arise from

Table 9. Important FDI theories

Researcher	Theory	Focus of the theory	Main criticism on the theory
Hymer (1960)	Partial	Characteristics of FDI in general	It assumes a completely static view of the firms' advantage along with a limited range of applicability in today's context.
Vernon (1966)	Product life cycle theory	Explained FDI from developed to developing countries.	Its applicability appears to be limited to highly innovative industries and it was originally based on American experiences.
Luostarinen (1970 & 1979) Johanson & Wiedersheim-Paul (1975) Johanson & Vahlne (1977)	Internationalization theory	Knowledge of a firm grows gradually over time and therefore it should also gradually increase its resource commitment.	The relative importance of psychic and business distance has decreased since the 1970s after the advances in information technology. It is found in many studies that now firms move faster in this internalisation path and may by-pass some stages of the model
Davidson & McFeirige (1985)	Location theories	Explain the impact of host country location-specific factors on a firm's FDI choices.	These theories however do not generate other attributes associated with the firms.
Williamson (1975) Buckley & Casson (1976)	Internalization theory	It is primarily concerned with identifying the situations in which markets for intermediate products are likely to be internalized, and hence those in which firms own and control value-adding activities outside their natural boundaries.	In this theory, it is too difficult to estimate a cost-benefit point to understand and this makes the testability of the models uncertain.
Anderson & Gatignon (1986 & 1988) Williamson (1987) Hennart (1988 & 1989) Erramilli & Rao (1993)	Transaction theory	Cost of hierarchies as an alternative way of transactions.	It has been criticised for being quite static, treats the investment decision as a discrete phenomenon and does not take into account changes in the environment.
Dunning (1980, 1988, 1993)	Eclectic theory	The eclectic theory consists of ownership-specific, location-specific and internalization advantages.	It is criticized for not sufficiently theorizing the relations between the three advantages, particularly for not making a clear distinction between the internalization and ownership advantages.



strategic alliances and network. Similarly, the concept of location-specific advantages requires countries to invest in creating environment conducive to investments and accumulation of immobile assets in specific geographical areas.

The eclectic theory remains the most comprehensive explanation of international production. This theory not only provides a rich and rebut framework not only for analyzing and explaining the determinants of international production and how it varies between firms, industries and countries over time; but also for our understanding of a wide variety of other firm-related issues. Cantwell (1991) maintains that it is rather an organizing paradigm for identifying the variables derived from different approaches which are most relevant in explaining a wide range of different environments in which international production has been established. Thus, the eclectic theory is strongest in those new items in the “ownership-specific advantage,” the “location-specific advantage,” or the “internalization advantage” substitutes old ones they become old-fashioned without altering the eclectic framework itself. It is not a theory but a paradigm or, more precisely, a taxonomy of various determinants of FDI. Theorists, empiricists and historians can freely invent new determinants to describe a particular case of FDI as long as they fall under one of the three headings. To encompass all the factors that could influence FDI choices and thereby increase its explanatory power, the eclectic paradigm is likely to be preferred. Thus, the eclectic approach has been selected as the framework in this study because of the above-mentioned integrative nature of the approach.

### **3. THE MAIN FEATURES OF THE ECLECTIC MODEL**

This chapter describes and discusses the eclectic framework within which the advantages influencing the FDI choices are evaluated. The main goal of this chapter is to explain how ownership-specific, location-specific and internalization (OLI) advantages can influence the FDI choices of a firm, which depend a lot on the interpretation of the eclectic framework. There is now substantial divergence between the original version of the model and most recent versions argued for in Dunning (1993, 1995) and in Gray (1996). Moreover this eclectic framework has become more dynamic over the years and the precise relationships between the ownership-specific, location-specific and internalization (OLI) advantages have not been determined (Kim & Hwang 1992); the description of the framework has largely been a matter of interpretation among scholars. Thus it is important to describe the view of the eclectic framework used in the later chapters of this study.

#### **3.1. Introduction**

A particular well-publicized approach is Dunning's (1980, 1983) eclectic framework. It seeks to offer a general framework for determining the extent and pattern of both foreign-owned production undertaken by a country's own enterprises and also that of domestic production owned by foreign enterprises. Unlike internalization theory, it is not a theory of the multinational enterprise (MNE) per se, but rather of the activities of the enterprises engaging in cross-border value-adding activities (Dunning 1993:76). Finally the eclectic approach chiefly addresses itself to positive rather than normative issues. It prescribed a conceptual framework for explaining, "what is" rather than "what should be" the level and structure of foreign value activities of enterprises.

The eclectic theory explains that the firm's decision to enter a foreign market and the choice of entry mode, depend upon the possession of ownership-specific, location-specific and internalization advantages. But still the detailed description of the factors influencing the location and ownership strategy related choices depends upon the interpretation of the eclectic model. It is therefore important to describe the perspective of the eclectic paradigm used in this study, particularly since this framework has developed over time and since there is now a substantial divergence between its original version and the most recent versions argued in Dunning (1993 & 1995) and in Gray

(1996). As a result the eclectic paradigm has become more dynamic over the years. The precise relationships between the variables in the eclectic model have not been determined and the description of the paradigm has largely been a matter of interpretation among scholars (Ekstöm 1998:35).

The eclectic theory, as advocated by Dunning (1981:79) is as follows:

1. It (i.e., the firm) possesses net ownership-specific advantages vis-à-vis firms of other nationalities in serving particular markets. These ownership-specific advantages largely take the form of the possession of intangible assets that do exist at least for a period of time; exclusive or specific to the firms that possess them.
2. Assuming condition 1 is satisfied, it must be more beneficial to the enterprise possessing these advantages to use them itself rather than to sell or lease them to foreign firms, that is, for them to internalize their advantages through an extension of their own activities rather than externalize them through licensing and similar contracts with independent firms.
3. Assuming conditions 1 and 2 are satisfied, it must be profitable for the enterprise to utilize these advantages in conjunction with at least some factor inputs (including natural resources) outside its home country; otherwise foreign markets would be served entirely by exports and domestic markets by domestic production.
4. Given the configuration of the ownership-specific, location-specific and internalization (OLI) advantages facing a particular firm, the extent to which a firm believes that foreign production is consistent with its long-term management strategy.

However, in other words, an important initial component of the eclectic framework of the international production argued that firms needed monopolistic intangible assets, or "ownership-specific advantage," in order to compete with foreign companies in an unfamiliar environment. The interpretation of the nature of that asset has been changed, modified and expanded over time. But it should be acknowledged that ownership-specific advantages are probably necessary for sustained profitability and growth.

Researchers have sought to explain firm profitability not only by the existence of ownership-specific advantages, but also by the extent and the nature of the firm's internalization activities. Studies in the recent past (e.g. Grant 1987; Buhner 1987; Kim

1989; Geringer 1991) have found a positive correlation between internalization and profitability.

It has also been suggested that internalization stabilizes profit and sales performance, since environmental factors and goods and factor markets in different countries are not perfectly correlated. Previous studies (e.g. Rugman 1975 & 1979; Hirsch 1976; Miller & Reuer 1994; Kim 1989) have also found a positive correlation between internalization and profit stability.

The chapter is organized in the following way. Section 3.2 briefly introduces the eclectic framework. The ownership-specific, location-specific and internalization (OLI) variables are then discussed in details in separate sections (Sections 3.2.1 to 3.2.3) including the general relationship between the OLI variables. Section 3.3 provides some concluding remarks.

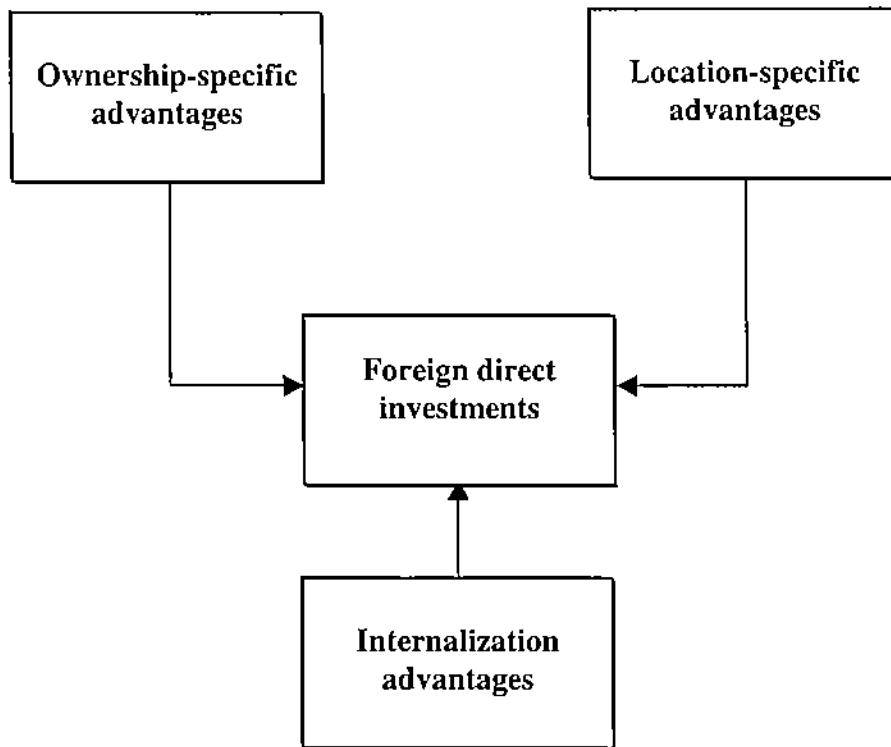
### **3.2. Features of the eclectic paradigm**

This framework is a precise configuration of the ownership-specific, location-specific and internalization advantages (and disadvantages) facing firms, and their strategic reaction to them, that will determine, at any given moment of time, the nature, level, and structure of a firm's activity (Dunning, 1993).

Dunning's eclectic framework of international production suggests that firms should select their FDI choices by considering three sets of advantages: Ownership-specific advantages (which are concerned with the control issue, the costs and benefits (risk) of inter-firm relationships and transactions), Location-specific advantages (which are concerned with the resource commitment issue, the availability and cost of such resources in a particular location) and Internalization advantages (which are primarily concerned with reducing transaction and co-ordination costs (Dunning 1993). These three sets of advantages influence a firm's FDI behavior by affecting the management's perception of asset power (ownership-specific advantage), market attractiveness (location-specific advantages), and cost of integration (internalization advantages) (Agarwal & Ramaswami 1992).

### 3.2.1. Ownership-specific advantages

First, in order for a firm of one nationality to compete with those of another by producing in the latter's own countries, they must possess certain advantages specific to



**Figure 2.** The eclectic framework

the nature and/or nationality of their ownership (Dunning 1988). These advantages are commonly known as ownership-specific advantages. Basically Dunning identifies three types of ownership-specific advantages that are as follows:

1. Those that stem from the exclusive privileged possession of or access to particular income-generating assets,
2. Those that are normally enjoyed by a branch plant compared with a de nova firm, and
3. Those that are a consequence of geographical diversification or multinationality per se.

As mentioned above, the eclectic paradigm argues that the ability of a firm to engage in FDI is usually based upon some competitive advantage of the investing company. In producer goods industries, this advantage has usually to do with the nature of the product supplied and the firm's ability to produce at a lower cost or take advantage of the economies of large-scale production. In consumer goods sectors, the possession of branded products and trademarks together with the ability to offer a reliable product customized to the needs of the local market are the main O advantages usually identified (Dunning 1993:142).

However, the significance of these O advantages varies between firms, and is both industry and country specific. Thus comparing the O advantages of US firms investing in the UK in the 1950s with Japanese MNCs investing in the 1980s, Dunning (1988) found that those of the former mainly comprised their ability to innovate particular goods and services, their managerial and marketing skills in producing and marketing these goods, and their capacity to exploit large and fairly homogenous markets; the O advantages of the Japanese firms again primarily consisted of their competence to produce differentiated, fault-free products at competitive prices. Other studies (Stopford 1974; Dunning & Archer 1987) show that throughout history UK MNCs have generally enjoyed a comparative O advantage in mature, relative low technology sectors and in consumer goods industries, whereas their German equivalents have recorded noteworthy performances in most high technology sectors. According to Akoorie and Enderwick (1992), New Zealand firms appear to compete more successfully in sectors in which price, product design or quality are at a premium. Chen (1983) and Schive and Hsueh (1985) found that Hong Kong and Taiwanese firms were able to compete against First World firms, particularly in other developing countries, because of their familiarity with the host countries' environment and their more appropriate management styles. On the other hand, a World Bank study (1989) has suggested that Third World firms have penetrated US and European markets to gain access to technology and market information. Parry (1982) found the ability of Australian firms to adapt foreign technology to meet the needs of smaller markets as a decisive competitive advantage. Likewise Rugman (1987) argued that Canadian firms in mature and resource-based sectors that invest in the US excel at marketing their products, building up a network of foreign distributors and establishing close long-term contractual relationships with their customers and suppliers.

The above-mentioned as well as a few other studies (Dunning 1990; JETRO 1990) have also found that underpinning these O advantages are systemic organizational and institutional capabilities. Research suggests that these are likely to be less industry-specific and more cultural or ownership-specific in nature. The holistic approach of Japanese firms, their ability to reduce market failures by Kieretsu-type relationships and their particular approach to human resource management underlie their particular O advantages, while those of US and European firms have been found to possess different kinds of competencies.

The types of O advantages enjoyed by foreign investors are also seen to vary according to the degree of multinationality of firms. This, in its turn, is likely to be a function of the age and experience of firms. The sequential theory of firm activity expounded by Kogut (1983) and later extended by Barlett and Ghoshal (1989) suggests that the way firms organize their assets may be as important as the asset themselves.

### **3.2.2. Location-specific advantages**

The second strand of the eclectic paradigm is concerned with the “where” of production. It has been suggested that a firm’s propensity to invest in a particular country is often strongly influenced by the factor endowments, created capabilities and markets available in that country relative to the others, as well as to the extent to which it is perceived that the economic system and policies of a country enable it to exploit its O advantages profitably. Likewise, the consequences of the presence of a firm for the economic welfare of a particular country will vary according to the same characteristics. For example, an investment by a telecommunication equipment producing company in a developing country with little indigenous technological capability will have a very different impact than the same investment in Finland or Sweden. Similarly the production and marketing of some consumer products (e.g. dried milk, microwave ovens and many medicines) by a US company, is likely to have different consequences in countries familiar with the contents of those products and the proper conditions for their use than in one where they are being produced for the first time.

Firms engage in foreign production whenever they perceive it is in their best interest to combine spatially transferable intermediate products produced in the home country, with at least some immobile factor endowments or other intermediate products in other

countries. While, in the eclectic paradigm, the advantages or disadvantages of particular locations are treated separately from the ownership-specific advantages of particular enterprises, and while the market for these advantages are internalized; the decision on where to site a mine, factory or office is not independent of the ownership of these assets nor of the route by which they or their rights are transacted. Similarly, the choice of location may be prompted by spatial market failure: historically the imposition of trade barriers has led to a lot of foreign manufacturing investment by firms. At the same time a reduction of transport cost and formation of economic unions or regional economic blocks (e.g. EU, NAFTA and ASEAN) have prompted greater regional specialization of production by firms (Dunning 1987).

Location-specific (L) advantages are country-specific factors related to the market under consideration – market potential and market risk – and are available to all firms in that particular market (Root 1987). However, some firms are better able to utilize these location-specific advantages than other firms, thus enhancing their competitive advantage either within the new market, for example through better co-ordination of within-country activities, or internationally, for example providing lower cost labor which would result in a cost advantage in all markets where the firm's products are sold (Dunning 1988). Measures of location-specific advantages include sales demand and potential demand, differences or similarity in culture, economic, legal, political and trade policies, similarities of market infrastructures and the availability of lower production costs (Dunning 1993). The common denominator among location-specific advantages is that they influence

1. the expected profitability of foreign production in relation to export and
2. the expected profitability of having production located in different countries (Liansheng 1992).

Location-specific advantage may then favor either the home country or a particular foreign country as a location for production and a firm holding O advantages may decide to internalize them, and put them to use in foreign locations when it finds that they can be utilized more profitably in these locations (Kimura 1989).

Previous studies have identified a number of L advantages that have had a significant effect on the propensity of firms to engage in foreign production and on the location of



that activity (Ekstöm 1998:39). The most commonly evaluated location-specific advantages include market size and growth, factor endowments, sources of supply, transportation costs, trade barriers and physical distance (Caves 1996). Hence, L advantages include not only factor endowments but also a number of location-specific advantages derived from spatial (or structural) market failures, such as restrictions in trade, and from transactional market failures (Dunning 1988). The location decision has actually become less influential on the comparative advantages of factor endowments and more on the strategies of competitors of supplying regional or global markets, the desire to fully exploit the economies of large-scale production, the need to reduce market instability and uncertainty, and the incentive to reap the gains from integrating related activities over space (Dunning 1988).

Despite the conceptual differences between L and O advantages, the choice of location is not independent of present ownership-specific (O) advantages or of the ability to acquire or generate new O advantages by establishing foreign production in different locations (Dunning 1988). There is a close linkage between O and L advantages (Sleuwaegen 1991). The investing firm may be stimulated to undertake FDI projects in particular locations in order to advance or protect its O advantages; it may also be stimulated to undertake foreign production in particular locations for the purpose of generating new O advantages that are derived from operating in that location (Ekstöm 1998:40). The choice of location is also determined by the fact that the various location alternatives may have different subsequent effects on a firm's OLI configuration (Gray 1996). As a result it is the complex interaction between the ownership-specific and location-specific factors that sheds light on overseas direct investment (Kumar & Kim 1984).

The relationship between L and O advantages has implications for O advantages (Ekstöm 1998:41). Operating production resources in particular locations or in a particular configuration of locations, significantly influences the O advantages associated with the common governance of activities in different locations (Dunning 1988). These O advantages refer to the benefits associated with operating in multiple geographical and product markets, such as production flexibility, geographical diversification and firm-level economies of scale and scope, i.e. synergistic economies in distribution, marketing and purchasing (Dunning 1993). As the transactional market

failures enabling firms to create these O advantages are, to a certain extent, country-specific, they have location-specific implications as well (Dunning 1988).

The importance of the configuration of location-specific advantages for a firm's O advantages emphasizes the importance of its portfolio of location-specific advantages (Ekstöm 1998:41). Recognizing the importance of a portfolio of location-specific assets means that changes in that portfolio will be undertaken if the portfolio becomes sub-optimal (Gray 1996). Firms are then expected to undertake FDI projects if this will create a new portfolio of location-specific assets that are perceived to be better than the old ones (Gray 1996).

### **3.2.3. Internalization advantages**

The final condition for international production is that it must be in the best interest of enterprises that possess ownership-specific advantages to transfer them across national boundaries within their own organizations rather than sell them, or their right of use to foreign-based enterprises (Dunning 1988). It also suggests that firms may or may not perceive that the international marketplace is the best modality for transacting intermediate goods or services. But certainly in the exploitation of specific intangible assets (Oa) (e.g., patent or trade mark), firms often have a choice between using the external market or not (Dunning 1988). Here the distinction between asset generation, or acquisition, and asset usage is an important one. Rugman (1981) argued that if an ownership-specific advantage is created by or becomes the exclusive property of a particular enterprise, it has in some sense "internalized" the market for its use.

Besides that a firm is undertaking foreign production to internalize its O advantages in foreign markets, the process of internalizing may also generate new O advantages and increase the benefits of internalizing (Ekstöm 1998). These new O advantages may either be internally generated or acquired from other firms (Dunning 1993).

The I advantages have an intermediate role in the eclectic framework (Randoy 1994). They are intermediate in the sense that the advantages of internalizing foreign markets are determined by a firm's O advantages (Denekamp 1995). They are influenced by the O advantages possessed prior to FDI as well as by those generated by undertaking FDI projects (Liansheng 1992). Since FDI has become the means by which new O

advantages are created, the benefits of internalization are increasingly derived from the O advantages internalization might generate (Gray 1996). Nowadays, firm internalize markets in order to acquire Oa advantages or to develop or enhance Ot advantages through co-ordination of geographically dispersed activities (Gray 1996). The I advantages are also intermediate in the sense that they are influenced by the expected profitability of operating production units in a particular location (Dunning 1980).

Firms utilize foreign production whenever the transaction cost of using the market to exchange products across borders exceeds the costs of co-ordinating the production and exchange of these products within the same hierarchy (Dunning & Kundu 1995). Thus the need to reduce buyer, supplier and governmental uncertainty, the need to protect the quality of production, the need to possess a high level of control and increasingly, the need to capture economies of independent activities speak in favor of hierarchies and induce firms to undertake foreign production rather than other servicing modes (Dunning 1993).

According to Dunning's framework, by internalizing, a firm utilizes or circumvents the existence of transactional market failures in order to economize on transaction costs and to capitalize more fully on its O advantages (Ekstöm 1998:42). According to the internalization theory, on the other hand, a firm internalizes markets in order to economize on transaction costs, which, in turn; generates advantages over other firms (Itaki 1991). The difference between the eclectic theory perspective on internalization and the internalization theory is essentially in their focus on the transactional market failures as either exogenous or endogenous (Liansheng 1992). In the eclectic paradigm, firms internalize to circumvent or utilize market failures, but they also internalize to capitalize on O advantages through the internal creation of market failures, based on those advantages. In the internalization theory, market failures are entirely exogenous (Ekstöm 1998:42).

### **3.3. Criticism of the eclectic paradigm**

As Dunning's paradigm consists of building blocks from other theories and models as described in the last chapter this is due to the fact that empirical verification of the paradigm has been considered impossible. In effect this is the first criticism which the paradigm has faced, as it imposes several operational / empirical limitations due to the

complexity of the variables used in the paradigm (Helleiner 1989; Melin 1992; Borsos-Torstila 1999). Secondly in the eclectic framework there is a redundancy of the concept "ownership-specific advantage." It is often argued that this ownership-advantage concept is redundant because it originates from the internationalization and integration in the sense that these acquire and exploit the ownership-specific advantages. Moreover, according to the eclectic framework the "ownership-specific advantage" includes the cost of its acquisition. After paying for the contribution for the entire factor input super-normal profits remain the firm's final purpose as a result of all the organizational power of internationalization and integration. It is the result of a firm's internal economies of integration, internalized external economies, minimized transaction costs, and market power (Itaki 1991).

Thirdly this framework is also criticized because of the issue of inseparability of the ownership-specific advantage from the location-specific advantage. Specifically there is no clear distinction between the "ownership-specific advantage" in engineering terms and in economic terms. The ownership-specific advantage is measurable in the case of quality innovations (e.g. a medicine), while it is not measurable in the case of productivity innovations (e.g. machine tools). Not only in immeasurable cases is, "the ownership-specific advantage" in economic terms inseparable from the "location-specific advantage," but in the measurable cases of quality innovation there is also no clear distinction of the ownership-specific advantages in engineering terms and economic terms. The latter depend on the cost of generating the engineering "ownership-specific advantage" by means of internationalization and integration of R&D (Itaki 1991). Moreover, economic "ownership-specific advantage" depends on the cost of generating the engineering "ownership advantage", which is different for different locations, and often it is very difficult to separate it from location-specific advantage. For instance Nissan has decided to invest in the U.K since it has an "ownership advantage" and the U.K has location-specific advantages. Although Nissan indeed possesses an engineering advantage in its quality control of automobile production, there is no guarantee that it will turn out to be an economic advantage all over the world. The very fact that Nissan chose the U.K. as its location of FDI will, hopefully, enable Nissan's sophisticated quality control to transform into an economic advantage. The FDI of Nissan, say, in the U.S. may well result in a failure and lose its economic advantage, simply because of its high engineering advantage, if the cost of

quality control is quite expensive there. Thus it can be concluded that the eclectic paradigm has lost its explanatory power in which the “ownership advantage” and the “location-specific advantage” can be independently and sequentially determined. Moreover the term “absolute advantage” does not exist in the real world. It is only a theoretical possibility and in future it should not only be seen as a warning to empirical researchers but to the theorists as well (Itaki 1991).

Fourthly in this eclectic framework, we often come across the ambiguity of this location-specific advantage. Location-specific advantage seems to be the most dominant of the three advantages in the eclectic paradigm. According to Dunning (1981) each country has a different set of prices, quality, and productivity of labor, energy materials, components and semi-finished goods. In eclectic theory there seems to be a most comprehensive list of various location-specific factors. In this theory, it seems to be very clear that the cheaper the location-specific factors are, the more profitable is FDI, provided the same quality and productivity of each input exist. The meaning of “cheap” input is not very clear in this paradigm. Of course, Dunning means “cheap” input in monetary terms. It is also another weakness of the eclectic paradigm that it explains the “location-specific advantages” in monetary terms rather than in real terms. It seems to us that it would be better for the firm if the local currency would be more depreciated. But the “cheaper” inputs owing to a depreciated currency will also eventually result in cheap profits i.e. the remittance is also depreciated in terms of the international currency, say, the U.S dollar, or the home currency. These “cheap” inputs, particularly “cheap” labor-inputs often have the adverse effects of shrinking the worker’s income and the host country market. Does it indicate a location advantage or disadvantage? The eclectic paradigm fails to give any answer to this question, as it does not include the level of exchange rates at all. In order to further study the impacts of exchange rates there is a need to distinguish between export-oriented FDI and local market-oriented FDI. The local market-oriented FDI prefers high value of a local currency but the export-oriented FDI prefers low value of a local currency. Also multinational banking in principle takes advantage of the low value of international financial center’s currency, say, the US \$, since “cheap” financial facilities there provide almost the same quality and quantity of financial services (Itaki 1991).

The fifth criticism of the eclectic theory is that this paradigm is strongest in those new items in the “ownership-specific advantage” the “internationalization advantage” or the “location-specific advantage” and should be substitutable once they become old-fashioned without altering the eclectic framework itself. It should be the weakest item when ascertaining which items are the most decisive in attracting FDI. The eclectic theorist would reply that the answer differs from case to case because the eclectic theory is not a theory but a paradigm (Cantwell, 1989). Theorists, empiricists, and historians can freely invent new determinants to describe a particular case of FDI as long as they fall under one of the three headings. However, at least in theory, the fewer the determinants the better in order to explain an economic phenomenon. Economists usually treat theoretical problems with one, two or three primary factors of production, i.e., labor, capital and/or land. Penrose (1959) made a new trend in the international trade theory of that time in which the factor endowments were defined in terms of multiple factors of production rather than simply labor and land.

*Why, to consider a traditional example, does Switzerland export watches? We could reply that it is because “Switzerland” is differentially well endowed with “labor skilled in watch-making,” or, alternatively, with “watch-making machinery.” (Penrose 1959)*

To substitute watch-making advantages for the watch-making endowments above should warn us of a possible danger that a detailed eclectic taxonomy could be tautological. Factors of production and advantages must be as non-substitutable as possible and remain relatively few in number if the concept is to remain meaningful for expounding, rather than describing, economic phenomena (Itaki 1991).

Finally critics often argued that the combination of three types of advantages, although it appears to be very convincing, but is still not necessary. Casson (1987) and Larimo (1993) have proposed that the assumption of ownership-specific advantage, such as superior technology, is unnecessary, as the benefits of internalization could in principle be sufficient to outweigh the costs. Dunning has developed his paradigm, apparently based, at least partly, on the critique. In the original form three types of ownership-specific advantages were identified:

1. those which stem from the exclusive privileged possession of, or access to, particular income generating assets

2. those which are normally enjoyed by a branch plant compared with a de nova firm, and
3. those which are a consequence of geographical diversification or multinationality per se.

In the later typology there has been a distinction between the asset (Oa) and transaction (Ot) advantages of multinational enterprises. While the former arise from the proprietary ownership of specific assets by firms, vis-à-vis those possessed by the other companies, the latter mirror the capacity of the firm hierarchies, vis-à-vis external markets to capture the transactional benefits (or lessen the transaction costs) arising from the common governance of a network of these assets, located in different countries. Other aspects of criticism on the eclectic paradigm are still awaiting the answer (Larimo 1993:31).

### **3.4. Summary**

The main goal of this chapter was to explain the eclectic theory of international production. More precisely this chapter attempted to demonstrate that even a decade after its inception, the eclectic theory developed by Dunning (1980, 1988 & 1993) provides a rich framework not only for analyzing and explaining the determinants of international production and how it varies between firms, industries and countries, and over time; but for our understanding of a wide variety of other firm-related issues.

The eclectic theory integrates several strands of international business theories on cross-border activities. It proposes that three types of advantages / variables influence cross-border business activities: ownership-specific variables, location-specific variables and internalization variables. Ownership-specific variables can be divided into asset specific advantages (Oa) and transaction variables (Ot). Ownership asset specific variables include various tangible and intangible assets owned by the investing firm whereas transaction specific advantage includes variables related to the ability of firms to capture the transactional benefits from the common governance of multiple and geographically dispersed activities. The degree of possession of various ownership-specific variables influences the degree of ownership chosen in foreign FDIs. Location-specific advantages (L) are essential in determining where firms will engage in cross-border value-adding activities. The level of location-specific advantages may also be expected

to influence the ownership strategies chosen. The last strand of the OLI approach comprises the internationalization advantages (I) that the company has in transferring assets within their organizations instead of via the market, because of the market failures. The greater the perceived costs of transactional market failure – and the greater the benefits of circumventing market failure – the more likely the company will be to exploit its ownership-specific advantages within the firm and the greater the degree of ownership it will prefer in its FDIs.

The eclectic theory provides a multi-theoretical approach for studying international production: international trade theory, resource-based theory and transaction cost theory are the basic theories used. It is rather an overall organizing paradigm for identifying the variables from each approach that are most relevant in explaining a wide range of different environments affecting the entry mode choices of the investing firms. The eclectic theory permits researchers to create determinants in order to make FDI choices. The strength of the theory could be characterized by its richness (several explanations) and its creativity (generations of new determinants and combinations of these and the existings ones). The strengths represents, however, also potential weaknesses (Anderson 1997). The strongest criticism of the theory has come from Itaki (1991). Itaki claimed that an ownership-specific advantage actually comes from an internalization advantage. Therefore, it is redundant to consider these as two separate determinants. Also, Dunning's theory has been called ambiguous about the sources of location-specific advantages. Despite these shortcomings, Dunning's theory is considered by many as one of the more comprehensive frameworks of international production. Thus eclectic theory has been selected as the framework in this study because of its above-mentioned integrative nature of approach.



## 4. STRATEGIC MOTIVES OF FOREIGN DIRECT INVESTMENT

This chapter provides a classification of different types of FDI projects based upon the investing firm's investment-level strategic motives. By identifying the strategic objectives underlying FDI projects, it becomes possible to analyze directly and explicitly the role of strategies in determining the propensity of the firms to undertake FDI projects. The distinction among strategic motives of FDI projects highlights "the differences in key features associated with different FDI projects" (Brewer 1993) and they indicate the strategic advantages the investing firm seeks by undertaking FDI's.

### 4.1. Introduction

Since the early 1990s many of the large firms are pursuing pluralistic motives, and most engage in FDI that combine the characteristics of each of the above categories. Moreover, the motives for any FDI venture may also change as, for example, when a firm becomes an established and experienced foreign investor (Dunning 1993:57). Initially, most firms invest outside their home countries to acquire or to gain access to markets. As they increase their degree of multinationality, however, they may use their overseas activities as a means by which they can improve their global market position by raising their efficiency or acquiring new sources of competitive advantage.

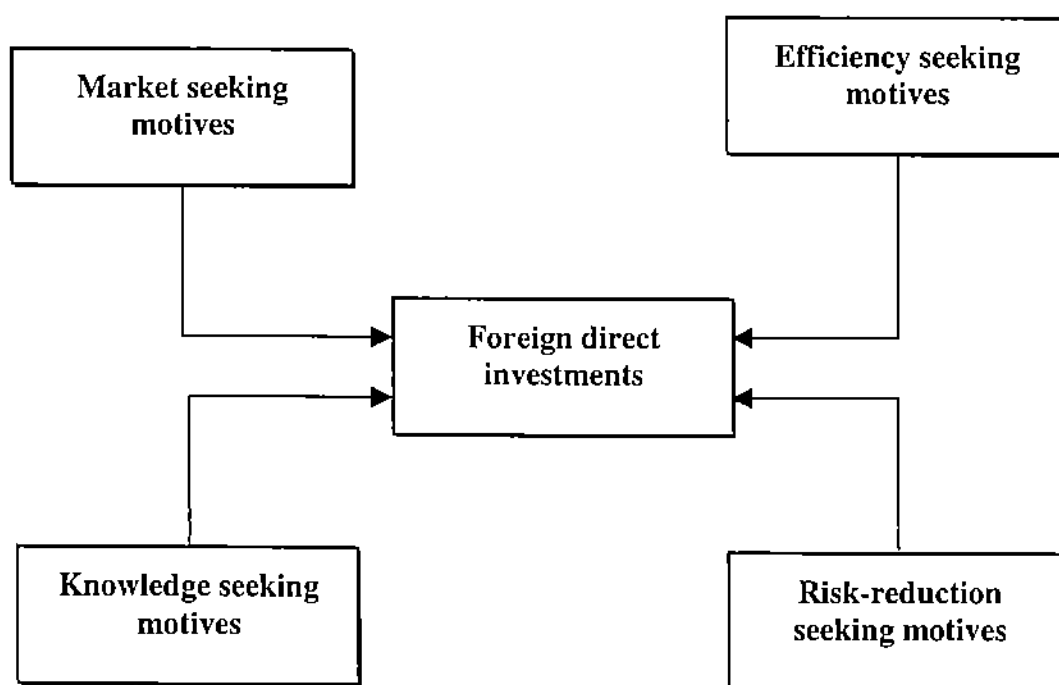
Based upon a number of previous studies (Kuhn 1960; Aliber 1970; Svedberg 1982; Dunning 1990; Dunning 1993:56) we have identified that individual FDI projects may be driven by the following four strategic motives:

1. *Market seeking*
2. *Efficiency seeking*
3. *Risk-reduction seeking*
4. *Knowledge seeking*

The motives for foreign production may also change as, for example, when a firm becomes an established and experienced foreign investor. Initially most firms invest outside their home countries to acquire natural resources or gain (or retain) access to markets (Dunning 1993:57). As they increase their degree of multinationality, however they may use their overseas activities as a means by which they can improve their

global market position by raising their efficiency or acquiring new sources of competitive advantage.

This chapter is organized as follows. In sections 4.2 to 4.5, we elaborate five categories of strategic motives and discuss common characteristics among FDI projects in those categories. Based upon a number of previous studies, we recognize that individual FDIs may be driven by (i) *market seeking motives*, (ii) *efficiency seeking motives*, (iii) *knowledge seeking motives* and / or (iv) *risk-reduction seeking motives*. Finally section 4.6 provides some concluding remarks.



**Figure 3.** The strategic motives of foreign production

## 4.2. Market seeking FDIs

*Market seeking FDIs* are undertaken to sustain or protect existing markets or to exploit or promote new markets (Dunning 1993:58). Apart from market size and the prospects for market growth, there are five main reasons that might prompt firms to engage in either sort of market seeking investment. The first is that their main suppliers or customers have set up foreign producing facilities and that to retain their business they need to follow them overseas. One recent example of this kind is that of some 300 Japanese auto-component suppliers who have set up manufacturing subsidiaries in the

US, or concluded joint ventures with US firms to supply US plants of leading Japanese auto assemblers.

The second reason for market oriented FDI is that quite frequently products need to be adapted to local taste or needs, and to indigenous resources and capabilities. In addition, without familiarizing themselves with the local language, business customs, legal requirements and marketing procedures, foreign producers might find themselves at a disadvantage vis a vis local firms in selling consumer goods like washing machines, stereo equipment and a wide variety of food and drink products, as well as those supplying intermediate products such as construction machinery, petrochemicals and forestry products (Dunning 1993:58; Ekström 1998:91). Shepherd, Silberston & Strange (1985) investigated the motives underlying UK outward FDIs. They concluded that the need to stay close to customers is the single most important reason underlying decisions to undertake FDI. Shaukat & Hafiz (1996) investigated the motives underlying UK outward FDI in Central Europe. Staying close to the customer was also among the most important strategic motivations in their study too.

The third reason for servicing a local market from an adjacent facility is that the production and logistic costs of doing so are less than supplying it from a distance. Obviously, this decision will be highly industry – and country – specific. Dunning (1993:58) states that the production of goods that are relatively costly to transport and can be produced economically in small quantities is more likely to be located nearer the main centers of consumption than those that cost relatively little to transport and yield substantial economies of scale in their production. Ekström (1998: 91) also argued that firms from countries that are geographically far removed from important markets are more likely to engage in market seeking FDI than those that adjoin those markets (e.g. compare French or Dutch investment with US investment in West Germany).

The fourth reason is that in some cases government regulations, import controls or strategic trade policy may prompt firms to relocate their production facilities. For example the Canadian telecommunication firm, Northern Telecom, moved many of its production facilities to the US in the late 1980s so that it could win Japanese contracts. At the time, Japan favored the US as a source of telecommunication equipment because of the politically sensitive US– Japan trade gap (Dunning 1993:59).

The fifth and increasingly important reason for *market seeking* investment is that a firm may consider it necessary, as part of its global production and marketing strategy, to have a physical presence in the leading markets served by its competitors. Dunning (1993:59) argued that most of the largest firms in the sectors dominated by international oligopolists (e.g. oil, rubber tiers, pharmaceuticals, semiconductors and advertising) not only operate production units in each of the TRIAD areas, but also increasingly in R&D. Such strategic *market seeking* investment might be undertaken for defensive or aggressive reasons with much of the “follow the leader” or “band-wagon” type of investment. Aggressive investments are those designed to advance the global interests of a firm by investing in expanding markets. The response of firms to the completion of the EU single market and to the opening up of Eastern Europe to FDI is essentially of this kind, although the belief that EU might be restrictive towards imports from non-EU countries has also led to some defensive strategic investment by non-EU firms.

Unlike those engaging in other kinds of FDI, *market seeking* firms tend to treat their foreign affiliates as self-contained production rather than as part of an integrated network of cross-border activities. In consequence, they tend to be the most responsive to local needs and requirements. The affiliates of *market seeking* firms will normally produce products similar to those supplied by their parent company, though usually of truncated range. Usually, too, the output will be sold in the country in which it is produced, although there may be some exports to adjacent markets (Dunning 1993: 59). In regionally integrated markets like the EU, however, production in one or a few countries might service all the countries in the region.

Randoy (1994) and Ekström (1998:91) argued that by undertaking *market seeking* FDI investments, the investing firms are motivated by the opportunity to capitalize upon their established O advantages. These O advantages could be capitalized upon in new locations or by increasing the amount of production in already established locations. In addition, firms may also be motivated to undertake *market seeking* FDI projects by the advantages associated with staying close to their customers and thus protecting their O advantages from deteriorating.

### 4.3. Efficiency seeking FDI

*Efficiency seeking FDI*s are undertaken in order to rationalize the structure of established production units in such a way that a firm can gain from the common governance interrelated activities in different locations (Dunning 1993a; Ekström 1998:94). According to Behrman (1981:34), firms undertaking efficiency seeking FDI are “looking for the most economic sources of production to serve a multi-country standardized market.” The potential benefits derived from undertaking *efficiency seeking* FDI are especially those of economies of scale and scope, which are derived from product and geographical concentration and from process specialization (Kogut 1983). The potential benefits are also derived from being established in multiple product markets (Abdel-Malek 1985).

The advantages associated with exploiting the scale economies of product and/or geographical concentration on a global or regional scale, as well as those scope economies associated with broadening their product line may motivate firms to initiate FDI projects designed to capture these advantages. These advantages are similar to the firm-level opportunity for global economies of scale and scope to capture by rationalizing and restructuring the configuration of a firm’s established production units, as well as to establish new production units designed to serve the regional or global market (Ekström 1998:94). The benefits are expected to motivate firms to locate their manufacturing facilities where marginal cost of production is lowest and to capture the advantages of operating interrelated activities within firms (Dunning, 1993). In these efficiency seeking FDI projects, the advantages of exploiting economies of scale and scope predominate over the importance of relative factor endowments across countries. These investments are normally undertaken in countries with broadly similar economic structures and income levels.

Foreign direct investments may also be driven by the transactional benefits associated with exploiting the economies of scale and scope in marketing, distribution, sourcing, R&D, and so on. Kim and Hwang (1992) argued that these FDI are designed to capture the scale economies of handling multiple products within the same distribution system, utilizing the same source of supply, and so forth. They further argued that these advantages are referred to as “global synergies.” To integrate new foreign operations

with a firm's established activities has been a more pronounced motivation among large European and US firms (Group of Thirty 1984).

Another important *efficiency seeking* objective is to undertake projects designed to capture the advantages of process specialization, that is, those of concentrating different stages of the value-added chain in different countries (Dunning, 1993). Morrison and Ruth (1992) argued that the advantages of doing this come from exploiting different factor endowments among various locations as well as from exploiting the scale economies in vertical integration. Kogut (1985) describes that as for capitalizing on factor endowments, the benefits of process specialization are determined partly by differences in factor endowments among countries per se and partly by the opportunity to configure value-added activities in such a way that each activity is located in a country providing the lowest marginal cost of production for that particular activity.

Ekström (1998:95) argued that the efficiency seekers are usually experienced large and diversified firms producing fairly standardized products and engaging in internationally accepted production processes. In the past, such FDI has usually occurred once resource based or *market seeking* investments have become sufficiently numerous and important to warrant some degree of rationalization. Increasingly, however, investment by new entrants, such as by the Japanese in the EU, is being undertaken on a product-by-product basis as part of a carefully integrated regional or global marketing strategy. In order for *efficiency seeking* foreign production to take place, cross-border markets must be both well developed and open. This is why it flourishes in regionally integrated markets. In practice, the *efficiency seeker* is likely to be a global corporation competing on the basis of products it offers for sale and its ability to diversify its assets and capabilities by exploiting the benefits of producing in several countries.

Dunning (1993:57) argued that *efficiency seeking* FDI is of two types. The first is that designed to take advantage of differences in the availability and cost of traditional factor endowments in different countries. This explains much of the division of labor within firms producing in both developed and developing countries, with capital, technology and information intensive value-added activities being concentrated in the former, and labor and natural resources intensive activities in the latter. The second kind of efficiency seeking FDI is that which takes place in countries with broadly similar

economic structures and income levels and is designed to take advantage of the economies of scale and scope, and of differences in consumer tastes and supply of capabilities. Here, traditional factor endowments play a less important role in influencing FDI, while “created” competencies and capabilities, the availability and quality of supporting industries, the characteristics of the local competition, the nature of the consumer demand and the macro- and micro-policies of the government play a more important role.

#### **4.4. Risk-reduction seeking FDI**

*Risk-reduction seeking FDI*s represent internal hedging activities conducted in order to reduce the level of risk by the firm. The importance of internalization as a risk reduction measure has been recognized elsewhere (Caves 1982; Vernon 1985; Rugman 1987). Dunning (1993) discusses the risk reduction advantages of undertaking FDI projects in relation to *efficiency seeking* and *knowledge seeking* motives. Dunning (1993:60) and Ekström (1998:96) argued that strategic asset-seeking FDI, for example, are designed to generate certain benefits for the investing firms, such as “opening up new markets, creating R&D synergies or production economics, buying market power, lowering transaction costs, spreading administrative overheads, advancing strategic flexibility and enabling risk to be better spread” (Dunning 1993). Thus, the *risk-reduction seeking* benefits in Dunning contrast with the ones noted in the present study in that risk reduction is here seen as an outcome rather than as an independent strategic objective.

Kogut (1989) claims that *risk-reduction seeking* FDI projects may be designed to reduce the corporate risk associated with unfavorable changes in macroeconomic variables, changes in supply and demand among national markets and the moves of the competitors and of national or regional governments. Firms may handle different risks by moving production units from unfavorable to favorable locations, as well as creating operational flexibility among production units in different countries. Prahalad and Doz (1987) argue that operational flexibility reduces corporate risks and provides a firm with the ability to exploit changes in economic factors such as exchange rate fluctuations, demand, supply and also the moves of the competitors.

Kogut (1989) explained that another important *risk-reduction seeking* objective is to undertake FDI designed to capture the advantages of smoothing the effects of supply-

and-demand fluctuations among national markets. Because of these risks, firms may undertake FDI projects designed to diversify the market risk by having production at multiple locations. The strategic objective to diversify geographically has been verified in several field studies (e.g. Shaukat & Hafiz 1996) on the motives underlying the decision to undertake FDIs.

Dunning (1993) and Ekström (1998:98) argued that firms may also undertake FDI projects because of the risks associated with the actual or potential moves of the competitors. Kim and Mauborgne (1988) maintain that these projects may be designed to prevent competitors from exploiting new profit opportunities as well as to proactively create better opportunities for responding to competitors in the future. Vernon (1985) claimed that the fear of being pre-empted by competitors is particularly great if competitors' moves may imply significant cost advantages or access to strategically important locations. The risk of lagging behind in the global technology race can also motivate firms in their international activities and stimulate allocation of R&D facilities and value-adding activities close to competitors. Firms may also find it necessary, from the point of view of global production and marketing strategy, to be located close to their competitors. In consequence, by undertaking FDI projects designed to reduce the impact of actual or potential moves made by competitors, the investing firms are taking measures to prevent their O advantage from deteriorating.

#### **4.5. Knowledge seeking FDIs**

*Knowledge seeking FDIs* are undertaken to maintain or develop competitive positions in certain products or geographical products by acquiring technological knowledge and capabilities and/or management expertise (Randoy 1994). The *knowledge seeking* objectives argued for in the present study corresponds to the strategic objectives underlying the "advantage-seeking" FDI motives described in Hedlund and Kverneland (1984). According to these authors, *knowledge seeking* FDI projects are motivated by access to new technology necessary to improve a firm's competitiveness (Ekström 1998: 92).

Dunning (1993), and Oxelheim (1993) explained that FDIs designed to acquire new technologies or capabilities are classified under the category of resource-seeking motives. The present study, however, recognizes and emphasizes the important



distinction in the advantages motivating FDI projects designed to acquire technological capabilities and management expertise and those advantages associated with establishing a firm in locations with favorable factor endowments. While Ekström (1998:93) argued that resource seeking FDI projects are primarily designed to internalize new location-specific advantages, *knowledge seeking* FDI projects are by nature designed to acquire new O advantages. According to Hedlund and Kverneland (1984), FDIs designed to acquire new technology are not explained by O advantages since they are actually designed to create new O advantages rather than to exploit existing O advantages.

In Dunning (1993), the strategic objectives to acquire new technologies are also captured within his “strategic asset-seeking motive.” This motive represents acquisition of strategic assets designed “to promote their long-term strategic objectives especially that of sustaining or advancing their international competitiveness (Dunning, 1993). Ekström (1998:93) argued that promoting long-term strategic objectives in order to sustain or advance their competitiveness would be an accurate description of any measure taken by firms; thus this definition does not make a distinction between different types of FDIs. We therefore do not recognize strategic asset-seeking investment as a separate category of FDI motives.

The motives for *knowledge seeking* FDIs is less to exploit specific cost or marketing advantages over their competitors than to add to the acquiring firm’s existing portfolio of assets, that they perceive will either sustain or strengthen their overall competitive position or weaken that of their competitors (Dunning 1993:60). Increasingly, too, strategic and rationalized FDIs are going hand in hand as firms restructure their assets to meet their objectives. An example was Grand Metropolitan’s sale of Inter Continental Hotels to a Japanese conglomerate and its purchase of Pillsbury Mills, a large US food-purchasing company and fast-food chain. Like the efficiency seeking FDIs, the *knowledge seeking* FDIs aim to capitalize on the benefits of the common ownership of diversified activities and capabilities in diverse economic and potential environments. They all arise from the imperfections of the product markets in which firms operate and the opportunities open to these companies to exploit, or indeed add to, these imperfections.

#### 4.6. Summary

The main purpose of this chapter was to provide a detailed classification of different types of FDI projects based upon the investing firm's investment-level strategic motives. Strategic motives are not part of Dunning's original OLI framework. However, Dunning (1993:56) and Ekström (1998:89) identify four main strategic motives of FDIs: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. The increasingly complex business situation makes any taxonomy of strategic motives a simplistic and formalized view of business conduct. Thus these strategic motives discussed in this chapter should therefore not be seen as mutually exclusive. FDI projects may be driven by several strategic objectives simultaneously and in various combinations. Distinguishing between different types of strategic advantages however, facilitates an understanding of motives underlying FDI decisions and the key features characterizing different types of FDIs.

Furthermore, strategic motives concern how the goals and long-term objectives of the firm affect the choices of FDIs. We are explicitly making FDIs contingent upon the other four advantages, since no time dimension is involved. It can be argued that the current FDIs are a product of the configuration of the present ownership-specific, location-specific, internalization and strategic advantages. In addition to these four advantages, the envisioned future strategy, as well as the historic configuration of the firm-specific, location-specific, internalization advantages and past strategy have an important effect on the current FDI choices. However, these factors are beyond our current model specification, which would require a time-series research design.

It has been argued (e.g. Dunning 1997) that in practice multinational firms operate in an environment in which both intermediate and final product markets are imperfect, and where the outcome of business decisions is uncertain. This being so, it is even more difficult to generalize about the strategic behavior of such firms than about that of their domestic equivalents. This is partly because of the greater range of choices open to multinational firms; partly because of the differences in perception of decision-makers in the multinational firms with regard to these motives; and partly because of the differences in attitudes with regard to risk taking. Thus some firms may place higher value on the risk-spreading opportunities of FDI than others; while multinational firms that compete in oligopolistic markets may gauge the value of their foreign activities as

much by their anticipated repercussions on their competitor's market position as on any profits that the affiliate may earn. This gives us an understanding of the fact that some firms may produce outside their national boundaries as part of coherent and coordinated global strategy, rather than earn profits on a specific FDI. This is, however, more likely to be the case with experienced and globally integrated multinational firms than with smaller firms undertaking their first foreign investment.

**Table 10.** Strategic motives affecting the FDI choices

Types of FDI	Explanations
<i>Market seeking FDI</i>	<i>Market seeking FDI</i> projects are undertaken to sustain or protect existing markets or to exploit or promote new markets. Apart from market size and the prospects for market growth, there are four main reasons which might prompt firms to engage in either kind of market seeking investment.
<i>Efficiency seeking FDI</i>	<i>Efficiency seeking FDI</i> projects are undertaken in order to rationalize the structure of established production units in such a way that a firm can gain from the common governance inter-related activities in different locations
<i>Risk-reduction seeking FDI</i>	<i>Risk-reduction seeking FDI</i> projects represent internal hedging activities conducted in order to reduce the level of risk of the firm. <i>Risk-reduction seeking FDI</i> projects may be designed to reduce the corporate risk associated with unfavorable changes in macroeconomic variables, changes in supply and demand among national markets and the moves of competitors and of national or regional governments.
<i>Knowledge seeking FDI</i>	<i>Knowledge seeking FDI</i> projects are motivated by access to new technology necessary to improve a firm's competitiveness. <i>Knowledge seeking FDI</i> projects are undertaken to maintain or develop the competitive position of certain products or geographical products by acquiring technological knowledge and capabilities and / or management.

Moreover, the motives for foreign production may change after a firm becomes established and an experienced foreign investors. Initially most firms invest outside their home countries to gain (or retain) access to markets and to spread their risks. As the firms increase their degree of multinationality (Dunning 1997), however, they may use their overseas activities as a means by which they can improve their global market position by raising their efficiency or acquiring new sources of competitive advantage.

## **5. DETERMINANTS OF LOCATION STRATEGIES IN FOREIGN DIRECT INVESTMENTS**

In this chapter, the basic decisions related to the location strategies of the investing firms in the target countries are reviewed. This chapter theoretically investigates how the ownership-specific, location-specific, internalization and strategic advantages influence the location strategies of the investing firms in the target countries. Then each of the above-mentioned advantages is reviewed in detail in different subchapters. Based on the extent of theoretical and empirical literature on location strategies, several hypotheses are developed regarding the components of the eclectic paradigm and the strategic motivational type of FDIs. The chapter ends with a summary of all the reviewed previous studies related to location strategies of the investing firms in the target countries.

### **5.1. Introduction**

Foreign direct investment (FDI) has always played an important role in the development of global economy. In the early 1980s, world economy was weakened by the two oil shocks of the 1970s, which caused deterioration in the balance of payments and resulted in increased external indebtedness and domestic inflation in many countries around the globe. One of the key strategies for the economic recovery in most countries was the promotion of foreign private investments and manufactured exports. The impressive growth particularly in East Asian economies could not be achieved without the flow of FDI that came from Japan, the EU and the US. Due to long-term benefits of private investments, countries around the globe cannot afford to lose the foreign direct investment, given their pressing employment problems, to sustain economic growth and industrialization.

The question of how to attract FDI by all countries is more relevant today, as expectations are focused increasingly on FDI to alleviate economic problems and to satisfy the need of these countries for financial, technical and entrepreneurial resources. Many countries, however, may not be under constraint in terms of FDI inflows but also in terms of capital lending. Attempts to alter the external financing structure of some of these countries towards increasing the role of transfers involving risk and profit sharing

may suffer (Chandrapalart, 2000). In order to overcome constraints in the supply of FDI, the determinants of FDI have to be identified in the first place

The purpose of this chapter is to identify how different ownership-specific, location-specific internalization and strategic advantages (see Figure 4) could influence the location strategies of Finnish firms in twelve South and Southeast Asian countries from 1980 to 2000. Dunning (1993:56) identifies four main motives of FDI: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. This chapter attempts to combine ownership-specific, location-specific, internalization and the strategic advantages of manufacturing FDI under one analytic framework. It therefore presents new theoretical and empirical insights into the determinants as well as the strategic advantages of investing manufacturing firms that engage in FDI ventures.

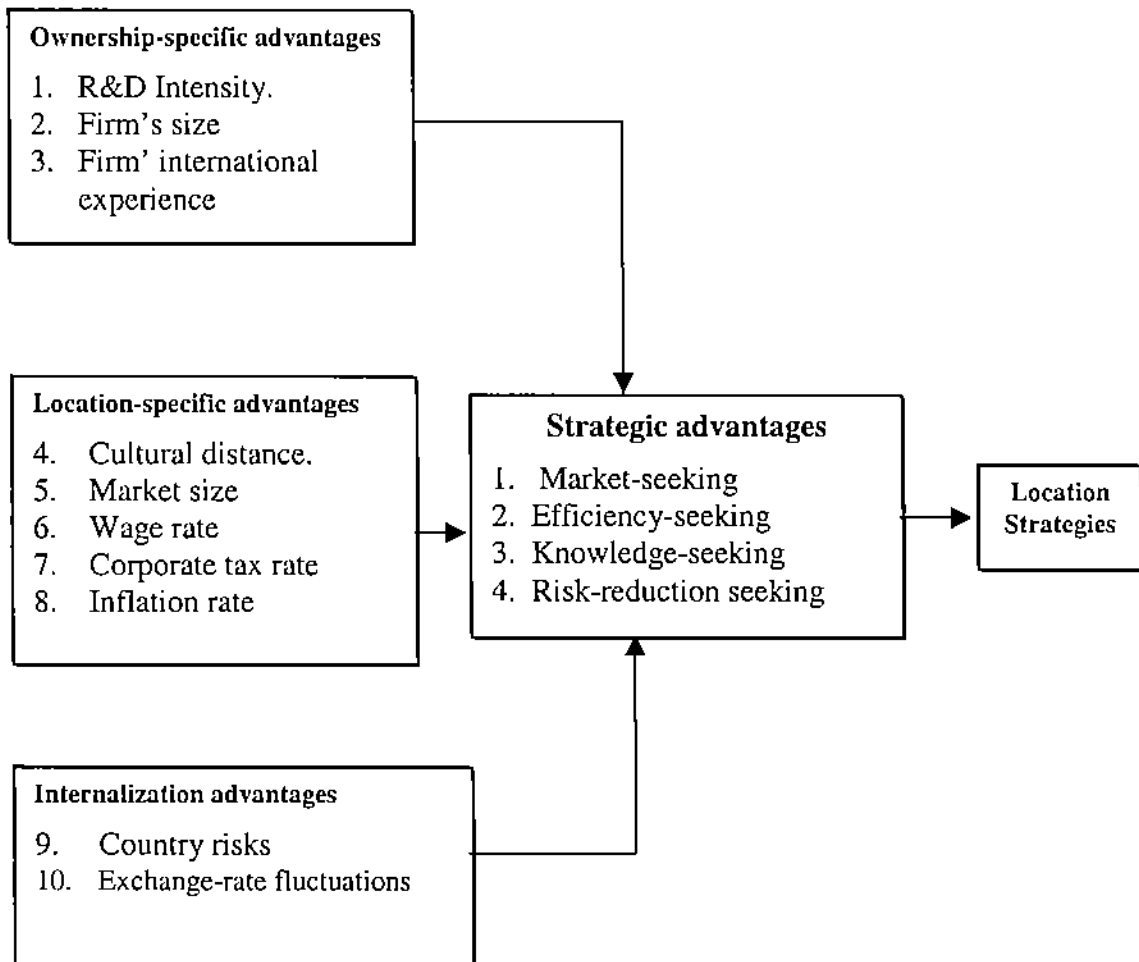
The chapter is organized in the following way. Section 5.2 introduces the eclectic framework, its underlying assumptions, transactional market failures and the role of firm strategies. The ownership-specific, location-specific and internalization advantages are then elaborated upon in separate sections (sections 5.2.1 to 5.2.3). Section 5.3 provides some concluding remarks.

## **5.2. The Framework**

The eclectic paradigm proposes that three types of factors influence cross-border business activities: ownership-specific variables, location-specific variables and internalization variables. While many scholars argue that ownership-specific and internalization factors share some similarities with the transaction cost perspective, the third component however clearly emphasizes the value of location-specific variables. Empirical support for the framework is emerging and this study will also be another step in this direction.

In this section the determinants of FDI location strategies have been categorized into four groups: Firstly, ownership-specific advantage include research and development intensity, firm's size and firm's international experience. Secondly, location-specific advantages include cultural distance between home and host country, market size, wage rate, corporate tax rates and inflation rates. Thirdly, internalization advantages include

country risks and exchange-rate fluctuations. Finally, *strategic advantages* include *market seeking, efficiency seeking, knowledge seeking and risk-reduction seeking motives* as the main strategic motives of direct investments.



**Figure 4.** The framework related to location aspects

The first part of our model (see Figure 4) consists of ownership-specific, location-specific and internalization advantages based on our interpretations of the eclectic framework. First, we also assume that the three sets of advantages affect each other and these proposed relationships act as the starting point for our conceptual model. The intermediate position of the strategic motives in the model reflects that they are a function of ownership-specific, location-specific and internalization advantages as well as other factors external to our model. External factors that might affect the strategic advantage could be past strategy, future strategy and the past configuration of the ownership-specific, location-specific and internalization advantages. However, our model is limited by the fact that we only consider the present contingencies, and we perform the empirical tests in the same context. In building a model we therefore

integrate, extend and modify the reviewed perspectives to fit our specific research problem.

### **5.3. Ownership-specific advantages**

To compete with hosts country firms in their own markets, firms must possess superior assets and skills that can earn economic rents high enough to counter the high costs of servicing these markets (Agarwal & Ramaswami 1992). Ownership-specific variables are unique internal factors that generate the firm's competitive advantage in the marketplace. A number of these ownership-specific variables are expected to have an impact upon a firm's choice of location.

#### **5.3.1. R&D Intensity**

FDI is seen as a vehicle by firms to accumulate new technologies when old technologies become obsolete (Shan & Song 1998). As the pace of technology increases, acquiring new capabilities becomes important to technology-intensive firms. Such a situation may lead to an eventual demise of the firm unless it actively seeks to acquire new technologies and capabilities by investing in companies and countries that possess such capabilities (Anand & Kogut 1997; Cantwell 1989; Shan & Song 1997). In performing a longitudinal analysis of the relationship between technology and FDI, Cantwell (1989) found that German and US firms are attracted to locations that are important sites of innovations within a specific industry. Likewise Cantwell (1995) confirms that firms are increasingly interested in developing new technologies in countries that are among the leaders in product and process innovation.

In support of this view, a growing amount of literature (e.g. Teece 1992; Dunning 1993 & 1995; Shan & Song 1997; Chang 1995; Almeida 1996; Frost 2001; Makino et al. 2002) suggests that ownership-specific advantages would arise not only from the possession of proprietary assets but from the capacity to acquire, or from the efficient coordination of, the complementary assets owned by other firms in a host country (Dunning 1995, 1998 & 2000). Firms that intend to build advantages through FDI therefore have a natural incentive to seek opportunities to invest in a particular location in which their needed technologies are available. Almeida (1996) has studied inward FDI in the U.S. semiconductor industry and found that foreign firms tended to cite local plants more frequently than similar domestic firms, suggesting that a primary purpose of

inward FDI by foreign firms in the U.S. semiconductor industry was to source local technology.

Belderbos and Sleuwaegen (1996) confirm that the desire to exploit existing technology or firm-specific intangible assets is the main determinant of Japanese investment in North America and Europe. Dunning (1992) also argues that firms undertake FDI in manufacturing R&D to exploit their existing advantages and firms invest in international R&D locations to improve the process of producing existing products to market in a cost-efficient manner. Furthermore Serapio and Dalton (1999) suggest that firms invest in overseas R&D to secure assets that are complementary to their core assets. These complementary assets may also help firms internalize operations by facilitating adaptation of their products and services to local markets. Serapio and Dalton (1999: 305) maintain that firms undertake FDI in R&D to “provide complementary assets that are essential to the success of their overseas manufacturing or sales operations.” Transplanted production and manufacturing operations in foreign locations often require adaptive development efforts; the product often has to be redesigned and reengineered. In order to improve firm’s capacity to respond to specific market conditions, R&D has to be conducted in the country where the subsidiary is located. As foreign subsidiaries assume greater responsibility, the R&D capacities accumulated in other countries shift from technical adaptation to autonomous product and process development. This accumulation of R&D capacities finally contributes to the stock of knowledge of the firm. On the basis of previous studies we therefore expect that R&D-intensive Finnish firms will undertake *knowledge seeking* FDIs in a target Asian country in order to enhance their technological competitiveness. Thus,

**H 1a** The higher the R&D intensity of the investing Finnish firm, the greater the probability that it will undertake *KS* FDI in a target Asian country.

### 5.3.2. Firm’s size

Foreign direct investment ventures unlike exporting require substantial financial as well as managerial resources. The literature on US and British multinationals suggests that the ability to generate internal sources for financing a project is an important determinant of planned overseas investment. Large firms, due to their large resource base, are often considered to be in a better position than smaller firms to make such commitments. It has been argued that the size and resources of the firms are likely to



influence the perceived risk of a project; one might expect that the readiness to engage in FDI projects – which are associated with a higher perceived risk – is dependent on the availability of resources (Benito 1995). Horsct (1972b) confirmed that size, more than any other variable explained the propensity of US firms to invest in Canada in the 1960s.

The impact of the firm's size has been investigated in several studies. In most of the previous studies (Owen 1982; Pearce 1989; Li & Guisinger 1992) it has been emphasized that large firms are more willing to undertake the risk and costs associated with FDI projects in distant and unfamiliar markets due to their large resource base. Wolf (1977) and Owen (1982) also demonstrated a positive relationship between US firm size and FDI. Juhl's (1978) analysis of German manufacturing FDI in less developed countries found firm size to be a positive and significant determinant of FDI. Similarly, Lall and Mohammad (1983) also concluded that FDI in India is positively related to the size of the investing firm. Bergsten et al. (1978:243) produced results that indicate that for US firms size is critical within the industry but not between industries. However, in a comprehensive investigation concerning the world's largest industrial enterprises, Pearce (1989) ascertains that there was no statistically significant relationship between size and the degree of multinationality of firms. Traditionally it has been argued that production units are located where the marginal cost of production is lowest. It is considered much easier for a large business to organize their production structure in such a way that it can exploit benefits of economies of scale in production. It could then lead to higher efficiency gains, a lower marginal cost of production and a large market share. We therefore expect that large Finnish firms will locate *market* and *efficiency seeking* FDI in a target Asian country. Hence,

**H 2a** The larger the size of the Finnish investing firm, the greater the probability that it will undertake *MS* and / or *ES* FDI in a target Asian country.

### 5.3.3. Firm's international experience

A firm's international experience can be considered an important source of ownership-specific advantages. Buckley and Casson (1985) argue that experience reduces the cost and uncertainty of serving a market. Padmanabhan and Cho (1999) maintain that the firm's past experiences manifest themselves in organizational routines that form the blueprint for the firm's future actions and, more importantly, serve as an important

source of competitive advantage. Similarly, Agarwal and Ramaswami (1992) conclude that firms without foreign market experience are likely to have more problems in managing foreign operations. The firm's knowledge base will increase with repeated experiences and be embodied in personal and organizational memory (Penrose 1959). For instance prior experience with a similar type of environment in a foreign country will allow the firm to "learn" from its past experience, and the learning will become very valuable when dealing with similar circumstances. Consequently the firm will prefer to use the same strategies, because these enhance the firm's value by reducing implementation costs in another foreign country, since the existing routines can be used.

Tallman (1992:462) also alludes to the importance of past decision specific experience in the firm's organizational structure decisions by noting that "the firm may reduce the uncertainty in a given situation by attempting to imitate either its own previously successful structures or its competitors' in the new market." Chang (1995) maintains that more internationally experienced firms face fewer knowledge disadvantages. The literature is not, however entirely free of discord. Maclayton, Smith and Hair (1980) found overseas business experience, measured in number of years, to have no relationship with a firm's evaluation criteria concerning a foreign market. But still, most previous research points to a positive relationship between the level of experience and FDI decisions. Furthermore, highly experienced firms will also be motivated to undertake market seeking FDIs by the advantages associated with staying close to their customers and thus protecting their ownership-specific advantages from deteriorating. We therefore expect that internationally experienced Finnish firms will undertake *market* as well as *efficiency seeking* FDIs in a target Asian country. Thus,

**H 3a** The larger the international experience of the Finnish investing firm, the greater the probability that it will undertake *MS* and/or *ES* FDI in a target Asian country.

#### **5.4. Location-specific advantages**

Firms interested in servicing foreign markets are expected to use a selective strategy and favor entry into more attractive markets. This is because their chances of obtaining higher returns are better in such markets (Agarwal & Ramaswami 1992). FDI theories suggest that investing firms will prefer those countries that provide greater location-specific advantages. Still, it has been known that both ownership-specific and location-

specific advantages separately and jointly influence the firm in its choice of target country for its FDI venture. Recent theoretical developments have expanded the role of location-specific variables by suggesting that it may be tied to ownership-specific advantages (Dunning 1997).

#### **5.4.1. Cultural distance**

Culture can be described as “the collective programming of mind that differentiate the motives and behavior of one social group to those of another” (Hofstede 1980:23). Culture provides challenge for the firms in terms of how to deal with the cultural distance within individual markets as well as across markets. Two approaches exist with regard to this question. Proper understanding of cultural differences allows determining when adaptation may be necessary and when regional or even global approaches could be applied. Culture is inherently conservative, but borrowing and interaction between various cultures (for example, by introducing new products and practices, new words in languages etc.) may lead to narrowing the distance between them. Dubin (1976) found that UK based firms have very often made their first FDI in Canada or in the US. Similarly Bergholm and Jagren (1985) also maintain that Swedish firms have often made their first FDI in other Nordic countries.

However, Benito and Gripsud (1992) found a very weak tendency for the first FDI by Norwegians firms to be made in countries that are culturally closer than those where later investments are made. Further, they did not find any evidence that the greater cultural distance between the home and host country could have a negative affect on the FDI decisions of the firms. In investigating FDI flows to Central and Eastern Europe, Mikalak (1992) suggests that inherent variations in language and culture dissuade potential investors, except in countries that have traditional ties with Central and Eastern Europe. Likewise Grosse and Trevino (1996:152) conclude that those countries culturally dissimilar to the US and / or farther away tended to have less FDI in the US. Davidson (1980) also finds that US firms have usually made their first foreign investments in countries like Canada and the UK. Root (1978) maintains that uncertainty due to cultural distance may also cause executives to undervalue foreign investments. Moreover, the potential rents realized from investment are generally higher in culturally familiar countries than in unfamiliar countries. We therefore expect that

Finnish firm will undertake *market* as well as *efficiency seeking* FDIs in a culturally close target Asian country. Hence,

- H 4a** The larger the cultural distance between the host and home country of the Finnish investing firm, the lower the probability that it will undertake *MS* and/or *ES* FDI in that Asian country.

#### 5.4.2. Market potential

Market size and the domestic competitive environment are considered to be important determinants of FDI (Dunning 1980; Porter 1990; Vernon 1966). Firms usually invest in large markets to capitalize on firm-specific assets by entering the market first, or by following leading firms in the new markets (Knickerbocker 1973). In either case, the future share of new markets is the driving force behind expansion into foreign markets. Haq (2001) concluded that firms are attracted to large and prosperous markets because these markets offer higher returns on investment, although they also present high entry barriers and competitive pressures. Culem (1988) reviews bilateral flows of FDI between six industrialized countries and shows that host-market size and rate of growth are a significant determinant of inward FDI. A number of empirical studies of FDI (e.g. Cunningham 1975; Swendenborg 1979; Dunning 1980; Scaperlanda et al. 1983; Papanastassiou & Pearce 1990) have also confirmed that the market potential of host countries has a significant and positive effect on attracting FDI.

Lunn, (1980) found the market size of the EEC to be a significant variable for US direct investment in Europe. Hennart and Park (1994) concluded that in order to avoid protectionism stemming from tariff and non-tariff barriers, Japanese firms were particularly interested in serving the large and sophisticated US product market in the 1980s. For developing countries (e.g. Root & Ahmed 1979; Torrissi 1985; Schneider & Frey 1985; Petrochilas 1989; Wheeler & Moody 1992) all those previous studies found market size to be a significant predictor of FDI. In either case, a future share of new markets is the driving force behind expansion into foreign markets. However, Wheeler and Moody (1992) further argue that the relationship between the flow of FDI and the size of the market becomes less significant when FDI is export-based and not market-based. In this case, firms undertake investment in a particular country to capitalize on factor costs such as raw materials and labor. Such countries usually have small markets but are generally endowed with cheap materials and labor. The US department of

Commerce's Current Survey of Business (1988:3) also reports that newly acquired or established foreign affiliates continue the trend of locating production activities in countries with large and prosperous markets, rather than in countries with low labor and input costs. Furthermore it has been argued (e.g. Sabi 1988) that firms expect to experience greater long-term profits through economies of scale and lower marginal cost of production in countries with larger market potential. We therefore expect that a Finnish firm will undertake *market* as well as *efficiency seeking* FDI in a target Asian country with a huge market potential. Thus,

**H 5a** The larger the market size of the target Asian country, the greater the probability that a Finnish firm will undertake *MS* and/or *ES* FDI in that Asian country.

#### 5.4.3. Wage rate

According to neoclassical theories, the labor-cost differential is considered an important determinant of FDI. The new international division-of-labor (NIDL) theories also focus on the cost minimization strategies of firms (Frobel et al. 1980). It can be argued that location-specific advantage induced by low wages increases the prospects of low production costs and could also stimulate the firms to establish themselves in new products and in new markets as well. Schoenberger (1988) also argued that US investment in Puerto Rico and Japanese investment in Ireland were mainly made on cost-minimization and tariff-free market access. The research on the determinants of FDI in developing countries also indicates that the labor cost differential has been a significant determinant of FDI (e.g. Riedel 1975; Schneider & Frey 1985; Onn 1989; Summary & Summary 1995; Wheeler & Mody 1992; London & Ross 1995). Riedel (1975) found that relatively lower costs of labor had been one of the key determinants of export-oriented FDI in Taiwan. In a study on FDI in industrialized countries (Belgium, France, Germany, Netherlands, U.K and U.S), Culem (1988) also found that foreign investors were sensitive to labor costs, other things equal, was a significant deterrent to inward FDI. London and Ross (1995:21) also conclude that foreign investors from developed countries seek labor which is "more domicile and less costly than that in the older industrial regions." In his study of FDI in Malaysia, Onn (1989) found that the abundant supply of young and relatively cheap skilled workers formed one of the strongest attractions for foreign investments. Austin (1990) noted those wages cost advantages are a primary reason for businesses to integrate developing

countries into their global production strategy. Likewise Rolfe and White (1992) found this to be the most important variable in their judgment modeling study of Caribbean investors.

There are, however, some empirical studies that argue that wage rate is not a significant determinant of FDI (e.g. Buckley & Dunning 1976; Karvis & Lipsey 1982; Papanastassiou & Pearce 1990; Yamawaki 1991). Karvis and Lipsey (1982) in a study of US firms in both developed and developing countries found that U.S firms invested in high-wage countries so that labor cost in general was not a major influence on FDI. Dunning (1980) finds that although there is a negative correlation between real wage rates and FDI, the effect is not, however, statistically significant. Buckley and Dunning (1976) maintain that there is no significant relationship between wage-rate differential and the flow of US FDI to the United Kingdom. Dunning (1996:38) observes that, "real wage costs are more likely to influence the mode of servicing developing country markets than developed country markets." In the context of developed countries, Froot and Stein (1991) claim that the change in the real wage cost of Japanese and US workers was a strong determinant of new investment by Japanese firms in the US in the 1980s. Traditionally it has been argued here that low wage rates may create an opportunity to achieve plant-level scale and scope economies, higher production efficiency and a larger market share. We therefore expect that Finnish firms will undertake *market* as well as *efficiency seeking* FDIs in a target Asian country with relatively low wage rates. Hence,

**H 6a** The higher the wage levels in the target Asian country, the lower the probability that Finnish investing firm will undertake *MS* and/or *ES* FDI in that target Asian country.

#### 5.4.4. Corporate tax rates

The location choice of the investing firms can also be influenced by another market imperfection – the income tax rate. Theoretically, higher corporate tax rates reduce the net profit and consequently discourage FDI (Hartman 1981). Thus, the need to locate manufacturing facilities in countries with relatively low tax rates serves the purpose of market as well as efficiency seeking FDIs. Pioneering work by Hartman (1981 & 1984) finds evidence that taxes and FDI are inversely related. Boskin and Gale (1986) re-estimate Hartman's (1984) equations, using updated series for the tax rate and the rate

of return. Their qualitative results are consistent with those of Hartman (1984), even though the estimated elasticity of FDI in relation to the rate of return is somewhat lower. Graham and Krugman's (1991) findings suggest that the changes in the US corporate tax rate in the early 1990s did not have a noticeable effect on inward FDI. Moody and Srinivasan (1991) do not find a significant relationship between tax rate and manufacturing FDIs.

The World Bank report (1995) maintains that pro-investment tax policies are often unnecessary and sometimes even detrimental to inbound FDI. Other studies (e.g. Jun 1989; Lizondo 1990; Brewer 1991; Cassou 1997; Wei 2000) indicate that the corporate tax rate is an important determinant of FDI. In a comparative study of FDI locations in US, Hines (1996) finds that state tax rates had a substantial impact on location of inward FDI. Wei (2000) uses a sample of bilateral investment of twelve home-countries to forty-five countries, and finds that a rise in corporate tax is a significant deterrent to FDI. Slemrod (1990) shows that US tax rates influence FDI inflows and the tax policies of the home country do not have a significant impact. Shah and Slemrod (1990) also observe that FDI flows to Mexico, particularly from the US, are sensitive to Mexico's tax policies. Gerlowski et al. (1994) find that foreign investors from Canada, the United Kingdom and Japan all have strong motives to avoid states with high tax rates. Yamada and Yamada (1996) suggest that tax related incentive policies such as lower corporate taxes on earnings are important determinants of FDI by Japanese firms in the European Union. Ermisch and Huff (1999) conclude that lower taxes on foreign corporate investments are a beneficial strategy in attracting FDI to less developed countries like Singapore. We therefore expect that a Finnish firm will undertake *market* as well as *efficiency seeking* FDIs in a target Asian country with relatively low corporate tax rates. Hence,

**H 7a** The higher the level of corporate taxes in the target Asian country, the lower the probability that Finnish investing firm will undertake *MS* and/or *ES* FDI in that target Asian country.

#### 5.4.5. Inflation

Inflation is also considered a proxy for the quality of macroeconomic management. The inflation rates of any country can substantially influence the relative prices between input goods and final goods within firms. As the anticipated and unanticipated changes

in the relative prices of goods, labor and capital within firms and among firms operating in different markets have the potential to influence the cost and benefits of servicing international markets through exports and foreign production, as well as the relative profitability among alternative locations for production. Thus high or low inflation rates in any particular country may trigger firms to expand or contract existing production operations, as well as enter or exit any foreign country. Foreign capital is known to detract from countries such as Russia, Yugoslavia and Thailand during periods of high inflation.

Scheider and Frey (1985) suggest that the rate of inflation in host countries is a negative and significant determinant of FDI in developing countries. Hyun and Whitmore (1989) find that high inflation rates in Latin America, Asia and Africa detract investments by Japanese firms. Similar findings have been reported by Sayek (2000) for FDI from the US. Sayek reports that a 3% increase in Canadian inflation reduces US investment in Canada by 2%. Similarly she also found that a 7% increase in Turkish inflation reduced US investment in Turkey by 1.9%. Finally, Schneider and Frey (1985) and Bajo-Rubia and Sosvilla-Rivero (1994) find that inflation and FDI are negatively related, thus creating an uncertain environment for foreign and domestic investors alike. It can be argued that if foreign investors are risk averse (or even risk neutral), higher inflation rate uncertainty may lead to a reduction of FDIs, because investors do not want to risk their expected profits from investment. As long as there is uncertainty, foreign investors will demand a high price to cover their exposure to inflation risks, and this, in turn, will decrease the volume of investment. Thus, to encourage investment, the stability of the inflation rate might be important. We therefore expect that Finnish firms will undertake *risk-reduction seeking* FDIs in a target Asian country with relatively low inflation rates. Thus,

**H 8a** The higher the levels of inflation in a target Asian country, the lower the probability that the Finnish investing firm will undertake *RRS* FDI in that Asian country.

### 5.5. Internalization advantages

Finally, firms that possess similar ownership-specific advantages and are faced with broadly comparable L-specific advantages of countries may still have different impacts on their operations because they organize and control these variables differently.



Internalization advantages arise when the potential rents to be realized from the firm-specific advantages are higher if they are transferred across borders within a firm's own organization than if they are sold in the external market for ownership-specific advantages. These internalization advantages may be created if the firm is able to reorganize and achieve internal transaction cost economies. This may be done through the introduction of new organizational structures, which reduce internal search, contracting and monitoring costs (Dunning 1997). A number of internalization variables have impact upon a firm's location choices. These variables include country risks and exchange rate fluctuations.

### **5.5.1. Country risks**

In many studies, country risk has been categorized as a location-specific variable (e.g. Hill, Hwang & Kim, 1991). However we decided to apply it as an internalization variable, as mentioned in Dunning (1993:84) and Chandprapalert (2000). Risks in foreign markets are frequently cited as a deterrent to inward FDI (Dunning 1996). Butler and Joanquin (1998:602) identify political instability as "the risk that a sovereign host-government will unexpectedly change the rules under which businesses operate." As the economic structures of advanced industrial nations have increasingly become integrated, and as more national governments have adopted market-oriented policies, the importance of political risk as a determinant of FDI has declined (Dunning 1996).

However, studies of the determinants of FDI in developing countries reach opposite conclusions (Edwards 1990; Lizondo 1990; Summary and Summary 1995). Edwards (1990) suggests that variables such as political instability and political polarization play a significant role in determining the flow of FDI into developing countries. Agarwal (1980) also finds a negative correlation between political instability and FDI. In a study of the post-independence economic transition in the Ukraine, Ishaq (1999) concludes that FDI flows to the Ukraine were relatively small in relation to the country's GDP, mainly due to the country's unstable and uncertain political climate. Likewise Nigh (1985) uses regression analysis to show that political conflict is a strong deterrent of FDI in the developing host countries of Asia and Africa. Summary and Summary (1995) find that the foreign registrant variable or the number of foreign agents registered with the US Justice department showed that political instability is the significant political determinant of FDI only in developing countries. Summary and

Summary (1995) further argued “both economic and political variables have a statistically significant effect on the US direct investment in the developing countries.”

Some empirical studies, however find mixed results (e.g. Lizondo 1990; and Wheeler & Moody 1992). Lizondo’s (1990) review of the literature on the determinants of FDI generally supported the negative relationship between political risk and FDI, albeit not in a conclusive manner. Likewise Wheeler and Moody (1992) suggest little significance in the relationship between political factors and FDI in 42 countries between 1982-88. It can be argued here that a firm only invests in the presence of a highly volatile political and economic environment if the investment is fully reversible, otherwise it may delay, or altogether terminate efforts if the investment is not easily modified or reversed. Traditionally, it has been argued that risks increase uncertainty, thereby discouraging inward FDIs. On the basis of number of empirical studies (e.g. Kogut 1989; Dunning 1993) we recognize that firms may take FDIs designed to reduce the corporate risks associated with the changes and moves of national and regional governments of the host country. We therefore expect that Finnish firms will undertake *risk-reduction seeking* FDIs in a target Asian country with relatively low levels of risk. Thus,

**H 9a** The lower the risks in the target Asian country, the greater the probability that the Finnish investing firm will undertake the *RRS* FDI in that Asian country.

### **5.5.2. Exchange rate fluctuations**

Caution must be exercised when examining currency fluctuations between host and home countries because the importance of changes in exchange rate to firms can vary based on ownership-specific objectives and strategies (Beamish et al. 2000). It is a commonly held view that exchange rates fluctuations increase risks and uncertainty, thereby affecting incentives to attract investments. This problem is typically analyzed in a microeconomic framework in terms of the theory of the firm under uncertainty. Kwon and Konopa (1993) argued that an unfavorable shift in foreign exchange rates also poses danger to foreign investors. Likewise Baldwin and Krugman (1989) focused on real exchange rate uncertainty. They showed that the sunk cost of entry may encourage firms to move into export activities that would appear profitable in the light of current real exchange rate levels. Mody and Srinivasan (1991) find a negative correlation between exchange rate fluctuations and FDI in some industrial sectors. In a study of currency

movement and its effect on the location of FDIs, Caves (1989) and Froot and Stein (1991) show that a negative relationship existed between exchange rate fluctuations and FDI inflows into the US.

The results are, however, again not uniform throughout these studies. In a survey of US transnational corporations (TNCs) in Latin America, Wallance (1990) finds that exchange rate fluctuation is the most negligible factor in markets entry decisions, and that market size and wage differential are more critical to the investment decisions of TNCs. Dunning (1996) also concluded that exchange rate fluctuations are rarely the most significant determinant in explaining the distribution of FDI. However Grosse & Trevino (1996) find that an increase in the value of home country currency in relation to the US dollar is a significant and positive determinant of the number of FDI transactions in the US. Here it can be argued that firms that seek cheap labor and efficiency for their operation and market for their products would benefit from strong home-currencies. On the other hand, if the subsidiary of the firm has to use the imported inputs for foreign production, then a low value of the host country's currency will discourage investment in that country. Overall, the exchange rate fluctuations show a significant and negative impact on FDI in developing countries (Summary & Summary 1995). We therefore expect that Finnish firms prefer to undertake *risk-reduction seeking* FDIs in a target Asian country with relatively low levels of exchange rate fluctuations. Hence,

**H 10a** The higher the levels of exchange rate fluctuations in a target Asian country, the lower the probability that the Finnish investing firm will undertake *RRS* FDI in that Asian country.

**Table 11.** Summary of the results obtained on the impact of OLI related variables on FDI choices in previous studies

Authors	Focus of the study	Independent variable	Results
Belderbos & Sleuwaegen (1996)	Japanese investment in North America and Europe	R&D	Positive
Shan & Song (1997)	FDI in biotech industry	R&D	Positive
Kuemmerle (1999)	FDI in R&D from the US, Japan, Germany, France and U.K.	R&D	Positive
Caves (1971)	Industrial corporations and foreign investment.	Firm's large size	Positive
Lail & Mohammad (1983)	Multinationals in Indian big business	Firm's large size	Positive
Li & Guisinger (1992)	US firms undertaking FDI's	Firm's large size	Positive
Maclayton, Smith & Hair (1980)	Internationalization of US firms in health-care products	Firm's large international experience	Negative
Chang (1995)	Expansion strategies of Japanese firms	Firm's large international experience	Positive
Padmanabhan & Cho (1999)	FDI by Japanese firms	Firm's large international experience	Positive
Bergholm & Jagren (1985)	Internationalization of Swedish firms	Low cultural distance	Positive
Benito & Gripsud (1992)	FDI by the Norwegian firms	Low cultural distance	Negative
Grosse & Trevino (1996)	FDI's by the US firms	Low cultural distance	Positive
Scaperlanda & Balough (1983)	US direct investment in the EEC	Large market size	Positive
Papanastassiou & Pearce (1990)	UK manufacturing industry	Large market size	Positive
Haq (2001)	US direct manufacturing investment abroad	Large market size	Positive
Buckley & Dunning (1976)	US FDI to the UK	Low wage rate	Negative
Wheeler & Moody (1992)	International investment location decisions of US firms	Low wage rate	Positive
Summary & Summary (1995)	Time-series, cross-sectional data on the flow of FDI to developing countries	Low wage rate	Positive
Mody & Srinivasan (1991)	US investment abroad	Low tax rate	Negative
Yamanda & Yamanda (1996)	Japanese FDI's in EU	Low tax rate	Positive
Ermisch & Huff (1999)	Hyper-growth in an East Asian NIC	Low tax rate	Positive
Scheider & Frey (1985)	Economic and political determinants of FDI	Low inflation	Positive
Hyun & Whitmore (1989)	Japanese direct foreign investment	Low inflation	Positive
Bajo-Rubia & Sosvilla-Rivero (1994)	Foreign direct investment in Spain	Low inflation	Positive
Edwards (1990)	Capital flows, foreign direct investment and debt-equity swaps in developing countries	Political instability	Negative
Wheeler & Moody (1992)	International investment location decisions of US firms	Political factors	Positive
Ishaq (1999)	Foreign direct investment in the Ukraine	Uncertain political climate	Negative
Mody & Srinivasan (1991)	US investment abroad	Exchange rate fluctuations	Negative
Froot & Stein (1991)	Foreign direct investments in the US	Exchange rate fluctuations	Negative
Grosse & Trevino (1996)	Foreign direct investments in the US	Exchange rate fluctuations	Positive

- Positive means that this variable increases the probability to undertake FDI
- Negative means that this variable reduces the probability to undertake FDI

## 5.6. Summary

The main goal of this chapter was to theoretically investigate the role of ownership-specific, location-specific, internalization and strategic advantages in the eclectic framework in order to further understand the location strategies of the investing firms in target countries. The eclectic paradigm proposes that three types of factors influence cross-border business activities: ownership-specific advantages, location-specific advantages and internalization advantages. While many scholars argue that ownership – specific and internalization factors share some similarities with the transaction cost factor perspective and however the third component (i.e. location-specific advantages) clearly emphasize the value of location-specific advantages.

The determinants of FDI location strategies have been categorized into four groups: Firstly, ownership-specific advantages includes research and development intensity, firm's size and firm's international experience. Secondly, location-specific advantages include cultural distance, market size, wage rate, corporate tax rates and inflation rates. Thirdly, internalization advantages include country risks and exchange rate fluctuations. Finally strategic advantages include *market seeking*, *efficiency seeking*, *knowledge seeking* and risk reduction as main motives for direct investments.

The first part of our model (see Figure 4) consists of ownership-specific, location-specific and internalization advantages based on our interpretations of the eclectic framework. We have assumed that the three sets of advantages affect each other and these proposed relationships act as the starting point for our conceptual model. The intermediate position of the strategic motives in our model indicates that strategic motive is a function of ownership-specific, location-specific, internalization advantages as well as other factors external to our model. External factors that might affect the strategic advantage could be past strategy, future strategy and the past configuration of the ownership-specific, location-specific and internalization advantages. However our model is limited by the fact that we only consider the present contingencies. In building a model we therefore integrate, extend and modify the reviewed aspects to fit our specific research problem.

First, as to ownership-specific advantages, based on the literature review it was expected that firm's large size and firm's large international experience increase the

probability to undertake *MS* and *ES* FDIs (see Table 12) in a target country. Similarly, high R&D intensity of the investing firm increases the probability to undertake *KS* FDIs in a target country. Secondly, as a location-specific advantage it was expected that large size of the target market, low cultural distance, low wage rate and low taxes in a target country increase the probability that the investing firm undertakes *MS* and *ES* FDIs. Likewise low inflation rates in a target country increase the probability that the investing firm undertakes *RRS* FDIs. Finally, as an internalization advantage it was expected that low levels of risks and a low level of exchange rate fluctuations in a target country increase the probability that the investing firm undertakes *RRS* FDIs.

**Table 12.** Types of international production (related to location aspects): some determining factors

Types of International Production	Ownership Advantages (O)	Location Advantages (L)	Internalization Advantages (I)
Market seeking FDIs	Large firms' size Large firms' international experience	Low cultural distance Huge market potential Low wage rates Low corporate taxes	
Efficiency-seeking FDIs	Large firms' size Large firms' international experience	Low cultural distance Huge market potential Low wage rates Low corporate taxes	
Knowledge seeking FDIs	High R&D intensity		
Risk-reduction seeking FDIs		Low inflation rate	Low country risks Exchange rate fluctuations

**Source:** Modified and adopted by the author based on Dunning (1993:82)

By identifying the strategic objectives underlying FDI projects, it becomes possible to analyze directly and explicitly the role of ownership-specific, location-specific and internalization advantages affecting the strategies regarding on the propensity of firms to undertake FDI projects. The distinctions among the strategic objectives of FDIs highlight "differences in key features associated with different FDI projects" (Brewer 1993:105; Ekström 1998:90) and they indicate the strategic advantages investing firms seek by undertaking FDIs.

## 6. DETERMINANTS OF OWNERSHIP STRATEGIES IN FOREIGN DIRECT INVESTMENTS

This chapter theoretically reviews how ownership-specific, location-specific, internalization and strategic advantages influence the ownership strategies of the investing firms in the target countries. Then each of the above mentioned advantages are reviewed in detail in different subchapters. Several hypotheses are developed regarding the extent of theoretical and empirical literature on the ownership strategies of the investing firms in target countries. The chapter ends with a summary of all the reviewed previous studies related to ownership strategies of the investing firms in the target countries.

### 6.1. Introduction

After location, the second most important foreign direct investment (FDI) related strategic decisions is the ownership-structure decisions. Ownership strategies has been defined as an institutional arrangement for organizing and conducting international business transactions, such as joint ventures and wholly owned operations. In the field of foreign direct investment (FDI), the question of ownership strategies seems to have attracted most attention in the research community. There are basically three reasons for this interest. Firstly, ownership strategy is one of the key components of the internationalization process. Therefore, research on the firm's internationalization process has to include international ownership strategies to a large extent. Secondly, the choice of correct ownership structure for a particular market is one of the critical decisions for firms in international operations. Finally, the theoretical contributions have been more advanced in the area of ownership structure choices in foreign markets than in other areas (e.g. location choices) of internationalization concept.

The main goal of this chapter is to identify how different ownership-specific, location-specific, internalization advantages and strategic advantages could influence the ownership strategies of the Finnish manufacturing firms in ten South and Southeast Asian countries from 1980 to 2000. Dunning (1993:56) identifies four main strategic motives: *market seeking (MS)*, *efficiency seeking (ES)*, *risk-reduction seeking (RRS)* and *knowledge seeking (KS)*. Because most of the Finnish firms in Asia have mainly been transferring technology to Asian firms thus *KS* appears to be less relevant when

compared with the *MS*, *ES* and *RRS* types of FDI in this context. We therefore propose that the *MS*, *ES* and *RRS* are the main strategic motives that can influence the ownership strategies of the Finnish firms in Asian markets. It is also hoped that the theoretical and empirical analysis of these relevant strategic motives along with the influencing OLI advantages can not only add to our understanding of the eclectic paradigm but also enrich our knowledge of FDI in general.

This chapter is organized in the following way. In section 6.2, the eclectic framework has been introduced. The theoretical and empirical literature on ownership strategies will be summarized and the crucial ownership-specific, location-specific, internalization and strategic advantages of the investing firms will be discussed in separate sections (sections 6.2.1 to 6.2.3). Finally section 6.3 provides some concluding remarks.

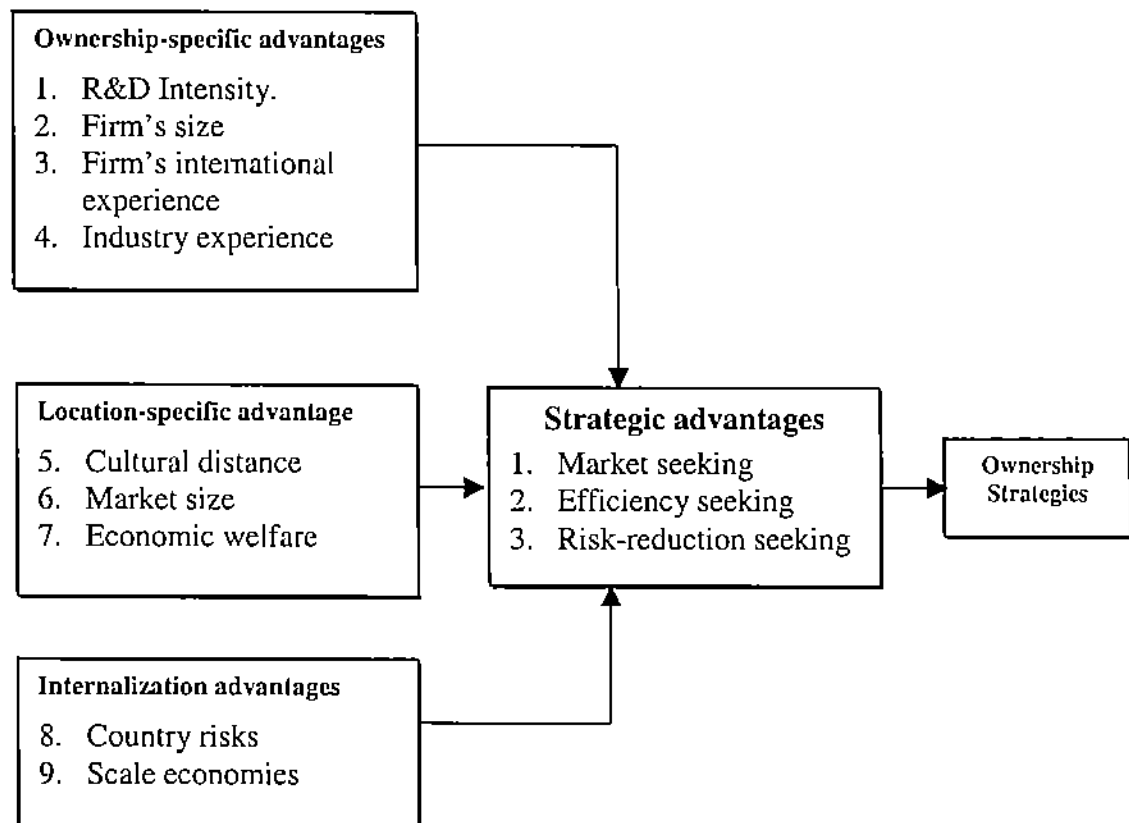
## **6.2. The Framework**

The eclectic paradigm proposes that three types of advantages influence cross-border business activities: ownership-specific advantages, location-specific advantages and internalization advantages. Ownership-specific advantages include various tangible and intangible assets owned by the investing firm whereas transaction specific advantage includes variables related to the ability of firms to capture the transactional benefits from the common governance of multiple and geographically dispersed activities. Location-specific advantages (L) are essential in determining where firms will engage in cross-border value-adding activities. The level of location-specific advantages may also be expected to influence the ownership strategies chosen. The last strand of the OLI approach comprises the internationalization advantages (I) that the company has in transferring assets within their organizations instead of via the market, because of the market failures. The greater the perceived costs of transactional market failure – and the greater the benefits of circumventing market failure – the more likely the company will be to exploit its ownership-specific advantages within the firm and the greater the degree of ownership it will prefer in its FDIs. ´

In this section the determinants of ownership strategies will be categorized into four groups: Firstly, ownership-specific advantages which include research and development intensity, firm's size, firm's international experience and industry experience. Secondly, location-specific advantages, i.e. cultural distance between home and host country,



market potential and level of economic welfare in the host country. Thirdly, internalization advantages, which include country risks and scale economies. Finally strategic advantages include *market seeking*, *efficiency seeking* and *risk-reduction seeking* as main motives of direct investments.



**Figure 5.** The framework related to ownership aspects

Buckley and Brook (1992:15) and Randoy (1994:65) point out how “motives, the process of direct investment and the ownership strategy (mode) into a particular foreign market vary greatly according to the characteristics of the entrant firm, its past relationship to the market and the nature of the foreign market.” In our model of ownership structure we attempt to capitalize on the above-mentioned quotation. We have included the factors related to “strategic motives” (strategic advantages), “the process of direct investment” (internalization advantages), “characteristics of the investing firm” (ownership-specific advantages), and “the nature of the foreign market” (location-specific advantages). Each of these advantages are part of our model of ownership strategy. We have not fully incorporated “past relationship to the market,”

although “international experience” is included in the model. However, our model is limited by the fact that we only consider present contingencies.

### **6.3. Ownership-specific advantages**

To compete with host country firms in their own markets, firms must possess superior assets and skill that can earn economic rents that are high enough to counter the high costs of servicing these markets (Agarwal & Ramaswami 1992). Ownership-specific advantages are unique internal factors that generate a firm’s competitive advantage in the marketplace. A number of these ownership-specific variables are expected to have an impact on the ownership strategies and motives of the firm.

#### **6.3.1. R&D Intensity**

The speed of applications of new technology to products, partly fueled by changing consumer demand, has made access to technology essential for survival in many firms. At the same time new technology has brought a degree of complexity and has made it more difficult for firms to have in-house mastery of increasingly diverse technologies required to develop sophisticated products (James 1992). As developing advanced technologies may require a level of effort beyond one firm’s abilities, international joint ventures (IJVs) may be considered an important vehicle to pool complementary technologies between partners (Contractor & Lorange 1988). For instance, many companies specialize in one particular segment of technology but often lack the breadth of knowledge to integrate other technologies to develop new products. This situation defined, as “hybridization of technologies” by Lynch (1989), can be best accomplished by integrating the technologies of partners. Hence, an entering firm that is seeking technology and tacit knowledge is more likely to enter the foreign market through a JV (joint ventures) with a firm that has the needed technology (Phatak et al. 1996). E.g. many (joint ventures) JVs in the pharmaceutical and biotechnology fields have this kind of rationale (Contractor 1986).

By contrast, an investor that possesses the full complement product and production know-how has strong incentives to keep control and to enter through WOSs. If knowledge is difficult to transact in markets, then transferring significant amounts of knowledge to a JV is likely to create problems. However, Kumar (1984) argued that FDI was the dominant mode of operation in those sectors that were characterized by a

high level of R&D intensity or firm-specific technology. Furthermore, the level of firm-specific technology influences the ownership strategy, since the firm with greater technology may also incur higher transaction costs in safeguarding their technology from misappropriation (Williamson 1985; Anderson & Gatignon 1988; Hennart 1987; Brouthers & Brouthers 2000).

A high level of ownership-specific technology tends to create contracting hazards because of the impact of opportunism (Williamson 1985; Hill 1990). Opportunism results when a partner organization takes advantage of the other firm's dependency through shrinking, free-riding or technology dissemination (Williamson 1985; Anderson & Gatignon 1988; Hill 1990; Hennart 1991). This risk is especially relevant in the Asian countries where the legal infrastructures and controls are often poorly developed. To safeguard specific assets from potential opportunism problems, firms may utilize high control governance structures, such as WOSs (Anderson & Gatignon 1988; Hennart 1991; Makino & Neupert 2000). Empirical support for a positive relationship between R&D intensity and WOSs has been found in several studies e.g. (Sanna-Randaccio 1990; Padmanabhan & Cho 1999; Buckley & Casson 1976; and Larimo 2000).

Firms with a low level of R&D intensity or firm-specific technology may be less concerned with opportunism and safeguarding their technology and more concerned with mode efficiency. It has been argued (e.g. Williamson 1985; Hill 1990) that less integrated ownership strategies like JVs provide more efficient organizational structures when there is a reduced threat of opportunism. We expect that Finnish firms have mainly been transferring technology to Asian countries. We therefore suggest that Finnish firms will choose WOSs in order to undertake *risk-reduction seeking* FDIs in a target Asian country. Hence,

**H 1b** The higher the R&D intensity of the Finnish firm, the greater the probability that its WOS will undertake *RRS* FDI in a target Asian country.

### 6.3.2. Firm's size

Frequently it is the firm's ability to determine its choice of ownership strategy. The typical argument in the literature is that integration entails significantly higher resource commitments such as WOSs and carries greater risk than shared-control structures. Consequently, larger firms have greater ability to expend resources and absorb risks than smaller ones and therefore are more likely to establish WOSs. Also, larger firms

may have greater bargaining power to negotiate for greater ownership and control in countries with restrictive investment policies (Lecrew 1984). It has also been argued (e.g. Gomes-Casseres 1985; Kogut & Singh 1985 & 1988b; Benito 1995; and Mutinelli & Piscitello 1997) that firms can access more control by holding more shares and consequently investing firms with strong financial resources may enter foreign markets via WOSs.

There is, however, another argument that leads to the opposite prediction namely that large firms prefer shared equity ventures. Hennart and Larimo (1998) concluded that WOSs may increase the managing costs of the parent company and by contrast, a JV structure between foreign investors and the local firms may make it possible to better access the resources without incurring large management costs. Larimo (1993) has also found that large size Finnish manufacturing firms had a higher propensity to enter OECD countries through JVs. Sanna-Randaccio (1990) also found the same for Italian investors abroad.

However, other scholars (e.g. Buckley & Casson 1976; Cho 1985; Yu & Ito 1988; Kimura 1989) suggest that the firm's ability to marshal resources is a potential determinant of ownership structure choices. Similarly, the results by Stopford and Wells (1972), Gomme-Casseres (1985:120) and Kogut and Singh (1985, 1988b: 425) gave support to the assumption that the probability of choosing a joint venture is greater among small firms than among big firms. Larimo and Tahir (2001) also found that large-size Nordic manufacturing firms have preferred WOSs in Asian markets. Furthermore organizational scientists (e.g. Lawrence & Lorsch 1967) argued that as the organization's size increases, its extent of specialization, standardization and formalization will increase correspondingly. Conventional wisdom would suggest that for the large size firms, it also becomes possible for economies of scale to be realized in the areas of production, marketing, advertising, purchasing and R&D. This could then lead to higher efficiency gains, lower marginal cost of production and larger market share. We therefore suggest that large Finnish firms will choose WOSs in order to undertake *market* and *efficiency seeking* FDIs in a target Asian country. Hence,

**H 2b** The larger the size of the Finnish firm, the greater the probability that its WOS will undertake *MS* and/or *ES* FDI in a target Asian country.

### 6.3.3. International experience

Almost all research that studied the determinants of FDI considers experience as a key determinant of a firm's asset. The traditional argument here is that the longer a firm operates in a foreign market the more experiential knowledge should have been accumulated within its organizational structures. Ekeledo (1998) has indicated that a firm with limited international experience that enters foreign markets is likely to use a low-involvement mode of operation to gain experience before getting involved in sole-ownership structures. Anderson and Gatignon (1988) also found that the manufacturing firm's propensity to employ wholly-owned-subsidiary (WOSs) increased with cumulative international experience.

Further, Makino and Delios (1996) stated that the comparative utility of structuring a foreign investment as a local JV, as opposed to a wholly owned subsidiary, decreased with greater levels of international experience because of the foreign firm's development of local knowledge. Similarly, Davidson (1980 & 1982) noticed that aggregate experience (as measured by the number of market entries or product transfers already executed), and prior manufacturing experience in the recipient country increased the firm's relative preference for WOSs. Dunning (1993:79) concluded that firms must have ownership-specific advantages (O) like "privileged possession of intangible assets" the exploitation of which creates firm value. Furthermore Padmanabhan and Cho (1999) argued that the firm's past experience manifests itself in organizational routines that form the blueprint for the firm's future action and more importantly, serve as an important source of competitive advantage. Consequently the firm will prefer to use the same strategies, because these enhance the firm's value by reducing implementation costs in the foreign country, which in turn could stimulate the firm to choose WOSs and to undertake *market* as well as *efficiency* -seeking FDIs in a target country.

The literature, however, is not without controversy. There is some evidence to indicate that international experience may not have any effect on the degree of control. Kogut and Singh (1988) observed that experience (as measured by the firm's pre-entry presence in the host country, and the degree of multinationality) plays no significant role in explaining why foreign entrants into the United States used JVs in preference to WOSs. Some researchers even suggest a negative relationship between the firm's

international experience and its desire for control. Daniels and Patil (1980) observed a tendency among firms investing overseas to start with complete control and to share it after operations became established. Taking a comparative perspective, Shetty (1979) argued that European firms were more agreeable to JVs than their American counterparts because of their longer overseas experience. However, most of the empirical studies (Gomes-Casseres 1985 & 1987; Agarwal & Ramaswami 1992; Sanna-Randaccio 1990; Tang 1994; Bell 1996; and Mutinelli & Piscitello 1997) point to a positive relationship between international experience and preference for WOSs. We therefore suggest that internationally experienced Finnish firms will choose WOSs in order to undertake *market* and *efficiency seeking* FDIs in a target Asian country. Hence,

**H 3b** The larger the international experience of the Finnish firm, the greater the probability that its WOS will undertake *MS* and/or *ES* FDI in a target Asian country.

#### **6.3.4. Industry experience**

The extent of a firm's industry experience can influence its ownership strategies and motives. The more experienced the firm is in the business sector, the less it will have need for the contributions of a potential partner. Consequently when a firm launches a subsidiary in a business with which it is well acquainted, it can be expected to choose a WOSs. When a firm decides to manufacture in a foreign market a product that it does not make at home, it is likely to need industry-specific knowledge and access to distribution. In that case, a shared equity venture with a local manufacturer may be the most efficient way to obtain the complementary inputs. The greater the level of experience in the relevant industry, it is argued, the more confident a firm tends to be about making commitments, and about its judgment of the degree of risk exposure. The case of Gillette illustrates this argument. For example, Gillette prefers to own 100% of the equity in its subsidiary making razor blades abroad. One reason is that they have enough industry experience and also they are best in the field worldwide. The management in Gillette sometimes feels that local partners provide useful information about the host country environment. However, they feel that at least in this business, there is little industry know-how that locals could bring to a venture. The knowledge of local customs that is needed in Gillette's ventures abroad could usually be acquired by hiring local managers (Gomes-Casseres 1985).

As discussed earlier, one type of tacit knowledge is how to operate in a given industry. In cases where the new investment is more comparable with or even totally similar to the current core activities, the investing firm does not need inputs from local firms. Relevant experience is, however, acquired preeminently through actual involvement, providing an important feedback loop in the process. Without appropriate experience, from the decision-maker's perspective, there tends to be a stronger sense of risk and uncertainty, which is likely to constrain the decision. At the same time though, perceived risk exposure can be altered by the ownership structure choice: for example, a high risk might be counterbalanced by the use of a low-commitment mode such as JV arrangements (Benito & Welch 1994). The positive relationship between relevant industry experience and the propensity to set up WOSs is also confirmed by several empirical studies (e.g. Stopford & Wells 1972; Gomes-Casseres 1985; Hennart 1991; Mutinelli & Piscitello 1997, and Larimo 2000). Furthermore firms with related experience will also be motivated to undertake *market seeking* FDIs by the benefits associated with staying close to their customer and thus protecting their competitive advantage from deteriorating. We, therefore suggest that Finnish firms with relevant experience will choose WOSs in order to undertake *market* and *efficiency seeking* FDIs in a target Asian country. Hence

**H 4b** The larger the industry-related experience of the Finnish firm, the greater the probability that its WOS will undertake *MS* and/or *ES* FDI in a target Asian country.

#### **6.4. Location-specific advantages**

Firms interested in servicing foreign markets are expected to use a selective strategy and favor entry into more attractive markets. This is because their chances of obtaining higher returns are better in such markets (Agarwal & Ramaswami 1992). FDI theories suggest that investing firms will prefer those countries that provide greater location-specific advantages. It has been known that both ownership- and location-specific advantages jointly and separately influence the firm for the choice of a target country for its FDI venture. Recent theoretical developments have expanded the role of location-specific variables by suggesting that it may be tied to firm-specific variables (Dunning 1997).

#### 6.4.1. Cultural distance

According to Hofstede (1980 & 1983), "culture is a collective mental programming of the mind which distinguishes the member of one group or category of people from another." Traditional entry mode literature (e.g. Anderson & Gatignon 1988; Kogut & Singh 1988b; Agarwal 1994) holds that firms minimize the high information costs associated with operating in culturally unfamiliar countries by seeking collaborative modes. Erramilli et al. (2002) argued that sharing the ownership of the subsidiary with a local firm, which essentially manages the entire local interface with local labor, suppliers, regulatory authorities, customer and the community also reduces the learning costs. Madhok (1997) has also maintained that organization routines that are effective in the home country may not be so in the host market when high cultural distance exists. This impedes the transfer of capabilities and skills within the firm boundaries. Moreover, executives perceive higher uncertainty about the market and demand structure in culturally distant countries. To reduce value erosion and uncertainty, a firm must collaborate with host country entities whose routines are better adapted to the local conditions in the culturally distant host country.

It must be noted here that the relationship between cultural distance and ownership structure is far from certain. The literature (e.g. Pisano 1989; Larimo 1993; Contractor & Kundu 1988; Erramilli & Rao 1993; Fladmoe-Lindquist & Jacque 1995) also offers a very intriguing counterview. Madhok (1997) and Lam (1997) argued that high socio-cultural distance could result in ineffective resource transfers across firm boundaries because of a mismatch in the foreign entrant's and local collaborator's lower absorptive capacity. Therefore, when cultural distance is large, the foreign entrants may actually prefer to internalize the transfer to preserve the value of its capabilities (and the resulting competitive advantage) (Erramilli et al. 2002).

However, most of the empirical studies (e.g. Kogut & Singh 1985; Kogut & Singh 1988b; Andersons & Gatignon 1988; Benito 1995; Bell 1996; Mutinelli & Piscitello 1997; Hennart & Larimo 1998; Padmanabhan & Cho 1999) favored JVs in culturally distant target countries. Kogut and Singh (1988) found that the effect of cultural distance and uncertainty avoidance is to increase the likelihood of favoring JVs over WOS. Hill et. al (1990) also argued that faced with uncertainty that arises from the unknown culture, the firm may be unwilling to commit substantial resources to a



foreign operation since such a commitment would substantially reduce the firm's ability to exit without cost if the host market proves unattractive. Similarly Anderson and Coughlan (1987) concluded that US electronics firms chose less integrated channels when entering Japan and Asian markets as compared with market entry into western European markets where they choose fully integrated channels. We therefore suggest that Finnish firms will choose WOSs in order to undertake *market* and *efficiency seeking* FDIs in a culturally close target Asian country.

**H 5b** The larger the cultural distance between the target and home country of a Finnish firm, the lower the probability that its WOSs will undertake *MS* and/or *ES* FDI in that target Asian country.

#### 6.4.2. Market potential

In addition to market size, market growth has been found to be an important determinant of overseas investment (Forsyth 1972; Weinstein 1977; Khoury 1979; Terpstra & Yu 1988). The market potential component may also influence the ownership structure choice because of its impact on market capacity and opportunity costs (Agarwal & Ramaswami 1992; Kim & Hwang 1992; Brouters & Brouters 2000). Target countries with huge market potential tend to have greater ability to absorb additional productive capacity, providing an opportunity to improve firm efficiency and market share. In stagnating and low-potential markets overcapacity may exist, making firms more reluctant to make large investments. Agarwal and Ramaswami (1992) argued that in huge potential markets firms tend to prefer WOSs so that they can (1) obtain scale economies, hence reducing per unit costs and (2) establish a long-term market presence. In small markets, firms may find that JVs provide better opportunities either because (1) they do not increase the capacity in the market, hence not impacting on competitor pricing strategies as severely, (2) they can provide a better return on investment by minimizing the resource commitment, based on lower expected returns, or (3) they reduce the switching cost of market exit if the product sales are low.

Financial and managerial commitments will be required to have more control of the swift establishment of outlets. Such investments are rationalized as a high demand condition that is expected to pay off invested capital. Thus, it can be concluded that a firm enters a high-potential market with high resource-commitment-ownership structures (e.g. WOSs) that allow more control to effectively penetrate the markets. The

same logic expects that a firm will use low resource commitment ownership structures in countries where the market potentials are expected to be low. Root (1994) also maintains that a low and uncertain sales potential of a target market should attract low commitment entry modes. The results by Stopford and Haberich (1978: 152-153) and Sanna-Randaccio (1990) also indicated the positive relationship between the market size and ownership structure. We therefore expect that Finnish firms will choose WOSs in order to undertake *market* as well as *efficiency-seeking* FDIs in target Asian countries with a huge market potential. Thus,

- H 6b** The larger the market size of the target country, the greater the probability that the WOS of the Finnish firm will undertake *MS* and / or *ES* FDI in that target Asian country.

#### 6.4.3. Economic welfare

The gross domestic product growth can be used to appraise the economic infrastructure and welfare of target countries. A high level of economic welfare suggests that a country is well developed and has a growing market. In previous studies (e.g. Onkvisit & Shaw 1993; Sarathy & Terpstra 1997) it has been argued that such markets are also highly attractive to foreign firms to produce and market their products for the local consumer. Sharma (2002) argued that particularly western products are generally perceived to be of superior quality compared with domestic brands in most Asian countries, the main reason being that most of the western brands compete globally and are therefore battle-tested. They also end up selling at a price higher than that of the local brands. As a result it makes them unaffordable to a large section of the local population. On the one hand, the quality of domestic brands has generally remained stagnant due to their protection against competition from foreign brands. As the per capita GDP grows substantially in many of these markets, the affordability of buying these costly foreign brands also grows for more and more people. On the other hand when the buying power of the consumers becomes low in those countries, due to macro-economic problems, they return to the purchasing of local brands. As a result, the consumption of foreign brands is cut down because of their usually high prices.

Harrigan (1985 a & b) also concluded that firms therefore tend not to commit substantial resources to a foreign market with a low growth or high demand uncertainty. Similarly Hill et al. (1990) have demonstrated as well that when demand conditions are

unstable and uncertain, then the investing firms will favor a route involving a relatively low level of commitments. Furthermore, it has been argued (e.g. Sarathy & Terpstra 1997) that under such conditions host governments often resort to price and exchange control policies. Brouther (2002) has also maintained that in low growth markets opportunity costs may be lower because of restrictions on pricing strategies.

However, in markets with a high level of economic welfare, WOSs are expected to provide greater long-term profitability for a firm, compared with a JV subsidiary, through the opportunity to achieve scale economies and consequently a lower marginal cost of production. Even if scale economies are not significant, a firm may still choose WOSs since they provide the firm with opportunity to establish a long-term market presence. Papanastassiou & Pearce (1990) also found support for WOSs in countries with high economic welfare. Likewise Dunning (1980) in his analysis of US firms supported this conclusion as well. We, therefore expect that Finnish firms will choose WOSs in order to undertake *market* as well as *efficiency seeking* FDIs in a target Asian country with a high level of economic welfare. Therefore,

- H 7b** The higher the level of economic infrastructure in the target Asian country, the greater the probability that the WOS of the Finnish firms will undertake *MS* and / or *ES* FDI in that Asian country.

## **6.5. Internalization advantages**

Finally, the internalization (I) variables are concerned with the cost of choosing a hierarchical mode of operation over an external mode (Dunning 1988 & 1993). The internalizing of international operations comes at a cost. These costs must be compared with the costs of finding and maintaining an external relationship to perform the same functions in the international markets. It is strongly believed that some internalization variables must be included in the consideration of ownership structures. An internalization variable i.e. the extent of scale economies, is expected to have an impact on a firm's choice of ownership structure in Asian markets.

### **6.5.1. Country risks**

In many studies, country risk has been categorized as a location-specific variable (e.g. Hill, Hwang & Kim 1991). However we decided to use it as an internalization variable, since it was regarded in Chandprapalert (2000) and Dunning (1993:84) in the same

way. Country risks are often reflected in frequent government changes, frequent changes in economic policies, military coups, riots, insurrections, worker strikes against the national authority, and so forth. For instance, a government that frequently reverses previous decisions discourages investment from abroad. Thus foreign firms are more likely to be cautious regarding equity investment in countries having political unrest (Root 1987; Rajib & Turgut 2000). This contextual risk is usually beyond the control of firms. Kim & Hwang (1992) argued that if an environment in a host country is uncertain and unpredictable, firms apparently hesitate to commit themselves too much as they may lose their strategic flexibility. Brouthers (2002) also concluded that firms tend to prefer JVs when entering countries characterized by high investment risks.

Previous empirical studies (e.g. Aharoni 1966; Goodnow & Hansz 1972; Agodo 1978; Root & Ahmed 1978; Root 1987; Anderson & Gatignon 1988; Fatehi-Sedeh & Safizadeh 1989; Benito 1995; Bell, 1996; and Mutinelli & Piscitello 1997) have confirmed that firms under high levels of risks in host countries are likely to choose low control ownership modes. Root (1987) concluded that a firm might also face other possible risks such as ownership or control risk, operation risk and transfer risk. Phatak et al. (1996) argued that firms prefer to avoid countries with high country risks like expropriation or nationalization, or economic risks like restrictions of assets, and limitations on operational and managerial choices. The Business Week (1981) also estimates that five hundred and sixty-three acts of expropriation were carried out against foreign firms in seventy-nine less developed countries. Anderson and Gatignon (1988) used the data from the Harvard Multinational Enterprise project embracing some 1267 foreign subsidiaries set up in 87 countries by 180 US firms between 1960 and 1975 and they also found that firms are most likely to opt for partnership when undertaking an investment in high risk countries. Bijur (1995) and Onkvisit and Shaw (1993) argued that levels of risk in the host country places a firm's assets at a heightened risk and the firm cannot afford to lose them or render them unproductive. We therefore expect that Finnish firms will choose WOSs in order to undertake *risk-reduction seeking* FDI in a target Asian country with a low level of risks. Hence,

**H 8b** The lower the level of risks in the target Asian country, the greater the probability that the WOS of the Finnish firms will undertake the *RRS* FDI in that Asian country.

### 6.5.2. Scale economies

Scale economies arise when inputs of a firm are shared, or utilized jointly with complete coordination. By inputs is referred to core factors such as R&D, marketing, or manufacturing. The implications of scale economies with respect to competitive advantage have become increasingly clear; they produce a positive impact on corporate profitability (Kim & Hwang 1992). This is typically actualized through enhanced innovative capability or some form of cost reduction. For example, Honda's engine technology once developed for producing motorcycles was virtually costlessly available for the production of engines in the different capacities in which Honda exploited it across the globe. Similarly, Yves Saint-Laurent leveraged its prestigious global brand name in high fashion to expand into the perfume, cosmetic and recently cigarette industry domains across the globe.

Porter (1986) argued that sharing can take place across segments and products, and may also involve joint use of different kinds of assets. Thus a diversified firm may share physical assets, cash or brand names across different businesses and markets. Hill et al. (1990) maintain that cross-subsidization of markets and exploitation of global brand names are a few examples of sharing tangible and intangible assets across different components of firm product and market portfolios. Furthermore, researchers (e.g. Jones & Charles 1982; Harrigan 1985a & b; Porter 1980) have also argued that the benefits of global strategy, including economies of scope, increase a firm's commitment to a business unit and can best be exploited through hierarchical control, which in turn helps the firm to achieve market as well as efficiency seeking motives of FDI. Also within many industries, firms are no longer able to compete as a collection of nationally independent subsidiaries. Rather competition is based in part on the ability of scale economies, and for a corporation to link and integrate its subsidiary activities across geographical locations (Porter 1986). However, regardless of the integration pattern, the common assumption typically made is that the parent firm has global responsibility for issues that involve activities crossing national boundaries. In order to achieve these scale economies, tight co-ordination is necessary, as their implementation often requires business units to "sacrifice" subsystem gains for the benefit of the overall organization. Therefore, when the need for global integration is high, firms are likely to prefer WOS for its affiliates (Phatak et al. 1996). We therefore expect that Finnish firms will choose

WOSs where the possibilities of scale economies are great in order to undertake *market* as well as *efficiency seeking* FDI in a target Asian country. Hence,

**H 9b** Making the FDI in an industry where possibilities of reaching scale economies are great increases the probability that the WOS of the investing firm will undertake the *MS* and/or *ES* FDI in a target Asian country.

## 6.6. Summary

The main goal of this chapter was to theoretically investigate how different ownership-specific, location-specific, internalization advantages and strategic advantages could influence the ownership strategies of the Finnish manufacturing firms in ten South and Southeast Asian countries from 1980 to 2000. Dunning (1993:56) identifies four main strategic advantages: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. Because most of the Finnish firms in Asia have been transferring technology to local firms, *KS* thus appears to be less relevant as compared with *MS*, *ES* and *RRS* types of FDI in this context. We therefore propose that *MS*, *ES* and *RRS* are the main strategic motives that can influence the ownership strategies of the Finnish firms in the Asian context. It is hoped that the theoretical and empirical analysis of these relevant strategic motives along with the influencing OLI variables can not only add to our understanding of the eclectic paradigm but also enrich our knowledge of FDI in general.

The determinants of ownership strategies have been categorized into four groups: Firstly, ownership-specific advantages include research and development intensity, firm's size, firm's international experience and industry experience. Secondly, location-specific advantages include cultural distance between home and host country, market potential and the level of economic welfare in the host country. Thirdly, internalization advantages include country risks and scale economies. Finally, strategic advantages include *market seeking*, *efficiency seeking* and risk reduction motives as main motives of direct investments.

In our model, we have included the factors related to "strategic motives" (strategic advantages), "the process of direct investment" (internalization advantages), "characteristics of the investing firm" (ownership-specific advantages), and "the nature of the foreign market" (location-specific advantages). We have not fully incorporated

**Table 13.** Summary of the results obtained on the impact of OLI related variables on the ownership-strategy-related choices in previous studies

Authors	Focus of the study	Independent variable	Results
Hennart (1987)	Entry mode choices.	R&D	Positive
Kumar (1990)	Multinational enterprises in India.	R&D	Positive
Phatak et al. (1996)	Entry mode choices in Thailand, Malaysia and Indonesia.	R&D	Negative
Kogut & Singh (1985)	Acquisition or Joint ventures choice by firms entering US.	Firm's large size	Positive
Larimo & Tahir (2002)	Ownership arrangement choices by Nordic manufacturing firms in Asian countries.	Firm's large size	Positive
Sanna-Randaccio (2001)	Italian investors abroad.	Firm's large size	Negative
Makino & Delios (1996)	Ownership choices made by Japanese firms in Asia.	Firm's large international experience	Positive
Padmanabhan & Cho (1999)	FDIs by Japanese firms in US.	Firm's large international experience	Positive
Shetty (1979)	European and American styles.	Firm's large international experience	Negative
Hennart (1991)	Japanese subsidiaries in the US.	Large industry-related experience	Positive
Larimo (2000)	Ownership choice of Finnish manufacturing firms in OECD countries.	Large industry-related experience	Positive
Larimo & Tahir (2002)	Ownership arrangement choices by Nordic manufacturing firms in Asian countries	Large industry-related experience	Not significant
Anderson & Coughlan (1987)	US electronic firms.	Low cultural distance	Positive
Hennart & Larimo (1998)	FDI by Finnish and Japanese MNEs in US.	Low cultural distance	Positive
Madhok (1997)	Entry mode choices.	Low cultural distance	Negative
Root (1994)	Entry mode choices.	Large market size	Positive
Sanna-Randaccio (1990)	Italian investors abroad.	Large market size	Positive
Dunning (1989)	Entry mode choices of US firms.	High level of welfare	Positive
Papansatassiou & Pearce (1990)	Sourcing of UK manufacturing industry.	High level of welfare	Positive
Phatak et al. (1996)	Entry mode choices in Thailand, Malaysia and Indonesia.	Low levels of risks	Positive
Sharma (2002)	Entry mode choices of US firms in Latin American countries.	Low levels of risks	Positive
Larimo & Tahir (2002)	Ownership arrangement choices by Nordic manufacturing firms in Asia	Low levels of risks	Not significant

- Positive means that this variable increases the probability of choosing WOS
- Negative means that this variable decreases the probability of choosing WOS

the “past relationship to the market,” although “international experience” is included in the model. Our model therefore is limited by the fact that we only consider present contingencies.

**Table 14.** Types of international production (related to ownership aspects): some determining factors

<b>Types of International Production</b>	<b>Ownership Advantages (O)</b>	<b>Location Advantages (L)</b>	<b>Internalization Advantages (I)</b>
Market seeking FDI	Large firms' size (WOS) Large firms' international experience (WOS) Large industry experience (WOS)	Low cultural distance (WOS) Huge market potential (WOS) High level of economic welfare (WOS)	
Efficiency seeking FDI	Large firms' size (WOS) Large firms' international experience (WOS) Large industry experience (WOS)	Low cultural distance (WOS) Huge market potential (WOS) High level of economic welfare (WOS)	
Risk-reduction seeking FDI	High R&D intensity (WOS)		Low country risks (WOS) Scale economies (WOS)

Source: Modified and adopted by the author based on Dunning (1993:82)

First, as to ownership-specific advantages, based on the literature review it was expected that firm's large size and firm's large international experience and large industry experience increase the probability of choosing WOS and undertaking *MS* and *ES* FDIs in a target country. Similarly, high R&D intensity of the investing firm increases the probability of choosing WOS in order to undertake *KS* FDIs in a target country. Secondly, as to location-specific advantages, it was expected that low cultural distance and large size of the target market and high level of economic welfare in a target country increase the probability that the investing firm chooses WOS in order to undertake *MS* and *ES* FDIs. Finally, as to internalization advantages it was expected that low levels of country risks in a target country increase the probability that the investing firm chooses WOS in order to undertake *RRS* FDIs. Similarly great possibilities of reaching scale economies increase the probability that the investing firm chooses WOS in order to undertake *MS* and *ES* FDIs in a target country (see Table 14).

The strategic motivations listed above should not be seen as mutually conclusive. The investments may be driven by several ownership-specific, location-specific,



internalization advantages and strategic motivations simultaneously and in various combinations. However, distinguishing between different types of strategic motivations facilitates a better understanding of the strategic motives underlying different FDI choices and key ownership-specific, location-specific and internalization advantages influencing the different types of FDIs.

## **7. METHODOLOGY AND CHARACTERISTICS OF THE SAMPLE OF THE PRESENT STUDY**

In this chapter, the methodology of the study and the characteristics of the participating firms have been reviewed. It provides a discussion of the sample and an overview of the statistical procedure used and descriptive statistics. In addition, the population of the firms and the types of investment in the sample have been discussed. Finally, the operationalization of the dependent, independent and control variables related to location and ownership aspects have also been presented in this chapter.

### **7.1. The Sample**

The complete list of Finnish firms that have made FDI in Asian countries was not available. Hence the author and the other project members jointly developed the register during the last three years, based on the annual reports of the firms, world development indicators and direct contact with the managers of the firm. All those manufacturing firms that had made FDI during 1980-2000 were included among the target firms. In order to maintain homogeneity among the target countries, Bangladesh, Nepal, Bhutan, Burma, Laos, Cambodia, Middle East and Central Asian countries were excluded from the list. Also, the amount of FDI made by Finnish firms in those countries has been very small.

In order to standardize the characteristics of the FDI projects included in the analysis, FDI in services, distribution and sales facilities have also been excluded from the sample. The present study therefore utilizes primary and secondary data only on the annual flow of manufacturing Finnish FDI in Asian countries. In Dunning (1993:5) FDI is defined as “a package of assets and intermediate products, such as capital technology, management skills, access to markets and entrepreneurship.” According to Randoy (1994), the definition used in Dunning shows that FDI comprises something more than a typical sales or a distribution subsidiary, which cannot fulfill the corresponding requirements. In addition, manufacturing FDI projects usually differ substantially from other types of FDI projects in terms of their strategic importance, the amount of risk involved and the amount of resources required (Larimo & Mäkelä, 1995). Given these differences, separate investigations for different sectors are warranted in order to gain a better understanding of the determinants of FDI in different settings. For example,

manufacturing FDI comprises working assets acquired by the US firms for the purpose of setting up and maintaining production operations abroad. On the other hand, service industry consists of mostly non-working financial instruments and assets. Manufacturing FDI data are therefore more appropriate to investigate the determinants of production capital investment by the firms in overseas operations.

The sample of the present study is based on primary and secondary data from 135 manufacturing FDIs made by Finnish firms in various South and Southeast Asian countries from 1980 to 2000. The time period between 1980 and 2000 is chosen because this time period represents a surge in manufacturing investments by Finnish firms in Asian countries. These 135 FDIs includes 77 *MS*, 78 *ES*, 44 *KS* and 32 *RRS* FDIs. However, these figures of *MS*, *ES*, *KS* and *RRS* make a total of 231, as approximately three-fourths of the investments are included in more than one type of FDI. The sample is based on information drawn from *World Development Indicators 2002*, company annual reports of firms, information taken from business journals, survey information and other information received through direct contact by the authors from Finnish companies.

The most common target country for investments was clearly China – 45 (33%) investments. The other most common target countries were Malaysia (25 FDIs, 18.4%) and Singapore (20 FDIs, 14.7%). On average, the same firm had two investments in the sample. The most well known Finnish firm Nokia made 10 investments, which was highest in number by a single company in the whole sample. In the sample, the investing firm already had some FDI-related experience, and in most of the cases firms had made at least five foreign direct investments before the reviewed FDI. Approximately three-fourths of the cases of investing firms did not have previous manufacturing experience from the target country, whereas one-fourth of the cases had at least one, in some cases already three or four previous units in the target countries. It therefore can be argued that the sample of the study is dominated by FDIs made by firms where the importance of international operations is high and they can be classified as MNCs by any standards. The investments were made in ten Asian countries, mainly Southeast Asian countries. Measured with the cultural distance, the distance to the closest target country was 1.52 (Thailand) and to the most distance target country was 5.01 (Japan) (see Table 18).

The sample information indicates that almost 80 percent of the investing firms were conglomerates or operating in different sectors of telecommunications, metal and engineering industry. The mean value of sales was FIM 15615 million, but the variations in the sales were great from FIM 18 million to over FIM 69176 million. Furthermore, of these 135 FDIs 113 (83.7%) were JVs and 22 (16.2%) were WOSs. Thus the ownership strategy distribution in FDIs made by Finnish firms in Western Europe and North America seem to have been just the opposite to the ownership strategies in Asian countries (see Larimo 2000). However, Delios and Beamish (1999) also found in their study of 1424 Japanese FDIs in nine Asian countries that 21.4 per cent of the FDIs were WOSs (23.0 % of all identified 2594 FDIs in the same period).

## 7.2. The methodology of the present study

Because of the nature of the dependent and independent variables, the binomial logit model is used in the analysis. In the binomial logistic model the probability of certain types of location / ownership choices and types of strategic motives are explained by the reviewed variables. Related to *location aspects* the regression coefficient estimates the impact of independent variables on the probability that the foreign investment is market, efficiency, *knowledge seeking* and / or *risk-reduction seeking*. A positive sign for the coefficient means that the variable increases the probability of undertaking an investment.

Similarly, related to *ownership aspects* the regression coefficient estimates the impact of independent variables on the probability that the WOS is a *market, efficiency, knowledge* and/or *risk-reduction seeking* type of FDI. A positive sign for the coefficient means that the variable increases the probability of choosing WOS and undertaking a certain type of investment.

The model can be expressed as

$$P(y_i = 1) = 1 / (1 + \exp(-a - X_i B))$$

Where  $y_i$  is the dependent variable,  $X_i$  is the vector of the independent variable for the  $i$ th observation,  $a$  is the intercept parameter and  $B$  is the vector of regression parameters (Amemiya, 1981).

### 7.3. Operationalization of the variables used in this study

#### 7.3.1. Dependent variables

*Market seeking FDI* (*MS*) are coded as dummy variables equal to one, if the investment is *market seeking* and zero otherwise. *MS*, are classified as the FDI undertaken to sustain or protect existing markets or to exploit or promote new markets. More precisely these investments firms undertake in a country or region to supply goods to markets in these or in adjacent countries. In most cases, part or all of these markets will have been service previously by exports from the investing firms which, either because of tariff or other cost raising barriers imposed by the host countries or because the size of the markets now justifies local production, are no longer best supplied by this route (Dunning 1993:58). Sometimes, however an enterprise may seek to replace its exports to a foreign market by investing in a third country and exporting to that market from there. Nicholas (1986) has found that no less than 94% of the UK MNEs with foreign manufacturing investment, first supplied the countries in which they then produced by exports.

It has been argued (e.g. Dunning 1993) that the single most important reason for market seeking investments remains the action of host governments encouraging such investment. The traditional argument chosen by the governments has to impose tariffs or other import controls. History suggests that the majority of first time manufacturing investment were undertaken to circumvent such trade barriers. Governments have also attempted to attract inward investment by offering a gamut of investment incentives ranging from tax concessions to subsidized labor costs and favorable import quotas. At the end of 1980s, market seeking investments probably account for about 45% of the total global direct investment and about 30% in developing countries.

*Efficiency seeking FDI* (*ES*) are coded as dummy variables equal to one, if the investment is *efficiency seeking* and zero otherwise. *ES*, are classified as the FDI projects are undertaken in order to rationalize the structure of established production units in such a way that a firm can gain from the common governance inter-related activities in different locations. Such benefits are essentially those of the economies of scale and scope and of risk diversification (Dunning 1993:59). They stem from cross-border product or process specialization, the learning experiences that result from

producing in different cultures and the opportunities for arbitraging cost and price differentials across the exchanges. The intention of *efficiency seeking* investment is to take advantage of different factor endowments, cultures, institutional arrangements, economic system and policies and market structures by concentrating production in a limited number of location to supply multiple markets.

In order for *ES* investment to take place, cross border markets must be open and well developed. As a result, it flourishes in the regionally integrated markets. In practice, *ES* investments are undertaken by global firms competing on the basis of the products it offers for sale and its ability to diversify its assets and capabilities by exploiting the benefits of producing in several countries.

**Table 15.** Description of dependent variables of the present study

<b>Variables</b>	<b>SYMBOL</b>	<b>Data Sources</b>
Market seeking	<i>MS</i>	Direct contacts with managers of the sample firms
Efficiency seeking	<i>ES</i>	Direct contacts with managers of the sample firms
Risk-reduction seeking	<i>RRS</i>	Direct contacts with managers of the sample firms
Knowledge seeking	<i>KS</i>	Direct contacts with managers of the sample firms

*Knowledge seeking FDI* (*KS*) are coded as dummy variables equal to one, if the investment is *knowledge seeking* and zero otherwise. *KS*, are classified as the FDI prompted to invest abroad to acquire particular and specific resources at a lower real cost than could be obtained in their home country. More precisely, *KS* FDI comprises of those investment undertaken by acquiring some assets to promote their long-term strategic advantages –especially that of sustaining or advancing their global competitiveness. The investing firms involved with such type of investment include both established firms pursuing an integrated global or regional strategy and first time foreign direct investors seeking to buy competitive strength in an unfamiliar market.

There are no statistical data on the significance on *KS* FDI by firms. What does seem certain, however, is that these investments are accounting for an increasing share of global activity by firms, particularly within the major markets of the world, and that they are concentrated in the technology and capital intensive manufacturing.

*Risk-reduction seeking FDI* (RRS) are coded as dummy variables equal to one, if the investment is *risk-reduction seeking* and zero otherwise. RRS, are classified as the FDI projects represent internal hedging activities conducted in order to reduce the level of risk by the firm. Examples of RRS types of FDI include outbound firm activity by Indian firms to circumvent restrictions on the share of domestic production they might attain; that by Israeli firms in the EU to by-pass the Arab boycott on products exported from Israel (Almor-Ellemers and Hirsch 1991); that by Swedish, US or Nigerian firms because opportunities for investments in some sectors are limited by their home governments; that by Japanese banks in Europe which engage in a wider range of services for their customers than they are allowed to undertake in Japan (Hawawini & Schill 1992).

RRS FDI, such as those just described most likely to originate from countries whose governments pursue strong interventionist macro-organizational policies. With the renaissance of pro-market economic strategies and the liberalization of many markets in recent years, one might anticipate rather less RRS FDI to occur in 2000s. The one exception might be where firms relocate their production activities as a result of trade barriers imposed on home country exports.

### **7.3.2. Independent variables related to location aspects**

#### **7.3.2.1. Ownership-specific advantages**

**Research and development intensity** (R&D) is proxied by using a classification of various four-digit SIC industries into three categories: high-tech branches; medium-tech branches, and low-tech branches. OECD classifies a branch as “high-tech” if on average it uses at least 4 per cent of its value added for R&D. Branches with an R&D – intensity between 1 and 4 percent are classified as “medium-tech,” and branches with less R&D – intensity as “low-tech.” The following branches were classified as high-tech using the statistics provided by the Nordic Statistical Secretariat: SIC 2833 –2834, 3573 –3574, 3579, 36, 37 and 38; medium tech branches were all 28 except 2833 & 2834, 30, 3339, 3341, 3356-3357, 3369, 35 except 3573-3574 and 3579, 39 and the rest were classified as low-tech branches. A similar type of classification has been used in the study by Stopford and Wells (1972) and percentage of R&D-expenditures of the firm’s sales has been used also by Zejan (1988) and Hennart (1991) as well. Other measures for R&D

intensity have been the absolute amount of R&D expenditures (e.g. Agarwal & Ramaswami 1990) and R&D intensity at the three or four digit industry level (Gatignon & Anderson 1988; Kogut & Singh 1988). The previous studies (Larimo 1993:216) argued that it is better to use the firm level R&D-figures instead of industry level figures, as there may be differences, even bigger differences, in R&D-intensity between firms in the same industry. The expected sign is positive.

**Table 16.** Description of independent variables related to location strategies

Variables	SYMBOL	Data Sources
R&D intensity	R&D	Four-digit SIC industries
Firm size	PSIZE	Annual Reports
Firm international experience	INTEX	Direct contact with managers of the firm
Cultural distance	CULTDIS	Hofstede (1980)/Kogut & Singh (1988)
Market size	MSIZE	World Development Indicators
Wage rate	WAGRAT	World Development Indicators
Income tax rates	TAX	World Development Indicators
Inflation rate	INFLA	World Development Indicators
Country risk	CRISK	World Development Indicators
Exchange rates	EXC	World Development Indicators

**Firm size (PSIZE)** is measured by the parent firm's global sales in the year preceding the investment in local currency, changed to FIM using the average exchange rate between the local currency and FIM in that year, and finally changed to FIM value in 2000. The turnover of the year preceding the investment is used because the investment decisions was apparently made already earlier and if the figures of the year of the investment were used, the foreign unit could already be included in the turnover figures of the investing firm, especially if the investment was made during the first half of the year. As alternative measures for the size of the firm, assets and revenues of the firm have been used (Kogut & Singh 1988a & b; Agarwal & Ramaswami 1990) as well as employees size (Anderson & Gatignon 1988) domestic sales (Sanna-Randaccio 1990) and whether the size of the MNE's asset were similar than the average for the MNE's in the same principles 3-digit industry (Gommes-Casseres 1985). However, the total sales of the firm seems to have been the most commonly used measures of firm size in the previous FDI studies. A logarithmic form of the variable is used because it is expected that influence of size variable is not linear but decreases. The expected sign is positive.



**International experience** (INTEX) is proxied by the number of foreign manufacturing investments made by the firm preceding the investment in case. Alternative measures for international experience have been used such as the share of foreign sales from total

**Table 17.** Expected results for each independent variable related to location strategies

Variables	SYMBOL	Expected Sign	Expected Results
R&D intensity	R&D	+	KS FDI
Firm size	PSIZE	+	MS & ES FDI
Firm international experience	INTEX	+	MS FDI
Cultural distance	CULTDIS	-	MS & ES FDI
Market size	MSIZE	+	MS & ES FDI
Wage rate	WAGRAT	-	MS & ES FDI
Tax rates	TAX	-	MS & ES FDI
Inflation rate	INFLA	-	RRS FDI
Country risk	CRISK	+	RRS FDI
Exchange rates	EXC	-	RRS FDI

sales of the firm (Hennart & Park 1991), the length of the years from the first manufacturing unit established by the firm (Dubin 1976; Zejan 1988), the number of foreign units (majority-owned) owned by the parent (Zejan 1988), the number of countries where the firm has a foreign manufacturing unit (Caves & Mehra 1986), the geographical diversity of foreign manufacturing (Dubin 1976), the number of employees abroad in relation to total employment and investments in fixed abroad in relation to total investments (Forsgren 1984). With respect to the various measures used it may be stated, for example, that the length of foreign operation was not used, because there is a danger that a firm may have owned only one small unit for a longer time, and this may give a wrong indication of the international experience of the firm. As it has been argued by Larimo (1993:218) that each new country where the firm has production gives an indication of the international experience of the firm. It has already been argued that each foreign unit increases the international experience of the firm. Therefore, the total amount of foreign manufacturing investments made was chosen as the measures. A logarithmic form of the variable is used as in the case PSIZE because also here the expected influence is not linear but decreasing. The expected sign is positive.

### 7.3.2.2. Location-specific advantages

**Cultural distance** (CULTDIS) is computed in the manner suggested by Kogut and Singh (1988), using a composite index based on differences between the Finland and

the target country of the investment along the four cultural dimensions (Power distance; uncertainty avoidance; individuality and masculinity) identified by Hofstede (1980). The arguments for the use was that the results have also been used in other FDI studies (Kogut & Singh 1988; Li & Guisinger 1991; Larimo 1993:219) and no better alternative for the classification seems to be available. The deviations were corrected for differences in the variances of each dimension and then arithmetically averaged. Algebraically the following index was used:

$$CD_j = 1/4 \sum_{i=1}^4 \{ (I_{ij} - I_{iu})^2 / V_i \} / 4$$

Where  $I_{ij}$  stands for the index for the  $i$ th cultural dimension and  $j$ th country,  $V_i$  is the variance of the index of the  $i$ th dimension;  $u$  indicates the Finland and  $CD_j$  is the cultural differences of the  $j$ th country from Finland. The results are presented in Table 18. The expected sign is negative.

**Table 18.** Cultural distance between Finland and different target countries of FDIs

Countries	Power distance	Uncertainty avoidance	Individualism	Masculinity	Cultural distance
China	68	40	25	57	3.29
India	77	40	48	56	2.15
Indonesia	78	48	14	46	2.73
Japan	54	92	46	95	5.01
Korea, Republic	60	85	18	39	1.92
Malaysia	104	36	26	50	4.28
Pakistan	55	70	14	50	2.01
The Philippines	94	44	32	64	3.91
Singapore	74	8	20	48	3.66
Thailand	64	64	20	34	1.52

**Market size (MSIZE)** is measured based on the value of gross national product (GNP) (milliard USD at current prices and current exchange rates) during the year of investment. The GNP was used as the measures of market size in the study by e.g. Zejan (1988). The value of GNP per capita, GDP (Zejan 1988) and the size of the industrial sector in the host country (Gomes-Casseres 1985, 1989) have been used as other measures of economic size of a country. The figures from Asian countries are taken from statistics provided by the World Development Indicators 2001. The expected sign is positive.

**Wage rate** (WAGRAT) is measured by the average wage rates in the manufacturing sector in the host country during the 1980s and 1990s. The previous studies (e.g. Schoenberger 1988; Austin 1990; London & Ross 1995) have also used the wage rate figures as a measure of labor costs in the host countries. The figures for the Asian countries have been taken from the statistics provided by the World Development Indicators 2001. The expected sign is positive.

**Tax rate** (TAX) is measured by corporate tax rates in the host countries during the year of investment. Corporate tax rates were also used as a measure of tax rate in the previous studies (e.g. Hartman 1981; Boskin & Gale 1986; Ermisch & Huff 1999). The figures for the Asian countries have been taken from the statistics provided by the World Development Indicators 2001. The expected sign is negative.

**Inflation rate** (INFLA) is measured by inflation rates in the host country during the year of investment. Inflation rate figures were also used as a measure in the previous studies (see e.g. Scheider & Frey 1985; Hyun & Whitmore 1989). As alternative measure for the inflation, consumer price index in the host country has also been used (Sayek 2000). However, it can be argued that the exact inflation rate figures can give the better overview of the existing inflation in the host country. The figures for the Asian countries have been taken from the statistics provided by the World Development Indicators 2001. The expected sign is negative.

### **7.3.2.3. Internalization advantages**

**Country risks** (CRISK) are measured by using the risk indexes for the target countries during the year of investment. Country risks were also used as a measure for risks in the host country in the study by Summary and Summary (1995). As alternative measure for country risks, political instability in the host country has been used by (e.g. Butler & Joaquin 1998; Edward 1990). The arguments for the use of country risks indexes in the present study is that as it is calculated on the basis of both political and economic risks variables and therefore provides a better overview of the overall existing risks in the host country. The country risk indexes were taken from the Euromoney statistics. The higher the risk, the lower the values for index. The expected sign is positive.

**Exchange rates fluctuations (EXC)** are measured by the percentage changes in the exchange rates in the host country during the year of investment. In the previous studies (e.g. Wallance 1990; Froot & Stein 1991; Kwon & Konopa 1993) percentage change in the exchange rate fluctuation has also been used as a measure for exchange rate fluctuations. The figures for the Asian countries have been taken from the statistics provided by the World Development Indicators 2001. The expected sign is negative.

**Table 19.** Summary of operationalization of variables related to location aspects

Variable	Description
R&D	R&D intensity is proxied by using a classification of various four digits SIC industries into three categories: high-tech branches; medium-tech branches, and low-tech branches. OECD classifies a branch as "high-tech" if on average it uses at least 4 per cent of its value added for R&D. Branches with an R&D – intensity between 1 and 4 percent are classified as "medium-tech," and branches with less R&D – intensity as "low-tech."
PSIZE	Firm's size is measured by the parent firm's global sales in the year preceding the investment in local currency, changed to FIM using the average exchange rate between the local currency and FIM in that year, and finally changed to FIM value in 2000
INTEX	Firm's international experience is proxied by the number of foreign manufacturing investment made by the firm preceding the investment in case.
CULTDIS	Cultural distance is computed in the manner suggested by Kogut and Singh (1988), using a composite index based on differences between the Finland and the target country of the investment along the four cultural dimensions (Power distance; uncertainty avoidance; individuality and masculinity) identified by Hofstede (1980).
MSIZE	Market size is measured based on the value of gross national product (GNP) (milliard USD at current prices and current exchange rates) during the year of investment.
WAGRAT	Wage rate is measured by the average wage rates in the manufacturing sector during the 1980s and 1990s.
TAX	Tax rate is measured by corporate tax rates in the host countries during the year of investment.
INFLA	Inflation rate is measured by inflation rates in the host country during the year of investment.
CRISK	Country risks are measured by using the risk indexes for the target countries during the year of investment.
EXC	Exchange rates are measured by the percentage changes in the exchange rates in the host country during the year of investment.

A summary of the main variables (related to location aspects) used in the study, their abbreviations and operationalizations, are presented in Table 19. However, the correlations between these variables are presented in Appendix 2. The highest correlations were found between PSIZE and INTEX (0.459), CRISK and WAGRAT

(0.431), INFLA and EXC (0.418), MSIZE and WAGRAT (0.417) and CRISK and CULTDIS (0.337). Those correlations are highest in all the four types of FDI samples. The other correlations were clearly low in this case.

### **7.3.3. Control variable related to ownership aspects**

**Ownership** (Ownership) is captured in the study by a dummy variable, which receives the value of one if the firm owned 95% or more of the subsidiary's equity and zero if owned at least 10%, but not more than 94%. The 95% cut-off point has been chosen because the firm usually has de facto total decision power also in situations where the share of ownership is a little under 100 % and the 95% cut-off point has been used in several other studies (e.g. in Stopford and Wells 1972, Anderson and Gatignon 1988, Gomes-Casseres 1989 and Hennart 1991). As Hennart (1991:488) and Larimo (1993:214) state in their study, one alternative would be to use the actual percentage of ownership. This, however, creates the implicit assumption that intervals are constant over the entire range of ownership. Yet moving from a 50 to a 51 percent ownership has usually much greater consequences for control than moving from 10 to 11 percent. The change is even clearer if we think about a change of 2 per cent in the ownership, and changes from 49 per cent to 51 and from 10 to 12 per cent. Therefore a qualitative choice variable has been chosen for this study. The alternative related to the form of investment are or should be clear.

### **7.3.4. Independent variables related to ownership aspects**

#### **7.3.4.1. Ownership-specific advantages**

**Research and development intensity** (R&D) is proxied by using a classification of various four digit SIC industries into three categories: high-tech branches; medium-tech branches, and low-tech branches. OECD classifies a branch as "high-tech" if on average it uses at least 4 per cent of its value added for R&D. Branches with an R&D – intensity between 1 and 4 percent are classified as "medium-tech," and branches with less R&D – intensity as "low-tech." The following branches were classified as high-tech using the statistics provided by the Nordic Statistical Secretariat: SIC 2833 –2834, 3573 –3574, 3579, 36, 37 and 38; medium tech branches were all 28 except 2833 & 2834, 30, 3339, 3341, 3356-3357, 3369, 35 except 3573-3574 and 3579, 39 and the rest were classified as low-tech branches. The expected sign is positive.

**Firm size** (PSIZE) is measured by the parent firm's global sales in the year preceding the investment in local currency, changed to FIM using the average exchange rate between the local currency and FIM in that year, and finally changed to FIM value in 2000. A logarithmic form of the variable is used because it is expected that influence of the size variable is not linear but decreases. The expected sign is positive.

**International experience** (INTEX) is proxied by the number of foreign manufacturing investments made by the firm preceding the investment in case. A logarithmic form of the variable is used as in the case PSIZE because also here the expected influence is not linear but decreasing. The expected sign is positive.

**Table 20.** Description of independent variables related to ownership strategies

Variables	SYMBOL	Data Sources
R&D intensity	R&D	Four-digit SIC industries
Firm size	PSIZE	Annual Reports
Firm international experience	INTEX	Direct contact with managers of the firm
Industry experience	INDEXP	Hofstede (1980)/Kogut & Singh (1988)
Cultural distance	CULTDIS	World Development Indicators
Market size	MSIZE	World Development Indicators
Economic Welfare	ECON	World Development Indicators
Country risks	CRISK	World Development Indicators
Scale economies	SCALE	Porter (1986), Yip (1992) Calori, Atamer and Nunes (2000)

**Industrial experience** (INDEXP) is measured by the related experience of the parent firm. A dummy variable equal to one if one of the products manufactured by the subsidiary was also produced by parents and zero otherwise. The expected sign for INDEXP is therefore positive.

#### 7.3.4.2. Location-specific advantages

Data on the index along the four cultural dimensions (power distance; uncertainty avoidance; individuality; and masculinity and femininity) for each country of the sample FDIs and for Finland were obtained from Hofstede (1980). **Cultural distance** (CULTDIS) is computed in the manner suggested by Kogut and Singh (1988), using a composite index based on differences between Finland and the target Asian country of the investment (see Table 18). The expected sign is negative.

**Market size (MSIZE)** is measured by gross national product (GNP) in the host country during the years of investment. The figures for Asian countries have been taken from the statistics provided by the World Development Indicators 2001. The expected sign is positive.

**Table 21.** Expected results for each independent variable related to ownership strategies

Variables	SYMBOL	Expected Sign	Expected Results
R&D intensity	R&D	+	RRS FDI
Firm size	PSIZE	+	MS & ES FDI
Firm international experience	INTEX	+	MS & ES FDI
Industry experience	INDEXP	+	MS & ES FDI
Cultural distance	CULTDIS	-	MS & ES FDI
Market size	MSIZE	+	MS & ES FDI
Economic Welfare	ECON	+	MS & ES FDI
Country risks	CRISK	+	RRS FDI
Scale economies	SCALE	+	MS & ES FDI

**Economic welfare (ECON)** is measured by per capita gross national product (GNP) in the host country during the year of investment. Zejan (1988) used annual average percentage change in gross domestic product (GDP). In some studies (Caves & Mehra 1986; Hennart 1991), e.g. by growth of shipments / average annual rate of growth of shipments over a period of five years preceding the entry in the 4-digit industry in which the unit was active. The use of industry-related variable would have been easier in the case of one target country or one field of industry only. There was neither of this type of concentration in this study, therefore it was decided that the per capita GNP would be used. The figures for Asian countries have been taken from the statistics provided by the United Nations and IMF. The expected sign for GNPCC is positive.

#### 7.3.4.3. Internalization advantages

**Country risk (CRISK)** is measured by using the political risk indexes for various target countries during the year of investment. The risk indexes were taken from the Euromoney statistics. The higher the risk, the lower the values for index. The expected sign is positive.

**Scale economies (SCALE)** is classified into three categories: maximum, medium and minimum. If scale economies has a value equal to two, it means that the investment was made in an industry where the possibilities of reaching scale economies were maximum, if it has a value equal to one then it means that the investment was made in

an industry where the possibilities of reaching scale economies are medium and if it has zero value it means that the investment was made in an industry where the possibilities of reaching scale economies are minimum. The classification of industries is based on Porter (1986), Yip (1992) and Calori, Atamer and Nunes (2000). The expected sign for SCALE is positive.

**Table 22.** Summary of operationalization of variables related to ownership aspects

Variable	Description
R&D	R&D intensity is proxied by using a classification of various four digits SIC industries into three categories: high-tech branches; medium-tech branches, and low-tech branches. OECD classifies a branch as "high-tech" if on average it uses at least 4 per cent of its value added for R&D. Branches with an R&D – intensity between 1 and 4 percent are classified as "medium-tech," and branches with less R&D – intensity as "low-tech."
PSIZE	Firm's size is measured by the parent firm's global sales in the year preceding the investment in local currency, changed to FIM using the average exchange rate between the local currency and FIM in that year, and finally changed to FIM value in 2000
INTEX	Firm's international experience is proxied by the number of foreign manufacturing investment made by the firm preceding the investment in case.
INDEXP	Industry experience is measured by the related experience of the parent firm.
CULTDIS	Cultural distance is computed in the manner suggested by Kogut and Singh (1988), using a composite index based on differences between the Finland and the target country of the investment along the four cultural dimensions (Power distance; uncertainty avoidance; individuality and masculinity) identified by Hofstede (1980).
MSIZE	Market size is measured based on the value of gross national product (GNP) (milliard USD at current prices and current exchange rates) during the year of investment.
ECON	Economic welfare is measured by per capita gross national product (GNP) in the host country during the year of investment.
CRISK	Country risks are measured by using the risk indexes for the target countries during the year of investment.
SCALE	If scale economies has a value equal to two, it means that the investment was made in an industry where the possibilities of reaching scale economies were maximum, if it has a value equal to one then it means that the investment was made in an industry where the possibilities of reaching scale economies are medium and if it has zero value it means that the investment was made in an industry where the possibilities of reaching scale economies are minimum.

The summary of the main variables (related to ownership aspects) used in the study, their abbreviations and operationalizations are presented in Table 22. However, the correlation between these variables can be seen in Appendix 4. The highest correlations



were found between PSIZE and INTEX (0.459), CRISK and CULTDIS (0.337), MSIZE and CULTDIS (0.263) and R&D and ECON (0.228). Those correlations are highest in all the four types of FDI's sampled.

## 8. EMPIRICAL FINDINGS OF THE PRESENT STUDY

In this chapter we empirically test the hypotheses developed in chapters 5 and 6 of this study. The first part of this chapter deals with the testing of hypotheses and model related to the location strategies of Finnish firms in Asian countries. The second part of this chapter deals with the hypotheses and models related to the ownership strategies of the Finnish firms in Asian countries. Based on the empirical findings, a summary and concluding remarks are presented in the final part of this chapter.

### 8.1. Empirical results related to location strategies of Finnish firms in Asian countries.

The results of the binomial logistic regression in the basic model are presented in Table 23. The estimated coefficients represent the probability of undertaking *market, efficiency, knowledge* and / or *risk-reduction seeking* FDI: a positive coefficient means that a certain type of investment has been undertaken and a negative coefficient signifies the opposite. The model has a satisfactory overall explanatory power with chi-squares of 108.671 with 6 DF ( $p=0.000$ ) both for *MS* and *ES* FDIs, 3.475 with 1 DF ( $p=0.062$ ) for *KS* FDIs and 51.994 with 3 DF ( $p=0.000$ ) for *RRS* FDIs. Another way of measuring how well a maximum likelihood model fits the data is to use the model to classify observations. The ability to classify can be judged against the classification rate that would have been obtained by chance. The rate is equal to  $a^2 + (1 - a)^2$ , where  $a$  is the proportion of *MS*, *ES*, *KS* and *RRS* in the sample. In the present case the baseline rates for *MS*, *ES*, *KS* and *RRS* are 52.3%, 52.6%, 55.6% and 63.8% respectively. Similarly, the results show that 93%, 93%, 65.2% and 85.9% of the observations are correctly classified for *MS*, *ES*, *KS* and *RRS* respectively.

Firstly in the case of *market seeking (MS)* and *efficiency seeking (ES)* FDIs, it has been found that large firm size (*PSIZE*), large international experience (*INTEX*) and large market size (*MSIZE*) increase the probability of Finnish firms undertaking *market seeking (MS)* and *efficiency seeking (ES)* FDIs. Likewise low cultural distance (*CULTDIS*) and low wage rates (*WAGRAT*) also encourage Finnish firms to undertake *market seeking (MS)* and *efficiency seeking (ES)* FDIs. **PSIZE** has a positive sign and it is significant at 0.05 levels both for *MS* and *ES* types of FDIs (see Table 23). Here it can be argued as the large firms are often considered it easier to exploit the plant scale

economies effectively and efficiently by allocating their large production resources in fewer locations, which in turn can stimulate the investing firms to undertake *MS* and *ES* FDIs in a target country. These OLI variables along with strategic motives (e.g. *MS* & *ES*) have not been reviewed much in the previous studies, however it has been indicated (e.g. Juhl 1978; Li & Guisinger 1992; Benito 1995; Mutinelli & Piscitello 1997) that large firm often have a resource base and they have better possibilities of undertaking FDIs.

**Table 23.** Parameter estimates for the binomial logit models related to location strategies

	Expected sign	MS	ES	KS	RRS
CONSTANT		4.675 0.000	4.675 0.000	-0.725 0.000	-13.456 0.000
R&D	+	NR	NR	0.007 0.074*	NR
PSIZE	+	0.000 0.059*	0.000 0.059*	NR	NR
INTEX	+	0.054 0.084*	0.054 0.084*	NR	NR
CULTDIS	-	-1.192 0.001***	-1.192 0.001***	NR	NR
MSIZE	+	0.004 0.000****	0.004 0.000****	NR	NR
WAGRAT	-	-0.001 0.000****	-0.001 0.000****	NR	NR
TAX	-	0.011 0.653	0.011 0.653	NR	NR
INFLA	-	NR	NR	NR	-0.332 0.001***
CRISK	+	NR	NR	NR	0.168 0.000****
EXC	-	NR	NR	NR	0.088 0.007***
SAMPLE SIZE		77	78	44	32
% correct observations		93%	93%	65.2%	85.9%

NR = Not Related

\*\*\*\*  $p < 0.001$ , \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

*INTEX* has a positive sign and it is significant at 0.08 levels for both *MS* and *ES* types of FDIs. Thus, large international experience has increased the probability of the Finnish firms to undertake *MS* and *ES* FDIs in target Asian countries. It can be argued here that the firm's past experiences manifest themselves in organizational routines that form the blueprint for the firm's future actions, and reducing the implementation costs of the investing firm, and thus encouraging the investing firm to undertake *MS* and *ES* FDI in a target Asian country. Previous studies (e.g. Buckley & Casson 1985; Agarwal

& Ramaswami 1992; Padmanabhan & Cho 1999) have indicated that internationally experienced firms have greater probability of undertaking FDIs as they face fewer risks and disadvantages in unfamiliar foreign countries.

**MSIZE** also has a positive sign and is statistically significant at the 0.000 level both for *MS* and *ES* types of FDIs. Thus a large market size of the target country has increased the probability of the Finnish firms to undertake *MS* and *ES* FDIs in target Asian countries. It can be argued that firms expect to experience greater long-term profits through economies of scale and lower marginal cost of production in target countries with larger market size. Thus, investing firms can be better stimulated to undertake *MS* and *ES* FDIs in a target country with a huge market potential. The results are somehow in line with the previous studies (e.g. Sabi 1988; Papanastassiou & Pearce 1990; Wheeler & Moody 1992) indicating that large market size of host countries has a significant and positive effect on attracting FDIs.

**CULTDIS** has a negative sign and is statistically significant at the 0.001 level for both the *MS* and *ES* types of FDIs. This indicates that the high cultural distance between the home and target countries has decreased the probability of Finnish firms to undertake *MS* and *ES* FDIs in a target Asian country. It can be concluded that in culturally similar countries, the demand structures are usually more alike than in culturally more distant countries. Furthermore, marketing, management and production strategies are more easily and less expensively transferable to culturally close countries and thus can encourage the investing firms to undertake *MS* and *ES* FDIs in a culturally close target country. The results partially coincide with the findings of previous studies (e.g. Mikalák 1992; Grosse & Trevino 1996) indicating that investing firms prefer to undertake FDIs in culturally similar countries.

**WAGRAT** has a negative sign and is significant at 0.001 level for both the *MS* and *ES* types of FDIs. Therefore, it can be concluded that the high wage levels in the host country reduces the probability of Finnish firms to undertake *MS* and *ES* FDIs in a target Asian country. It can be argued here that with the increase in market share, it also becomes relatively more profitable to increase the degree of product specialization and to operate within specific product niches. As a result, reduction in labor costs and further market growth are likely to open up new investment opportunities for firms to

undertake *MS* and *ES* FDIs in a target country with relatively low wage rates. In the previous studies (e.g. Rolfe & White 1992; London & Ross 1995) it has also been argued that low wage rates may create an opportunity to achieve plant-level economies of scale; higher production efficiency and lower marginal costs of production which in turn could lead to large market shares for the investing firms.

**TAX** does not appear to be a significant variable, indicating that higher or lower taxes do not increase or decrease the probability that Finnish firms undertake *MS* and / or *ES* FDIs in target Asian countries. These findings are partially in line with the results of earlier studies (e.g. Root & Ahmed 1978; Cable & Persaud 1987; Moody & Srinivasan 1991; Graham & Krugman 1992) focusing on the preferential taxation and / or tax incentives to attract manufacturing FDIs. The World Bank Report (1995) also argued that pro investment policies are often unnecessary for and sometimes even detrimental to inward FDIs.

In the case of *knowledge seeking (KS)* FDIs, **R&D** has a positive sign and is significant at 0.074 levels. It can be concluded here that the higher research and development intensity (R&D) of Finnish firms increases the probability that they will undertake a *KS* type of FDI. It can be argued that the globalization of manufacturing R&D is becoming a popular strategy for firms to exploit and accumulate technological capabilities. Although these OLI variables along with *KS* FDIs have not been reviewed much in the previous studies, however, it has been indicated (e.g. Cantwell 1989; Anand & Kogut 1997; Shan & Song 1997) that R&D intensive firms acquire new technologies by investing in locations that possess such capabilities.

Finally, in the case of *risk-reduction seeking (RRS)* FDIs, low levels of country risks (**CRISK**), inflation rate (**INFLA**) and high levels of exchange rates (**EXC**) increase the probability of undertaking *RRS* FDIs. **CRISK** has a positive sign and is significant at 0.001 level, which indicates that the lower risks in the target country increase the probability that Finnish firms undertake *RRS* FDI in that Asian country. To the best of our knowledge, these OLI variables together with the *RRS* FDIs have not been reviewed much in the previous studies, however it has been indicated (e.g. Edwards 1990; Lizondo 1990; Butler & Joanquin 1998) that most of firms often prefer to undertake investment in a country with relatively low levels of risk.

**INFLA** has a negative sign and is significant at 0.001 level, indicating that a high level of inflation decreases the probability of Finnish firms to undertake *RRS* FDIs in a target Asian country. It has been concluded in the previous studies (e.g. Scheider & Frey 1985; Hyun & Whitemore 1989; Sayek 2000) that inflation and FDIs are negatively correlated. It can be argued that the inflation rate indicates the macroeconomic stability of the target country and also captures uncertainties in the economy as well, and therefore high inflation rates can detract inward FDIs.

Against expectation **EXC** has a positive sign and is significant at 0.007 level, indicating that an increase in exchange rate fluctuations would increase the probability of undertaking *RRS* FDIs. It can be argued here that a firm that seeks resources or efficiency for their operations, and those making initial investment outlays, would benefit from weak currencies of the host country. Thus, the depreciation of the local currency may enhance the competitiveness of the host country as well. Further, this reasoning would also support the widely held view that countries can attract FDIs by devaluating their currency (Baldwin & Krugman 1989).

## **8.2. Empirical results related to ownership strategies of Finnish firms in Asian countries.**

The results of the binomial logistic regression in the basic model are presented in Table 24. The estimated coefficient represents the probability of choosing WOS and undertaking *market*, *efficiency* and / or *risk-reduction* seeking FDIs: a positive coefficient means that WOSs are chosen and a certain type of investment is undertaken; however, the negative coefficient signifies the opposite. The model has a satisfactory overall explanatory power with chi-squares of 85.121 with 3 DF ( $p=0.000$ ) both for *MS* and *ES* FDIs and 34.586 with 3 DF ( $p=0.000$ ) for *RRS* FDIs. Another way of measuring how well a maximum likelihood model fits the data is to use the model to classify observations. The ability to classify can be judged against the classification rate that would have been obtained by chance. The rate is equal to  $a^2 + (1 - a)^2$ , where  $a$  is the proportion of *MS*, *ES* and *RRS* in the sample. In the present case the baseline rates for *MS*, *ES* and *RRS* are 52.3%, 52.6% and 63.8% respectively. Similarly the results show that 88.6%, 88.6% and 84.4% of the observations are correctly classified for *MS*, *ES* and *RRS* respectively.

In the case of *market (MS)* and *efficiency seeking (ES)* FDIs, it has been found that large firm size (**PSIZE**), large international experience (**INTEX**), large market size (**MSIZE**) and a high level of economic welfare (**ECON**) increase the probability that Finnish firms will choose WOSs and will also undertake *MS* and *ES* FDIs. However, large **CULTDIS** decreases the probability that a Finnish firm will choose WOSs and will undertake *market (MS)* and *efficiency seeking (ES)* FDIs. **PSIZE** has a positive sign and is significant at 0.05 level for both *MS* and *ES* types of FDIs. Here it can be argued that large firms due to their large resource base are often considered to be able to exploit the scale and scope economies effectively as well as efficiently by undertaking WOSs, which in turn can stimulate the investing firms to undertake *MS* and *ES* FDIs in a target country. These OLI variables along with strategic motives (e.g. *MS* & *ES*) have not been reviewed much in the previous studies, however it has been indicated (e.g. Gomes-Casseres 1985; Kogut & Singh 1985 & 1988b; Benito 1995; and Mutinelli & Piscitello 1997) that large firms often have a large resource base and have better ability to absorb risks and therefore are more likely to establish WOSs in target countries.

**INTEX** has a positive sign and it is significant at 0.05 level for both *MS* and *ES* types of FDIs. Thus, large international experience has increased the probability that Finnish firms choose WOSs and undertake *MS* and *ES* FDIs in a target Asian country. It can be argued here that the firm's past experiences manifest themselves in organizational routines and also serve as an important source of competitive advantage. Consequently the firm prefers to use the same strategies, which thus can enhance the firm's value by reducing the implementation costs, which in turn could also stimulate the firms to choose WOSs in order to undertake *MS* and *ES* FDIs in a target country. Previous studies (e.g. Gomes-Casseres 1985 & 1987; Agarwal & Ramaswami 1992; Sanna-Randaccio 1990; Tang 1994; Bell 1996; and Mutinelli & Piscitello 1997) also indicated that internationally experienced firms prefer to establish WOSs in unfamiliar foreign countries.

**MSIZE** also has a positive sign and it is statistically significant at the 0.002 level for both for *MS* and *ES* types of FDIs. Thus a large market size in the target country has increased the probability that Finnish firms choose WOS and undertake *MS* and *ES* FDIs in a target Asian country. It can be argued that firms expect to experience greater long-term profits through economies of scale and lower marginal cost of production in

target countries with a larger market size. Thus, investing firms can be better stimulated to choose WOSs and to undertake *MS* and *ES* FDIs in a target country with a huge market potential. The results of previous studies (e.g. Agarwal & Ramaswami 1992; Kim & Hwang 1992; Brouthers & Brouthers 2000) have also indicated the positive relationship between large market size and WOSs.

**Table 24.** Parameter estimates for the binomial logit models related to ownership strategies

	Expected sign	MS	ES	RRS
<b>Constant</b>		16.924 0.000	16.924 0.000	-14.243 0.000
<b>R&amp;D</b>	+	-0.070 0.367	-0.070 0.367	0.006 0.908
<b>PSIZE</b>	+	0.000 0.086*	0.000 0.086*	NR
<b>INTEX</b>	+	0.039 0.087*	0.039 0.087*	NR
<b>INDEXP</b>	+	0.173 0.849	0.173 0.849	NR
<b>CULTDIS</b>	-	-1.750 0.000****	-1.750 0.000****	NR
<b>MSIZE</b>	+	0.002 0.000****	0.002 0.000****	NR
<b>ECON</b>	+	0.242 0.000****	0.242 0.000****	NR
<b>CRISKS</b>	+	-0.171 0.000****	-0.171 0.000****	0.171 0.000****
<b>SCALE</b>	+	-0.776 0.163	-0.776 0.163	NR
<b>OWNERSHIP</b>		0.133 0.868	0.133 0.868	NR
<b>SAMPLE SIZE</b>		77	78	32
<b>% correct observation</b>		88.6%	88.6%	84.4%

NR = Not Related

\*\*\*\*  $p < 0.001$ , \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

**ECON** also has a positive sign and it is statistically significant at the 0.002 level for both for *MS* and *ES* types of FDIs. It indicates that a high level of economic welfare in a target Asian country increases the probability that the WOS of Finnish investing firm will undertake *MS* and *ES* FDIs in a target Asian country. It can be concluded that high growth markets provide the firms with long-term presence in the market through the opportunities of scale and scope economies and consequently lower production costs and thus can also encourage investing firms to choose WOSs in order to undertake *MS* and *ES* FDIs in those countries. The results of previous studies (e.g. Dunning 1980;



Papanastassiou & Pearce 1990) have also found support for WOSs in countries of high economic welfare.

**CULTDIS** has a negative sign and it is statistically significant at the 0.001 level for both the *MS* and *ES* types of FDI. This indicates that high cultural distance between the home and host countries decrease the probability that the WOS of the Finnish investing firm undertakes *MS* and *ES* FDI in a target Asian country. It can be argued that organization routines that are effective in the home country may not be so in target countries and moreover managers also perceive uncertainty about the market and demand structures in culturally distant countries and therefore encourage the investing firm to collaborate with the local firms in the target country. The results coincide with the findings of previous studies (e.g. Kogut & Singh 1985; Kogut & Singh 1988b; Andersons & Gatignon 1988; Padmanabhan & Cho 1994; Benito 1995; Bell 1996; Mutinelli & Piscitello 1997; Hennart & Larimo 1998) indicating that investing firms prefer to undertake JV arrangements in culturally distant target countries.

**CRISK** also has a negative sign and is significant at 0.001 level, indicating that high levels of risks in the target country increases the probability that WOS of the investing firm will undertake *MS* and *ES* FDI in a target Asian country. According to our model (see H8) we should not have included **CRISK** for *MS* and *ES* types of FDI, since **CRISK** appeared to be highly correlated with **MSIZE** and **CULTDIS** we therefore have included it in runs for *MS* and *ES* types of FDI. A similar case is true for **R&D**, which also has a negative sign, but it does not appear to be a significant variable for *MS* and *ES* types of FDI. We have included it in our runs for *MS* and *ES* FDI as it also appeared to be highly correlated with **ECON** (see Table 24).

However, in the case of *risk-reduction seeking (RRS)* FDI, **CRISK** has a positive sign and it is significant at the 0.001 levels, which indicates that lower risks in the target country increases the probability that Finnish firms choose WOSs in order to undertake the *RRS* FDI in a target Asian country. To the best of our knowledge, these OLI variable together with the *RRS* FDI have not been reviewed much in the previous studies, however it has been indicated (e.g. Aharoni 1966; Goodnow & Hansz 1972; Agodo 1978; Root and Ahmed 1978; Benito 1995; Bell 1996; and Mutinelli & Piscitello

1997) that the firms prefer to undertake WOSs in a country with relatively low levels of risks.

### 8.3. Summary

The main goal of this chapter was to empirically investigate the role of ownership-specific, location-specific, internalization and strategic advantages in the eclectic paradigm in order to further understand the FDI choices of Finnish firms in ten South and Southeast Asian countries from 1980 to 2000. Dunning (1993) identifies four main strategic types of FDIs: *market seeking (MS)*, *efficiency seeking (ES)*, *knowledge seeking (KS)* and *risk-reduction seeking (RRS)*. To the best of our knowledge, studies on the determinants of FDI rarely combine ownership-specific, location-specific, and internalization advantages with strategic motivations of the investing firms in Asian markets. This is apparently the first study trying to analyze how different ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI behaviour of Finnish manufacturing firms in Asian countries.

**Table 25.** Types of international production (related to location aspects): some empirical evidence<sup>6</sup>

<b>Types of International Production</b>	<b>Ownership Advantages (O)</b>	<b>Location Advantages (L)</b>	<b>Internalization Advantages (I)</b>
Market seeking FDIs	<i>Large firms' size</i> <i>Large firms' international experience</i>	<i>Low cultural distance</i> <i>Huge market potential</i> <i>Low wage rates</i> Low corporate tax rates	
Efficiency-seeking FDIs	<i>Large firms' size</i> <i>Large firms' international experience</i>	<i>Low cultural distance</i> <i>Huge market potential</i> <i>Low wage rates</i> Low corporate tax rates	
Knowledge seeking FDIs	<i>High R&amp;D intensity</i>		
Risk-reduction seeking FDIs		<i>Low inflation rate</i>	<i>Low country risks</i> <i>Exchange rate fluctuations</i>

**Source:** Modified and adopted by the author based on Dunning (1993:82)

Based on the literature review in the case of location aspects, it was expected that larger size of the firm, larger international experience, large size of the target market, low cultural distance, low wage rate and low taxes increase the probability that *MS* & *ES*

<sup>6</sup> All the variables that appear significant in the statistical analysis are shown in *italic letters* in the Table.

FDIs will be undertaken. Secondly, high R&D intensity increases the probability that *KS* FDIs will be undertaken. Finally, low inflation rates, low exchange rate fluctuations and low levels of risks in the target country increases the probability that *RRS* FDIs will be undertaken.

**Table 26.** Types of international production (related to ownership aspects): some empirical evidences<sup>7</sup>

<b>Types of International Production</b>	<b>Ownership Advantages (O)</b>	<b>Location Advantages (L)</b>	<b>Internalization Advantages (I)</b>
Market seeking FDIs	<i>Large firms' size (WOS)</i> <i>Large firms' international experience (WOS)</i> Large industry experience (WOS)	<i>Low cultural distance (WOS)</i> <i>Huge market potential (WOS)</i> <i>High level of economic welfare (WOS)</i>	
Efficiency seeking FDIs	<i>Large firms' size (WOS)</i> <i>Large firms' international experience (WOS)</i> Large industry experience (WOS)	<i>Low cultural distance (WOS)</i> <i>Huge market potential (WOS)</i> <i>High level of economic welfare (WOS)</i>	
Risk-reduction seeking FDIs	High R&D intensity (WOS)		<i>Low country risks (WOS)</i> Scale economies (WOS)

Source: Modified and adopted by the author based on Dunning (1993:82)

Similarly in the case of ownership aspects, it was assumed that a firm's large size, large international experience, large industry experience, low cultural distance between home and the target country, large size of the target market, high level of economic welfare in the target country and a great potential possibilities of reaching scale economies increase the probability of choice of WOSs and undertaking *MS* and *ES* FDIs. Similarly high R&D intensity of the Finnish firm and low levels of risks in the target country increases the probability of choice of WOS and undertaking *RRS* FDIs.

The empirical part of the study was based on 135 manufacturing FDIs made by Finnish firms in various Asian countries between 1980 and 2000. The sample is based on information drawn from company annual reports, business journals, survey information and other information received through direct contacts with the Finnish companies. A binomial logistic model was used in the analysis of the impact of different ownership-

<sup>7</sup> All the variables that appear significant in the statistical analysis are shown in *italic letters* in Table.

specific, location-specific and internalization variables on the *MS*, *ES*, *KS* and *RRS* FDI choices.

In the case of location aspects, the results indicated that nine variables were statistically significant in the total sample (see Table 25). As was expected, large firm size, larger international experience large size of the target market, low cultural distance and low wage rate had increased the probability of undertaking *MS* and *ES* FDIs. Secondly, high R&D intensity of the investing firm has increased the probability of undertaking *KS* FDIs. Finally, low inflation rate, a low level of risks and a high level of exchange rate fluctuations in the target country have increased the probability of *RRS* FDIs being undertaken.

In the case of ownership, the results indicated that six variables were statistically significant in the total sample (see Table 26). As was expected, large firm size, larger international experience, low cultural distance, large size of the target market, and a high level of economic welfare have increased the probability of choosing WOSs in order to undertake *MS* and *ES* FDIs. Likewise, low levels of risk in the target Asian country have also increased the probability of choosing WOSs in order to undertake *RRS* FDIs.

Further, with reference to the eclectic approach, in the whole sample ownership-specific advantages (O), location-specific advantages (L) internalization advantages (I) and strategic motivations have influenced the FDI-related choices of Finnish firms in Asian market (see Table 25 & 26). The individual strategic motivations listed above should not be seen as mutually exclusive. FDI projects may be driven by several ownership-specific, location-specific, internalization and strategic advantages simultaneously and in various combinations. Conceptually, however, distinguishing between different types of strategic motivations facilitates a better understanding of the strategic motives underlying different FDI decisions and key ownership-specific, location-specific and internalization (OLI) variables influencing the different types of FDIs.

## **9. SUMMARY, CONCLUSIONS AND IMPLICATIONS OF THE PRESENT STUDY**

The present study empirically analyzed how the ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI behavior of Finnish manufacturing firms in Asian countries. The chapter begins by briefly summarizing the research conducted in the current study, re-emphasizes the theoretical statement of the study along with the contributions and conclusions of the study. It also provides a discussion of the scientific and managerial implications of the present study. Finally this chapter ends with some implications for future research.

### **9.1. Summary and conclusions**

According to Kojima (1978), foreign direct investments by multinational corporations from developed countries significantly contributed to the growth and development of East Asian countries through the transfer of technology, training and development of the skill of the workforce, the provision of capital for future development and the exploration of manufactured goods. FDI can also raise income and employment levels and can help to utilize the resources in the host country. Similarly a study by Chandrapalart (1999:109) also argued that FDI assists in the economic development and industrialization of many developing countries. South and Southeast countries are certainly no exception.

Furthermore FDI is also becoming a key strategy and an integrated element of business strategy in an increasing number of firms. While international production practices are still unfamiliar to many firms, yet a great number of firms within such industries as automobile, electronics and software have carried out international production for many years. In the coming years, an increasing number of firms will confront the pressure to internationalize their production resources.

The academic interest in FDIs has been increasing considerably in the recent years. The results are evident by the growth of FDI studies. However, there are still a few rigorous frameworks that provide a deep understanding of international production. In other words, there are many remarkable and interesting, yet unexplored research subjects

relating to FDIs. One interesting question is how manufacturing Finnish firms have carried out their FDI operation in growing South and Southeast Asian markets.

The present study attempted to empirically investigate how the ownership-specific (O), location-specific (L), internalization (I) and strategic advantages have influenced the location and ownership strategies of the Finnish firms in ten South and Southeast Asian countries from 1980 to 2000. The present study has been conducted with three inter-related but separate objectives. The specific objectives of the study were:

- *To contribute to the extension of the OLI framework of international production.*
- *To empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages have influenced the location strategies of the Finnish manufacturing firms in Asian countries.*
- *To empirically analyze how the ownership-specific, location-specific, internalization and strategic advantages have influenced the ownership strategies choices of Finnish manufacturing firms in Asian countries.*

Despite the increased interest into FDIs, very few studies (e.g. Chandrapalert 2000; Vyas 2000) have been undertaken so far to empirically analyze the influential ownership-specific, location-specific and internalization variables together with the strategic motives in order identify the FDI choices of foreign investors. These strategic motives have remained primarily anecdotal. Empirical analysis of strategic motives along with the influencing ownership-specific, location-specific and internalization (OLI) variables can add to our understanding of the eclectic paradigm and also enrich our knowledge of FDI in general.

This study validates the eclectic paradigm developed by John H. Dunning. As predicted by the paradigm, the OLI variables and the strategic motives of FDI were identified. This modified version of eclectic paradigm estimated for South and Southeast Asian countries offered some interesting insights. In the case of location aspects, it was found that large firm size (PSIZE), large international experience (INTEX), large size of the target market (MSIZE), low cultural distance (CULTDIS) and low wage rates (WAGRAT) have increased the probability of undertaking *marketing seeking (MS)* and *efficiency seeking (ES)* types of FDIs by Finnish firms. Secondly, high R&D intensity

(R&D) of Finnish firms have increased their probability of undertaking *knowledge seeking (KS)* types of FDIs. Finally, low inflation rates (INFLA), low level of risks (CRISKS) and high level of exchange rate fluctuations have increased the probability of undertaking *risk-reduction seeking (RRS)* FDIs in a target Asian countries (see Table 27).

Similarly in the case of ownership aspects, it was indicated in the present study that large firm size (PSIZE), large international experience (INTEX), low cultural distance (CULTDIS), large size of the target market (MSIZE) and high level of economic welfare (ECON) have increased the probability of choosing WOSs in order to undertake *market seeking (MS)* and *efficiency seeking (ES)* types of FDIs. Likewise, low levels of risks in the target country (CRISKS) have also increased the probability of choosing WOSs in order to undertake *risk-reduction seeking (RRS)* types of FDIs by Finnish firm in Asian countries (see Table 28).

This study also contributes to the literature of international business by focusing on firms based in Finland, a small industrialized country where the domestic market conditions are very different from those of the multinationals of the USA or Japan that have dominated in past research attention. Moreover, studies on the determinants of FDI rarely combine ownership-specific, location-specific, and internalization advantages along with strategic motivations of firms in Asian markets. To the best of our knowledge, this is apparently the first study trying to analyze how the ownership-specific, location-specific, internalization and strategic advantages have influenced the FDI choices of Finnish manufacturing FDIs in Asian countries. It therefore presents new data and new empirical insights into the determinants as well as the strategic advantages of Finnish manufacturing firms that engage in FDI ventures in Asia.

**Chapter 2** reviews some of the leading foreign direct investment (FDI) theories and explanations of the growth of multinational firms. More precisely, this chapter attempts to discuss the strength and weaknesses of different conceptual frameworks. These theories and frameworks can be broadly divided into four paradigms: **1.** Market imperfection paradigm, **2.** Behavior paradigm, **3.** Environment paradigm and **4.** Market failure paradigm. There is a large diversity in theoretical explanations of international production and there is no unanimously accepted FDI theory. However, all these

theories share one common feature; nearly all of them are primarily related to outward foreign investment. Rather, the use of particular paradigms and theories often reflects the issues addressed and questions asked. In addition to the general review of the FDI theories in the whole chapter, argumentations have been made for selecting the eclectic theory as the framework of this study.

**Chapter 3** describes and discusses the eclectic framework within which the advantages influencing the FDI choices are evaluated. The main goal of this chapter is to explain how ownership-specific, location-specific and internalization (OLI) advantages can influence the FDI choices of a firm, which largely depend on the interpretation of the eclectic framework. There is now substantial divergence between its original version and most recent versions argued for in Dunning (1995 & 1993) and in Gray (1996). Moreover this eclectic framework has become more dynamic over the years and the precise relationships between the ownership-specific, location-specific and internalization (OLI) advantages have not been determined (Kim & Hwang 1992) and the description of the framework has largely been a matter of interpretation among scholars. Thus it is important to describe the perspective of the eclectic framework used in the later chapters of this study.

**Chapter 4** provides and elaborates upon classification of investment level strategic motives. Basically FDI projects are commonly undertaken in line with several strategic motives simultaneously; hence, the various strategic motives are not mutually exclusive. It has been discussed in this chapter that the choice of location and ownership strategies should be conditional upon the type of FDI projects discussed, because these variables may stimulate firms to undertake certain types of FDI projects and because certain types of FDI projects are more (or less) sensitive to the changes in these factors.

**Chapter 5** theoretically investigates how the ownership-specific, location-specific, internalization and strategic advantages influence the location strategies of the investing firms in the target countries. Then each of the above mentioned advantages are reviewed in detail in different subchapters. Based on the extent of theoretical and empirical literature on the location strategies, several hypotheses (see Table 27) are developed regarding the components of the eclectic paradigm and the strategic motivational type of



FDIs. The chapter ends with a summary of all the reviewed previous studies related to location strategies of the Finnish firms in Asian countries.

**Chapter 6** theoretically reviews how the ownership-specific, location-specific, internalization and strategic advantages influence the ownership strategy choices of the investing firms in the target countries. Then each of the above-mentioned advantages are reviewed in detail in different subchapters. Several hypotheses (see Table 28) are developed regarding the extent of theoretical and empirical literature on the ownership strategies of Finnish firms in Asian countries. The chapter ends with a summary of all the reviewed previous studies related to ownership strategies of the investing firms in the target countries.

In the **Chapter 7** the methodology of the study and the characteristics of the participating firms have been reviewed. It provides a discussion of the sample and an overview of the statistical procedure used and descriptive statistics. In addition, the population of the firms and the types of investment in the sample have been discussed. Finally, the operationalization of the dependent, independent and control variables related to the location and ownership strategies of Finnish manufacturing firms in Asian countries have also been presented in this chapter.

**Chapter 8** empirically tests the hypotheses developed in chapters 5 and 6 of this study. The first part of this chapter deals with the testing of hypotheses and the model, related to the location aspects of Finnish firms in Asian countries. The results indicated that nine variables were statistically significant in the total sample. As was expected, large firm size, larger international experience large size of the target market, low cultural distance and low wage rate had increased the probability of undertaking *MS* and *ES* FDIs.

Secondly, high R&D intensity of the investing firm has increased the probability of undertaking *KS* FDIs. Finally, low inflation rate, a low level of risks and a high level of exchange rate fluctuations in the target country have increased the probability of undertaking *RRS* FDIs (see Table 27).

The second part of this chapter deals with the hypotheses and the model related to the ownership strategy choices of the Finnish firms in Asian countries. Based on the

**Table 27.** Summary of the results related to location strategies of Finnish firms in Asian countries

<b>H 1a:</b>	R&D	Supported Significant at $P < 0.05$ (R&D intensity is positively related to the extent of undertaking <i>KS</i> FDI in a target Asian country).
<b>H 2a:</b>	PSIZE	Supported Significant at $P < 0.05$ (Firm's size is positively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 3a:</b>	INTEX	Supported Significant at $P < 0.05$ (Firm's international experience is positively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 4a:</b>	CULTDIS	Supported Significant at $P < 0.001$ (Large cultural distance is negatively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 5a:</b>	MSIZE	Supported Significant at $P < 0.001$ (Market potential is positively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 6a:</b>	WAGRAT	Supported Significant at $P < 0.001$ (Lower wage rate is positively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target country).
<b>H 7a:</b>	TAX	Unsupported Significant at $P > 0.05$ (Higher corporate tax is negatively related to the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target country).
<b>H 8a:</b>	INFLA	Supported Significant at $P < 0.001$ (Higher inflation rate is negatively related to the extent of undertaking <i>RRS</i> FDIs).
<b>H 9a:</b>	CRISK	Supported Significant at $P < 0.001$ (Lower risks are positively related to the extent of undertaking <i>RRS</i> FDIs).
<b>H 10a:</b>	EXC	Supported Significant at $P < 0.001$ (High exchange rate fluctuations are positively related to the extent of undertaking <i>RRS</i> FDIs).

**Table 28.** Summary of the results related to ownership strategies of Finnish firms in Asian markets

<b>H 1b:</b>	R&D	Unsupported Significant at $P > 0.05$ (R&D intensity is positively related to the WOS and the extent of undertaking <i>RRS</i> FDI in a target Asian country).
<b>H 2b:</b>	PSIZE	Supported Significant at $P < 0.05$ (Firm's size is positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 3b:</b>	INTEX	Supported Significant at $P < 0.05$ (Firm's international experience is positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 4b:</b>	INDEXP	Unsupported Significant at $P > 0.05$ (Firm's related experience is positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 5b:</b>	CULTDIS	Supported Significant at $P < 0.001$ (Large cultural distance is negatively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 6b:</b>	MSIZE	Supported Significant at $P < 0.001$ (Market potential is positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).
<b>H 7b:</b>	ECON	Supported Significant at $P < 0.001$ (Economic welfare is positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target country).
<b>H 8b:</b>	CRISK	Supported Significant at $P < 0.001$ (Low Country risks are positively related to the WOS and the extent of undertaking <i>RRS</i> FDIs in a target country).
<b>H 9b:</b>	SCALE	Unsupported Significant at $P > 0.05$ (Scale economies are positively related to the WOS and the extent of undertaking <i>MS</i> and <i>ES</i> FDIs in a target Asian country).

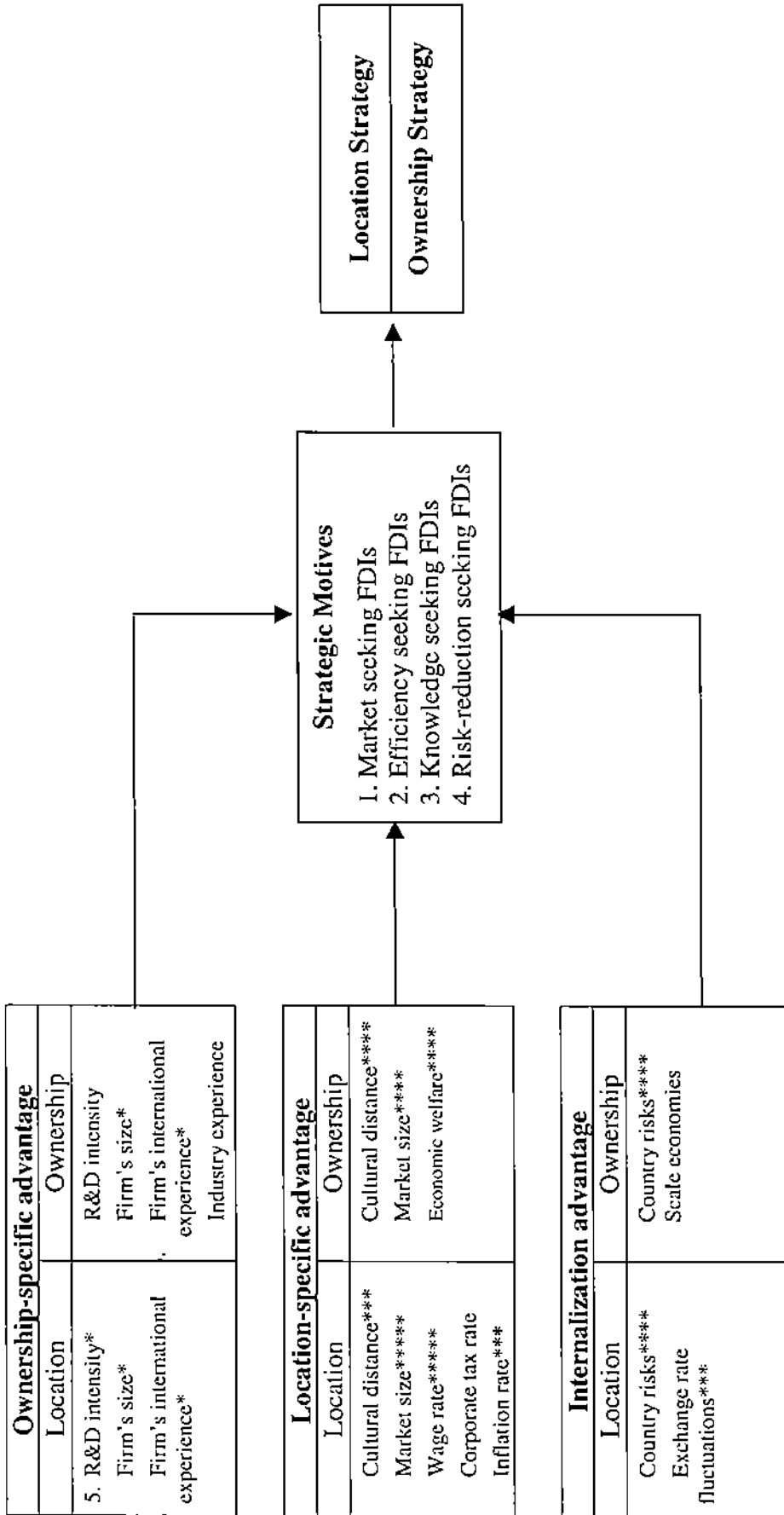
empirical findings and results, summary and concluding remarks are presented in the final part of this chapter. The results indicated that six variables were statistically significant in the total sample. As was expected, large firm size, larger international experience, low cultural distance, large size of the target market, and high level of economic welfare have increased the probability of choosing WOSs in order undertake *MS* and *ES* FDIs. Likewise, low levels of risks in the target Asian country have also increased the probability of choosing WOSs in order to undertake *RRS* FDIs (see Table 28).

## **9.2. Scientific and managerial implications of the present study**

This study has identified and empirically verified the significance of strategic motives in relation to FDI choices. This study is among the first to attempt to incorporate strategic motive together with the OLI advantage at the firm- or divisional level of analysis as suggested by e.g. Hill, Hwang and Kim (1990); Melin (1992); Dunning (1993); and Chandprapalert (2000). The implication is that strategic motives need to be an integrated part of further model development on FDI choices.

This is an empirical study of the expected FDI behavior of the Finnish firms in Asia, which is an important issue given the recent rapid growth of manufacturing investment by Finnish firms in Asia. In the conceptualization of variables affecting the FDI strategies of the Finnish firms, efforts were made to incorporate the key variables from the existing literature. The results of this study have shown that these variables have indeed contributed to the explanation of FDI behavior of the Finnish firms in Asia.

Much of the existing literature on FDI has presented either a list of considerations without identifying variables affecting the FDI decisions or focused on each FDI decision in isolation. Here we have identified three main underlying variables that influence the FDI decision: ownership-specific, location-specific and internalization advantages. These three main underlying advantages are then linked to strategic objectives of the investing firm that have been previously discussed in the literature. In addition, we have argued that a firm's location and ownership strategies depend on the strategic relationship the firm envisages between operations in different countries.



\* Statistically significant at the 0.1 level, \*\* significant at the 0.05 levels, \*\*\* significant at the 0.01 levels, \*\*\*\* significant at the 0.001 levels

**Figure 6.** Modified version of eclectic framework  
Source : Modified and adopted by the author on the basis of Dunning's eclectic paradigm.

One particular advantage of this study is the attempt to build a "complete" model of FDI choices and foreign market resource commitment decisions. Since this study attempts to build a comprehensive model of foreign market servicing, it provides managers with a framework in which these FDI choices can be easily evaluated.

The empirical results of the present study have indicated that there is a relationship between economic variables, strategic motives and FDI choices. We have assumed that the ownership-specific, location-specific and internalization advantages are affecting each other and these proposed relationships act as the starting point for our conceptual model. The intermediate position of the strategic motives (see Figure 6) in our model reflects that strategic motive is a function of ownership-specific, location-specific, internalization advantages as well as other factors external to our model.

External factors that might affect the strategic advantage could be the past strategy, future strategy and the past configuration of the ownership-specific, location-specific and internalization advantages. However our model is limited by the fact that we only consider the present contingencies. In building a model we therefore integrate, extend and modify the reviewed perspectives to fit our specific research problem.

More precisely this study helps in expanding the eclectic paradigm by suggesting that FDI choices are significantly affected by ownership-specific, location-specific and internalization and strategic advantages. Our position therefore in this study is that strategic motives apply and extend the economic factors. This allows each factor to be considered not in isolation, but with reference to its strategic impact upon a firm's global strategic objectives. It is hoped that the extended version of the eclectic model of this study could enrich the existing explanations of international production.

This extended version of the eclectic framework can also be useful in identifying the possible trade-offs between the diverse considerations and, therefore, in understanding the benefits as well as costs associated with selecting a particular choice. The different factors may suggest different alternatives and resolving those differences may involve trade-offs. It is further argued that each FDI choice cannot be viewed in isolation and it must be considered in relation to the overall strategic objectives of the firm. Finally this

framework makes the strategic issues more explicit that management must deal with and that might otherwise be resolved through omission.

For managers it is often considered difficult to achieve, “optimization” given the complexity that characterizes the real world, the uncertainty that exists as to the future state of nature, and the bounded rationality of the choices. Thus, “satisfactory” rather than optimal solution seems to be the best that can be achieved. Nevertheless, assuming that global markets are reasonably competitive, in the long run competitive forces will eliminate those firms that make FDI decision inconsistent with value maximization. Hence it is of critical importance that management decision-makers consider the relative weight of the ownership-specific, location-specific, internalization and strategic advantages identified herein when making FDI choices.

Finally, the findings of this study may also help the Asian governments to identify and prioritize these problems, so that they may move to solve these problems more efficiently. It is also hoped that these findings will help the governments of other countries and region as well in recognizing and identifying factors that might discourage FDI.

### **9.3. Limitations of the present study**

In the present study although efforts will be made to ensure the generalizability of the empirical results, a few limitations of the study must be acknowledged. The limitations of the study are discussed below:

1. Dunning’s eclectic paradigm is widely accepted as an explanation for international production, but still few researchers have attacked the validity of the paradigm. The strongest criticism to the theory has come from Itaki (1991). Itaki claimed that an ownership-specific advantage actually comes from an internalization advantage. Therefore, it is redundant to consider these two separate determinants. He also points out that the ownership advantages cannot be separated from the location-specific advantage and they are simultaneously determined. Also, Dunning’s theory has been called ambiguous regarding the sources of location advantages.

2. The use of secondary data brings several limitations, which may include lack of control over the inclusion of potentially meaningful business or products, inability to calibrate measures and errors in reproduction. Nevertheless longitudinal data provide the power to examine relationships that cannot be seen in purely cross-sectional studies.
3. This study analyzes the macroeconomic aspects. However, the microeconomic aspect may become important if a firm plans a subsidiary in a particular industry, considerations of comparative advantage in the industry may then become important. For instance firms can make investment decisions with reference to market conditions in a particular product.
4. Generalizability of finding may be problematic because the sample is confined to Finnish manufacturing FDI in ten South and Southeast Asian countries during the time period starting from the year 1980 to 2000. However study of a single region may provide an opportunity to more fully understand issues like regulations, risks, role of host and home governments, and particularly FDI behavior in general.
5. *Finally*, there are a great number of variables that influence FDI behavior, but in this study we consider only a few of them due to both the consideration of data availability and ease of measurement procedures. It must be conceded that it is not possible to include all the variables, even if we are able to identify them.

#### **9.4. Implications for future research**

The purpose of this study was to develop and extend the OLI paradigm in order to understand the FDI behavior of Finnish firms in Asian markets. The methodological choices and the results received give basis for some suggestions for future research:

1. The present study looks at only the investment behavior of Finnish manufacturing firms that may have little in common the terms of market, resources, industrial and corporate structures and strategies, and the degree of internationalization. It is possible that there are considerable differences across different industries. For example strategic considerations differ greatly between telecommunication and wood processing in terms of markets, technology, inputs, joint ventures and wholly owned subsidiaries. It is therefore recommended that the present study be



replicated for different industries in order to analyze distinct investment characteristics of each industry. It would also be interesting to explore the investment behavior of service firms for instance, as compared to manufacturing firms.

2. It would also be interesting to add some more economic and strategic variables to the present framework. These variables could be transportation cost and unionization that could affect for example the FDI choices of foreign investors. Additionally, performance is an important dimension of any FDI ventures and it could be included in the proposed framework in the future. It would be very interesting to know whether a certain FDI strategy performs better than the others in a specific situation.
3. It would also be interesting to compare the investment behavior and motivations of non-Finnish firms: it may be expected that Japanese, American and other Europeans firms would have different behaviors and investment motivations. Future studies may also incorporate some of these multi-cultural attitudes.
4. It would also be interesting to use research approach utilized in this study to identify the significant FDI behavioral and motivational similarities and differences that exist between the Nordic manufacturing firms in Asian countries.
5. It would also be interesting to do similar work in different countries in that region of the world and make some cross-country comparisons. Other countries in Africa or around the Mediterranean may even be good candidates for this type of research.
6. There is a need to systematically explore the situational contingencies that surround the FDI choices. By this we mean identifying under what set of circumstances each of the particular FDI choices, or sets of considerations, should dominate and play a more important role than the others do. Such a research could assist managers in their important and difficult task of prioritizing variables affecting the FDI choices, and could therefore better focus their time and resources – which are often limited – on those variables most likely to affect success in a given situation.

7. *Finally*, there are many theories that explain the FDI behavior of the investing firms. From the theoretical point of view, it would be interesting to assess the applicability of each of these theories in the Asian context. One could include, for example, internationalization process theory, and transaction-cost theory and a product life cycle approach.

Although there have been many studies where FDI behavior of the firms have been studied, but the number of studies where the influential ownership-specific, location-specific and internalization variables together with the strategic motives have been analyzed have been much more limited. Therefore, it is hoped that the clarification and specification of the relationship between OLI variables and strategic motives affecting the FDI choices and the empirical findings and conclusions presented in this study, will contribute to a broader understanding of the FDI behavior, particularly in FDIs made in Asian countries.

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**LIST OF APPENDICES**

APPENDIX 1. LIST OF FINNISH MANUFACTURING FIRMS THAT HAVE INVESTED IN ASIA DURING 1980-2000 .....	178
APPENDIX 2. THE CORRELATION MATRIX BETWEEN DIFFERENT VARIABLES (RELATED TO LOCATION ASPECTS).....	179
APPENDIX 3. THE DESCRIPTIVE STATISTICS OF DIFFERENT VARIABLES (RELATED TO LOCATION ASPECTS) .....	180
APPENDIX 4. THE CORRELATION MATRIX BETWEEN DIFFERENT VARIABLES (RELATED TO OWNERSHIP ASPECTS).....	181
APPENDIX 5. THE DESCRIPTIVE STATISTICS OF DIFFERENT VARIABLES (RELATED TO OWNERSHIP ASPECTS) .....	182

**APPENDIX 1. LIST OF FINNISH MANUFACTURING FIRMS THAT HAVE INVESTED  
IN ASIA DURING 1980-2000**

Ahlstrom	KWH
Amer	Kyro
Asko	Labstystems
Aspocomp	Larox
Cultor	Metra
Eimo	Neste
Elecoteq	Nokia
Electer	Novart
Enso	Ojala-yhtymä
Enso-Gutzeit	Outokumpu
Finnscrew	Partek
Finvest	PMJ Automec
Fimet	Polar Electro
Fiskars	Raisio
GWS	Raute
Halton	Repola
Hartela	Retting
Huhtamäki	Savcor Coating
IVO	StoraEnso
JOT-Yhtiöt	Tamfelt
Katko	Tampella
Kemira	Turo Tailor
Kone	UPM-Kymmene
Konecranes	Valmet
Kuusakoski	Wärtsilä

APPENDIX 2. THE CORRELATION MATRIX BETWEEN DIFFERENT VARIABLES (RELATED TO LOCATION ASPECTS)

	R&D	PSIZE	INTEX	CULTDIS	MARSIZ	WAGRAT	TAX	INFLA	CRISK	EXC
R&D	1.000									
PSIZE	-0.221	1.000								
INTEX	-0.124	0.459	1.000							
CULTDIS	0.100	0.025	-0.039	1.000						
MARSIZ	0.091	0.109	0.033	0.263	1.000					
WAGRAT	-0.046	-0.050	-0.077	0.256	0.417	1.000				
TAX	-0.130	-0.157	0.021	0.217	-0.261	0.318	1.000			
INFLA	0.266	-0.065	0.031	-0.240	-0.200	-0.313	0.052	1.000		
CRISK	0.117	-0.150	-0.047	0.337	0.222	0.431	0.091	-0.292	1.000	
EXC	0.133	-0.001	0.044	-0.143	-0.019	0.060	0.031	0.418	-0.186	1.000

**APPENDIX 3. THE DESCRIPTIVE STATISTICS OF DIFFERENT VARIABLES  
(RELATED TO LOCATION ASPECTS)**

	N	Minimum	Maximum	Mean	Std. Deviation
R&D	109	0,40	12	2,30	2,12
PSIZE	123	18,8	69176,3	15615,682	17015,805
INTEX	132	0	69	18,26	14,69
CULTDIS	135	1,52	5,01	3,0973	,9141
MSIZE	135	13,6	4836,0	449,765	645,712
WAGRAT	135	472	31687	3292,01	5213,04
TAX	125	0	75	30,18	17,88
INFLA	135	-6,0	15,0	4,659	4,871
CRISK	135	39,0	98,4	72,510	11,680
EXC	132	0	49,58	7,5060	12,4142

APPENDIX 4. THE CORRELATION MATRIX BETWEEN DIFFERENT VARIABLES (RELATED TO OWNERSHIP ASPECTS)

	R&D	PSIZE	INTEX	INDEXP	CULDIS	MSIZE	ECON	RISKS	SCALE
R&D	1.000								
PSIZE	-0.221	1.000							
INTEX	-0.124	0.459	1.000						
INDEXP	-0.097	-0.110	-0.025	1.000					
CULDIS	0.100	0.025	-0.039	-0.117	1.000				
MSIZE	0.091	0.109	0.033	-0.058	0.263	1.000			
ECON	0.228	-0.092	-0.105	0.093	0.156	-0.116	1.000		
CRISK	0.117	-0.150	-0.047	0.040	0.337	0.222	0.198	1.000	
SCALE	0.013	-0.027	-0.163	-0.036	0.091	0.041	-0.162	-0.052	1.000

**APPENDIX 5. THE DESCRIPTIVE STATISTICS OF DIFFERENT VARIABLES  
(RELATED TO OWNERSHIP ASPECTS)**

	N	Minimum	Maximum	Mean	Std. Deviation
R&D	109	0,40	12	2,30	2,12
SIZE	123	18,8	69176,3	15615,682	17015,805
EXP	132	0	69	18,26	14,69
INDEXP	132	0	1	2,27E-02	,15
CULTDIS	135	1,52	5,01	3,0973	,9141
MSIZE	135	13,6	4836,0	449,765	645,712
ECON	132	-11	15	7,70	3,75
CRISK	135	39,0	98,4	72,510	11,680
SCALE	135	0	2	1,47	,58