

CHAPTER TWO

LITERATURE REVIEW

2.1 Internalization theory

Compared with the monopoly superiority theory, the internalization theory differs in that its basic assumption is that the intermediate product market (especially the technology market) has incomplete competition (Casson, 2016). Internalization theory provides different research ideas from monopoly superiority theory. The major change is that it brings the theory of outward foreign direct investment (Meyer, 2016). The salient feature of the internalization theory is that it first introduces market transaction internalization principles into international direct investment research, and that the analysis of the fundamental causes of international direct investment from the perspective of the company's own development (Forsgren, 2017).

The internalization theory puts more emphasis on the important role of intellectual property protection, which also makes the dimension of theoretical research closer to the practical foundation of multinational corporations to carry out international direct investment.

In addition, the internalization theory explains direct investment, export trade, and licensing arrangements. Export trade is vulnerable to trade protection restrictions, while foreign direct investment avoids host country discrimination policies and bypasses trade barriers (Farrell, 2015). The licensing arrangement is likely to cause technological leakage and impede its monopoly status for knowledge products. Besides, the success of the internalization theory over the monopoly superiority theory lies in its rational interpretation of why developing countries will also experience direct foreign investment, as well as the huge amount of investment in R&D funds of multinational corporations after World War II. If the theory of monopolistic superiority is based more on the analysis of the external development environment of the enterprise, then the theory of internalization is turning to the internal reasons of the multinational corporations' subjectivity and internal research to conduct international direct investment. However, this also determines that only considering the internal factors and ignoring the analysis of changes in the market environment will cause the theory to lose its objective perspective and create one-sided and limited problems. In fact, the internalization of the enterprise has become an objective reality since the emergence of the commodity economy, and the international direct investment is a product of the market development to a certain extent. Therefore, the internalization advantage is not the fundamental cause of

international direct investment. But, this theory does not illustrate well the location choice of international direct investment (Buckley, 2009).

2.2 Theories of technology upgrading and innovation

The researchers co-founded the theory of technological innovation industry upgrading in the early 90s of the last century (Cantwell et al, 1990). This theory carried out the trend of the growth of foreign direct investment in developing economies analysis. In the study, Canterwell and Tolentino raised two basic issues: First, the upgrading of the industrial structure of developing economies is the result of the improvement of the technological R&D capabilities of local companies. This ability is not improved overnight. But there is a process of gradual development and accumulation. Secondly, there is a positive correlation between the development of active technological level and the extent of development of foreign direct investment of local enterprises. The theory proposes that foreign direct investment in developing economies, regardless of their industrial structure or geographical distribution, is constantly changing. Moreover, this process is predictable. In addition, the theory also focuses on the analysis of the industrial characteristics and geographical characteristics of foreign direct investment by enterprises in developing economies.

From the perspective of regional characteristics, developing countries follow the rules that of investing directly in neighboring countries, then expanding direct investment in other developing countries, and gradually developing direct investment into developed countries (Luo, 2007). The theory of upgrading the technological innovation industry believes that the development process of Chinese companies in Taiwan, Singapore, and South Korea is a good demonstration of this theory: these areas have unique advantages in areas such as corporate chemistry, computer science, biotechnology, genetic engineering, semiconductors, and software development. Similarly, foreign direct investment in these regions is also relatively competitive.

The theory of upgrading the technological innovation industry puts forward a dynamic process in which developing country companies improve their technology based on technological innovation and accumulation, and in the mutual promotion of industrial structure and foreign investment (Porter, 2000). However, this theory ignores the fact that foreign investment by transnational corporates in developing countries is both a result of domestic technological advancement and industrial upgrading, and also an economic reality that shows domestic technological progress and industrial upgrading.

2.3 Integrated international investment development theory

The theory of integrated international investment development was proposed by Japanese scholar (Ozawa, 1992). The theory holds that from the national perspective, foreign direct investment in developing economies will go through four phases: first, attract foreign investment; second, transition from imported foreign investment to direct foreign investment; and the third phase Foreign direct investment based on low-cost labor forces is developing toward technology-oriented and trade-supported foreign direct investment; the latter stage is the symbiotic phase of the input of capital-intensive and capital-output-type inputs and foreign investment. The theory emphasizes that the upgrading of foreign direct investment in developing countries should be based on the enhancement of comparative advantages and on the basis of export-oriented strategies, combining the optimization and upgrading of the country's industrial structure with the advantages of developing foreign direct investment, and jointly implementing outward investment. In the study, we can comprehensively analyze the dynamics of the economic development process, the changes in comparative advantage, and the dynamics of foreign direct investment. The theory is that economic development will change factor endowments and comparative advantages, promote the transnational growth of enterprises, and overseas operations will in turn enhance industrial competitiveness and allow companies to grow into leading international companies. The theory is mainly analyzed from the macro perspective and fully complies with the dynamic comparative advantage.

2.4 Savings gap theory

The savings gap theory was proposed by Rosenstein (Rosenstein, 1994). His theory is that when a country's internal savings capacity is insufficient, the method of introducing funds from abroad can maintain the country's economic growth rate to its natural level. The savings gap theory points out that foreign investment can effectively supplement the savings capacity of developing countries, and the use of foreign capital can effectively bridge the gap between domestic savings and the investment needed for the plan, thus realizing the goal of national economic growth. Foreign investment is an important part of the economic development strategy of developing countries. Again, the savings gap theory believes that the external imbalances in developing countries are due to the imbalance in their internal economic development. However, the use of foreign capital can change the imbalance of this internal savings and investment gap. The savings gap theory stands at the perspective of developing countries and proposes policy proposals at the national level. The theory holds that if developing countries want to fundamentally change the

weak state of domestic economic development, they must increase domestic labor productivity. The introduction of foreign capital can to make up for the gap in savings, it should be used in technological innovation and technological reforms to fundamentally improve labor productivity and capital utilization efficiency. This is an important measure to transform the poverty and backwardness of developing countries (Dollar, 1992).

2.5 Classical economic growth theory and its development

2.5.1 Adam Smith's theory

Adam Smith is the founder of the theory of economic development. In the mid-century book "The Wealth of Nations", he described how to increase the wealth of the people. That is, he systematically elaborated the theory of economic development. Adam Smith's research shows that the two ways the country promotes economic growth can be obtained first by increasing labor efficiency, and by increasing the amount of productive labor (Smith, 2005). He believes that increasing labor efficiency is more effective in promoting economic growth in these two ways. Adam Smith divides labor into productive labor that can create value and unproductive labor that cannot create value. Productive labor creates wealth, but unproductive labor consumes wealth. Therefore, the mass input of productive labor in labor can be effective Smith's research shows that the improvement of labor efficiency mainly depends on the amount of capital accumulation and the degree of division of labor. Division of labor can improve the proficiency of laborers and reduce the losses caused by the conversion of secondary operations. The accumulation of capital can increase the stock of capital and increase the number of labor, which directly promotes economic growth. David Ricardo further improved economic development theory on the basis of Adam Smith's theory of economic development. His viewpoint became an important theoretical source and pillar of modern economic development. Ricardo proposed that the long-term development of a country's economy must be kept open to the outside world and the country's The continuous integration of the economies of the world can bring about the sustainable development of the national economy; social wealth is the source of economic accumulation; conversely, economic development leads to the growth of social wealth; economic growth is the process of interest transfer, and economic growth and interest distribution are interrelated. Ricardo's theory of economic development has become an important source of research on economic development in the later period (Eltis, 2000).

2.5.2 Harold-Dorma economic growth theory

Harold (1939), a British economist, and Domar (1945), an American economist, proposed two very similar economic growth models. These two models were proposed during the dynamic study of Keynes's economic theory. The theory is known as the Harrod-Dorma economic growth model. Harold divided the economic growth rate into three types: real growth rate, balanced growth rate, and natural growth rate. The actual growth rate is the actual economic growth rate achieved by the society. It is noteworthy that, under normal circumstances, the actual growth rate cannot be calculated using the basic formula of the Harrod model. This is because the actual economic situation does not satisfy Harold's Assumptions. Harold believes that when the actual growth rate deviates from the equilibrium growth rate, it will cause short-term economic fluctuations. When the equilibrium growth rate deviates from the natural growth rate, it will lead to long-term economic fluctuations, and if there is a deviation, there will be self-enhancement. Therefore, it is almost impossible to achieve long-term equilibrium growth with an actual growth rate equal to the equilibrium growth rate and equal to the natural growth rate, and it is often vividly called the "blade-style" economic growth.

2.5.3 Solow- Swann economic growth theory

The general equilibrium economic growth model established by Solow and Swan laid the foundation for neoclassical economic growth theory (Aghion, 1998). The general equilibrium economic growth model is mainly studied from the perspective of the variability of capital coefficients, and seeks to ensure the main conditions for balanced economic growth between the constant saving rate and the economic growth rate. This model divides economic growth into two sources. This is the economic growth brought about by the increase in the number of factors, and the economic growth brought about by the increase in the factor technology level. The theory holds that without increasing the input of factors, technological progress can shift the production function upwards by changing the production function, thus achieving the purpose of economic growth, and emphasizing the role of technological progress in promoting economic growth. Solow and Swan think that by adjusting the combined ratio of capital and labor in production through the role of capitalist market mechanisms, economic activity can achieve a balanced growth of full employment as Harold said. This model of economic growth has improved the interpretation of the effects of technological progress on capital accumulation in the course of economic growth, reversed the pessimism in the economic theory circle, and was used by most governments as the theoretical basis for formulating economic growth policies

(Knight, 1993).

The favorable factors of FDI to the host country are mainly reflected in the following four aspects:

(1) Resource transfer effect. International direct investment has a positive contribution to the economy of the host country and can provide resources that the host country lacks, such as capital, technology and management skills, thereby increasing the country's economic growth rate.

Capital: Many multinational companies have huge scale and financial strength, and thus have financing channels that host country companies cannot obtain. These sources of funds may be their domestic companies, or they may be multinational companies that, with their good reputation, are more likely to raise capital from the capital market than host-country companies. Therefore, international direct investment is an important way to use foreign capital.

Technology: The key role played by technological progress in economic growth has been widely accepted. However, many countries, especially developing countries, lack the resources and skills necessary for research and development necessary to develop their own products and develop production technologies. Through international direct investment, necessary technologies can be introduced for these countries.

Management skills: Obtaining foreign management skills through international direct investment can also bring benefits to the host country. A local company that once trained in a foreign multinational company's subsidiary and has held a management, finance, or technical position would leave the company and help establish a local company, which would have a beneficial spin-off effect. Similarly, the advanced management techniques of foreign multinationals can stimulate local suppliers, distributors, and competitors to improve their own management techniques, which will also have similar effects.

(2) Employment effect. International direct investment can increase employment in host countries. Foreign MNCs employ a certain number of host country residents. This has a direct effect. As a result of this investment, the jobs created by local suppliers and employees of multinational companies in local consumption are indirect effects. Even if the indirect effect is not greater than the direct effect, it is at least equivalent to the direct effect. However, not all international direct investment can

increase employment. For example, some international direct investment projects will cause the same competition in the host country to shrink, and as a result, new jobs may not be enough to offset the lost jobs. The net increase in the number of jobs has thus become the main point of negotiations between multinational corporations and host countries.

(3) International balance of payments effect. For most of the host countries, the impact of international direct investment on a country's balance of payments is an important policy issue. International direct investment has three potential impacts on the balance of payments. First, when a multinational company establishes an overseas subsidiary, the capital project of the host country will benefit from the initial capital inflow. For the home country, it will be capital outflow. Therefore, it should be credited to the debit of the capital project of the home country. However, this is only a one-time effect. Contrary to this, the return of such investment profits to foreign parent companies will also result in the outflow of funds, which is debited in the host country's current account. Second, if international direct investment becomes a substitute for the import of goods and services, it can improve the current account of the host country's balance of payments. Third, when multinational corporations use their foreign subsidiaries to export goods and services to other countries, the host country's state revenue and expenditure have improved (Thirlwall, 2004).

(4) Competition effect. By increasing consumers' choices, international direct investment can help increase the level of competition in the domestic market, thereby lowering prices and improving consumer economic welfare. The intensification of competition can often stimulate companies to increase capital investment in equipment, equipment and research and development, in order to occupy a dominant position in the competition with their opponents. The resulting long-term results include an increase in labor productivity, product and production process innovation, and a higher rate of economic growth. The impact of international direct investment on domestic market competition is particularly important in the service industry.

The disadvantages of international direct investment on the host country are mainly manifested in the following three aspects:

The negative effects of competition: If the foreign multinational company's subsidiary is far stronger than the host country's domestic enterprise, or if the multinational company subsidizes the cost of the subsidiary, the host country's own company will be eliminated from the competition. Once a foreign company gains a monopoly in the market, it will raise prices and adversely affect the economic welfare

of the host country. This phenomenon is even more serious for those countries where there are fewer major domestic companies (generally less developed countries). In addition, if a particular industry in a country is a so-called Infant Industry that has a potential comparative advantage, then allowing international direct investment to enter the industry means that it deprives domestic companies of development opportunities. However, some inefficient domestic competitors often use the above arguments as a basis to lobby the government to limit the direct investment of foreign multinational corporations.

The negative effect of the balance of payments: If the international direct investment project generates profits, and the subsidiary company remits profits to the foreign parent company, this profit outflow will be credited to the borrower of the labor revenue and expenditure in the host country's current account of international payments. The measures taken by some countries for such capital outflows are to limit the amount of foreign subsidiaries' profits flowing to their home countries. In addition, if a foreign subsidiary imports a large amount of products for input from abroad, the result must be recorded as a borrower for trade balances in the host country's current account of international payments. In order to avoid this adverse impact on the balance of payments, some countries have established localization rate indicators for foreign direct investment projects and require that they use a certain amount of domestically produced spare parts.

The negative effects on national sovereignty: Many host governments fear that foreign direct investment will lose some of their economic independence. Major decisions made by foreign parent companies will affect the host country's economy, while the host government has no actual control over this.

The benefits of international direct investment are in the three aspects: The current account of the home country's balance of payments will be improved due to the inflow of foreign investment income. The increase in home country exports will have a favorable employment effect. Multinational corporations in home countries can also learn valuable skills from foreign markets and transfer such skills back to their home countries. This is equivalent to the reversed resource transfer effect. Through contact with foreign markets, multinational companies can learn more advanced management techniques and more advanced products and processes.

2.6 Theories related to FDI

2.6.1 Investment and trade substitution theory

After the Second World War II, economists combined the international theory and the industrial organization theory to analyze the FDI. The Canadian economist Mundell is one of the representatives. From the perspective of international trade, Mundell uses comparative static analysis to point out that because of the inevitable various forms of trade barriers in international trade, in order to occupy the international market, investment is a form of trade or a substitute. Mundell believes that international trade leads to international direct investment, and that in the absence of trade barriers, both sides can gain benefits (Mundell, 1957).

2.6.2 The theory of marginal industry expansion

Aiming at the expansion of international capital in 1970s, Japanese economist Kojima put forward the theory of marginal industry expansion. If the host country lacks capital support and corresponding technical support, the host country becomes a disadvantaged industry. Taking into account the theory of comparative advantage in international trade, the host country should import products that are relatively inferior and export products that are of relative national superiority. The theory holds that it is necessary to improve the trade but also transfer the international industry by investing in the domestic inferior industries, transferring these disadvantages to other countries, and expanding their production exports to the dominant industries (Dunning, 1973).

2.6.3 International production compromise theory

Denning systematically summarized structural market factors and the incomplete natural market factors to analyze the formation of multinational corporations and their foreign investment behaviors (Denning, 1977). The international production compromise theory is known as the general theory of international direct investment with a high degree of generality, wide coverage and adaptability. The theory of international production compromise holds that ownership advantage, internalization advantage and location advantage are the basic factors to determine the behavior of multinational corporations and foreign direct investment. At the same time, the different combinations of these basic elements also determine the main forms of enterprise participation in international economic activities, namely license trade, commodity export and foreign direct investment.

2.6.4 Monopolistic advantage theory

Stephan, an American economist, first studied the theory of foreign direct investment, and put forward the theory of monopolistic advantage in his doctoral thesis. He believes that the motivation of direct investment of multinational corporations is caused by market adjustment defects. He divides the monopolistic advantages into two categories: one is the knowledge asset advantage including all intangible assets such as production technology, management and organizational skills and sales skills, and the other is the scale economic advantage caused by the large scale of the enterprise (Hymer& Stephen, 1976).