

Taxonomy of foreign direct investment

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Abstract

Different classifications of Foreign Direct Investment (FDI) are found scattered in the literature of Finance, Economics and Business. They all have come to exist since FDI is considered from different perspectives. But most of the categories of FDI seem to have their appellation after being considered from the investors' points of view while the classification of FDI from the perspective of host country is scarcely found in the literature. Furthermore, the existing taxonomy (from host country's perspective) is not adequate to explain the attitude of host economies towards foreign investment. Hence, owing to the revered researchers, the present study encompasses all of the antecedents and develops a comprehensive Taxonomy of FDI. The Classification of FDI from the perspective of host country is duly emphasized here.

Keywords: foreign direct investment, taxonomy, investor's motives, host country's perspective, classification of FDI

Introduction

In the post-globalized period, a considerable number of studies have analyzed the impact of Inward FDI on the host economies. The research suggests that a recipient country gets multi-dimensional benefits from the inward FDI. Evidently, countries' involvements in investment promotional activities suggest their interests in getting invested. Ample number of researches have also been undertaken so far to analyze the motives of the corporate investors for making investment abroad. In course of their studies the researchers spontaneously developed taxonomy of FDI for expressing the motives of the investors. On the other side, a comprehensive taxonomy of FDI from the perspective of host country is rarely found in the literature. Consequently, the existing taxonomy of FDI fails to explain host country's attitude towards FDI.

Objective of the Study

Academicians and researchers considered FDI from different angles and categorized it accordingly. Evidently, most of the classifications of FDI are made from the investors' point of view while only a few attempts have been made to classify it from the perspective of host country. Furthermore, absence of a holistic approach to the classification of FDI from host country's perspective left it incomplete. Therefore, the study is intended to develop a comprehensive Taxonomy that classifies FDI into well-defined categories.

Rationale of the Study

Taxonomy is not a mere categorization but a scientific scheme of classification that provides a clear conception about the items of a class and their attributes. The existing classifications of FDI are the output of research undertaken by the researchers from different time periods and are found scattered in a wide range of literature. Hence, the categories and classes of FDI require to be assembled together in a comprehensive taxonomy so that the learners, researchers and educators can easily distinguish between the categories.

There are three major parties interested in direct investment -

1. The investing firm and corporate beneficiaries inside or outside the firm;
2. The invested firm or the subsidiary in which the investment is made;
3. The host economy and its people or in a broad sense, the nation as a whole.

The parties being guided by their own interests consider FDI from different perspectives. Hence, a well-defined categorization of FDI will make them understand it better and thereby help them in concentrating on a specific category of their respective requirements.

Neither all FDIs are desired to an economy nor do all the economies desire the same kind of FDI in their countries. Therefore, the host governments adopt and alter FDI related policies according to their national need. Hence, an explicit taxonomy can make the public authorities able to find the specific type(s) of FDI they actually want to focus on. Besides, the policies taken by the governments on certain types of FDI having particular appellations will provide their people with clear conceptions about governments' motives and national interests behind the decision.

The Taxonomy of FDI

Present Taxonomy, encompassing all the existing coherent classifications and considering FDI from the perspectives of all the interested parties, classifies it under the following heads:

a) Classification Based on the Directions of the Capital Flow

Two terms commonly used to define the direction of FDI flow are:

1. Inward FDI
2. Outward FDI.

This classification suggests two directions of the capital when it moves from one economy to another. The two terms are majorly used by the academicians, researchers and

economists. A particular case of FDI is 'inward' for a recipient country and at the same time, is 'outward' for the home country of the investing firm.

b) Classification Based on the Orientation of the Production

Harvard professor Richard E. Caves (1971) ^[1] classified FDI as:

1. Horizontal FDI
2. Vertical FDI
3. Conglomerate FDI

"*Horizontal FDI* is undertaken for the purpose of horizontal expansion to produce the same or similar kinds of goods abroad (in the host country) as in the home country" (Moosa, 2002) ^[6]. *Vertical FDI* has two sub-categories – i) Forward Vertical FDI and ii) Backward Vertical FDI. *Forward Vertical FDI* is made to set up distribution outlets in the host country intending to be nearer to the consumers and to supply company's finished product to the markets of host country and/ or third country. *Backward Vertical FDI* is made to process raw materials or necessary inputs in the host country for the final production in the home country of the producing firm. *Conglomerate FDI* is undertaken for both the purpose of producing goods or inputs and establishing company's distribution outlets in the host country. Thus, it is a combination of Horizontal and Vertical FDI.

c) Classification Based on the Motives of the Investors

Simply, the multi-national firms make cross-border investments for getting competitive advantages globally. A plethora of literature came to describe the motives of the investors for making direct investment outside their home countries. Perhaps, the motives of making FDI are best described by John H. Dunning and Sarianna M. Lundan (2008) ^[2] in their book *Multinational Enterprises and the Global Economy* where they explain the motives for making cross-border investment by Natural resource seekers, Market seekers, Efficiency seekers, and Strategic asset seeker investors (Dunning & Lundan, 2008, pp. 67-77) ^[2].

Earlier, Dunning (1998) ^[4] categorized FDI as:

1. Resource seeking FDI
2. Market seeking FDI
3. Efficiency seeking FDI
4. Strategic asset seeking FDI

In the cases of *Resource Seeking FDI*, the multi-national firms are motivated to acquire best quality natural, human and man-made resources at optimal cost in the host country. Dunning and Lundan (2008) ^[2] identified that the resource seekers seek three types of resource in the host country – i) physical resource; ii) 'cheap and well-motivated unskilled or semi-skilled labour', and iii) 'technological capability, management or marketing expertise and organisational skills' (Dunning & Lundan, 2008, pp. 68-69) ^[2]. According to Dunning (1998) ^[4], the objective of making *Market Seeking FDI* is not only to enter a host country's domestic and adjacent market but to find other locational facilities that make the markets more efficient (Dunning, 1998) ^[4]. The *Efficiency Seeking FDI* is made with a motive of harvesting cost benefit by establishing the production facilities in the best possible global locations where labour, material, machinery, etc. are available at an optimal cost. With the growing influence of knowledge intensive economy, multi-

national firms' motive of possessing knowledge-based assets is identified in their investment decisions. Often a multinational firm opts for making FDI to acquire 'Ownership Specific Advantage' (Dunning, 1988) ^[3] by creating assets through business operation in the host country (Dunning, 1998) ^[4]. Dunning categorized this kind of direct investment as *Strategic Asset Seeking FDI*. Dunning's taxonomy is unanimously accepted by the academicians, researchers and practitioners and further studies have been undertaken on the basis of this classifications. Franco, *et al.* (2008) ^[5] modified the classification and put forward a 'Motivation-based Classification of FDI'. They classified FDI into *Resource seeking*, *Market seeking*, and *Non-marketable asset seeking FDI* (Franco, Rentocchini, & Marzetti, 2008) ^[5].

d) Classification from the Perspective of Host Country

Moosa (2002) ^[6] classified FDI from the perspective of the host country as Import-substituting FDI, Export-increasing FDI, and Government-initiated FDI. Perhaps this was the first classification of FDI from 'the perspective of the host country' but the categories need to be well-defined and some additions are required for a better explanation of host economy's attitude towards FDI in the post-globalized period. A recipient country gets multi-dimensional benefits from inward FDI. It accelerates industrialization in developing countries. On the other hand, a recipient country may experience some disadvantages of inward FDI. The occurrence of firm's profit transfer to home country or over-dependence on the foreign capital and knowledge may taste bitter to the invested countries. Thus, all FDIs are not desired to an economy and not all the economies desire the same kind of FDI in their countries. There must be one or more motives that drive the countries attracting and encouraging foreign investments. Some common motives are - Revenue generation, Export promotion, Import-substitution industrialization, Employment generation, Human resource enhancement, Natural resource extraction, Acquisition of technology and knowledge intensive assets, Earning foreign exchange, Restricting monopoly in domestic market, Serving native consumers, and above all, the sustainable economic growth.

Thus, keeping an eye on the motives and interests of the host country FDIs can be classified into the following five categories:

- Export Oriented
- Import Substituting
- Domestic Market Caring
- Resource Exploiting
- Intangible Asset Building

If a foreign firm invests in its production facilities situated in a host country to produce the industrial inputs or the finished goods/services and export them to another country (third country), the investment may be called an *Export Oriented FDI*. Generally firms prefer those global locations for production where they can get cost advantage by exploiting resources and other locational advantages. Here the investors' prime intention is to export the products and services to the third countries from the host country and in such cases the investment made by the firm is 'Efficiency Seeking' if considered from the investors' perspective. On the other hand, this is the most welcomed FDI for the recipient country which is blessed with revenues (taxes both on production and

export), foreign exchange reserves and new employments. This kind of investment is commonly found occurring in the global value chain production.

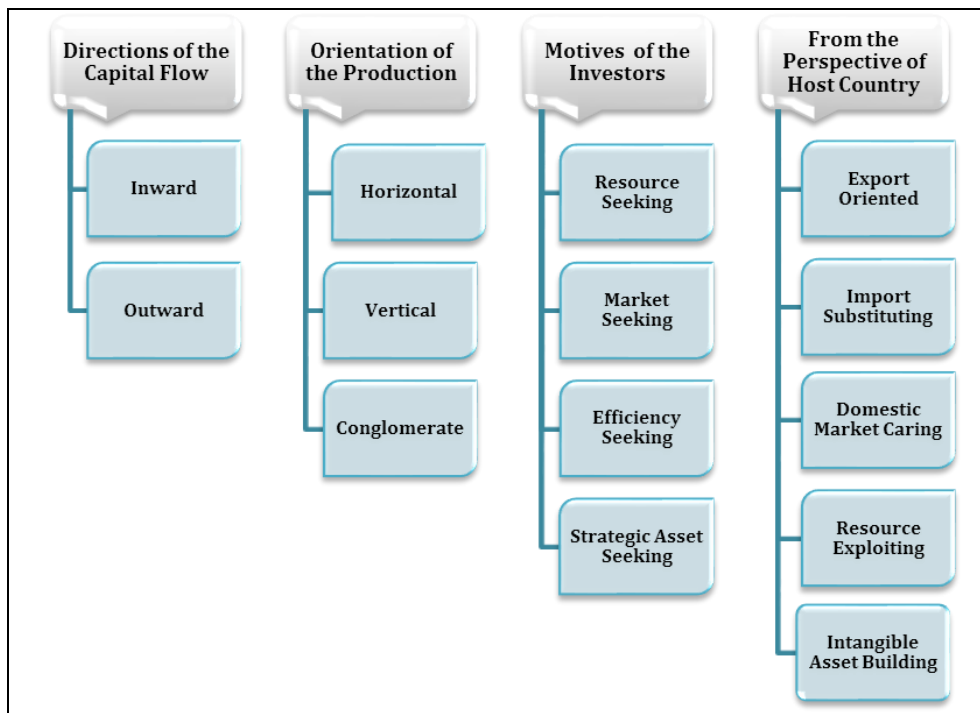
When a foreign firm invests in its production facilities situated in a host country to produce goods having high demand in the domestic market and thereby substitutes the imports of such goods, it may be called an *Import Substituting FDI*. Less industrialized countries regularly require importing some particular goods for the domestic consumers; this drains their money and increases trade deficits. In such cases, FDI in domestic manufacturing is really a boon to the host countries and they offer different incentives to the foreign investors for propelling import-substitution industrialization.

Domestic Market Caring FDI literally serves the host market by producing goods or services which are not produced in host land in proportion to the domestic demand and the imports of which are not economically viable. Countries motivate foreign firms for producing certain necessary goods and services for the native consumers in the cases where either the domestic producers are not capable of producing those goods or a few producers are enjoying monopoly there. The FDI is ‘Market Caring’ in the sense that it cares for the domestic consumers and, at the same time, leads the market to a perfect competition.

When FDI is undertaken with an intention of exploiting natural and some specialized human resources, it may be

categorized as *Resource Exploiting FDI*. Countries with abundance of natural resources but not having required infrastructure and capital for extraction of the same, attract FDI for making the resources marketable. In some cases foreign investors establish their production facilities in a particular region of the host country for exploiting specific skill or specialized knowledge of the local workforce that is required for a particular industry agglomerated at that region. FDI, when develops and enhances knowledge and skills of the host workforce or help in building a place brand through the process of production or any other kinds of business operation, may be considered as *Intangible Asset Building FDI*. Technology-FDI is a common example of this kind of FDI. Knowledge assets are created from the foreign investment made in the knowledge intensive industries. FDI in Research & Development or in Education sector may also be considered as *Intangible Asset Building FDI*. Again, host country’s intangible asset is created in the cases where the investors (especially the resource seekers) produce goods of global fame in the host land and thereby contribute to its country brand.

In addition to that, often FDI is categorized as Greenfield Investment, Merger & Acquisition, Joint Venture, Licensing and the like. All these terms suggest means of corporate investments and the study does not consider them as categories of FDI.



Source: Caves (1971) [1]; Dunning (1998) [4]; Moosa (2002) [6]; & the Author

Fig 1: Taxonomy of Foreign Direct Investment

Conclusion

It is true that the corporate decision of making FDI is merely guided by investors’ interests but there are other interested parties among which the recipient economy holds the prime position. Hence, in a great number of empirical studies, FDI is found to be analyzed from the host country’s point of view but a comprehensive taxonomy of FDI from the perspective of the host country is scarcely found in the literature. The

present study, having a holistic approach, encompasses the existing classifications to develop a Taxonomy of FDI. Emphasis is made on the ‘perspective of host country’ and special care has been taken in the appellation of the categories keeping an eye on the changed attitude of developing economies towards foreign investment. Hope the taxonomy will be helpful for public policy makers to tell about their FDI-policy.

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