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Re-examining location antecedents and pace of foreign direct investment: Evidence from Taiwanese investments in China

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ABSTRACT

The objectives of this study are to examine variations in the preferences of location antecedents and the pace of foreign direct investment (FDI) by multinational enterprises' (MNEs) in relation to increased FDI experience and evolved strategic intentions. Using a rank-ordered logit model (ROLM), this study analyzes a total of 2688 investments in China from 731 Taiwanese-listed firms (TLFs) during 1997–2007. The results show that TLFs demonstrate distinct preferences for location antecedents at different stages of their FDI in China. In the early stages, TLFs attempt to exploit their existing competency and favor locations with advantages in infrastructure, labor cost, market size, and openness. In the later stages, locations with better production efficiency, labor quality, and R&D capability are more attractive because TLFs have become accustomed to the local business environment and intend to explore capabilities that create sustainable competitiveness in the face of competitive challenge. The results show that two antecedents, agglomeration and policy incentive, have consistent influence on location choice during the entire FDI process. The results also show that greater FDI experience contributes to a more intensive inter-investment time span and accelerates a TLF's investment pace.

1. Introduction

Location choice is an imperative that multinational enterprises (MNEs) consider when expanding business outside home boundaries. In his eclectic paradigm, Dunning (1977) demonstrates that location is one of the three pillars that determines foreign direct investment (FDI). A number of studies investigate where MNEs decide to locate and articulate the influence that FDI location has on MNEs' performance (Vanhonacker & Pan, 1997), their competitiveness in the global market (Dunning, 1998), and their intra-organizational configuration (Dunning, 1995). Despite these efforts, the location choice of MNEs deserves greater academic attention given the ongoing shift in FDI patterns in the world economy over the last decade (Chadee, Qiu, & Rose, 2003).

The reasons why MNEs allocate business in a specific country or region are of great interest to researchers in the international business field. A review of the literature indicates that some specific characteristics of host destinations are attractive to MNEs in both cross-country settings (Billington, 1999) and within-country settings (Ma & Delios, 2007). Yet, most empirical studies treat each FDI decision by the same firm as an independent case (Benito & Gripsrud, 1992) and overlook the fact that MNEs can adjust their criteria for choosing a FDI location by basing it on their accrued FDI experience. With long-term experience in running businesses in international markets, MNEs are able to develop and accumulate experience that affects their subsequent strategy-making (Johanson & Vahlne, 1977). Given this, MNEs can show diverse location preferences during the FDI process (Dunning, 1998), and the location advantages emphasized in early FDI cases might differ from those in later ones. The effects of, and changes in, location antecedents over time are thus in need of greater research (Flores & Aguilera, 2007).

In addition, the tenure of MNEs' international operation can impact not only their location preference but their FDI pace as well. Johanson and Vahlne (1977) point out that MNEs' knowledge that is relevant to a specific market derives from cumulative local experience and determines the speed of subsequent investments. Based on research on the internationalization of the Hong Kong garment industry, Lau (2003) asserts that the time span between investments for firms shortens over time. Also, Davidson (1980) mentions that MNEs increase entry frequency into the same country in light of accumulated location-specific experience. These observations imply that the continuous investments of MNEs enable them to develop a better understanding of their investment destinations and this learning effect can then facilitate their future location decisions. However, this contention lacks robust supporting evidence (Nadolska & Barkema, 2007).

Taken as a whole, the objectives of this study are to examine how the learning effect influences MNEs' dynamic preferences with regard to FDI-location antecedents and the time span between successive FDI cases. To this end, this study analyzes a sequence of FDI cases of Taiwanese manufacturing firms in China. According to the latest report of the United Nations Conference of Trade and Development (UNCTAD,

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2010), China has become the second largest recipient of FDI after the U.S. and received investments valued at US$95 billion in 2009. Of the numerous countries investing in China, Taiwan, which officially opened investment in China in 1991, accounts for a large portion of FDI in China in spite of the political hostility between these two parties (China Statistical Yearbook, 1997–2007 editions). Notably, this paper delves into the FDI patterns of TLFs in China at the provincial level and explicitly focuses on the economic incentives, like market size and labor cost, each province offers (Buckley, Devinney, & Louviere, 2007; Coviello & McAuley, 1999). Though China is a unitary nation with a uniform legal system, the institutions that contribute to a well-operating market economy (e.g., property rights protection and contract enforcement) can vary across provinces and influence a MNE's location choice (Du, Lu, & Tao, 2008). Given that Taiwan and China share the same language and similar cultures, very little cultural distance exists between them (Zhang, 2005). These close cultural ties enable TLFs to quickly adapt to the distinct local business environment by connecting to the local authorities and to minimize the influence of institutional variation. Hence, this study excludes location antecedents such as culture, language, and regulations (O'Grady & Lane, 1996; Schroath, Hu, & Chen, 1993; Sun, Tong, & Yu, 2002).

The structure of this paper is as follows. Section two begins with a review of literature on FDI location choice and associates the MNEs' FDI motives with their preferred location advantages. The remainder of this section introduces nine major location antecedents that MNEs consider for FDI decisions in China. Section three delineates the potential effect of learning on the motive-preference relationship and on the FDI expansion pace. The ROLM and measurements of the focal variables adopted are in section four. The final two sections present the empirical results and discussion.

2. Literature review

Compared with exporting, licensing, and non-equity alliances, FDI is an important scope-growing strategy and an entry mode with high commitment (Chang & Rosenzweig, 2001). Although FDI involves higher operational risk and liability for MNEs, they can benefit from this investment through effective management control, communication; and, more importantly, decision autonomy (Zaheer, 1995). Of the FDI-related decisions that MNEs make, location choice has a crucial impact on the probability of success and profits.

A review of the studies on location choice suggests two main research streams (Hong, 2007). One concentrates on location attractiveness and advocates that MNEs invest in locations with advantageous characteristics (Tahir & Larimo, 2004). Wei, Liu, Parker, and Vaidya (1999) argue that the studies developed from traditional location theory, new location theory, and institutional environment consideration identify labor cost, infrastructure, market size, agglomeration effect, and policy incentives as the major location antecedents. The underlying assumption of this view is that "an investment's profitability is a function of several location characteristics (Shaver, 1998, p. 471)."

The other stream asserts that the FDI motives of MNEs guide their location decisions (Chen & Chen, 1998; Chung & Alcácer, 2002; Dunning, 1988, 1998; Makino, Lau, & Yeh, 2002). In his prominent article, Dunning (1998) identifies four FDI motives for MNEs that comprise resource-seeking, market-seeking, efficiency-seeking, and strategic asset-seeking. Following Dunning's classification, Makino et al. (2002) distinguish FDI motives into asset-exploitation and asset-exploration, either of which leads firms to choose different location patterns.

Firms with asset-exploitation motives are those that intend to transfer their specialty to a host country and extend their existing asset advantages (e.g., production know-how). Exploitation-oriented investments mostly occur in less developed countries (LDCs) or in a downstream direction. Conversely, firms with asset-exploration motives expect to acquire/upgrade essential assets (e.g., technology) through FDI, and exploration-oriented investments usually take place in developed countries (DCs) or in an upstream direction. Dunning and Narula (1996) propose similar arguments in their investment development path (IDP) framework.

In fact, these two streams are not independent but interrelated (He & Wong, 2004). Nachum, Dunning, and Jones (2000) claim that they are complementary and that an FDI decision is the result of the harmonization of motives of MNEs and the location advantages of the host country. Galan, González-Benito, and Zuñiga-Vincente (2007) further recognize that the FDI motive of MNEs is the prerequisite of location choice, and MNEs make decisions by linking the evaluation of advantages (characteristics) of a destination with specific motives. MNEs with asset-exploitation mindsets have primarily resource-, efficiency-, and market-seeking motives and prioritize factors such as labor cost and market size and potential; but those with asset-exploration mindsets seek strategic assets and emphasize factors such as R&D capability and human capital. However, these two streams are static analyses, and they ignore the accumulated FDI experience that might have an impact on the motives of MNEs and their location preference.

In recent years, scholars have been calling for the examination of sequential investments because the experience of MNEs in international operations might affect their subsequent investment behavior (Lin & Yeh, 2004), especially for within-country FDI cases (Kogut & Chang, 1996). For example, Davidson (1980) contends that MNEs continue to invest within the same country due to the learning effect. In a similar vein, Mudambi (1998) observes that the amount of investment is dependent on duration, and points out that the longer MNEs invest in a specific location, the greater the amount of investment that exists. Chang and Rosenzweig (2001) find that the entry modes MNEs employ in the early stages clearly differ from those in the subsequent stages of investment in the U.S., and Greenfield investments have priority over acquisitions. They maintain that the reason MNEs vary their FDI modes over time is that the initial liability of being foreign declines with the accumulation of local knowledge. Thus, MNEs prefer to increase their commitment to the host destination and switch FDI motives from asset-exploitation to asset-exploration. In this regard, MNEs not only exploit their existing firm-specific advantages for short-term survival but also engage in developing sustainable competitiveness for long-term growth (Prange & Veridier, 2011).

Researchers that examine both spatial and temporal variations in FDI location decisions find that MNEs also adjust the relative importance of location antecedents in their FDI trajectory. Analyzing the FDI data of the top 100 U.S. MNEs in 1980 and 2000, Flores and Aguilera (2007) demonstrate a transition in their preferred location antecedents. Over time, the influence of GDP (Gross domestic productivity) declines, and U.S. MNEs place greater emphasis on the population and infrastructure factors in their subsequent investments. Sun et al. (2002) examine investments by MNEs in China and obtain similar evidence. By comparing the periods of 1986–1991 and 1992–1998, they claim that the effects of location antecedents shift. The market factor becomes more important for MNEs when deciding where to locate, but labor wages significantly reverse that factor's effect on the location choice of MNEs, shifting from positive to negative. This shift implies that MNEs modify their strategy towards China from an export-oriented strategy to a local market-oriented strategy (Sun et al., 2002). MNEs initially pay higher wages to their employees for high-quality products to export, and then take cost into consideration when the products target local consumers. Even though Flores and Aguilera (2007) and Sun et al. (2002) depict the alteration of the effect of location antecedents, they base their findings on the comparison of only two sample periods.

Due to the foregoing discussion, further analysis of sequential FDI patterns is necessary. Taiwan became listed as a newly industrialized economy (NIE) in the early 1970s. (Boltho & Weber, 2009). In view of the IDP framework of Dunning and Narula (1996) and the insights of