Location Decisions of Multinational Enterprises

Ahmet Yağmur ERSOY\textsuperscript{1}, Mustafa İlteriş YILMAZ\textsuperscript{2}

Abstract
One of the basic areas of international trade theory is production decisions of Multinational Enterprises (MNEs). MNEs stay on the focus of current international politics and international economic relations. MNEs, as one of the building blocks of economic integration, constitute both push and pull strategies of integration. The world is evolving towards a more conservative structure day by day in the aspect of economic. Neo-liberal policies leave place to to protectionism increasingly. Under these circumstances, location decisions made by MNEs which are determinants of global production and investment, and the policies of host countries give direction to economic gains. The study is based on systematization of location decisions that MNEs will take in both production and investment points by using literature review technique. To this end, the causes and effects of firm, industry and country specific location decisions of MNEs are discussed and the results are categorized on the basis of cause-effect relationships. The theoretical substructure which is obtained with this study will be input for future empirical studies.

Keywords: Multinational Enterprises, Location Decisions, International Trade

\textsuperscript{1} Yrd. Doç. Dr., Sakarya Üniversitesi, ayersoy@sakarya.edu.tr
\textsuperscript{2} Doktora Öğrencisi, Sakarya Üniversitesi, mustafailterisyilmaz@gmail.com
INTRODUCTION

The basic problematic of the paper is “What FDI theories state about choice of location, which is one of the most important decisions in international trade activities?”

In this study it is aimed to establish a framework that will provide input to future studies that are planned by considering the numerous theories about investment decisions of multinational companies with country specific, industry specific and firm specific dimensions.

Selection of the location will be made by literature review by compiling the key studies in the literature and by making a categorization with country specific, industry specific and firm specific dimensions, and contributing to the related field by developing the study with eclectic researches.

Qualitative research method has been adopted in the study and literature review technique has been applied with content analysis.

The generally accepted Foreign Direct Investment theories that have lead the literature on international trade and location selection have been evaluated.

The focus of the study is multinational companies.

1. Multinational Enterprises (MNEs)

MNE, as one of the building blocks of economic integration, is one of the forces that creates both the push and pull dynamics.

There are various definitions in the literature related to multinational companies. However, the following definition can be considered as one of the most correct definitions:

Multinational enterprise is an enterprise that engages in FDI and owns or, in some way, controls value-added activities in more than one country. This definition is which one is widely accepted by many areas like OECD, UNCTAD or most national governments with so many scholars and practitioners (Dunning and Lundan, 1992: 3).

It should be noted that although some definitions refer to the ownership concept (foreign partnership), most of the definitions indicate to do the activities in different countries. Among these definitions there are also some others which stipulate some quantitative requirements like minimum 20% of total material resources should be at a foreign country or minimum 35% of total profit must be made by international activities. It can be said that multinational companies are companies that operate in more than one country, earn profits, or provide services or produce in more than one country to carry out activities that support their main activity.
2. FDI Theories

As noted before, the main feature that makes a company "multinational" is that it operates in a foreign country. The main tool used at this point is FDI. The generally accepted theories and approaches in FDI literature are mainly and chronologically;

- Vernon’s Product Life Cycle Theory (1966)
- Hymer and Kindleberger’s Industrial Organization Theory (1969)
- Caves’s Caves Theory (1971)
- Buckley and Casson’s Internalization Theory (1976)
- Krugman’s New Trade Theory (1979)
- Porter’s Cluster Theory (1998)
- Dunning’s Eclectic Paradigm (2001)

2.1. Product Life Cycle Theory

Product Life Cycle Theory was firstly developed by Raymond Vernon in 1966. The theory began to be important for international trade literature with the article; International Investment and International Trade in the Product Cycle. The theory emphasizes the importance of uncertainty and the effects of scale economies and the timing of innovations. According to this theory, production of new technology goods will first be realized in developed countries with high income, technologically advanced level, which can make high R&D spending. In addition, the firm can make closer contact with suppliers and consumers in the local area. In this way, uncertainties about consumption and production for the firm are eliminated. On the other hand, the communication between producers and consumers has also developed in these countries and the feedbacks which are important in the process of product standardization are easy. After the product is born in this way, demand is increasing over time and standardization in production and production begins. The standard eliminates the need for flexibility in production, and reducing the costs is only thing left behind. When the domestic market is full, export starts. After a while, the monopoly situation is now completely destroyed and the way to reduce costs is sought. At this time, competition is strict. Technology and production methods are imitated by competitors. In order to reduce the cost of production and to protect the cost advantage against other countries, investments are shifted to developing countries where labor costs are cheap (Vernon, 1966: 193).

In this theory, it is emphasized that comparative advantage can be passed from the country which carries the product to the market to another one.
2.2. Industrial Organization Theory

This theory is also called as oligopolistic power, structural market disruption, market power, or Hymer - Kindleberger theory.

The theory developed by Hymer and Kindleberger, states that the main reason for the FDI is the oligopolistic industrial structure on the markets. Perfect competition conditions will lead to be decreased the profit will be made, not to be absorbed the costs and not to be amortized the barriers. Therefore, it is based on the assumption that the international and investor enterprises are faced with uncertainty and risk, and that the invested countries are more advantageous. Due to these reasons, companies that are going to invest must have certain advantages over the companies of the host country in order to be successful in the target market. These advantages should enable foreign firms to earn more than they can earn in their own country as well as more than domestic firms can in the host countries.

The advantages mentioned above should create a monopoly advantage for the investor firm. These advantages are unique to foreign companies and other firms in the market can not benefit from them. Hence, the Industrial Organization Theory explains foreign investment with the absence of competitive conditions in the foreign markets in which these firms operate.

Companies will need to protect their superiority, especially new "technical secrets", such as distribution networks, scale economies, product and price differentiation, proprietary marketing and advertising methods, technology they own, managers' knowledge and skills. Therefore, instead of selling or renting technological superiorities, the company may prefer to keep this superiority as a "technical secret" and take advantage of it. For this reason, instead of licensing the risk of not being able to protect technical secrets, company technical secrets may have to be put into production outside of the country itself, or to invest in other words(Hymer, 1979).

The theory fails to explain why companies with advantages have invested in their own country instead of producing and exporting, and why they prefer one to another from two countries with the same characteristics.

2.3. Caves Theory

The Caves Theory was first set up by R. E. Caves in the 1971 study "International Corporations: The Industrial Economics of Foreign Investment". The strategies about investments of multinational enterprises were discussed.

According to Caves; The oligopolistic superiority of multinational firms growing through horizontal integration is the product differentiation ability (Caves, 1996).
In this case, due to the structure of the target market, the same product is differentiated and sold in new markets. These investments will lead to cluster economies.

Multinational companies that want to protect their differentiated products from imitation risks internalize the sub-processes of a commodity by establishing their own production facilities in these markets, which on the other hand is considered vertical integration. In this case, scale economies will occur.

There are two types of FDI:

- The same product is sold in different markets = Horizontal integration -> Mass economy.
- The sub-processes of a commodity are internalized = Vertical integration -> Scale economy.

Although the theory is not as effective as the mainstream theories, it has made important contributions to the development of mainstream theories.

It has been criticized because of it suggests multinational enterprises have only one oligopolistic advantage.

2.4. Internalization Theory

The Internalization Theory is a theory which was first discussed by P.J. Buckley and M. Cason and which is developed by J.H. Dunning and A.M. Rugman. It is questioning; why a firm chooses FDI rather than a lease or licensing agreement?

According to Buckley (1988), firms either do FDI where where they can do all their business at the least cost or the advantage of internalization is above the advantage of it grows by internalizing as long as the benefit of internalization is higher than the cost. Multinational companies enhance their competitiveness with technical skills such as production technology, marketing and management that they have gained from past production experiences. For this reason, instead of licensing agreements, they make FDI in different countries in order to maximize profits (or cost minimization) because of the difficulty of maintaining their superiority. In other words, by horizontal and vertical integration method they will integrate to the other firms from foreign countries.

Among the advantages of internalization; advantages such as avoidance of bargaining and customer uncertainties, avoidance of trade barriers, avoidance of delay, differences in tax rates between countries and the effect of regulation by governments, transfer pricing to the greatest possible reductions and price discrimination among market are may be stated (Buckley and Casson, 1976).
According to theory, the internalizations made by international companies can be divided into three types:

1. Investments made by many fabricated firms that are horizontally integrated to protect their company-specific advantages like patents.

2. The investments that many vertically integrated factories make to contain all the production stages of a good (e.g. oil).

3. Investments based on distribution of risk to the international arena

In the production of a commodity, the gathering of the works of different stages in the management of a single organization is expressed as vertical integration.

Vertical integration occurs, forward, towards consumer; backward, towards raw material production.

2.5. New Trade Theory

The basic hypothesis of the model, which Krugman developed in 1979 and advanced in 1980, is as follows: Countries, despite having similar technology, factor endowment, cost structures and preferences, benefit from free foreign trade thanks to the benefit increase created by product diversification under monopolistic competitive conditions and the cost advantages created by intrinsic economies.

The New Trade Theory has been developed for the purpose of explaining intra-industry trade.

Inter-industry trade refers to the trade of completely different products produced by different industries, whereas intra-industry trade refers to the trade of different products of the same industry or the broad product group. Krugman shows that intra-industry trade does not have serious income distribution problems. It is possible that intra-industry trade has fewer adjustment problems than intra-industry trade.

The New Trade Theory explains the industrial goods trade with intra-industry trade differentiation and scale economies.

Production factors are assumed to be mobile between countries and transport costs are included in the analysis. International price determinants are firms operating in monopolistic competition markets. Countries are not able to specialize according to comparative advantages because they are exporters and importers of a commodity due to intra-industry trade conditions.
The New Trade Theory is a model of an under-competing industry in which the following assumptions apply:

1. Each company can differentiate its product
2. Each firm accepts the price applied by its competitors as data

The purpose of product differentiation is to create the impression that the goods are different from other goods in the consumer’s eyes. In the end of the process if the goods can be substituted from nearby places it will leads to not differentiation the product.

Another factor explaining New Trade Theory is “scale economies”.

By specializing on a narrower product range, firms that benefit from internal scale economies achieve lower average production costs and produce differentiated goods with close substitutes, while importing goods they do not produce.

Krugman expanded his international trade model, which he developed in 1979, by adding transportation costs in 1980, and by explaining the formation of geographical economy in 1991.

2.6. Cluster Theory

The clusters are natural occurrences of the sectors occurring in specific regions, due to their self-condensation depending on various factors.

According to M. E. Porter, clustering is the geographical concentration of companies that are both competitive and cooperating in the same field of activity, particular local specialist suppliers, service providers, companies in related sectors and related institutions. M. E. Porter has also mentioned that “Geographic, cultural, and institutional proximity leads to special access, closer relationships, better information, powerful incentives, and other advantages in productivity and innovation that are difficult to tap from a distance. The more the world economy becomes complex, knowledge based, and dynamic, the more this is true.” (Porter, 1998: 90).

Clustering is one of the most common forms of regional development projects. Focusing on the high competitive power of international competitiveness is a major success factor for clustering.

Porter has stated that a coop generally consists of these items; Suppliers of special inputs, industry-specific infrastructure providers, customers and businesses related to technology-related talents, technology-related or joint-ventures are in the cluster. In addition, many clusters consist of public and other organizations (universities, standard institutes, brain teams, vocational
training providers and trade associations) that provide industry-specific education and information, research and technical support.

Multinational enterprises will be clustered in certain regions by making FDI to have industry-specific advantages.

2.7. Eclectic Paradigm

Dunning has developed an eclectic theory by synthesizing theories of industrial organization, internalization and geographic economy. According to Dunning, the following three conditions are related to a company’s production abroad, called OLI in short (Dunning, 2001):

1. Ownership advantages: The firm must possess material or non-material goods and skills so that it can compete with the local companies which have the knowledge and experience there in production.

2. Location advantages: An advantage to be obtained in the destination country should make it more profitable to produce in the host country than to produce and export it in the source country.

3. Internalization advantages: FDI by the firm should be more profitable than selling, renting, or licensing these skills.

Ownership advantages (O): These advantages are the advantages that a firm has superior to other firms operating in the same place. These company-specific superiorities are divided into two groups as superiority based on existence and operational superiority. Advantages that express the superiority, talent and rights obtained from the market conditions in which the business operates are called superiority based on existence. Operational advantages of the firm due to its production capacity and wide range of fields of activity are called operational advantages.

Location advantages (L): Geographical location advantages are only available to companies in a particular region; non-transferable, non-exchangeable costs may be sorted as below:

- Economic factors such as the quantity and quality of the production factors in the invested country, the size and structure of the market, production and telecommunication costs,
- The proximity of relations between the investing country and the investor country, the similar language or culture between these countries and the cultural advantages such as the general attitude towards the investor or the free market of the invested country,
- Political advantages as all policies related to the investor’s future investment in the target market.
Internalization advantages (I): As mentioned earlier in the internalization theory, firms internalize positive externalities through vertical or horizontal integration if they see risks in relation to them, such as licensing agreements, and if they provide cost advantages.

According to this paradigm, the form and breadth of the FDI to be made is determined by determining these three advantages perceived by the enterprise.

Dunning (2000: 164-165) has also described four types of FDI, categorizing the reasons why a firm wants to invest in other countries as follows:

- **Market Seeking FDI**: FDIIs made by the firm to meet the demands of a particular market or various markets
- **Natural Resource Seeking FDI**: FDIIs made by companies that want to reach natural resources and unqualified workforce
- **Efficiency Seeking FDI**: FDIIs that aim to make the business division more effective or aim to specialize
- **Strategic Asset Seeking FDI**: FDIIs made by companies that want to protect and duplicate their ownership advantage and/or want to reduce the ownership advantage of their competitors

CONCLUSION

It is addressed at this study that Multinational Enterprises are the one of main variables of world economic integration and relations. The aim of this study is to categorize the theoretical background which explains the locational behavior of MNEs. The models argued above are generally empirically tested and findings generalized as theories. In this study it is not claimed to test any empirical models. The claim is to categorize recent studies via literature research methodologically. The output of the study is at the schema 1. The theories are categorized in three types;

- **Country-Specific Theories**:
  - Product Life-Cycle Theory
  - Eclectic Paradigm
  - Internalization Theory
- **Industry-Specific Theories**
  - Cluster Theory
  - Caves Theory
  - New Trade Theory
  - Internalization Theory
- **Firm-Specific Theories**
• Industrial Organisation Theory
• Eclectic Paradigm
• Internalization Theory

As it is seen Eclectic Paradigm is both country-specific and firm-specific theory. Also it is clear that, Internalization Theory has country-specific, industry-specific and firm-specific aspects.

**Schema 1: Categorisation of FDI Theories**

In the future research we will examine the locational decisions of MNEs which prefers Turkey as a host country. And the locational effects of MNEs will be categorize as the form of home countries. This study will have an input role for these future studies.
REFERENCES


