Implications of Ownership, Location, and Internalization Advantages for FDI Policies

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Questions About FDI Policies
- When does foreign direct investment (FDI) occur?
- What benefits can FDI provide for host countries?
- What government policies increase benefits from FDI?

When Does FDI Occur?
- Logistics of coordinating activities across multiple locations can be challenging
- Ownership, location and internalization advantages help overcome difficulties
- Operating as a multinational can be worthwhile, especially as information and communication technologies improve

Ways to Serve a Foreign Market
- Export: produce in home market and ship to foreign market
- FDI: produce in foreign market using a subsidiary
- License: produce in foreign market using a foreign firm

Ownership Advantage
- First need a reason why foreign market not served by a foreign firm
- Must be something that domestic firm does better than foreign firms – domestic firm must be special
- Examples: technology (unique product design, better product, lower cost), superior management or organization skills

Location Advantage
- Next need a reason why production should be located in the foreign market
- Must be something that makes production in foreign country better than production in domestic country – host must be special
- Examples: lower factor prices (comparative advantage), import restraints, rule of law
**Internalization Advantage**

- Finally need a reason why production should be kept within one firm
- Must be something that makes internal transactions better than arm’s length
- Examples: impossible to write complete contracts for every possible event, difficult to enforce, risk of opportunistic behavior

**Internationalization Strategy**

- Firms often move from exporting to FDI and then to licensing as build experience in a country or in similar countries
- Technology transfer increases as does exposure to risk of imitation and opportunistic behavior
- Hardest to protect ownership advantage under licensing

**What Benefits Can FDI Provide for Host Countries?**

- Benefits from FDI generally stem from the existence of ownership advantage
- Any firm that engages in FDI must be special, have some dimension of superiority (often technology) that offsets the inherent difficulty of operating as a multinational
- Possible that local firms may be able to gain from similar ownership advantages

**Technology Transfer**

- Improvements in information and communication technologies could increase amount of technology transfer that occurs without FDI
- Firms could use backward engineering even if item not produced locally
- Patents disclose some information about inventions that could lower cost of imitation

**Easing Technology Transfer**

- Multinationals may adapt production technologies to local conditions
- Local firms may then have easier time copying adapted technologies
- Workers exposed to technologies may leave to work for local firms
- Part of inventions often kept as trade secret – firms patent around innovations

**Creating Better Jobs**

- Multinational firms pay higher wages, even controlling for industry, firm size, etc
- Could be creaming (hiring best workers) in part but also use more capital
- Better technologies make workers more productive and their output more valuable
- Workers may be trained to use new technologies, and some training general
**Linkages From FDI**

- **Forward linkages:** added supply lowers cost of intermediates – higher profits for local producers and entry (but possibly lower profit for suppliers and exit)
- **Backward linkages:** added demand raises price of intermediates – higher profits for local suppliers and entry (but possibly lower profit for producers and exit)

**Consumer Benefits**

- FDI may bring consumer benefits similar to (but beyond) the benefits of opening up to international trade
- Arrival of new varieties or better qualities of products to a market
- Lower prices for consumer goods than if imported, especially in the case of substantial import restrictions

**What Government Policies Increase Benefits From FDI?**

- Policies to attract better FDI generally must augment the location advantage, so host country more special
- Important to not tamper with ownership advantage (what makes firm special)
- Examples: infrastructure (highways, ports, airports), education (computers and foreign language), national treatment, transparency

**When Thinking About FDI, Remember OLI!**

- Ownership, location and internalization advantages important for understanding when FDI occurs
- Ownership advantage influences possible benefits of FDI
- Location advantage determines how best to attract FDI