Determinants of Foreign Direct Investment and the Advantages Theory:
A Literature Review and Future Research Agenda

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ABSTRACT

This study reviews three classic international business theories and some related empirical studies to identify the gaps in the literature and suggest future research directions. In international business studies, most analyses on the determinants of FDI are centered on three concepts of firm-specific, internalization, and location advantages according to the monopolistic advantage theory, internalization theory, and OLI paradigm. These three advantages determine whether a firm will internationalize, how it will enter foreign markets, where it will locate in the host country, and how it will perform in a foreign market. However, These theories are set up with the premise of firm-specific advantages and cannot be used to explain the phenomenon of emerging market multinational enterprises, which have emerged in large numbers in recent years. Simultaneously, these theories, which focus on manufacturing, need to be used to explain the internationalization of the service industry in-depth and with greater relevance.

KEYWORDS

Firm-Specific Advantage, Foreign Direct Investment, Internalization Theory, Multinational Corporation, OLI Paradigm

INTRODUCTION

After World War II, due to the rapid growth of multinational corporations (MNCs), the international business (IB) theory related to MNCs began to develop gradually. Core theories in the field of IB analyze the overseas activities of enterprises. The development of related theories can be traced back to Hymer's doctoral dissertation titled, "*The International Operations of National Firms: A Study of Direct Foreign Investment*" in 1960, when he was at the Massachusetts Institute of Technology in the United States (US). He proposed the monopolistic advantage theory (MAT) in a dissertation published in 1976. Before the MAT, the international trade theory (ITT)—with the factor endowment theory as its core—was primarily employed to explain the behaviors of enterprises concerning foreign direct investments (FDIs). According to ITT, factor endowments determine the FDI behaviors of enterprises. Therefore, countries with capital shortages exhibit high-interest rates and vice versa, resulting in capital flows from countries with sufficient capital to those that lack it (MacDougall, 1960).

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From 1914 to 1956, Hymer (1960) confirmed that US MNCs were generally concentrated in several industries that were insensitive to fluctuations in interest rates. Furthermore, most MNCs raised funds in the capital market of the host countries. This result revealed severe flaws in the perspective of capital arbitrage for explaining the FDI behaviors of MNCs and the need to establish new theories to better explain FDIs by burgeoning MNCs. As espoused in his doctoral dissertation, Hymer conducted an in-depth analysis of the factors behind the formation of MNCs based on his question "why do FDIs occur?"

Following Hymer (1960), Buckley & Casson (1976), Dunning (1977), and other scholars have also explained the internationalization behaviors of firms. Due to the background at the time, most theoretical studies and theories in the analytical framework were based on firms in developed countries, especially manufacturing firms, explaining their internationalization behavior in detail. However, since the 21st century, with the deepening of economic globalization, internationalization behaviors are no longer limited to firms in developed regions, as many firms in emerging markets have also started their internationalization. In addition, the booming internationalization of the service industry has become a hot topic in recent years. It seems that part of these changes cannot be explained by the existing IB theory.

This study thus used the pioneering results of Hymer (1960) as the starting point to review and clarify the MAT, internalization theory, and OLI paradigm by reviewing the literature on the relationships between the motivation of firm internationalization and three types of advantages: firm-specific advantages, internalization-incentive advantages, and location-specific advantages. This study also reviews the empirical literature and related studies in seven major IB journals from 1972 to 2022 and identifies new themes from the latest studies that can provide scope for future research (*Journal of International Business Studies*, *International Business Review*, *Journal of World Business*, *Review of World Economics*, *International Marketing Review*, *Journal of International Management, and Management International Review)*. In addition, several other representative studies are cited in this paper. This study thus provides a comprehensive understanding of IB research to date and, to some extent, predicts the direction of future research. Furthermore, it provides practical insights on the internationalization of enterprises.

LITERATURE REVIEW

Monopolistic Advantage Theory by Hymer (1960)

Hymer has proposed that the formation of MNCs—the primary motivation for conducting FDIs—is to "control" local business activities for two reasons. The first is the removal of conflict. When enterprises from various countries compete in an imperfect market, foreign ownership of and control over local business activities eliminates cross-border competition and forms an international oligopoly, monopolizing the profits generated by foreign businesses. The second relates to comparative advantages. Enterprises generally encounter three disadvantageous situations during their overseas development: (i) MNCs face additional costs to obtain information that they are unfamiliar with, for instance, regarding the local economy, legislations, and business practices; (ii) they are accorded differential treatment; and (iii) exchange rate risks. Hence, MNCs must benefit from specific advantages to overcome these unfavorable conditions when competing with local enterprises.

Hymer proposes four advantages based on the findings of Bain (1956): (i) the ability to obtain factors of production at low costs, (ii) knowledge of achieving efficient production, (iii) excellent distribution capabilities, and (iv) the ability to differentiate themselves from competitors. Enterprises with these advantages may enjoy the exclusive benefits of launching overseas business activities. Numerous scholars have adopted Hymer's proposed advantages, proposing theories on MNCs. These were termed monopolistic advantages by Hymer's tutor, Kindleberger (1969), firm-specific advantages

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