Foreign Direct Investment and Governments

Catalysts for economic restructuring

Edited by

John H. Dunning and Rajneesh Narula

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The investment development path revisited

Some emerging issues

John H. Dunning and Rajneesh Narula

PART 1: THE THEORY

The nature of the investment development path

The notion that the outward and inward direct investment position of a country is systematically related to its economic development, relative to the rest of the world, was first put forward by John Dunning in 1979, at a conference on 'Multinational Enterprises from Developing Countries' which took place at the East–West Center at Honolulu.[1]

Since then the concept of the investment development path (IDP)[2] has been revised and extended in several papers and books (Dunning 1981, 1986, 1988a, 1993; Narula 1993, 1995; Dunning and Narula 1994). The following paragraphs summarize the state of thinking – prior to this volume – on the nature and characteristics of the IDP.

The IDP suggests that countries tend to go through five main stages of development and that these stages can be usefully classified according to the propensity of those countries to be outward and/or inward direct investors. In turn, this propensity will rest on the extent and pattern of the competitive or ownership specific (O) advantages of the indigenous firms of the countries concerned, relative to those of firms of other countries; the competitiveness of the location-bound resources and capabilities of that country, relative to those of other countries (the L specific advantages of that country); and the extent to which indigenous and foreign firms choose to utilize their O specific advantages jointly with the location-bound endowments of home or foreign countries through internalizing the cross-border market for these advantages,[3] rather than by some other organizational route (i.e. their perceived I advantages).

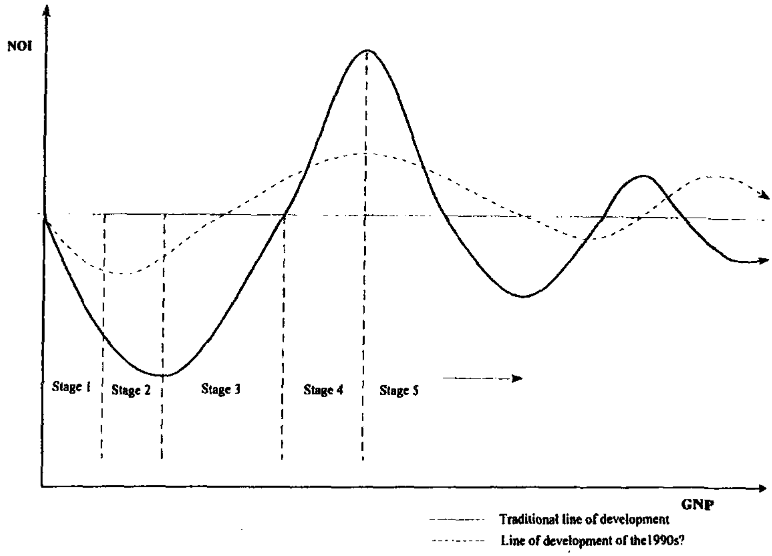

Figure 1.1 The pattern of the investment development path
Note: Not drawn to scale – for illustrative purposes only

A diagrammatic representation of the IDP, which relates the net outward investment (NOI) position of countries (i.e. the gross outward direct investment stock less the gross inward direct investment stock) – as a continuous line – is presented in Figure 1.1. We shall briefly summarize the main features of these stages, but pay particular attention to Stage 5, which we did not consider in our earlier writings.

Stage 1

During the first stage of the IDP path, the L specific advantages of a country are presumed to be insufficient to attract inward direct investment, with the exception of those arising from its possession of *natural* assets. Its deficiency in location-bound *created* assets[4] may reflect limited domestic markets – demand levels are minimal because of the low per capita income – inappropriate economic systems or government policies; inadequate infrastructure such as transportation and communication facilities; and, perhaps most important of all, a poorly educated, trained or motivated labour force. At this stage of the IDP, there is likely to be very little outward direct investment. *Ceteris paribus*, foreign firms will prefer to export to and import from this market, or conclude cooperative non-equity arrangements with indigenous firms. This is because the O specific advantages of domestic firms are few and far between, as there is little or no indigenous technology accumulation and hence few created assets. Those that exist will be in labour-intensive manufacturing and the primary product sector (such as mining and agriculture), and may be government influenced through infant industry protection such as import controls.

Government intervention during Stage 1 will normally take two forms. First it may be the main means of providing basic infrastructure, and the upgrading of human capital via education and training. Governments will attempt to reduce some of the endemic market failure holding back development. Second, they engage in a variety of economic and social policies, which, for good or bad, will affect the structure of markets. Import protection, domestic content policies and export subsidies are examples of such intervention at this stage of development. At this stage, however, there is likely to be only limited government involvement in the upgrading of the country's created assets, e.g. innovatory capacity and human resources.

Stage 2

In Stage 2, inward direct investment starts to rise, while outward investment remains low or negligible. Domestic markets may have grown either in size or in purchasing power, making some local production by foreign firms a viable proposition. Initially this is likely to take the form of import substituting manufacturing investment – based upon their possession of intangible assets, e.g. technology, trademarks, managerial skills, etc. Frequently such inbound foreign direct investment (FDI) is stimulated by host governments imposing tariff and non-tariff barriers. In the case of export-oriented industries (at this stage of development, such inward direct investment will still be in natural resources and primary commodities with some forward vertical integration into labour-intensive low technology and light manufactures) the extent to which the host country is able to offer the necessary infrastructure (transportation, communications facilities and supplies of skilled and unskilled labour) will be a decisive factor. In short, a country must possess some desirable L characteristics to attract inward direct investment, although the extent to which foreign firms are able to exploit these will depend on its development strategy and the extent to which it prefers to develop technological capabilities of domestic firms.

The O advantages of domestic firms will have increased from the previous stage, wherever national government policies have generated a virtuous circle of created asset accumulation. These O advantages will exist due to the development of support industries clustered around primary industries, and production will move towards semi-skilled and moderately knowledge-intensive consumer goods. Outward direct investment emerges at this stage. This may be either of a market seeking or trade-related type in adjacent territories, or of a strategic asset seeking type in developed countries. The former will be characteristically undertaken in countries that are either lower in their IDP than the home country, or, when the acquisition of created assets is the prime motive, these are likely to be directed towards countries higher up in the path.

The extent to which outward direct investment is undertaken will be influenced by the home country government-induced 'push' factors such as subsidies for exports, and technology development or acquisition (which influence the I advantages of domestic firms), as well as the changing (non-government-induced) L advantages such as relative production costs. However, the rate of outward direct investment growth is likely to be insufficient to offset the rising rate of growth of inward direct investment. As a consequence, during the second stage of development, countries will increase their net inward investment (i.e. their NOI position will worsen), although towards the latter part of the second stage, the growth rates of outward direct investment and inward direct investment will begin to converge.

Stage 3

Countries in Stage 3 are marked by a gradual decrease in the rate of growth of inward direct investment, and an increase in the rate of growth of outward direct investment that results in increasing NOI. The technological capabilities of the country are increasingly geared towards the production of standardized goods. With rising incomes, consumers begin to demand higher quality goods, fuelled in part by the growing competitiveness among the supplying firms. Comparative advantages in labour-intensive activities will deteriorate, domestic wages will rise, and outward direct investment will be directed more to countries at lower stages in their IDP. The original