Chapter 1
Sourcing Strategies of Firms:
Recent Theoretical Developments

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ABSTRACT

The purpose of the chapter is to present recent theoretical developments in FDI theories with an emphasis on sourcing strategies of firms. It is stated that economic theory explains the existence of the so called vertical FDI as the result of market failures or transaction costs and incomplete contracts. Firms engage in foreign sourcing due to lower costs or an access to unique resources but that sourcing takes place within firms' boundaries in order to benefit from internalization advantages. Although recent theories have been developed in the context of FDI from developed countries, those new insights can be easily applied to the case of outward FDI from emerging economies as well.

INTRODUCTION

Foreign Direct Investment (FDI) has become one of the most popular forms of the internationalization of firms and an integral part of the global economy. In 2010 about a quarter of the world output was generated by transnational corporations and 10% of that output was produced by FDI entities in host countries (UNCTAD, 2011, p. 25). It is also estimated that one third of the world trade is intrafirm and in 1994 more than 40% (36%) of the US imports (exports) was made within the same organization (Antras, 2003, p.1375). Regarding emerging markets, in 2003 more than 55% of Chinese exports was shipped by FDI entities (Goldstein, Lardy, 2005, p. 11-12). Cravino and Levchenko (in press, appendix: Table A1), using ORBIS database for 2004-2012 period, document that, for example, the ratio of foreign multinationals' revenue to total sales was between 20% and 30% in countries like Mexico, Ukraine or Serbia. Those figures suggest that the impact of FDI on economic activity around the world has become profound.

It is worth stressing that FDI as a mode of internationalization may both decrease or increase the volume of international trade. In case of the so called horizontal FDI that type of investment is a substitute for exports. The motive behind such an investment is market seeking and that goal may be achieved by exporting or presence on the foreign market (FDI). If that kind of FDI was prevalent, then we would

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observe FDI and trade flows going in the opposite directions. However, the world economy has been characterized by increasing both FDI activities and international trade. It means that the other (vertical) type of FDI must be dominant in the global economy. Vertical FDI can be seen as fragmentation of the production process and locating some stages abroad. It is connected with the movements of inputs and intermediate goods across borders, hence that type of FDI leads to an increase in the volume of international trade.

The main aim of the article is to present the reasons why firms engage in vertical FDI (and it is equivalent to the reasons why firms source inputs using their own organizations). The first section overviews the abilities of neoclassical theory to explain such a phenomenon. The second part focuses on market failures which enable economists to justify vertical FDI within neoclassical theory framework. The third section presents the most popular alternative theories of FDI. The fourth part includes the authors commentary on the development of FDI theory.

BACKGROUND

The dynamic growth of FDI activities has been observed especially since mid-1980's with the noticeable acceleration since mid-1990's. It seems that the empirics goes in tandem with the theory. The first models of vertical FDI were formalized in the mid-1980's (Helpman 1984 and 1985, Ethier 1986). Additionally, the so called eclectic theory of international production (OLI paradigm) was introduced. That theory suggests that a firm investing abroad must exploit three kinds of advantages:

- **Ownership Advantages:** Associated with the competitive edge of a company (due to, for example, market power or size),
- **Location Advantages:** Related to beneficial characteristics of the host country/region (like a significant pool of cheap labor or an easy access to natural resources, technology etc.),
- **Internalization Advantages:** Stemming from keeping certain operations within firm's organization.

According to Gattai (2006, p. 227), the literature from the 1980's and 1990's was mainly focused on the first two types of advantages and the issue of internalization was underestimated, although Rugman (1980, s. 370) stated then that *existing FDI theories are really subcases of the theory of internalization*. However, since then that aspect of FDI has become an important research topic. One of the reasons has been the availability of huge firm-level datasets. It became clear that firms are heavily engaged in outward FDI. For example, Antras (2014, p. 32) presented the share of intrafirm imports in total imports for various industries in the United States (see Figure 1). In many of them that share was higher than 80% (in vehicle-related industries). Even in the so called light industries intrafirm imports was observed. It seems that many firm are willing to organize sourcing from abroad, but within their own organization. That observation makes internalization as one of the most vital aspects of FDI researchers should investigate.

It seems that economists have tried to enrich the FDI theory by modelling the decisions of firms to engage in international investment. Firms sourcing inputs in other countries may do so by contracting independent suppliers (international outsourcing) or by vertical FDI (offshoring). When such a decision is not trivial (FDI or not) but it is possible to organize sourcing in different ways, it is especially important to specify why some companies try to keep supplies within their own boundaries. Having