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An economic theory of FDI: A behavioral economics and historical approach☆

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Abstract

This is an attempt to argue that explaining the foreign investment decision (FDI) need not lie outside the realm of economics, for it can be explained using the attributes of behavioral economics. Behavioral economics, which tries to improve the assumptive realism of economic theory, and objects to the neoclassical acceptance of the simplistic economic model of rational agents exhibiting optimizing behavior, is certainly capable of explaining the decision of multinational enterprises making investment decisions when they face the complex and uncertain international environment. It is in this spirit that I have tried to model the FDI decision using the attributes of behavioral economics.

However, before presenting this behavioral economics model of FDI decisions, I discuss the problems that neoclassical economics faced in explaining the new reality of FDI/international production after World War II, when neoclassical economists utilized the unrelated arbitrage theory of portfolio flows to explain it. I do also Stephen Hymer's critique of that attempt, and his attempt to explain FDI decision, which helped it move outside of the realm of economics. I do also review and discuss the various FDI theories that emerged, after the 1960 dissertation of Hymer, in the works of Dunning, Buckley, Casson, Markusen, and others presented as transaction cost, internalization, and the eclectic theories of foreign direct investment. While praising the contributions of these theories, I argue that they are inferior to the behavioral economics based model I develop in this model.

JEL classification: A12; B19; F21

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1. Introduction

In the years prior to World War II, international production (including foreign direct investment) comprised a small share of international business. Since international trade constituted the largest component of international business, international economists essentially focused their attention on the explanation of trade among nations. The Ricardian and other versions of the comparative advantage doctrine, which assumed perfect international immobility of the factors of production (thus zero FDI), were utilized to explain trade among nations.

After World War II, in particular after the 1960s, the character of international business began to change. It was during this phase of international economic history that the multinational enterprise (MNE), thus foreign direct investment (FDI) and other forms of international production, began to emerge and gradually become significant.

Unable to explain the unprecedented rise of FDI via the comparative advantage doctrine, for explanation, international economists adhered to the neoclassical arbitrage theory of portfolio flows. In its original (1936) version, this theory had been utilized to explain foreign investment activity in its portfolio (and not direct) form (Iverson, 1936). However, the portfolio theory too was unable to explain foreign direct (or other forms of) international investment. Thus, there emerged other attempts to explain the FDI theory. But, the new FDI theories gradually moved away from economics, and towards the new and interdisciplinary field of international business. This move could be explained by the absence of realism on the part of those neoclassical theories, and the complexity of the international production environment which involves more than the mere economic assumptions of conventional economics. What I want to argue is that this need not be the case. Economics, when it includes proper, realistic and relevant assumptions, should have the ability to explain the phenomenon of foreign direct investment and capture the reality of international production. While neoclassical economics is too narrow to capture this complexity, behavioral economics, on the other hand, should have no conceptual difficulty in dealing with this reality. The reasons are: (1) behavioral economics tries to make economic theory consistent with the accumulated body of knowledge in all behavioral sciences including psychology, sociology, anthropology, organization theory, and decision science; (2) it tries to improve the assumptive realism of economic theory by emphasizing the importance of empirical research and the explanation of observed behavior, rather than deducing principles of economic behavior from features of human nature assumed to be valid at all times and in all cultures; and (3) it objects to the neoclassical acceptance of the simplistic economic model of rational agents exhibiting optimizing behavior. It is in this spirit that Herbert Simon introduced the notion of bounded rationality, and replaced the maximization assumption of conventional economics with satisficing. (see Hosseini, 2003).

In the analysis of MNC decisions, I will not assume that MNC decision makers are omnisciently rational. Rather, in the face of complex and uncertain political, economic, and cultural environments, I will argue that MNC decision makers – as imperfect human beings – naturally display limited mental and analytical capacity, in contrast to the omniscient entrepreneur of neoclassical economics. (See Galbraith and Kay, 1986, pp. 2–19).

In the paper, after discussing the inadequacies of neoclassical trade theories, I will review the post-1960 contributions of Hymer, Dunning, Buckley, Casson, Teece, Galbraith, Kay,