DIRECT PRIVATE FOREIGN INVESTMENT:
A SURVEY AND RECONSIDERATION OF
TRADITIONAL THEORY

by

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We accept this thesis as conforming to the
required standard.

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ABSTRACT

The purpose of this study is, first, to outline the neo-classical investment theory and the main competing hypotheses which seem to form the bases of the policy measures adopted by governments of capital-importing and capital-exporting countries to stimulate the flow of direct private foreign investments (DPFIs), and, second, to re-examine and reconsider a few of the assumptions and implications of the theory and the hypotheses in the light of certain reported investigations of direct foreign investment decisions of firms.

A review of the neo-classical investment theory shows that the theory assumes that firms aim at profit maximization, that firms systematically scan domestic and foreign environments for investment opportunities and that firms undertake direct investments, whether domestic or foreign, to maximize their profits.

According to this theory, when firms make investment decisions, they have before them a number of investment propositions, both domestic and foreign. They then carefully appraise these propositions in terms of costs, benefits and risks and decide in favour of those propositions which promise them high returns and low risks.
This theory therefore implicitly suggests that it is possible to provide considerable stimulation to the flow of DPPIs by merely affecting firms' expectations of returns and risks of such investments.

Disagreements over the validity and usefulness of the neo-classical investment theory as an explanation of the flow of DPPIs lead to a formidable number of alternative explanations or hypotheses. Some of these are: (1) the higher profit rate abroad hypothesis, (2) the lower costs abroad hypothesis, (3) the monopolistic competition hypothesis, (4) the growth of the firm hypothesis, (5) the marketing considerations hypothesis, (6) the market size hypothesis, (7) the maintenance of market hypothesis, and (8) the product cycle hypothesis.

Each of these hypotheses is based on a number of assumptions, most of which seem similar to those made by the neo-classical investment theory for most of them implicitly assume that: (1) firms normally look across their national boundaries for investment opportunities, (2) firms possess financial and suitable managerial resources to undertake direct investments abroad, (3) firms are generally prepared to use their resources to investigate direct foreign investment projects, and that (4) firms make cross country comparisons of projects to determine which project or projects they should undertake.
Some reported investigations of the foreign investment decisions of firms, however, suggest that firms do not, in fact, systematically scan the globe for areas to make an investment and that most firms do not normally consider the possibilities of investing abroad. The reasons why firms do not normally look abroad for investment opportunities can probably be found in: (1) organization traditions and attitudes, (2) generally held beliefs of firms, (3) limitation of company resources, (4) departmental structures, (5) complexities of investing abroad, and (6) information and investigation costs.

These investigations also suggest that: (1) generally firms consider direct investments abroad only when they are "pressured" (or "threatened") or "persuaded" (or "instigated") to do so, (2) when firms consider direct foreign investment projects, they agree in principle right from the beginning to accept them, (3) firms evaluate direct foreign investment projects sequentially and do not weigh them alongside each other, (4) different firms use different criteria to determine the acceptability of foreign investment projects.

This study accepts the conclusions of these investigations and suggests that any theory of DPPIs has to recognize that direct foreign investment alternatives are not given to firms and that there is a need to incorporate
the "initiating forces" into the theory. It also suggests that it is probably not possible for countries to provide considerable stimulation to the flow of DPPIs without first devising some policy measures to initiate firms to consider investment opportunities across their national boundaries.
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He acknowledges complete responsibility for this study, its conclusions and the weakness that may remain in the argument.
CHAPTER ONE

INTRODUCTION.

Purpose of the Study.

Policy measures adopted by governments of capital-importing and capital-exporting countries\(^1\) to encourage, stimulate and direct the flow of direct private foreign investments (DPIs)\(^2\) are based on certain theories and hypotheses regarding the underlying determinants of such investments. They are also based on certain assumptions regarding the behavior and motivations of private investors and the manner by which they arrive at a decision to undertake such investments.

\(^1\)Countries which try to attract direct private foreign investments may be called "capital-importing countries" or "host countries" whereas countries which try to encourage their citizens to undertake direct investments abroad may be called "capital-exporting countries" or "source-countries".

\(^2\)The U.S. Department of Commerce regards direct private foreign investments as "all those foreign business enterprises in which a U.S. person, organization or affiliated group owned a 25 per cent. interest, either in the voting stock of a foreign corporation, or an equivalent ownership in a non-incorporated foreign enterprise." (U.S. Department of Commerce, U.S. Business Investments in Foreign Countries, A Supplement to the Survey of Current Business. Washington, 1960, p. 76)

For the purpose of this study, however, we need not worry about the kind of precise definition necessary for statistical analysis. The term may, therefore, be simply taken to include all industrial and commercial operations located within a country which are owned, either wholly or partially, and controlled, either implicitly or explicitly, by private individuals, business firms or affiliated groups from another country.
It is the purpose of this study, first, to outline these theories and hypotheses together with their main assumptions and implications with regard to the manner in which private investors, particularly firms or companies, analyze direct foreign investment projects and the methods by which DPFIs can be stimulated, and, second, to re-examine and reconsider a few of these assumptions and implications in the light of the behavioural theory of the firm and certain reported investigations of direct foreign investment decisions of some companies.

Organization of the Study

Chapter Two of this study presents the main elements of the neo-classical investment theory. (The main elements of the classical investment theory are presented in Appendix I.)¹ It outlines the early and modified assumptions of this theory and discusses the methods of evaluating investments as suggested by it. The chapter also reviews some of the problems

¹Like the classical investment theory, the neo-classical investment theory is, simply stated, a set of abstract deductions on investment and investment behaviour of investors based on the assumptions that human action is rational and that all rational action is self-seeking in its nature. But unlike the classical investment theory, the neo-classical investment theory is more rigorous and makes "utility" and "marginalism" as integral parts of its analytical apparatus. See Edmund Whittaker, Schools and Streams of Economic Thought, (Chicago: Rand McNally & Company, 1960), pp. 187-190 and pp. 311-312 for a summary of these two schools of economic thought.
associated with evaluating direct private foreign investment projects and some of the implications neo-classical investment theory has for direct private foreign investment incentive programs.

Chapter Three contains a brief survey of alternative hypotheses—alternative to the classical and neo-classical investment theories—which purport to pin-point the immediate or proximate cause for firms and investors to undertake direct investments abroad. It contains not only a review of these alternative hypotheses but also a discussion of their main assumptions and implications.

Chapter Four attempts to re-examine and reconsider, in the light of some reported investigations of direct foreign investment decisions of some companies, one of the main assumptions of the neo-classical investment theory and most alternative hypotheses of DPFIs—that direct foreign investment alternatives are given to firms or that firms systematically scan the globe for areas to make an investment. It also attempts to provide some explanations to the phenomena actually observed by various scholars.

In Chapter Five, the results of past studies are pooled together to provide further insights into the foreign investment decision process of firms or companies. This chapter discusses the initiating forces in DPFIs and the manner in which most
firms or companies probably consider, investigate and evaluate
direct foreign investment projects. It also contains some
aspects of the behavioural theory of the firm relevant to the
above issues.

Finally, in Chapter Six, the amin assumptions and
implications both of the theoretical materials and of the re­
ported investigations are briefly reiterated and summarized.
The chapter also notes an exception to the observations made.

It concludes with some observations on changes that may be
taking place with respect to the consideration of direct
foreign investment projects.

Limitations and Problems Encountered.

One major problem faced by the writer in this study
arises from the paucity of theoretical material on DPFIs, in
particular on the decision-making process involved.¹ There
is a paucity of theoretical material on DPFIs because, until
recently, economists have neglected the study of such invest­
ments. In international economics, scholars have concentrated
on trade theory; the movement of goods has been seen as a
powerful engine of economic growth and adequate for the

¹The little theoretical material on DPFIs is concentrated
largely on the study of long term capital flows in relation to
the mechanism of adjustment in the Balance of Payments together
with the effects of such flows on the summarized statement of a
country's economic transactions with the rest of the world.

The second major problem faced by the writer pertains to the problem of sieving, selecting and sampling from the wide array of hypotheses, the main hypotheses and of distilling from them the main ideas. The writer has solved this problem by giving emphasis to those hypotheses and ideas which seem to him especially significant and with which he is closely familiar.

In the reconsideration of the theoretical material on DPFIs, the writer is mainly concerned with pointing out that foreign investment alternatives are not given to firms, that most firms probably do not normally look across their national boundaries for investment opportunities, that most firms probably only investigate direct foreign investment opportunities when they are pressured (or threatened) or persuaded (or instigated) to, that when firms evaluate direct foreign investment projects they probably have, before the investigation, in principle agreed to accept the project, and, that they probably do not carry out cross country comparisons of profitability. No attempt is made in this study to prove or disprove the validity of any or all of the hypotheses nor is there an effort made to develop a comprehensive and
conclusive theory of direct private foreign investment decision. This study is an attempt to point out what appear to be important missing links in the theoretical bases of government policies to stimulate DPFI's.
CHAPTER TWO

NEO-CLASSICAL INVESTMENT THEORY AND
DIRECT PRIVATE FOREIGN INVESTMENTS.

Introduction.

The classical economists such as David Ricardo, J. S. Mills, Adam Smith, Nassau William Senior and Karl Marx and the neo-classical economists such as Auguste Walras, Alfred Marshall, Karl Menger, Philip Wicksteed and Knut Wicksell do not have a theory of direct private foreign investments separate from a theory of direct private domestic investments or a theory of foreign investments separate from a theory of domestic investments. To them,

... the basic principles of foreign investments are essentially the same as those of home investments. The chief motive power that drives the machinery of both is financial profit. The principal criteria by which the goodness of a foreign investment is judged are the same as those by which a domestic investment is judged,1 and having separate theories for domestic and foreign investments is superfluous.

They assume that the investment decision process is a simple process in which investors --sometimes conceived as made up of single entrepreneurs and sometimes conceived

as made up of firms acting as omniscient economic men--
evaluate given alternative investment projects in terms of
costs and benefits and select and undertake those projects
which will help them (the investors) to achieve their goal
of profit maximization. They maintain that under conditions
of certainty, investors have perfect knowledge of all invest-
ment projects and of all the consequences attached to each
and they will undertake any investment project that yields
benefits in excess of the resources used. Under conditions
of uncertainty, however, they maintain that investors will
still be attempting to select and undertake investment projects
which will help them to maximize their profits but because of
the lack of perfect knowledge, investors will be making their
investment decisions on the basis of expected returns, expected
costs and expected riskiness of investment projects and on
the basis of their own risk preferences and their investment
budgets.

Although the classical and neo-classical investment
theories are both built on the same basic assumption, that
the primary goal of the industrial concern is the maximization
of profits in the long run, there seems to be one important
distinguishing feature between them. While the classical
investment theory seems to be largely macro-oriented and
attempts to explain the flow of investment in the aggregate,
the neo-classical investment theory seems to be largely micro-
oriented and attempts to explain the investment decision-
making process at the level of the firm or company. When
viewed in terms of a theory of DPFIs, the former, therefore, seems to attempt to provide an explanation as to why DPFIs flow from one country to another while the latter attempts to explain why a firm or company chooses a foreign investment project and undertakes direct investments abroad.

The classical and neo-classical investment theories have been severely criticized. They have been labelled as static, normative and vague theories. But despite these criticisms, they are still held as the most convincing explanations for the flow of DPFIs. And, these theories seem to provide the basic assumptions on which the foreign investment incentives of many countries are devised.

This chapter is devoted to a discussion of the neo-classical investment theory, the methods of evaluating

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1See Yair Aharoni, The Foreign Investment Decision Process (Boston: Harvard University, Graduate School of Business Administration, Division of Research, 1966), pp. 245-303 for a summary of the criticisms levelled at the classical and the neo-classical investment theories.

2The fact that many people still believe that "foreign investment is primarily prompted by profit rates being differentially higher than those of alternative domestic investment opportunities or higher than export profit rates" and that "investment flows to the area of highest return" suggests that the classical and neo-classical investment theories have wide general acceptance as explanations for the flow of DPFIs. See Judd Polk, Irene W. Meister and Lawrence A. Viet, U. S. Production Abroad and the Balance of Payments: A Survey of Corporate Investment Experience (New York: National Industrial Conference Board, Inc., 1966), pp. 64-65 for similar views.

3A summary of the classical investment theory as it applies to foreign investments is presented in Appendix I.
investment projects—both domestic and foreign projects—as suggested by it and some implications of this theory for direct private foreign investment incentive programs.

**Pure Neo-classical Investment Theory.**

**Basic Assumptions and Basic Investment Decision Rule.**

Neo-classical investment theory in its pure form accepts as its starting point the following assumptions:¹

1. There is perfect competition in the market place, meaning that the market is made up of a large number of buyers and sellers of factor inputs and factor outputs and that no single buyer or seller is able to influence price.

2. All firms in the same industry produce homogeneous products so that the product of one firm is a perfect substitute of another in the same industry.

3. The primary goal of the firm, a buyer of factor inputs and a seller of factor outputs, is the maximization of profits.

4. The "state of the art" remains constant i.e. there are no technological changes.

5. Firms have perfect and costless knowledge of all present and future investment opportunities or alternatives, of all present and future factor prices, product prices, demand and supply conditions, and cash flows associated with each investment alternative, and of the courses of

¹These assumptions are seldom all explicitly spelt out in an elucidation of the neo-classical investment theory but the analyses outlined by it implicitly take these for granted. Some of these assumptions, however, are explicitly stated in some expositions. For a summary of some of these assumptions see Yair Aharoni, op. cit., pp. 7 and 246.
action which will help them to maximize their profits.

6. Investment alternatives or projects available to a firm are "independent" of one another, meaning that the profitability of any project is not significantly affected by the acceptance or rejection of any other project in the set.

7. Firms can freely lend or borrow at the going market rate of interest i.e. there is no limitation on the amount of funds a firm can raise at the prevailing risk-free interest rate.

8. Firms do not face any organizational complications or constraints. This flows from the assumptions that; (i) firms have no limitation on the amount of funds they can raise, (ii) decisions are made by organizations rather than people, and (iii) when people join organizations, they agree to conform to, in return for the "inducement" offered, the goals set by the organizations.

Given that firms have available to them a set of investment projects —both domestic and foreign investment projects— and that their goal is to maximize their profits, pure neo-classical investment theory postulates that the investment decision process is a simple process in which firms investigate and evaluate all given investment projects with a view toward selecting and undertaking those projects which will help them to maximize their profits.

Clearly, a business firm will increase its profits by selecting and undertaking any investment project that yields revenues in excess of the cost of the resources needed for that project. It follows, therefore, that according to this theory, a firm will undertake investment projects —whether they be domestic or foreign investment projects— so long as the benefits
associated with the project exceed (or are equal to) the resources used. And

... the cut-off point will be where the revenues are equal to the costs of the resources used. Failure to extend investment to the point where revenues equal costs will result in the full profit potential going unexploited; investment beyond that point will only result in certain projects making losses.¹

But since the benefits and the costs associated with a project have a time dimension in that some of the benefits are to be derived and some of the costs are to be incurred in the future, the theory implicitly assumes that in evaluating investment projects firms take account of the time value of money.

**Measures of Acceptability and Investment Decision Rules.**

Two measures of acceptability that reasonably ensure that the time value of benefits and costs associated with projects are taken into account are:

1. **The Internal Rate of Return.**

By definition, the internal rate of return is simply the rate of discount that will equate the present value of the benefits with the present value of the costs associated with the project. It

can be found by solving for \( r \) in the equation:

\[
\sum_{t=0}^{n} B_t (1 + r)^{-t} = \sum_{t=0}^{n} C_t (1 + r)^{-t}
\]

where

- \( B_t \) ... benefits derived from the project at the end of period \( t \).
- \( C_t \) ... costs associated with the project at the end of period \( t \).
- \( n \) ... last period in which benefits or costs occur.
- \( r \) ... the rate of return.

2. The Net Present Value.

The net present value of a project is simply the difference between the present value of benefits and the present value of costs associated with the project or

\[
N.P.V. = \sum_{t=0}^{n} B_t (1+k)^{-t} - \sum_{t=0}^{n} C_t (1+k)^{-t}
\]

where

- \( N.P.V. \) ... net present value.
- \( B_t \) ... benefits derived from the project at the end of period \( t \).
- \( C_t \) ... costs associated with the project at the end of period \( t \).
- \( n \) ... last period in which benefits or costs occur.
- \( k \) ... cost of capital, which under pure neo-classical investment theory is the market rate of interest.
In the above formulation, the cost of capital is assumed to remain constant over time. If this rate changes over time, the net present value of a project can be computed by

\[ N.P.V. = \sum_{t=0}^{n} B_t (1+k_i)^{-t} - \sum_{t=0}^{n} C_t (1+k_i)^{-t} \]

where \( k_i \) is the cost of capital or the market rate of interest in period \( i \) and the other symbols have the same meanings as before.

As long as the internal rate of return of a project exceeds the supply price of funds, which under pure neo-classical investment theory is the market rate of interest, that project increases the profits of the enterprise and should therefore be undertaken. Therefore, according to pure neo-classical investment theory, a firm undertakes a direct foreign investment project because the foreign investment project's internal rate of return is greater than (or equal to) the market rate of interest.

Under the net present value criterion, a project will increase the profits of the firm if it has a positive net present value. Therefore, under pure neo-classical investment theory, a firm that uses the net present value measure to evaluate investment projects undertakes a direct foreign investment because the project has a positive net present value.
General Neo-classical Investment Theory.

Relaxation of Basic Assumptions.

Pure neo-classical investment theory has been attacked and criticised by a number of economists. These attacks or criticisms fall into one of two lines:

1. The theory is unrealistic because it does not have enough variables in it or because the variables of the theory do not in fact correspond to the significant variables of the firm.

2. The theory is unrealistic because profit maximization simply does not correspond to the actual principles which motivate and direct the behaviour of firms, or even if firms want to maximize profits there is no way of doing it.

Attempts to take into account some of the criticisms of the neo-classical investment theory in its pure form and to extend the theory to include additional variables and to modify some of the crucial assumptions include the recognition

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3 Ibid., p. 36.
of the following:  

1. In the real business world, firms are not of atomistic size. Rather they are of different sizes.

2. In some industries, the number of firms is small and activities of different firms are interdependent.

3. Products of firms in the same industry are not necessarily perfect substitutes for each other.

4. Capital markets are far from perfect and firms do not face a perfectly elastic supply curve of capital.

5. Firms cannot lend or borrow freely at a given rate of interest so that investment budgets of firms are at any particular point in time limited in amount.

6. The supply price of funds to a firm i.e. its cost of capital, differs not only from the market rate of interest but it also differs between firms.

7. The "state of the art" or technology does not remain unchanged.

8. Firms do not have full and exact knowledge of all present and future factor prices, product prices, demand and supply conditions and cash flows associated with each project and they do not know exactly which of the courses of action will help them to maximize their profits.

With respect to the investment decisions of firms and the evaluation of investment projects, the most important assumptions relaxed are the assumptions that investment decisions are made under conditions of perfect certainty (perfect knowledge) and that firms face a non-capital rationing situation (no limitation on the amount of funds at the

---

prevailing market rate of interest).

It should, however, be noted that neo-classical investment theory in its modified or general form still takes for granted that:

1. the primary goal of the firm is the maximization of profits,

2. investment alternatives are given to the firm, (This follows from the presumption that because of the pressure of competition, the desire to survive as viable entities in a competitive environment and the goal to maximize profits, firms continuously scan domestic and foreign environments for investment opportunities.)

3. firms do not face any organizational constraints other than financial constraints,

4. firms consider, investigate and evaluate all known investment alternatives before they make a decision to accept or reject a particular investment alternative, (This implies that before and in the process of investigation of investment alternatives, firms do not feel a commitment to accept any of the alternatives.)

and that

5. due to capital rationing, firms make comparisons of the desirability of investment alternatives or projects and select those alternatives or projects with higher net expected present values or expected internal rates of return before selecting those with lower ones.

Since these assumptions form the gist of the neo-classical investment theory and since they seem to form the bases of the foreign investment incentive programs of many countries, their validity will be examined later in this study.
Recognition of Risks and Uncertainty.

Neo-classical investment theory in its general form recognizes that firms operate in a world of uncertainty, that in making investment decisions firms do not have perfect knowledge of all the consequences attached to each investment alternative and that when firms undertake investment projects they face all kinds of risks and uncertainties.¹

The risks and uncertainties recognized in neo-classical investment theory, however, are only those pertaining to the outcomes of investment alternatives.² These include:

1. **calamity risks** - the risks that a firm's future net operating receipts for all time may be wiped out because of catastrophes such as wars and revolutions, fires and floods, embargoes and confiscations,

2. **technical risks** - the risks resulting from an increase in input in relation to output,

3. **price risks** - the risks that prices of productive services may be increased or the prices of goods sold may be decreased,

4. **payment risks** - the risks that customers may default or delay their payments,

and 5. **tax risks** - the risks that the tax rate may be increased or the tax allowances decreased.

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¹ Although Frank H. Knight in Risk, Uncertainty, and Profit (Boston: Houghton Mifflin Company, 1921), has drawn a distinction between risk and uncertainty -- the former being a situation where the probabilities of alternative outcomes are known while the latter are not -- neo-classical investment theory generally still treats uncertainty as synonymous with risk.

² Yair Aharoni, *op. cit.*, p. 255
Since neo-classical investment theory recognizes only risks and uncertainties pertaining to the outcomes of investment alternatives, it fails, in the context of the investment decision process, to recognize that there is uncertainty about investment opportunities and about the responses of people within and without the firm to investment proposals. In other words, it fails to recognize that certain investment opportunities or certain types of investment opportunities may never become known to certain investors and that although certain investors are fully aware of certain investment opportunities or certain types of investment opportunities, they may not consider these opportunities simply because they regard these "outside their line of business".

Incorporating Risks and Uncertainty in Investment Analysis.

Neo-classical investment theory maintains that under conditions of uncertainty the investment decision process is still simply one in which firms and investors evaluate given investment projects with a view toward selecting and undertaking those projects which will help them to maximize their profits. What firms and investors attempt to maximize, however, is not actual profits -- for this cannot be known ex-ante-- but rather expected return (or utility).

The theory takes risks and uncertainty into account
in investment analysis by assuming that firms and investors are able to form some expectations of the pattern of future cash flows and of risks associated with each investment project\(^1\) and by assuming that uncertainty can be compensated for by higher returns.\(^2\)

Since the risks and uncertainty recognized in neo-classical investment theory only relate to the outcomes of investment alternatives, attempts to formally incorporate considerations of risks and uncertainty in investment analysis merely take the form of suggestions of better methods to evaluate investment projects or to obtain the expected net present values or the expected internal rates of return of projects. The methods suggested include:

1. **The Method of Certainty Equivalents.**

   When this method is used and the net present value of a project is calculated, the risk elements in the income stream are taken into account by multiplying the expected cash flows for each period of the project's life by certainty equivalent co-efficients associated with them to obtain the certainty equivalent cash flows for each period.

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\(^1\)In neo-classical investment theory expectations are treated as an exogenous variable. How expectations are formulated and how the expected values of the cash flows are known are not discussed. See Aharoni's comment in Yair Aharoni, *op. cit.*, p. 251

\(^2\)See for example, Joel Dean, *op. cit.*, p. 568
of the project's life. These certainty equivalent cash flows are then discounted by a risk free discount rate to obtain the net present value of the project.¹

2. The Method of Risk Adjustment.

Under this method, the risk elements in the income stream are taken into account by drawing up a subjective probability distribution for the net cash flows for each period of the project's life, calculating the expected value of the net cash flow for each period² and then discounting these by the firm's cost of capital³ to obtain the net present value of the project.

3. The Use of Simulation (Hertz's technique).

According to David B. Hertz risk elements can be better taken into account by first deriving a probability distribution of possible rates of return on the investment and then computing the


²In calculating the expected values of the net cash flows for the various periods, account is to be taken of the quality of the income streams.

³Using a firm's cost of capital to discount the net cash flows of a project is only appropriate if the firm's cost of capital is higher than its opportunity cost attributable to the resources used in the project.
expected rate of return. This involves three steps. In Hertz's words they are:

i. Estimate the range of values for each of the factors (e.g. range of selling price, sales growth rate, and so on) and within that range the likelihood of occurrence of each value.

ii. Select at random from the distribution of values for each factor one particular value. Then combine the values for all the factors and compute the rate of return (or present value) from that combination ...

iii. Do this over and over again to define and evaluate the odds of the occurrence of each possible rate of return ...

The result will be a listing of the rates of return we might achieve, ranging from a loss (if the factors go against us) to whatever maximum gain is possible with the estimates that have been made.

For each of these rates the chances that it may occur are determined
... The average expectation is the average of the values of all outcomes weighted by the chances of each occurring.¹

4. Adjustment of the Discount Rate.

When this method is used and the internal rate of return of a project is calculated, the risk elements associated with a project are taken into account by raising the discount rate higher than the firm's cost of capital—the higher the degree of risks associated with the project, the higher is the discount rate raised.

Since the degree and the nature of risks associated with a project vary from country to country, from project to project and over the life-time of any particular project, firms using this method of evaluating investment proposals may use different discount rates for projects located in different countries (to reflect differences in patterns of risks as between countries), different discount rates for different projects (to reflect the fact that

environmental factors have different influences on different projects) and different discount rates for each year of the project's life (to reflect the time pattern of uncertainty).  

In the above discussion on the methods of incorporating risks in investment analysis, no reference was made to the measurement of risks associated with the variability of expected net cash flows although in evaluating risky investment projects a measure of this variability is important. It is important because the best investment projects for a firm or an investor are not necessarily those with the highest net expected values or the highest expected internal rates of return because an investment project for which the expected net present value or the expected internal rate of return is higher than that of another may be dangerous to the firm or investor if during a particular time period the net receipts decline so much that the firm or investor cannot fulfill its obligations to its financiers. Therefore, in evaluating risky investment projects neo-classical investment theory also suggests that the variability of outcome values be determined. Widely used measures of this variability

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of outcome values are the standard deviation (or the variance) and the semi-deviation (or the semi-variance).\textsuperscript{1}

Thus, neo-classical investment theory suggests that two measures are essential in the evaluation of given risky investment proposals: (1) a measure of the expected return for each proposal, and (2) a measure of the risks (variability of outcome values) associated with each proposal. Once these measures have been made for the various investment proposals before the firm, which of these proposals it will undertake depends on the expected rates of return of these proposals, the standard deviations or the semi-variances of their cash flows, the amount of risks each proposal adds to the overall riskiness of the firm, the risk preferences of the firm as well as the capital budget of the firm.\textsuperscript{2}

\textbf{Evaluating Direct Private Foreign Investment Projects.}

\textbf{Additional Problems, Variables and Assumptions.}

\textit{Neo-classical investment theory assumes that in making investment decisions, firms make estimates of costs

\textsuperscript{1}For a detailed discussion on these measures, see Harry M. Markowitz, \textit{Portfolio Selection}, (New York: John Wiley and Sons, Inc., 1952), Chapters 4 and 9.

\textsuperscript{2}How these measures are employed is discussed below.}
and returns from all investment projects before them, weigh the potential investment projects in one foreign country alongside the projects located at home and in other foreign countries and then make a firm decision and commitment to undertake any particular project or set of projects.

In this process of evaluation firms face more problems with regard to the evaluation of foreign projects than with regard to the evaluation of domestic projects because in evaluating foreign projects, firms have to deal with dissimilarities in financial attitudes, institutions, legal system, governmental policies and other environmental variables. More specifically, they will have to consider such new variables as exchange rate risks, differential inflation rates, taxes across national boundaries, different sources and costs of funds, effective versus nominal rates of interest, fringe benefits, joint ventures, special inducements and developing local capital markets.1

Neo-classical investment theory implicitly assumes that when firms evaluate foreign investment projects, they are aware of these additional problems and variables and that, because of the impossibility of obtaining perfect information on these variables, firms will make assumptions

about them. If this is not done, it is not possible for them to proceed to calculate expected net present values or expected internal rates of return.

Some of the major additional problems and major additional variables for which assumptions have to be made include:

1. **Future exchange rates and conversion risks.**

   In evaluating direct domestic investment projects, firms are mainly concerned with solvency risks—risks relating to the safety and profitability of the investment venture per se—but in evaluating direct foreign investment projects, firms are concerned not only with solvency risks but also conversion risks—risks relating to currency devaluation and currency depreciation—\(^1\) for "not only may the future foreign exchange rate be different from that anticipated but various types of restrictions may be introduced as regards the transferability of funds from one country to another."\(^2\)

   Firms evaluating direct foreign investment projects, therefore, need to develop schedules of

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2 Sune Carlson, op. cit., p.108
relevant anticipated exchange rates\textsuperscript{1} in order to convert incremental cash flows associated with a foreign investment project into domestic currency equivalents. Since in most countries, different exchange rates are applied for different types of transactions and for different types of payments, "schedules of relevant anticipated exchange rates" means "series of foreign exchange rate projections over time for raw material imports, export sales, dividend remittances and equipment importation."\textsuperscript{2}

2. Reinvestment Rate.

To reduce pressure on their balance of payments and stabilise their foreign exchange rates, countries may place restrictions on the remittance of cash flows of foreign subsidiaries located within their borders.\textsuperscript{3} This means that of necessity a parent company may have to reinvest some of the cash flows from its foreign subsidiaries in the countries in which such cash flows occur.


\textsuperscript{2}Ibid., p. 146

Consequently, in analyzing a foreign investment project, a firm may need to look beyond its first proposed commitment and include all subsequent reinvestments provoked by the initial investment\(^1\) i.e. it may need to look at foreign investment projects as commitments plus required reinvestments rather than merely initial investment choices.\(^2\) (Alternatively, it may need to make some assumptions regarding the possibility of selling the project at the end of a certain time period or the possibility of selling stocks on the basis of the value of the foreign project and move to higher rate of return areas). It may need to make some assumptions regarding the extent of reinvestments required, the return from such reinvestments together with the effects of such reinvestments on its future financial flexibility.

3. **Income Tax Issues.**

The amount of taxes a firm has to pay on the earnings of one of its foreign subsidiaries depends not only on the size of the earnings received\(^3\) but also on the geographical location

\(^{1}\)David B. Zenoff and Jack Zwick, *op. cit.*, p. 148

\(^{2}\)Ibid., p. 149

\(^{3}\)This in turn depends on the concept of income used and the methods of allocating expenditures as between parent and subsidiary allowed.
of the income source, the official headquarters of the firm, the residence and nationality of its shareholders, its type of legal organization and so on. The amount of taxes it has to pay to the country in which its subsidiary is located depends not only on the size of the earnings and the size of the capital invested but also on whether earnings are repatriated or not and if they are repatriated on whether they are sent home in the form of dividends, amortizations on loans or of management and licence fees. The amount of taxes it has to pay to its own government, however, depends not only on the size and origin of repatriated and non-repatriated earnings but also on the amount of taxes paid abroad and on whether the earnings are repatriated through a third country—a so called "tax haven".  

Since taxes affect the returns from a project, a firm in evaluating a direct foreign investment project has, prior to making the comment, to make some assumptions regarding its intention—taking possibilities into consideration--

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to repatriate—either wholly or partially—cash flows from the project, the timing and the methods of repatriation as well as tax rates—both at home and abroad—on different types of incomes over the life span of the project.

4. **Financing Alternatives.**

In the case of domestic investments, different plans for financing a particular investment alternative affect the return from the investment alternative only through the cost of capital. But in the case of foreign investments, different financial plans for financing a particular alternative affects not only the cost of capital but may also affect three other elements:

i. the cost of the asset required to implement the alternative,

ii. the operating costs in the foreign country under the alternative,

iii. the magnitude of the dividend remittance privilege.¹

This is so because in some foreign countries duties on imported raw materials vary with the method of financing the imports, the rate of the excess profit tax varies with the size of the local equity base and the remittance privilege varies with the size

¹David B. Zenoff and Jack Zwick, *op. cit.*, p. 154
of paid-in capital.

Consequently, in analyzing a direct foreign investment alternative, a firm needs to identify or assume possible financing alternatives, regard a project as an investment alternative financed in a particular way and develop separate receipt and disbursement projections for each project.


Neo-classical investment theory assumes that once a firm has identified the problems and variables involved in evaluating its set of investment projects and has made some assumptions regarding them, it begins to make an estimation of the cash and cash value of non-cash outflows and inflows associated with each project.

In the case of direct foreign investment projects, the theory seems to suggest that the cash flows considered are only the cash flows to the parent company for unless this is the case, it is not possible for the firm to compare the acceptability of both domestic and foreign projects alongside each other.

\[Ibid., p.155\]
With a foreign investment project, the cash and cash value of non-cash inflows and outflows to the parent company may comprise:

1. the initial cash investment together with the cash value of an old piece of machinery that is to be shipped to the proposed foreign subsidiary.

2. the imputed cost of transferring the know-how. (A cost may be imputed on the transfer of the know-how because by transferring know-how to other environments, the firm exposes itself to the possibility of competition in the foreign market as well as in other countries.²)

3. income earned from increased exports either of parts or of finished products less income lost through reduced exports.

4. dividends that the parent expects to receive from the proposed venture. Here allowance needs to be made for domestic and foreign tax liabilities and credits, and for foreign exchange conversion costs.

5. management contracts, license fees, royalties, disclosure fees and contribution to overhead after allowance has been made for taxes, foreign exchange conversion costs, and for additional costs to provide the services covered by such payments.

6. loan principal repayment and interest (less domestic tax payments).

7. income through transfer pricing. (If the proposed foreign subsidiary has a purchase or sales relationship with the parent or with other subsidiaries, it may be possible to shift income from the subsidiary to the parent or other subsidiaries through an arbitrary use of transfer prices (and vice versa).

8. other incremental revenues less costs arising from economies and diseconomies of scale, including


² David B. Zenoff and Jack Zwick, op. cit., pp. 157-158.
and 9. terminal value of the assets, including any retained profits.

The theory assumes that once a firm has estimated all the incremental cash flows associated with a foreign investment project and has converted these into domestic currency equivalents using the estimated exchange rates at the time the flows are expected to occur, the firm then goes through a process of determining the net present value of the project by discounting the incremental cash flows (in domestic currency) by the predetermined cost of capital and of measuring its riskiness by determining the dispersion of possible net expected values. This is done for all the projects before it.

Reaching a Conclusion.

According to neo-classical investment theory, once a firm has calculated the expected returns (measured by the net present value or the internal rate of return) and the riskiness (measured by the standard deviation or the semi-deviation of the expected net cash flows) of the projects before it, it will rank these projects based on the relative importance it attaches to maximizing profitability versus minimizing risks. And once the projects have been ranked, the firm goes through a process of selecting and undertaking projects --beginning
with the highest ranking—until its investment budget is exhausted.\(^1\) This process can be better explained with the help of Figure 1.

In the figure, the curves I to IV represent the firm's utility functions—indifference curves reflecting the firm's attitude toward risk and profits\(^2\)—and the dots represent investment alternatives plotted according to net expected values (all positive, for projects with negative net expected values are rejected outright) and the associated standard deviations.

_Ceteris paribus,_ a firm will rank a project with a higher expected return above one with a lower expected return and one with lower risks above one with higher risks. Thus, if the projects before a firm and the firm's utility functions are as plotted in Figure 1, the firm will rank project 6 above project 2 and project 7 above project 3.

But which project will be ranked higher—project 6 or project 7? In this illustration, the utility indifference curves of the firm indicate that the firm will rank project 6

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\(^1\)Projects selected must, however, have positive net present values or internal rates of return greater than the cost of capital.

FIGURE 1. PROJECT SELECTION DECISION IN THEORY.
above project 7 for project 6 is on a higher utility function of the firm than project 7.

The firm will only be "indifferent" or be just as willing to accept either project when both are on the same utility function of the firm. Thus, in the illustration, the firm will be just as willing to accept project 1 as project 5 and just as willing to accept project 2 as project 3. In other words, project 1 and project 5 will have the same ranking and projects 2 and 3 will also have the same ranking.

But suppose indifference curve II is the firm's least acceptable return for risk trade-offs, then in this case, the firm will reject both projects 1 and 5 for although both have positive net present values, the returns associated with them are considered by the firm insufficient to compensate for the risks expected.

**Neo-classical Investment Theory: A Brief Review.**

Neo-classical investment theory assumes that, because of the pressure of competition, the desire to survive as viable entities in a competitive environment and the goal to maximize profits, firms continuously scan domestic and foreign environments for investment opportunities. From this, it
concludes that when firms make investment decisions they
(1) have a number of possible investment propositions, both
foreign and domestic, before them, (2) carefully appraise
these investment alternatives in terms of costs, revenues,
profits and risks, (3) compare the relative returns and risks
from these alternatives, and, (4) decide in favour of the
investment alternatives that look most promising.

Implications of Neo-classical Investment
Theory for Direct Private Foreign
Investment Incentive Programs.

Since neo-classical investment theory postulates
that firms scan the globe for investment opportunities, that
they consider, investigate and evaluate these opportunities,
and, that they select and undertake those opportunities which
appear most promising in terms of returns and risks, the theory
implicitly suggests that it is possible to provide considerable
stimulation to the flow of DPFIs by merely affecting favour­
ably firm's expectations of returns and risks of such invest­
ments. This is because if the returns expected from certain
investment projects are raised and their expected risks are
lowered, these investment projects will appear more promising
and firms, both foreign and domestic, will undertake them.
In short, neo-classical investment theory implicitly suggests
that if a country desires to stimulate DPFIs, it has to devise
incentive programs whereby returns from such investments will be increased and their risks reduced.

This implies that if a country wants to attract DPFIs, it will be able to achieve its objective by

1. reducing or eliminating the tax load of foreign firms and investors either by granting them "tax holidays" or by granting them provisions for accelerated depreciation for plant and equipment and accelerated amortization for expenditures connected with research and development, export promotion, etc.,

2. offering foreign firms and investors tariff exemptions or reductions on imports of raw materials and on plant and machinery,

3. offering them loans at low interest rates,

4. offering them grants and subsidies to meet the cost of machinery and equipment and other fixed assets including that of plant building and that of site development,

5. offering them protection against competition through the erection of tariff walls, introduction of import quotas and restrictions on the number of firms allowed to be set up in the industry to which foreign firms are to be attracted,

and

6. offering them protection against nationalism and political risks through undonditional guarantees that their assets will not be nationalized or in the event of nationalization, they will be fully and fairly compensated,

because by offering foreign firms and investors these incentives

a country affects favourably their expectations of returns and risks of investments located within its borders.

For a country desiring to encourage its citizens to undertake DPFIs, on the other hand, the theory implicitly suggests that it will be able to achieve its objective by offering its own citizens and firms tax reductions or exemptions on their foreign earned incomes, loans with low or no interest rates and other incentives which will increase the returns from foreign projects, and, by offering them protection against risks of foreign operations including the risks of expropriation, nationalization, war and insurrection and non-convertibility of investment earnings.

Summary.

Neo-classical Investment Theory.

Neo-classical investment theory assumes that the basic principles which govern foreign investments are essentially the same as those governing domestic investments because firms undertake investments, whether foreign or domestic, to maximize their profits. It, therefore, regards having separate theories for domestic and foreign investments as unnecessary.
In its pure form, this theory assumes that investment decisions of firms are made under conditions of perfect competition, perfect certainty, constant technology, and no organizational constraints or limitation of financial and other resources and that the investment decision process is a simple process where firms evaluate given investment projects, both foreign and domestic, with the object of selecting and undertaking those projects which will help them to maximize their profits.

Since any project that yields revenues in excess of the cost of the resources employed will increase the profits of the firm, the theory in its pure form implicitly suggest that firms will undertake any investment project, whether foreign or domestic, so long as the benefits associated with the project exceed the resources used.

This theory in its pure form has been severely criticised and some of its basic assumptions have been labelled as unrealistic. But despite these criticisms, it still maintains that it is valid as an explanation of the investment decision process of firms -- that in making investment decisions, firms evaluate given investment alternatives in terms of costs and benefits, weigh these alternatives alongside each other and select those alternatives which will help them to maximize their profits. The only differences admitted are that firms calculate the expected rather than the actual returns and costs (for
actual returns and costs cannot be known ex-ante) associated with the investment alternatives and that they make their decisions on the basis of these expected returns, the riskiness of these alternatives, their risk preferences and their investment budgets.

Implications of Neo-classical Investment Theory.

Since neo-classical investment theory assumes that when firms make investment decisions, they (1) have before them a number of investment propositions, both foreign and domestic, (2) evaluate and compare the relative returns and risks of these propositions, and (3) undertake those propositions which promise high returns and low risks, it implicitly suggests that it is possible to accelerate the flow of DPFIs by merely affecting firms' expectations of returns and risks of such investments and that "the growth of international direct capital flows will necessarily continue so long as opportunities for profitable foreign investment abound."¹ What countries have to do to encourage DPFIs, therefore, is to offer firms incentives such as "tax holidays", accelerated depreciation allowances and loans with low or no interest rates, and protection against competition,

nationalization, war and insurrection, and other political
risks.

**Neo-classical Investment Theory and Evaluating Investment Projects.**

If firms have full knowledge of all investment projects and of all the consequences attached to each project —as is assumed by the neo-classical investment theory in its pure form— the acceptability of an investment project can be measured by determining either the actual net present value (NPV) or the actual internal rate of return (IRR) of the project. Where the NPV of the project is positive or its IRR is greater than the cost of capital, the project adds to the profits of the firm, and, according to neo-classical investment theory will be undertaken.

If firms do not have full knowledge of all the consequences attached to each investment project, NPVs or IRRs of the projects cannot be exactly determined. However, assuming that firms are able to form some expectations of the pattern of the future cash flows and of the risks associated with each project —as is done in neo-classical investment theory in its general form— these NPVs or IRRs of investment projects can be estimated. Methods which can help firms to estimate the NPV or the IRR of a project or a set of projects more accurately include (1) the method of certainty equivalents, (2) the method
of risk adjustment, (3) the use of simulation, and (4) the adjustment of the discount rate.

But NPVs or IRRs in themselves do not indicate the riskiness of investment projects for they do not give any indication of the variability of the expected net cash flows of any of the project; the riskiness of any project can only be determined by calculating either the standard deviation or the semi-deviation of the expected net cash flows.

Neo-classical investment theory assumes that in evaluating a set of risky investment projects, firms calculate the expected returns (measured by the NPV or the IRR) and the riskiness (measured by the standard deviation or the semi-deviation) of the projects before them. And once they have done this, they rank the projects on the basis of the relative importance they attach to maximizing profits versus minimizing risks. And once they have ranked the projects, they select and undertake those projects—beginning with the highest ranking—until their investment budgets are exhausted.

Neo-classical investment theory admits that in this process of evaluation, the foreign projects present special problems and require firms to make certain assumptions regarding some of the major variables. For example, it admits that in evaluating DPPI projects, firms need to make some assumptions regarding (1) future exchange rates and conversion
risks, (2) the reinvestment rate, (3) income tax issues, and (4) financing alternatives, and to "re-interpret" the meaning of the term "project" for unless these additional assumptions are made, firms cannot calculate "accurately" the NPVs or the IRRs and the standard deviations or semi-deviations of the projects.
CHAPTER THREE

ALTERNATIVE HYPOTHESES OF DIRECT PRIVATE FOREIGN INVESTMENTS.

Introduction.

Neo-classical investment theory assumes that firms aim at profit maximization and it asserts that they undertake direct investments abroad because these investments help them to maximize their profits. To some economists, this explanation seems unconvincing because it is based on the assumption that when firms make investment decisions they evaluate a number of investment alternatives simultaneously and make comparisons of them. To others, the theory is unconvincing simply because they believe that profit maximization is not the primary goal of firms. And to a totally different group the theory is unsatisfactory because it does not pin-point the significant variables considered by firms in direct foreign investment decisions.

This disagreement among economists on the validity and usefulness of the neo-classical investment theory as an explanation of the flow of DPFIs has led to a number of alternative explanations or hypotheses, each of which purports to pin-point the immediate or proximate cause for firms to undertake such investments.
Research efforts to verify the validity or non-validity of these hypotheses have relied in the main on interviews, qualitative evidence and check list questionaires¹ and on an analysis of some published data as are available on direct investments by one country either in various countries abroad or in particular industries.² But all these efforts have not produced conclusions of any pragmatic value.³ Inspite of this, these hypotheses are still regarded by many as plausible explanations for the flow of DPFIs or why firms undertake direct investments abroad.

In this chapter, these hypotheses and some of their main assumptions and implications are outlined.


**Higher Profit Rate Abroad Hypothesis.**

The higher profit rate abroad hypothesis, briefly stated, says that firms undertake direct investments in countries other than their own primarily because "they calculate that in doing so they will increase the return on their capital."¹ This hypothesis reasons that firms are in business to make a profit — not necessarily to maximize profits — and if a higher profit rate can be earned abroad that is where the firms' interest will turn.

This hypothesis, therefore, maintains that firms set up marketing facilities abroad because they expect to earn a higher rate of return by employing their resources in this manner than by employing them in other ways and relying on exports, that they invest in manufacturing factories abroad because the returns expected from these investments are higher than those expected from utilizing the resources in expanding home production or in entering a new line of domestic business and that they invest in foreign lands in the extraction of petroleum, tin, gold and bauxite and in the production of rubber, cocoa, coffee and rice because they are motivated by the prospect of earning rates of return above what they will be able to obtain by employing their

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resources in domestic investments.

Like the neo-classical investment theory, this hypothesis assumes that:

1. firms are keen to invest in foreign lands,

2. there are no governmental prohibitions or restrictions, placed either by the firms' own governments or by foreign governments, to firms undertaking direct investments abroad,

3. firms are continuously on the lookout for profitable direct investments abroad,

4. firms possess financial and suitable managerial and technical resources to undertake direct investments overseas,

5. firms are generally prepared to invest financial and managerial resources in the investigation of investment projects located in other countries, and that

6. when firms investigate foreign investment projects, their objective is to find out whether such projects are more profitable than domestic projects and not merely to find profitable projects,

and it seems to suggest that it is possible to influence significantly the size and direction of the flow of DPFIs by merely raising firms' expectations of profit rates from such investments.

The only major difference between this hypothesis and the neo-classical investment theory is that this hypothesis implicitly assumes that when firms make investment decisions, they compare one direct investment project abroad with one direct investment project at home while the neo-classical investment theory assumes that firms compare more than two investment projects at a time.
Lower Costs Abroad Hypothesis.

This hypothesis says that firms undertake direct investments in certain foreign countries because they calculate that in doing so they will reduce their costs of supplying their products either to the foreign local market or the home market or other foreign markets. It probably has its origin in Weber's theory of location, which when reduced to its lowest terms, states that "the entrepreneur selects the plant size which minimizes the sum of all expenditures."¹

Stated differently, this hypothesis claims that firms undertake direct investments abroad either because production costs² are lower abroad than at home or because of one or more of the following reasons:

1. Reduced transport costs.
2. Reduced distribution, inventory and servicing costs.
3. Reduced tariff duties and taxes.
4. The cheapness of unskilled labour.³
5. Abundance of certain natural resources.


²For an interesting discussion on some of the factors that affect costs of production see Robert Theobald, Profit Potential in the Developing Countries, (New York: American Management Association, 1962), pp. 50-69.

Like the higher profit rate abroad hypothesis, this hypothesis too seems to accept most of the assumptions of the neo-classical investment theory for the assumptions that this hypothesis makes probably include the following:

1. Firms are keen and anxious to invest in foreign lands.

2. There are no governmental prohibitions or restrictions, placed either by the firms' own governments or by foreign governments, to firms undertaking direct investments abroad.

3. In the course of their operations and competition with rivals, firms are continuously on the lookout for cost reduction investment opportunities across their national boundaries.

4. Firms possess financial and suitable managerial and technical resources to undertake direct investments overseas.

5. Firms are generally prepared to invest financial and managerial resources in the investigation of investment projects located in other countries.

6. When firms investigate and evaluate foreign investment projects, they are mainly interested to seek projects which will help them to reduce their cost of servicing their present markets or markets whose demand schedules of the products they intend to produce are well known to them. This implies that it assumes that firms have full knowledge of the revenue side of their operations.

7. A firm's ability to compete depends primarily on its ability to cut down costs.

If, as suggested by this hypothesis, cost items are the most significant variables considered by firms in evaluating foreign investment projects, then it is possible, ceteris paribus, for capital-importing countries to attract foreign firms to establish manufacturing factories in them by merely granting them tariff exemptions, grants and subsidies.
of various forms and by helping them to keep wages and other manufacturing costs low.

**Monopolistic Competition Hypothesis.**

The monopolistic competition hypothesis attributes the flow of DPFIs largely to the advantages foreign firms enjoy over domestic firms. According to this hypothesis, a firm that undertakes direct investments overseas does so not only because it expects to earn a higher rate of return by investing abroad than at home but also because it has some advantages over existing or potentially competitive firms in the same line of production in the foreign country and is able to earn more than local firms can. It maintains that this must be the explanation for

... the firm's operation must have higher returns abroad than at home to compensate for risks, higher in foreign operations than in domestic. But it must also have a higher return than local firms in the foreign country to cover the extra costs of operating at a distance from its headquarters, otherwise,

... those firms, operating more cheaply in other respects because they are nearer the locus of decision-making and without the filter of long lines to distort communication would put the intruder out of business.¹

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This hypothesis surmises that the advantages foreign firms which undertake DPFIs have over firms in the host countries arise from one or more of the following sources:

1. Monopolies of knowledge and technology.
2. Superiority of managerial and entrepreneurial talent.
3. Internal economies of scale which the large foreign firms can take advantage of by horizontal integration and possibly charging monopoly prices.
4. External economies of scale which the foreign firms with their worldwide credit standing can take advantage of by vertical integration.
5. Imperfectly competitive markets for goods, owing to product differentiation, special marketing skills, retail price maintenance and administered prices.
6. Imperfectly competitive markets for factors, including in addition to technology and entrepreneurship, access to a larger volume of credit and at lower rates of interest.
7. Government interference in goods and factor markets for national, economic, political or racial purposes.

And if the industry is new to the country, the foreign firms which are already in the industry may have an advantage over local entrepreneurs who are just attempting to enter into it simply because the marginal cost of extending operations is substantially lower than what an entrepreneur has to incur in terms of research expenditures, costly experimentation and

1 These advantages of foreign firms and their implications for a theory of DPFIs are more elaborately discussed by Kindleberger in American Business Abroad, pp. 12-27.
advertising when he first ventures into a new industry and sets up a new plant.¹

But what induces firms enjoying certain "monopolistic advantages" to investigate the possibility of undertaking direct investment projects in certain countries abroad? Do these firms systematically scan the globe for investment opportunities which they can exploit? The hypothesis is silent on these points. It seems to take for granted that foreign investment alternatives or projects are given to these firms or to assume that if firms have some hunches that they enjoy some "monopolistic advantages" over local firms in certain countries and that they may be able to earn higher returns there than at home and higher returns than local firms can, these firms will immediately undertake investigations of investment projects located there. This suggests that the hypothesis implicitly assumes that:

1. firms are keen to undertake direct investments abroad,

2. firms scan foreign and domestic environments for investment opportunities,

3. firms are generally prepared to invest financial and managerial resources in the investigation of direct foreign investment projects,

4. firms with "monopolistic advantages" over local firms do not face organizational or other constraints in undertaking direct investments abroad,

and that

5. only "rates of return" are vital in investment analyses and decisions.
If this hypothesis fully explains the cause of the flow of DPFIs and if firms with "monopolistic advantages" continuously (1) scan foreign and domestic environments for investment opportunities, (2) weigh potential projects located in foreign countries against similar potential projects located at home, (3) make calculations of costs and revenues to see whether profit rates are higher for foreign projects than for domestic ones, and (4) calculate to see whether local investors will be able to earn more than them if they too decide to undertake similar projects, then the most effective way for a country to attract foreign investments is by increasing or protecting the "monopolistic advantages" enjoyed by foreign firms and investors and the most effective way for a country to encourage its citizens and firms to undertake direct investments abroad is by creating "monopolistic advantages" for them and allowing them to exploit these advantages abroad.

Growth of the Firm Hypothesis.

According to the growth of the firm hypothesis, a successful firm grows (and expands) and as it does, "its expansion itself tends to create opportunities for further expansion --opportunities that did not exist before the expansion was undertaken,"¹ for with the completion of

its expansion plan, unused services largely in the form of managerial services become available for further production at no extra cost to the firm.¹ This drives it to further growth and expansion. In growing, the firm may well go abroad.²

A slight variation of this hypothesis connects the drive to further growth and expansion of a successful firm not with the release of unused managerial and other services but with the "apparently ceaseless flow of surplus income"³ and its ever-increasing pool of retained earnings; the pool of retained earnings grows because when a firm makes exceptional profits it does not distribute them all out as dividends.⁴ Because of this growth of surplus cash flows, the firm desires to find rewarding outlets⁵ and to grow and expand.

¹Ibid., p. 536
²Kindleberger, American Business Abroad, p. 536
⁴Firms normally do not distribute all profits as dividends because they fear that extra dividends may lead stockholders to expect more and because ploughed-back earnings can help stockholders to escape the personal income tax and can be cashed in, if need be, at the lower rate on capital gains. See Kindleberger, American Business Abroad, p. 10
⁵Christopher Layton in Trans-Atlantic Investments, (Boulogne-Sur-Seine, France: The Atlantic Institute, 24 Quai du-4 Septembre), p. 24, attributes United States direct investments in Europe in the late fifties largely to "the desire simply to find a rewarding outlet for the large cash flow companies have enjoyed during the long American boom."
What makes a firm grow and expand abroad rather than at home, however, is not made explicit in this hypothesis —although Penrose seems to suggest that differentials in expected profit rates are the basis\(^1\)— for what the advocates of this hypothesis is particularly concerned is to explain that a pre-disposition to grow —either at home or abroad— is inherent in the very nature of firms.

Since this hypothesis does not make explicit what makes growing firms consider foreign investment projects, it can only be inferred that this hypothesis too takes for granted that foreign investment alternatives are given to firms or that it is in the nature of firms to look for investment opportunities in foreign lands. This suggests that it also accepts many of the assumptions made by the neo-classical investment theory. For example, it seems to accept the neo-classical assumptions that firms (at least growing firms) are keen to invest in foreign lands, that they are normally prepared to invest time and money in the investigation of foreign investment projects, and that they are free to undertake direct investments abroad if they so decide. The only neo-classical assumption that this hypothesis seems to reject is the assumption that firms possess financial and managerial resources to undertake direct investments.

overseas. It points out that only growing firms possess these resources.

If, as suggested by this hypothesis, only growing firms consider, investigate, evaluate and undertake direct investment abroad, then countries will only be able to stimulate growing firms to undertake such investments. This implies that they should direct their incentive programs mainly to such firms.

Marketing Considerations Hypothesis.

The marketing considerations hypothesis maintains that the main reason subsidiary plants have been set up in foreign countries in great numbers arises from the need to sustain marketing efforts to obtain increased business.¹ It maintains that foreign subsidiaries are established either to help market the companies' products more effectively or to help gear their products to the needs and requirements of the foreign local market.²


² Sanford Rose in "The Rewarding Strategies of Multinationalism," (in Fortune, September 15, 1966, p. 104), notes that "there is some evidence that companies are excessively concerned with adapting products to specific markets."
According to this hypothesis, companies usually begin business operations abroad by exporting directly to local wholesalers or agents; companies adopt this as a first step toward foreign investments because they realize that foreign operations are intricate and risky. But after a time, these companies may find that their penetration of the foreign market has gone far enough to require expenditure on local stockholding and sales and promotional activities and that they have understood some of the complexities of foreign operations. At this stage, the companies set up selling subsidiaries abroad so as to ensure that "the volume of sales is maximized, that standards of the companies are maintained and that adequate after sales service and maintenance is available."¹ And as they become established, they may realize that the foreign country has certain peculiarities in consumer preferences, in engineering standards, legal codes and other technical requirements and that they will be able to increase their volume of sales if they undertake local production and redesign their products to suit local requirements. At this stage, they set up foreign subsidiaries so as to achieve a more flexible response to the changing demands of the foreign local market.

This hypothesis assumes that firms undertake direct foreign investments only to serve their markets which they

¹Robert Theobald, op. cit., p. 26
have established through exports and that firms without large foreign markets do not consider such investments. It also seems to assume that firms with large export markets are constantly analyzing their markets for advantages of undertaking marketing, assembly or manufacturing operations there.

If firms normally begin foreign operations with direct exports and undertake direct investments abroad only in stages, then the most effective way for countries to get foreign firms to set up manufacturing factories within their borders is to encourage them first to become exporters, and, once they have built up their export markets, to encourage the local citizenry to demand certain changes in the design or technical characteristics of the exporters' products.

**Market Size Hypothesis.**

Economists who look at the geographical distribution of DPFIs seem to think that such investments are undertaken largely because of the size of the market. According to this hypothesis, firms undertake direct investments overseas primarily because the overall size of the foreign country's market\(^1\)--both current and potential--is large. The "great

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\(^1\)The overall total size of a country's market is generally thought to be some function of the population size of the country, its Gross National Product and its rate of growth of Income. See Robert Theobald, *op. cit.*, pp. 53-60 for a fuller discussion on the size of a country's market.
international expansion of industry since World War Two has been in pursuit of markets --populations with purchasing power,"¹ they claim.

The logic of this hypothesis runs as follows. A large market enables firms to install special purpose equipment, take advantage of bulk purchases, spread overhead and other fixed costs over a larger number of units of output, and to economize on the use of transport. It enables firms to introduce technology meant for mass production, to enjoy economies of scale and to reduce their unit manufacturing costs. Therefore, as soon as the size of a country's market is large enough or appears to be growing to a size large enough to permit the capturing of economies of scale, firms will rush into the country to establish manufacturing plants.²

This hypothesis assumes that: (1) firms are keen and anxious to undertake direct foreign investments and are constantly on the look-out for foreign investment opportunities, (2) firms are prepared to invest time and money in the investigation of foreign investment opportunities, (3) firms have some way to discover that a country's market has grown in

²Anthony E. Scaperlanda and Lawrence J. Mauer, op. cit., p. 560
size, (4) firms are more concerned with the size of the foreign country's market as a whole rather than their own market size as participants in the market, (5) firms undertake direct investments in certain foreign countries to produce goods largely for these countries,\(^1\) and, (6) firms do not face organizational or other obstacles to undertaking direct investments abroad.

**Maintenance of Market Hypothesis.**

The maintenance of market hypothesis asserts that companies undertake assembly or manufacturing operations in a foreign country primarily because they want to hold on to or maintain a market within that country that they had already established through exports from the home base.\(^2\)

Like the marketing considerations hypothesis, this hypothesis assumes that companies first enter foreign countries with their products through exports. But unlike the marketing considerations hypothesis, this hypothesis does not assume that companies which have entered foreign markets through exports are anxious to substitute foreign subsidiaries for

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\(^1\) The whole set of countries which make up a common market may be thought of as one country.

exports. In fact, this hypothesis takes the line that so long as the companies find that they can continue to serve their foreign markets through exports, they will continue to serve these markets that way and not launch direct investment operations there; it is only when these companies are threatened with the loss of their export markets either because of tariff duties, quotas or exchange controls imposed by the governments of the host countries or because of strong competition from local manufacturers or because of some inadequacies of their foreign distributors that they begin to investigate the possibilities of undertaking direct investments there.

This hypothesis seems to assume that generally firms are unwilling to undertake direct investments overseas, that only firms which have developed export markets undertake direct investments abroad, that when firms undertake direct investments abroad, they produce goods only for the local foreign markets, and that when firms find that their export markets are being threatened, they will probably undertake direct investments in these markets. It seems to suggest that the most effective way for countries to attract foreign firms to establish subsidiaries and branches within their borders is first to attract them as exporters and once these exporters have got themselves established, to threaten them with the loss of their export markets.
Product Cycle Hypothesis.

The product cycle hypothesis puts emphasis on the technical characteristics of products as a determinant of the flow of DPEIs and links the flow of such investments to the product cycle thesis. This hypothesis tries to explain not only why firms undertake direct foreign investments but also why a substantial part of direct foreign investments since World War Two has been undertaken by U. S. firms.

In brief this hypothesis states that new products, particularly those associated with high income and labour saving, are likely to be first introduced in the United States. These products when they are first introduced are not "matured" and the technical characteristics of the products make them unsuitable for production overseas. They are, therefore, produced domestically and sold in the home market as well as abroad. But as the export markets for these products expand and as the products and their production processes become "standardized" certain forces set in to push the producers to locate their production plants abroad.

Raymond Vernon\(^1\) explains why United States producers rather than producers in other countries are likely to be the

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first to introduce new products associated with high income or labour saving in the following way. First, "the United States market consists of consumers with an average income which is higher ... than in any other national market."\(^1\) Second, the market is "characterized by high unit labour costs and relatively unrationed capital compared with practically all other markets."\(^2\) These two characteristics of the United States market make it a place where new products associated with high income and labour saving are likely to be first introduced. The United States producers rather than producers in other countries are likely to be the first to spy and avail themselves of the opportunity of introducing such new products because an "entrepreneur's consciousness of and responsiveness to opportunity are a function of communication ... and ... that ease of communication is a function of geographical proximity."\(^3\)

This hypothesis asserts that the first producing facilities for new products will be located in the United States because in the early stages of a product's life:

1. the design of the product is often in a constant state of flux and there is a real advantage for manufacturers to be close to the market for their product; they can rapidly translate demands for

\(^1\)Ibid., p. 192
\(^2\)Ibid., p. 192
\(^3\)Ibid., p. 192
design changes into more suitable products.\textsuperscript{1}

2. the production processes are unstable. This demands the manufacturers to keep their investments on fixed assets and fixed overheads down as far as possible by making use of outside services of sub-contractors, specialized suppliers, engineers and scientists.\textsuperscript{2} These services are more readily available in the United States than elsewhere.

3. cost differences are unimportant. Cost differences are unimportant because the price elasticity of demand for the output of individual firms is comparatively low\textsuperscript{3} and because entry into the market is limited by know-how.\textsuperscript{4}

Hence, this hypothesis argues that such new products will first be produced in the United States and be exported.

But in time a number of changes occurs that pushes the manufacturers to undertake production of the product abroad. First, "the product becomes sufficiently standardized for price competition, hence cost considerations, to begin to play a significant role in locational decisions."\textsuperscript{5} Second, "the demand in some non-United States markets grows sufficiently large to support a local production facility that can exploit


\textsuperscript{3}Raymond Vernon, op. cit., p. 195

\textsuperscript{4}See Hirsch, op. cit., p. 19

\textsuperscript{5}Raymond Vernon, manager in the international economy, (Englewood Cliff; New Jersey: Prentice-Hall Inc., 1968), p. 81
the existing scale economies.\textsuperscript{1} Third, the United States manufacturers face a stagnant demand and falling prices in the home market partly because of the entry of new competitors -- patents on their products may have expired -- and partly because the demand for their products has reached a "peaked-plateau". Fourth, potential foreign producers now have a market close at hand and their costs may be lower than those of the United States manufacturers.\textsuperscript{2} All these forces may make the United States manufacturers realize that if they do not start producing overseas some others will. Those who realize this undertake direct investments abroad.

Thus, like the market considerations and the maintenance of market hypotheses, this hypothesis assumes that firms undertake direct operations abroad in stages -- beginning with direct exports and finally ending up with establishing subsidiaries and branches in the export markets, and, like them, it seems to assume that only firms with developed export markets undertake direct investments abroad and that when firms undertake direct investments abroad, they produce goods only for their export markets.

This hypothesis therefore suggests that countries which desire to encourage foreign firms to establish subsidiaries

\textsuperscript{1}Ibid., p. 80

\textsuperscript{2}Louis T. Wells, Jr., op. cit., p. 3
or branches within their borders should first attract them as exporters and help them to build up their export markets. It also suggests that countries will only be able to attract firms producing "standardized" products to undertake direct investments abroad.

Other Hypotheses.

There is a formidable number of hypotheses on why firms undertake direct investment projects located in countries other than their own and it is not possible to discuss all of them in this study. The following are some of the hypotheses left undiscussed:

1. Firms undertake direct investments abroad because direct investments abroad make it possible for them to exercise influence over the price developments of raw materials with a view to stabilization of prices.¹

2. Firms undertake direct investments abroad because they want to ensure a continuous supply of raw materials which are not produced at home or occur only in insufficient quantities.²


²Ibid., p. 30
3. Firms undertake direct investments abroad because of vertical integration. They desire to undertake the whole range of operations from the production of the raw materials they use to the final sale of their manufactured goods.¹

4. Firms undertake direct investments abroad because of their desire to diversify geographically. Geographical diversification ensures that political upheavals in any one country and failure of any one particular enterprise do not affect firms critically.

5. Investors undertake direct investments in certain countries because they have a kindred ancestry, similar language and mutual traditions with the people there.²

Implicit in all these hypotheses is the assumption that there are opportunities for profits in direct foreign investments for it is illogical to infer that the hypotheses will assume that firms undertake direct investments, whether foreign or domestic, to incur losses. Implicit in most of these hypotheses is also the assumption that firms make cross comparisons of projects located in different countries to determine which project or set of projects they should under-


But what prompt firms to consider direct investment projects abroad? What prompt them to consider potential investment projects located in certain countries but not in others? And what prompt them to make cross country comparisons of projects? Most of the hypotheses are silent on these points. This is probably because most of them accept the neo-classical assumption that firms are keen to invest abroad and are systematically scanning the world for areas to make an investment.

Summary.

The Alternative Hypotheses.

Disagreements over the validity and usefulness of the neo-classical investment theory as an explanation of why firms undertake direct investments abroad and of how firms make direct foreign investment decisions have led to a formidable number of alternative explanations or hypotheses, each of which purports to pin-point the immediate or proximate reason for firms to undertake direct investments overseas.

Some of the main hypotheses generally offered to explain why firms undertake direct investments in foreign
lands are:

1. The Higher Profit Rate Abroad Hypothesis. This states that firms undertake direct investments abroad because they are able to earn a higher rate of profit abroad than at home.

2. The Lower Costs Abroad Hypothesis. This states that firms undertake direct investments abroad because such investments enable them to reduce their costs of supplying goods to their present markets or some markets known to them.

3. The Monopolistic Competition Hypothesis. This states that firms undertake direct investments abroad because they enjoy some "monopolistic advantages" over foreign firms and want to capitalize on their advantages.

4. The Growth of the Firm Hypothesis. This states that firms grow (and expand) and as they do so, they release unused managerial and financial resources. These lead to further growth and expansion - both at home and abroad.

5. The Marketing Considerations Hypothesis. This states that firms undertake direct foreign investments because they desire to market their products more efficiently and to serve the special needs of the local foreign markets.

6. The Market Size Hypothesis. This states that it is the size of the foreign country's market that attracts foreign firms to undertake direct operations there.

7. The Maintenance of Market Hypothesis. This states that firms undertake direct investments abroad because of their desire to hold onto foreign markets which they have built up through exports.

8. The Product Cycle Hypothesis. This states that each manufactured product has a life cycle of its own. In the early stages of a manufactured product's life cycle, the product and its production processes are not "standardized" and some factors militate against producing the product abroad but as the product and its production processes become "standardized" a number of forces push the producers to undertake production of the product abroad.

9. The Raw Material Supplies Hypothesis. This states that firms undertake direct investments abroad
because of their desire to ensure a continuous supply of their raw material requirements.

and 10. The Diversification of Risks Hypothesis. This states that firms undertake direct investments abroad because they want to diversify their investments geographically. Geographical diversification reduces risks.

Their Assumptions.

Each hypothesis of DPPs implicitly or explicitly makes a number of assumptions, most of which seems to be similar to those made by the neo-classical investment theory. It is, however, difficult—probably impossible—to spell out all the assumptions of each of these hypotheses because some of these hypotheses have a number of variations and, therefore, a number of different sets of assumptions.

There is, however, one assumption that is made by all the hypotheses and all of their variations. This is the assumption that for firms to undertake direct investments abroad there must be an opportunity for the firms undertaking such investments either to make profits or to prevent the loss of potential profits.

But what directs the attention of firms to the opportunity abroad to make profits or to prevent the loss of potential profits is not made clear in most of these hypotheses. This is probably because most of them assume that firms are
keen to invest in foreign lands and are continuously on the look-out for investment opportunities abroad. Most of them also seem to assume that:

1. there are no governmental prohibitions or restrictions to firms undertaking direct investments abroad,

2. firms possess financial and suitable managerial and technical resources to undertake direct investments abroad,

3. firms are generally prepared to invest financial and managerial resources in the investigation of direct foreign investment projects and that

4. firms make cross comparisons of projects located in different countries to determine which of the projects or sets of projects they should undertake.

It should, however, be noted that each hypothesis has one or two assumptions characteristic only to itself. For example, with the lower cost hypothesis, the special assumption made is that a firm's ability to compete internationally depends primarily on its ability to cut down costs while with the maintenance of market hypothesis, the special assumption made is that firms are not willing to invest in their export markets unless they are threatened with the loss of these markets.

Their Implications.

Each hypothesis of DPPIs has certain implications for direct foreign investment incentive programs. For example, with the lower cost abroad hypothesis, the main implication is
that cost items are the most important variables considered by firms in direct foreign investment decisions and countries desiring to attract foreign firms should help them to keep wages and other manufacturing costs low, while with the product cycle hypothesis the main implication is that countries should direct their incentive programs to firms producing "standardized" products.

However, partly because all the hypotheses implicitly assume that for firms to undertake direct investments abroad there must be some opportunities for profits and partly because most of them do not make explicit what prompts firms to consider direct investments abroad, the general impression these hypotheses collectively seem to create is that it is possible to encourage the flow of DPFIs by increasing the returns from such investments.
CHAPTER FOUR

RECOGNITION AND CONSIDERATION OF DIRECT PRIVATE FOREIGN INVESTMENT ALTERNATIVES: CONSTRAINTS, HIDDEN RESISTANCES AND INERTIAS.

Introduction.

Neo-classical investment theory and most hypotheses of DPFIs assume that when companies make investment decisions they have a large number of possible investment propositions, both domestic and foreign, before them. The companies then carefully appraise each of these possibilities in terms of some criteria and decide in favour of the investment that looks most promising. This implies that the theory and most of the hypotheses also implicitly assumes that companies are anxious to invest abroad, that they are continuously scanning domestic and foreign environments for investment opportunities, and that they are prepared to invest time and money in the investigation of foreign investment projects.

In this chapter, the assumption that companies normally scan the globe for investment alternatives is re-examined in the light of some reported investigations of the direct foreign investment decisions of some companies.
This chapter begins by outlining four aspects of the investment decision process from the initial recognition to the acceptance of an investment project or projects. It then goes to point out that neo-classical investment theory and most hypotheses of DPFIs seem to take for granted the first aspect of the decision process—the recognition or generation of potential investment projects—because they assume that firms normally search for investment opportunities across their borders. Once this is done, it brings together the results of some studies made by other scholars and argues that companies probably do not normally scan the globe for investment opportunities and that investment alternatives cannot be taken as given. The chapter concludes with some explanations as to why companies probably do not normally consider, investigate and evaluate foreign investment projects.

Recognition and Consideration of Direct Private Foreign Investment Alternatives.


A descriptive model of an investment decision from the initial recognition to the acceptance of an investment project or projects should show that there are at least four aspects to the process:

1. Recognition or generation of a potential investment project or projects.
2. Collection of information on and preliminary investigation of the project or projects.

3. Comprehensive evaluation of the "potentially acceptable" project or projects.¹

4. Final decision on whether to accept or reject the "potentially acceptable" project or projects.

These four aspects are similar to those recognized by Williams and Scott, and also Quirin and to those suggested by Aharoni's discussion of the foreign investment decision process.²

Although these four aspects suggest a serial process—and to some degree they are—they cannot be said to be successive and ordered steps for "investigation and evaluation are often not preliminary to the decision but fused with it."³ Figure 2 attempts to depict these four aspects.

The first aspect (and also the first step in an investment decision process), recognition or generation of a potential investment project or a set of projects, has to do with how and when ideas for investment are germinated or generated. It has to do with activities and conditions which cause firms to search for or to recognize an investment project as "potentially acceptable" to a firm if after the preliminary investigation, the firm is prepared to evaluate it in detail.

¹ A project is defined as "potentially acceptable" to a firm if after the preliminary investigation, the firm is prepared to evaluate it in detail.


³ Bruce R. Williams & W. P. Scott, op. cit., p. 18
The dashed lines and arrows indicate the possibilities of "recycling" from a "later" stage to the repetition of an earlier one, caused by the lack of information at the earlier stage or changed circumstances at the later stage.

Recognition or generation of a potential investment project or projects.

Collection of information on and preliminary investigation of a potential investment project or projects.

Comprehensive evaluation of a "potentially acceptable" investment project or projects.

Final decision and choice of investment projects.

FIGURE II. ASPECTS OF AN INVESTMENT DECISION MAKING PROCESS.

project or a set of projects which they are prepared to investigate and evaluate and to which they are prepared to commit their managerial and financial resources.¹ With respect to DPFIs, this aspect of the investment decision process has to do with activities and conditions which lead firms to search or to recognize investment projects located outside their boundaries.

The second aspect, collection of information and preliminary investigation, has to do with the collection of as much "free" or "low cost" pertinent information as possible and the preparation of rough estimates of outlays, revenues and operating costs of the project or projects. The object of this preliminary investigation is to derive a preliminary estimation of the internal rate of rates of return or some other measures of desirability and to determine whether more detailed and comprehensive analysis and evaluation of the project or projects are warranted.

Generally, if a preliminary investigation shows that a project or a set of projects appears promising in terms of the firm's goals and in the light of the various constraints² faced by the firm, a comprehensive evaluation of the project

¹For a discussion on project recognition and generation see G. David Quirin, op. cit., pp. 16-19.

²These constraints include among others, financial and managerial resources.
or projects is made. This aspect of the investment decision-making process involves making detailed investigation of revenue, capital costs, operating costs, sources of funds and so on and these estimates of the projects' benefits and costs are converted into measures of desirability.¹

The fourth aspect, final decision, is a simple process of either accepting or rejecting a particular project or of selecting, in terms of the firm's goals and in the light of its constraints, the most desirable investment projects from a set of projects. Under the neo-classical investment theory, this means selecting the most profitable investment projects.

As the first step in an investment decision-making process is the recognition or generation of investment alternatives, the first step in a DPFI decision-making process must be the recognition or generation of DPFI projects or alternatives. And the first prerequisite to a DPFI must, therefore, be general willingness on the part of firms to consider direct foreign investment alternatives.²


²Peter P. Gabriel, The International Transfer of Corporate Skills: Management Contracts in Less Developed Countries, (Boston: Harvard University, Graduate School of Business, Division of Research, 1967), p. 79.
Direct Private Foreign Investment Theories and the Recognition and Consideration of Investment Alternatives.

The pure neo-classical theory of investment assumes that investment decisions are made under conditions of perfect certainty and that investors are fully aware of all available investment alternatives — both domestic and foreign. It assumes that firms have accurate information on the costs to be incurred and the returns to be received from alternatives and that decisions are made on the basis of this information.¹

When it is recognized that investment decisions are made under conditions of uncertainty, neo-classical investment theory only recognizes the uncertainty of income flows and continues to take for granted that investment alternatives, including direct foreign investment alternatives, are given to firms. The implicit assumption is that because firms aim at profit maximization, they will "systematically search the world for the most profitable investment opportunities"² and that they will continuously adjust their portfolio of investments to changes in the pattern of alternatives available.³

³R. M. Cyert, et. al., op. cit., p. 309
Most alternative hypotheses of direct private foreign investments—alternative to the neo-classical investment theory—also either take for granted that investment alternatives are known to firms or implicitly assume that firms systematically search the globe for areas to make an investment. The higher profit rate abroad, the lower costs abroad and the monopolistic competition hypotheses, for example, all implicitly assume that because the primary goal of firms is to make profits, profits are a powerful propelling force to drive firms to look across their national boundaries for investment opportunities.

Only a few of the alternative hypotheses of DPFIs recognizes that investment alternatives are not given to firms, that normally firms do not search and consider direct foreign investment projects and that only when certain stimulants or initiating forces are brought to bear on firms, will they consider the possibilities of investing abroad. In the case of the maintenance of market hypothesis, for example, the initiating forces recognized include all those forces which threaten to cut off or reduce substantially a firm's export sales whereas in the case of the product cycle hypothesis, the initiating forces recognized include stagnating demand and falling prices in the home market, the entry of new competitors and the threat of competition in the foreign market.

Investment alternatives can be taken as given or for granted if investment decision makers have perfect knowledge
of all investment alternatives—both domestic and foreign—and of all the consequences attached to each. But once imperfect knowledge about the future is admitted and once perception and cognition intervene between the investment decision makers and their objective environments, investment alternatives cannot be taken as given. They must be sought and the consequences which will follow on each alternative will have to be determined. ¹

**Empirical Evidence.**

A number of economists ² who examine the investment decisions of companies find that most companies do not normally look across their national boundaries for profitable investment opportunities and that in only a few cases are direct private investments overseas the result of aggressive economic motives and careful analysis of potential gains from alternative employment of capital.

Barlow and Wender, for example, in their comprehensive survey of the foreign investment decisions of some U. S.

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² These include E. R. Barlow, Ira T. Wender, Yair Aharoni, Peter S. Gabriel, and Judd Polk.
companies find that:

... most companies who are not foreign investors have never given serious thought to investing in foreign countries.

... a company typically does not consider various areas of the world in which investment may (might) take place, find an opportunity for a particular product in a country and make an investment.

... it is a comparatively rare situation for a company to invest in a foreign country solely as a result of an appraisal indicating that excellent profits can be obtained,

and that

... in the majority of cases ... the shift from export to local marketing or assembly or manufacture is not the result of smooth natural transition. Usually something happens that makes it necessary for management to decide whether it is willing to manufacture or assemble locally in order to hold onto a foreign market.

Stobaugh Jr., in his studies also comes to a similar conclusion for he observes that "most companies do not make use of a large scale rational screening process to identify foreign investment opportunities. He explains the phenomena in the following way:

1E. R. Barlow and Ira T. Wender, op. cit., p. 193
2Ibid., p. 158
3Ibid., p. 158
4Ibid., p. 147
... most companies interested in foreign expansion make so many different products, and there are so many countries, that searching for a good investment opportunity represents a major effort. As a result, decisions on investments often are made in reaction to circumstances of the moment rather than as a result of a careful search for the best opportunity.1

And Aharoni who looked at the direct foreign investment decisions of companies contemporaneously too observes that most companies are only concerned with domestic investments and that they "simply do not in practice consider investing abroad."2 According to him, for most companies, "the possibility of foreign investment is not considered because it is never conceived of as a possibility worth any time and effort."3

The evidence, therefore, seems to be in support of the hypothesis that companies are generally not anxious to undertake direct investments abroad, that most companies do not normally consider and investigate direct investment projects overseas to the point of learning the economics of the situation and whether or not it will be possible to make large profits, that

... most decisions to invest abroad are precipitated by factors which are beyond company control but which make it impractical for the company to serve foreign markets only through exports.4

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1Ibid., p. 135
2Yair Aharoni, op. cit., p. 50
3Ibid., p. 53
4Judd Polk, et. al., op. cit., p. 43
and that for most companies undertaking direct investments overseas,

... their investment decisions are made in response to competitive necessities that affect the entire earning position of their operations abroad rather than as a result of the search for the best opportunity.¹

Constraints, Hidden Resistances and Inertias.

It is not difficult to find some explanations as to why most firms are not interested in foreign investments and why most of them do not normally consider direct foreign investment projects to the point of evaluating them. The explanations can probably be found in:

1. Organization traditions and attitudes.
2. Psychological obstacles or generally held beliefs.
3. Limitation of company resources.
4. Departmental structures.
5. Multiplicity of environments and complexities of investing abroad.
6. Information and investigation costs.

Organization Traditions and Attitudes.

Each firm at any moment in its history has a series of attitudes which may roughly be defined as policy or

¹Ibid., p. 42
strategy. These attitudes include views on the sort of business in which the firm ought to participate, the types of products it will produce, the market and market segments for which products are now or will be designed, the extent to which it will diversify or concentrate on its activities, the rate it should grow, the standard of performance it should seek and so on.

With age, each firm has its own accepted ways of doing things and handling problems and members of the firm accept these as a way of life —perhaps the only way of life.

The "accepted ways of doing things and handling problems", and these attitudes and traditions must have a strong and powerful influence over the character, the goals and the opportunities of the firm and over the recognition and consideration of investment alternatives.

Firms which find their present policies and practices suitable in the sense that their goals are achieved by following these policies and adopting these practices must be very unwilling to change these tried and established ways of doing things for "there is a certain safety in doing the

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1Richard D. Robinson (in International Management, (New York: Holt, Rinehart and Winston, 1967), p. 6), defines a strategy as "a policy choice that, once being made tends to be institutionalized and thereby resist change in the short run."
job the established way." This view is clearly brought out by Hoopes who maintains that:

... the mature organization has usually developed a strong momentum of its own in certain directions, propelled by basic convictions and policies that have become ingrained, particularly where the organization has been successful. Such an organization is less able to look freshly at each day's experience, for it has become habituated to approaching its problems through an elaborate body of precedents and rules that are heresy to challenge.2

This suggests that firms whose past exposure to direct foreign investment experience is limited3—and most firms fall into this category—and who do not face any serious problems in exporting their products are not likely to follow a policy of considering foreign investment opportunities side by side with domestic projects. In fact, as some economists have found, they may even refuse to make a preliminary analysis or investigation of foreign investment projects when such project proposals are brought to them in general terms simply because direct foreign investments are "outside their line of business" or because these projects will "disturb the

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3 Peter S. Gabriel believes that a company's willingness to consider a foreign investment project tends to be a function of its previous exposure to foreign experience. See Gabriel, International Transfer of Corporate Skills, p. 79
balance of the firm."¹ Hence, most firms do not normally consider direct foreign investment projects partly because their traditions and attitudes militate against such investments.

Psychological Obstacles or Generally Held Beliefs.

A second explanation as to why companies do not normally consider investing abroad can perhaps be found in the beliefs generally held by companies and their executives: for if they believe that direct foreign investments are not in their interest they are not likely to consider such investments whereas if they believe that foreign investments are in their interests they will consider such investments.

According to Robert Theobald, "few companies have adopted the belief that investment abroad is necessary for continued profit in the company."² This therefore partly explains why companies do not normally look across their national boundaries for investment opportunities.


²Robert Theobald, op. cit., p. 19
A more satisfactory explanation, however, must be sought in the interests, beliefs and attitudes of company executives. According to Barlow and Wender, executives in companies unfavourably inclined toward direct foreign investments—and most companies by their reluctance to consider direct investments abroad implicitly show that they belong to this category of companies—are not interested in foreign opportunities or operations and they have not gathered specific information about foreign markets. As a result of their lack of interest in and knowledge of foreign markets and operations, these executives have a tendency to exaggerate the risks and problems of foreign operations and they are likely to have some deep seated inhibitions as regards investments in unfamiliar areas. They... are pessimistic about the future opportunities in foreign countries... have the general attitude that all foreign investment is inadvisable because of the instability of foreign countries, the prospect of another war, or the general attitude of foreign governments... feel that there is no opportunity to get profits out of foreign countries because of exchange restrictions.

Their attitude toward and their beliefs as regards foreign investments lead the executives to see all kinds of

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1 E. R. Barlow and Ira T. Wender, op. cit., p. 194

2 Bryson thinks that this is the most serious obstacle to direct foreign investments. See George D. Bryson, Profits from Abroad, (New York: McGraw-Hill Book Co., 1964), p.5

3 E. R. Barlow and Ira T. Wender, op. cit., p. 195
obstacles in investing abroad. These psychological obstacles—obstacles which exist in the minds of company executives and which operate independently of the merits of specific foreign investment proposals—affect direct foreign investments typically by preventing firms from making intensive investigation of foreign projects. ¹

Limitation of Company Resources.

A company planning to invest abroad will have to have a stock of resources, not simply financial capital but also resources of managerial and technical skills for unless a company possesses these, it will not be able to invest at home, let alone abroad.

Foreign operations, however, call for more resources than domestic operations because "a longer time dimension is required for success in international business than in purely domestic because of the growth factor and associated restrictions on monetary movement."² They also call for different kinds of resources partly because "determining the feasibility of a foreign venture requires individuals with

¹Ibid., p. 200. See also Gabriel, International Transfer of Corporate Skills., pp. 16-20

²Robinson, International Management, p. 7
an international mentality,"¹ and partly because "management of overseas operations requires individuals who are technically competent, familiar with a company's methods and able to command the trust of senior executives,"² and have a training in foreign languages and in marketing.³

While financial resources may not be a serious problem with many companies, finding people in the company who have the necessary qualifications, experience and skills to evaluate and manage a direct foreign investment operation can be a real and grave problem for most companies. This is

¹According to F. T. Haner ("Determining the Feasibility of Foreign Venture," in Business Horizons, Vol 9, No. 3, (Fall 1966), p. 39), the individual with an international mentality has the following typical characteristics. "He adapts to new surroundings and retains self-control. Determination and resourcefulness seem natural. Somehow, he stays healthy and spends much less time on his back in a hotel room. He adapts to uncomfortable situations and immediately begins to look for solutions to problems as they arise. He does not always enjoy local food but does not offend by making a major issue of his eating habits. The ugliness of poverty is as disagreeable to him as to others but does not affect his evaluation of the potential of the project or the stature of local people."


³According to Peter P. Vogel ("Round 2 in International Business," in Business Horizons, Vol. XI, No. 4, (August 1968), pp. 57-62), during the initial period of the entry of the United States into the world market, many corporations gave maximum importance to knowledge of languages and men were sent abroad because of their knowledge of languages. After 1960, however, the emphasis was on men with great experience in marketing. He found that both categories of men were inadequately prepared. He suggested that they should be given training both in languages and in marketing.
because most companies have not undertaken direct foreign investments and are, therefore, not likely to possess personnel who are conversant with direct foreign investment project evaluation and management. Most companies are, therefore, likely to be prone against considering foreign investment opportunities—simply because they do not possess the resources to undertake such operations.

**Departmental Structures.**

Another reason why most companies normally consider and evaluate only domestic rather than foreign projects can probably be found in the way most companies are departmentally structured.

Generally, the structure of companies—except that of the few internationally oriented companies—is designed with the needs of the domestic environment in mind.¹ This means that most companies do not have an international business department which handles both exports and foreign investments. Rather, their exports are likely to be handled by their sales departments and their foreign investments, if any, by their investment departments. Such a structure is likely to act as a check to the consideration of direct

foreign investment projects because

... the manner in which a company is structured relative to exports, foreign operations and research bears very heavily on the way in which management reacts to foreign projects, ¹

and because

... there is no group in the company specifically assigned to the task of developing foreign projects. ²

A company structure which is designed with the needs of the domestic environment in mind may also act as a check to the consideration of DPFIs through discouraging company personnel to propose such investments. Company personnel are discouraged from proposing such investment projects because such proposals usually generate conflicts — and most company personnel are not likely to like open confrontations with their colleagues— between the proposers and the sales personnel. Conflicts usually arise because proposals for manufacturing or licensing enterprises abroad may mean that the sales people may have their export sales, which they have built up, "destroyed" by foreign manufacture. ³

Hence, most companies do not normally look abroad for investment opportunities partly because of the way they are departmentally structured.

¹Robinson, International Business Policy, p. 198
²Ibid., pp. 204-205
³For a further discussion on this, see Robinson, International Business Policy, pp. 198-207.
Multiplicity of Environments and Complexities of Investing Abroad.

If a company has all its investments within the limits of its own national borders, it will most probably be operating under one political, legal, economic and social system and its executives may have to deal with people who speak a common language, believe in the same religion and have a kindred ancestry, mutual traditions, a similar frame of mind and value system. Its executives can operate with ease and confidence for the domestic distribution patterns, trade terms, and nuances of consumer tastes and preferences, competitors' strength and weaknesses are all second nature to them.¹

By comparison, if a company has its investments within a number of national boundaries, its executives will have to cope with not only a more elaborate set of organizational variables but also a far more complex and sensitive array of factors for direct investment abroad involves operating effectively:

1. within different national sovereignties;
2. under widely disparate economic conditions;
3. with peoples living within different value systems and institutions;

4. as part of an industrial revolution set in the complex world;
5. often over greater geographical distances;
6. in national markets varying greatly in population and area.

Figure 3 presents some of the complexities involved in foreign operations. It tracks some of the more important implications for the firm's executives generated by these six variables and their interplay. To take an example, according to Robinson,

... different national sovereignties generate different legal, monetary, and political systems. Each legal system implies a unique set of relevant rights and obligations in relation to property, taxation, control of monopoly, business organization, contract. These in turn require the firm to consider new organizational relationships, acquire new skills, adopt new accounting and control procedures, that is, new in the sense of being different from that required in a purely domestic setting. 

More specifically, the executives will have to deal with new variables such as foreign exchange, differential inflation rates, tax and interest rate differentials—both effective and nominal—across national boundaries, special inducements of and possible conflicts with host countries beside differences in production and marketing costs in the countries in which the company has its investments. Furthermore, they will have to deal with differences in human relationships—which in some respects are reflected in costs but which at the same time add to the challenges, satisfactions

1Robinson, International Management, p. 3
2Ibid., p. 3
Important Variables in the International System
Which Generate:

1. Different National Sovereignties
   Int'l Political System
   Different Legal Systems

2. Disparate National Economic Conditions
   Different Monetary Systems
   Different Political Systems

3. Different National Values and Institutions
   Agrarian-Based Society
   National Poverty - Relative

   Elite-Mass Differentiation
   Drive For Catch-up Economic Development

5. Geographical Distance
   Foreign Reference Models
   Different Communications Systems

6. Different Areas and Population
   Time Difference
   Different Market Size

Leading to Differences in:

1. Perceived National Power
   Pressures Against Aliens
   Property Rights
   Taxation
   Antitrust Rights
   Corporate Law
   Contract Law

2. Currency Exchange Control
   Financial Policy
   Monetary Policy
   Financial Institutions

3. Controls over Business
   Import And Export Controls
   Property Rights
   Effectiveness of Market Econ. Policies
   Elasticities of Supply & Demand

4. Value of Time
   Degree of Traditionalism
   Factor Mix
   Regionalism
   Education and Skill Levels

5. Institutional Paternalism
   Incentives
   Urbanization
   Growth Rates
   Pressure for High Rate of Investment
   Role of Government (i.e. Planning, Control)

6. Pressure for Immediate Consumption
   Borrowing of Political And Social Concepts
   Borrowing of Technology
   Language
   Communications Media

7. Inventory Levels or Means of Transport
   Control of Monopoly and Competition

8. Controls of Monopoly and Competition
   Inflation Vulnerability
   Assess Vulnerability to State Control and/or Competition
   Deal with Market Controls
   New Patterns of Labor-Management Relations

9. New Processes and Processes Mixes (i.e. Plants)
   Incur Added Cost
   Face New Problems of Control
   Incur Higher Costs
   Consider New Operating Policies

Note: Many Important Relationships Are Not Charted Here
This Scheme Is Presented Only as an Illustration

Source: Richard D. Robinson: International Management,
and frustrations of managements in ways that cannot be reduced to pecuniary terms.¹

If a company wishes to consider investing abroad, its executives will, therefore, need to have a comprehensive knowledge of the multiplicity of variables imbedded in the foreign environments—not only in general terms of an investment climate but also in more specific terms for a particular investment. They will also be required to acquire new tools, concepts, analytical methods and types of information for they will now be faced with a wider range of operational problems.² This can affect the willingness of companies to search and consider DPFI alternatives in more than one way.

First, it can affect the search for and the consideration of DPFIIs by discouraging executives to propose such investments or to make a preliminary investigation and analysis of them when these are brought to them in general terms. The executives are discouraged from proposing and from making a preliminary investigation and analysis of direct foreign investment projects either because the mere mechanics of international transactions and of foreign operations are

¹Dan Throop Smith, op. cit., p. 93

insurmountable to them\(^1\) or because they fear that if they propose such investments they may have to take charge of these operations—a task for which they are ill-equipped.

Second, the complexities of investing abroad can check the consideration of DPFIs because of the investments required in training executives. Most companies are unlikely to be prepared to incur financial costs or to take management personnel away from tasks closer at hand so as to provide them with training in the mechanics of foreign operations, especially when they are operating successfully at home and have "unlimited" profitable domestic projects; however, they are probably prepared to undertake the investment in training their executives in foreign operations when they are faced with some serious problems for which an investment abroad appears to be an easy solution.

**Information and Investigation Costs.**

Before a company invests in a new venture it will attempt to weigh its profit prospects against the risk of incurring losses. To do this, requires information in many

\(^{1}\)Kolde believes that even the mere mechanics involved in exporting and importing is often insurmountable to the typical corporate executive. See Endel J. Kolde, *International Business Enterprise*, FES, Chapter 8, p. 16
specific directions. For example, the company needs to have general information pertaining to the basic strengths and weaknesses of the economy of the country in which the venture is to be undertaken, the administrative and political structure of the country, and its current legislation covering such things as taxes, incentives for foreign investments, local ownership requirements and monopolistic practices.\(^1\) It also requires specific information such as the size of the market for its product, the share of the market it can conquer, its selling price, its cost of production including the cost of capital, selling expenses and other overhead expenditures, and not overlooking estimated losses.\(^2\)

Such information is generally more easily obtained for the domestic than for a foreign market. In fact, very often detailed statistics for the foreign market are lacking so that appraising investment projects located in it is not only difficult but practically impossible.\(^3\) Furthermore, where there is ample quantity of information, there may be questions of reliability and relevance, particularly where there is conflicting opinion and evidence. In view of the

\(^1\)For a fuller discussion on the nature of general information investors require, see Appendix II.


\(^3\)This is particularly true of the LDCs for in some there are no trade literature, market surveys, trade associations or market research companies to rely on.
greater difficulty of obtaining information for a foreign market, companies can be expected to have a reluctance to consider direct investment abroad if domestic direct investment opportunities are still attractive.

Information also affects companies' willingness to consider direct foreign investment projects through cost of collection. For as certain information is required before companies can weigh the prospects of an investment project and as the collection of information, especially of the right information, involves a high cost, both in terms of finance and in terms of the diversion of management attention from other tasks closer at hand, companies will have to decide whether they want to invest in the collection of the required information before they can consider, analyze and evaluate the proposed investment project. Where the cost of obtaining the required information is exhorbitant—and this is more likely to be the case for information pertaining to a foreign than a domestic project—companies may decide not to invest in the information.¹

Even if companies are prepared to invest in the collection of general information pertaining to foreign

¹Traditional economic theory tells us that an investor will invest in information only so long as the marginal expected return from the information gained exceeds the expected opportunity cost. But this is not of much help because it is difficult to calculate the cost as well as the returns.
markets, they are not likely to be prepared to carry out on-the-spot-investigations of foreign investment proposals, involving lengthy negotiations in foreign countries over matters such as tax incentives, foreign exchange rates and availability, assurance of continued tariff and other forms of protection, because such on-the-spot-investigations are expensive and time consuming—and the investment project or projects investigated and evaluated may after all be rejected. It is perhaps mainly for this reason that companies do not normally consider direct foreign investment projects.

Summary.

An investment decision from the initial recognition to the acceptance of a project or projects involves:

1. Recognition or generation of a potential investment project or a set of projects.

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1 It should be noted that even with respect to exports Vernon finds that "entrepreneurs are not readily disposed to pay the price of investigating overseas markets of unknown dimension and unknown promise." See Vernon, "International Investment ... in the Product Cycle," p. 202

2 For a discussion on the problems and troubles involved in determining the feasibility of a foreign investment venture and in carrying out negotiations in foreign countries, see Haner, "Determining Feasibility of Foreign Ventures,"; Haner, "Investment Negotiations in Developing Countries,"; and Williams, "Negotiating Investment in Emerging Countries."

3 This is also the conclusion of Aharoni's study. See Yair Aharoni, op. cit., Chapter 4.
2. Collection of information and preliminary investigation of the project or projects.

3. Comprehensive evaluation of the "potentially acceptable" project or projects.

4. Final decision on whether to accept or reject the "potentially acceptable" project or projects.

Neo-classical investment theory and most hypotheses on direct private foreign investments ignore the recognition or generation of potential investment projects and take for granted that investment alternatives, both domestic and foreign, are given to firms. The assumption they implicitly make here is that the firms' search for higher profits lead them to scan the home and foreign environments for investment projects.

Empirical studies of the investment decisions of some firms reveal that at least with respect to foreign investments such is not the usual case. It seems that firms do not, in fact, systematically scan the globe for areas in which to make an investment and that most firms do not normally consider the possibilities of investing abroad.

Several explanations can be given as to why firms do not normally consider the possibilities of undertaking direct investments abroad. First, they may not consider such possibilities because their traditions, attitudes, departmental structures and resources militate against undertaking direct foreign investments. Second, they may not consider such investments because of their misconceptions about the climate of
investment in other countries and because of their belief that all foreign investments are bad. Third, they may not consider foreign investments because of their unwillingness to invest their financial resources in the training of their managerial personnel in the mechanics of foreign investment operations, an area of business operations in which they are not favourably inclined. Finally, they may not consider such investments because of their unwillingness to invest their financial and managerial resources in the collection of scanty and probably unreliable information and in the investigation and evaluation of projects which after all they may not undertake.
CHAPTER FIVE

INITIATING FORCES, AND THE ORIGINATION, CONSIDERATION, INVESTIGATION AND EVALUATION OF DIRECT PRIVATE FOREIGN INVESTMENT PROJECTS.

Introduction

Surveys into the direct foreign investment behaviour of companies reveal that most companies do not normally consider making direct investments abroad, that "most companies do not have a "master plan" for international investment arrived at through careful evaluation of the various possibilities of employing capital so as to maximize the return on it,"¹ and that most company decisions to undertake direct investments are not the result of continued planning.²

If most companies do not normally make use of a large scale screening process to identify direct foreign investment opportunities, how do direct foreign investment projects usually originate within them? And when they become aware of or are alerted to such projects, how do they consider, investigate and evaluate them? Are direct foreign investment

¹Judd Polk, et. al., op. cit., p. 73
²See Chapter Four of this study.
decisions the result of evaluations of alternatives or are they made for each proposal on its own merits alone, independent of other proposals? Do companies rely solely on the discounted cash flow method to evaluate investment projects? If not, what are other criteria companies use to determine the acceptability of direct foreign investment projects?

Before we draw upon the results of past research into the foreign investment decision behaviour of companies to answer these questions, it is not inappropriate to review some aspects of the behavioural theory of the firm, especially those relating to search and search behaviour, because the manner in which direct foreign investment projects originate within companies and the manner in which these projects are considered and evaluated are suggested by this theory.


One concept which may have some relevance to the behavioural theory of the firm is the concept of homeostasis—that is of a mechanism for stabilizing a variable or a group of variables within a certain limit of toleration. When applied to organizations, this concept suggests that:
... every ... organization is characterized by a group of ... variables and the organization consists mainly in more or less elaborate apparatus to maintain these variables between an upper and a lower limit. Should any of the essential variables rise above the upper limit, machinery must be brought into play to reduce it; should it fall below the lower limit, machinery must be brought into play to raise it.\(^1\)

Another concept which may have some relevance to the behavioural theory of the firm is the notion of satiation, a notion which enters rather prominently into the treatment of motivation in psychology. This notion, briefly stated, maintains that "the motive to act stems from drives and action terminates when the drive is satisfied."\(^2\) This notion, therefore has some parallels to the concept of homeostasis for both these notions suggest dissatisfaction as a stimulant to search and search behaviour being induced only when performance falls short of the level of aspiration.

If business behaviour can be explained in terms of these notions, then it can be expected that:

1. company goals are stated not in maximizing terms but rather in satisficing terms.

2. companies do not attempt to maximize profits but rather to attain a certain level or a certain rate of profit, or to hold a certain share of the market or a certain level of sales.

\(^1\)Kenneth E. Boulding, \textit{op. cit.}, p. 36

3. within companies variables or a group of variables are allowed to fluctuate within certain ranges without arousing much concern among the participants.

4. search --including the search for investment projects-- and search behaviour within companies will be induced only when performance falls short of the level of aspiration or when the companies are faced with certain problems for which no satisfactory solution readily presents itself.

There is some evidence that business goals are, in fact, stated in satisficing terms. First, there is the series of studies stemming from the pioneering work of Hall and Hitch\(^1\) that indicates that businessmen often set prices by applying a standard mark-up to costs. Second, there is the series of studies\(^2\) which indicates that the investment behaviour of companies is strongly influenced by the amount of accumulated funds. Third, there is the work of Cyert and March\(^3\) which indicates that companies consider resources as fixed and impose feasibility rather than optimality tests on proposed expenditures or projects.

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Researches into the search and investment decision behaviour of companies\(^1\) also confirm that the notion of homeostasis and of satiation have some relevance to the behavioural theory of the firm. They also provide some other interesting insights into the behaviour of companies. They indicate that:

1. search is usually a response to some specific event rather than as a form of continued planning. It is generally motivated by a problem.

2. once a problem or problem area is recognized, there is local rather than general scanning of alternatives to solve the problem.

3. during the early scanning process, only rough expectation data are used to scan out obviously inappropriate actions or alternatives.

4. once a few alternatives are considered as satisfactory, these are sequentially considered in detail.

5. the non-comparability of expected costs and returns leads to estimates that are vague and easily changed, and makes the decisions exceptionally susceptible to factors of attention focus and of available organization slack.

6. a firm commitment to an action is taken before the search for information proceeds very far.

7. the search becomes more and more intensive as the decision approaches implementation.

8. the company considers resources as fixed and imposes feasibility tests rather than optimality tests on the proposed expenditure or project.

9. the first satisfactory solution to be discovered is accepted.

These researches also suggest that not only are organizations looking for alternatives but alternatives are also looking for organizations.\(^1\)

Initiating Forces and the Origination of Direct Private Foreign Investment Projects.

Several studies of the foreign operations of companies\(^2\) reveal that typically a company's involvement with a foreign country begins with a relatively small export or service handled by company personnel abroad\(^3\) and that generally a company only considers direct investments overseas when it is faced with a problem or certain problems which threaten the achievement of one or more of its broad goals and when the nature of the threat to its goals is such that foreign investment is the easiest and most logical response;\(^4\) quite frequently the problem faced by the company is simply a challenge or a threat to an existing profitable situation.

\(^1\)R. M. Cyert, et. al., op. cit., p. 338

\(^2\)See for example the work of E. R. Barlow and Ira T. Wender, op. cit.; Yair Aharoni, op. cit.; Judd Polk, et. al., op. cit.; and Vernon, "International Investment ... in the Product Cycle."

\(^3\)Direct investments in raw material production are the exceptions.

\(^4\)Charles D. Hyson and Dale R. Weigel, op. cit., p. 38
These studies also reveal that the main forces or pressures that usually upset the normal chain of events in a company and lead some individuals in it to focus attention on the possibilities of investing abroad and to devote time and other resources to the investigation of this possibility are:

1. forces or pressures which threaten the company with the loss of its export sales and its foreign market. These include:

   i. government activities which take the form of:

      a. the introduction of import quotas and high tariff duties on the company's products.

      b. the introduction of foreign exchange control with respect to the company's products or with respect to goods imported from the company's country.

      c. an agreement by the government of the country to which the company is exporting its products with other governments to form a common market and liberalise trade within the common market area.

      d. the introduction of legislation to impose import restrictions and limitation on the number of companies allowed to produce the company's products.

   ii. strong competition in the foreign market posed by local manufacturers or other foreign exporters.

\(^1\)Yair Aharoni calls these forces "initiating forces."
iii. inadequacies of the local distributors, who may be doing a poor job of marketing the company's products or who may not have funds for expansion to serve the market adequately.

iv. local distributors deciding to drop the company's line in favour of that of another company.

2. forces or pressures which threaten the company with the loss of its home market. These include among others:

i. strong competition from abroad.

ii. strong competition in the domestic market from other local manufacturers leading to a sharp decline in the company's sales.

iii. a cut-off or a threat of a cut-off of the company's raw materials which can only be obtained from abroad.

3. forces or pressures which threaten to reduce the company's relative standing in the home market and which threaten to pre-empt it from investing in foreign markets. These usually arise when other domestic companies, particularly rival companies, undertake investments abroad.

Forces or pressures which threaten the loss of a company's export market bring the possibilities of foreign investment to the attention of the decision makers within the company and immediately precipitate a decision on their part as to whether they are willing to set up an assembly plant or convert their assembly operations into manufacturing operations because if they do not make the decision immediately the company may face exclusion from the market in which it has been operating profitably. Forces which threaten the loss of a company's home market, particularly where the threat
originates from abroad, precipitate a decision on the part of management as to whether it is willing to undertake foreign investments because the company's very survival is being threatened. And forces which threaten to pre-empt a company from a foreign market or markets precipitate a decision because if it does not make a decision it may find that its future growth and expansion may be restricted and that it may not be able to maintain, build and fortify its position in the foreign and domestic markets.

Although in most cases companies consider investing abroad only when they are pressured or faced with some threat to one or more of their broad goals --and this is usually the case with companies having a large export base rather than with those without much contact with a foreign market\(^1\) --there are occasions when a company may be persuaded to consider investing in a foreign market by some "individuals so close to the firm --and so important to it-- that management feels compelled to manifest some positive response to proposals suggested by them."\(^2\) Some of the individuals from whom proposals may originate include the company's regular distributors or customers within the foreign country --who may request that they be given permission to establish local manufacture or

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1E. R. Barlow and Ira T. Wender (in op. cit., pp. 198-200) show that industries with the smallest percentage of export to total production are those with the smallest relative number of companies as foreign investors. Hence the above implication.

2Robinson, International Business Policy, p. 268
assembly operations on a licensing basis—and other companies which have been the company's main buyers and which have just started foreign operations.

Sometimes the stimulus for getting a company to consider and appraise an investment opportunity abroad comes from some high ranking executives within the organization who may have had the project lying at the back of their mind for quite some time.\(^1\) In these cases, for the company to be persuaded to consider such proposals, the executives presenting the proposals must be very important in the company, influential and capable enough to convince skeptical executives that such proposals are meritorious and that it is worthwhile to go abroad to judge whether conditions are attractive for investments.\(^2\)

There are also occasions when a company is instigated to consider direct investments abroad by some individuals and institutions who have no connection with it. For example, some foreign industrialists may, because of rapid technological change or of having similar interests and philosophy, put a proposal to the company for a licensing management, a joint venture or a merger, or some foreign government agencies or

\(^1\) See Yair Aharoni, *op. cit.*, pp. 58-61

\(^2\) Zwick finds that "certain individuals by virtue of longevity of successful company service and company status are the best project supporters." See Jack Zwick, "Is Top Management Really on Top?" in *Columbia Journal of World Business*, Vol. 1, No. 1, (Winter 1966), p. 90
some development banks may, because of their desire to promote economic growth within their country, put before the company a tentative investment project. Besides, the company's home government may request that the company consider certain overseas projects. In all these instances, the company is likely to investigate the proposal seriously if the tentative proposal is accompanied by a preliminary report suggesting that such an arrangement may prove to be very attractive to the company in terms of profits, that there are opportunities of growing in the protected overseas market and that a rejection of the proposal may injure the company's foreign or domestic operations.

The Consideration, Investigation and Evaluation of Direct Private Foreign Investment Projects.

Consideration of Investment Proposals.

Once a company is alerted to a direct foreign investment project as a consequence of pressure or persuasion, the project is either rejected outright or considered depending on the nature of the initiating force, the gravity of threat to the company's goals the proposed project posed, the nature of support the project enjoyed from key people in management,¹ the

¹The personal interest and support of key people in the company is likely to play a larger role in the foreign than in the domestic case precisely because of the greater number of imponderables.
political orientation and political stability of the country of suggested investment\(^1\) and a host of other factors.

If the product characteristics of the company are suitable for foreign investment\(^2\) and the proposed project poses a serious threat to the achievement of one or more of the company's goals or if it enjoys the support of key people in management, the project is likely to be considered. It is also likely to be considered if the potential investment the company has been alerted to promises it a market for components and other products or utilization of an old piece of machinery which it possesses or capitalization of its know-how and spreading of its fixed costs\(^3\) or if it has surplus funds for which it has not been able to find some suitable domestic investments or if the initial outlay for the proposed investment is small\(^4\) and the investment incentives offered by the

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\(^1\) The National Industrial Conference Board Survey of Obstacles and Incentives to Private Foreign Investment, 1967-68 indicates that there might be outright rejection of investment proposals coming from countries with a socialist or communist political orientation or with the threat of political instability and nationalism. See Conference Board, Private Foreign Investment: Obstacles, pp. 3-4.

\(^2\) Vernon in "International Investment in the Product Cycle," shows that only companies whose products have "matured" and are "standardized" will be likely to undertake DPFIs.

\(^3\) Aharoni calls all these inducements "auxiliary forces". See Yair Aharoni, op. cit., pp. 70-74.

\(^4\) Most writers, including Barlow and Wender, and Vernon conclude that except for investments in raw material production, companies are generally unprepared to invest in a foreign project if the size of the initial investment is large.
foreign government appear attractive.

If only one investment project is presented before management and this is a project it is prepared to consider, this project is generally considered on its own merits; management does not normally look for other projects and compare this project with other potential projects in the domestic market or in some other countries. This is partly because of the enormous cost, both in terms of finance and in terms of the diversion of management attention from tasks closer at hand, involved in collecting information and in making on-the-spot-investigations of projects. This assertion finds support not only from Barlow and Wender's survey but also from a number of other studies. For example, Barlow and Wender found that a large United States manufacturing company alerted to an investment opportunity abroad,

... did not compare this investment proposal with the possibility of investment in any other country. It looked at this investment proposal alone. The only consideration was whether it seemed sound. It was not a question of whether this investment would be more profitable than other possible investments abroad or in the United States,¹

and with another company they found that when the foreign government imposed import restrictions and the company's distributor did not have capital required for local manufacture the company,

¹E. R. Barlow and Ira T. Wender, op. cit., p. 173
... on a purely individual basis ... decided to go ahead with this investment ... this investment proposition was not compared with other possibilities abroad or at home. The situation was appraised; it was decided that the expenditure was necessary and that a profit would be made; then the decision to go ahead was reached.1

Similar conclusions were reached by Polk et. al., in their survey. They claim that:

... companies indicated that very few decisions are reached by comparing different investment opportunities, including opportunities in the United States. Most companies do not have a "master plan" for international investment arrived at through careful evaluation of the various possibilities of employing capital so as to maximize the return on it. On the contrary, each proposal is considered on its own merits.2

If, on the other hand, management is alerted to a number of foreign investment projects simultaneously and they all pose some threat to the company's goals, commonsense suggest that the company is likely to consider and evaluate the alternative which poses the greatest amount of threat before considering the other alternatives. This is borne out by empirical studies for Barlow and Wender found that:

... in general, the company takes action in those countries where action is most required. It does not necessarily expand its plant in the country that will provide the greatest profit; rather it expands in the country where the pressure is greatest for such expansion.3

Thus it can be concluded that in general companies consider

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1Ibid., p. 174
2Judd Polk, et. al., op. cit., p. 73
3E. R. Barlow and Ira T. Wender, op. cit., p. 175
direct foreign investment alternatives sequentially and if the alternative examined satisfies the constraints set, the alternative is accepted.

Commitment and the Investigation of Investment Proposals.

According to Aharoni, investigating and evaluating a direct private foreign investment project is a very costly\(^1\) and time consuming affair.\(^2\) Partly because of this, a company if it decides to investigate a proposed project, must have right from the beginning accepted in principle to carry out the investment.\(^3\) This acceptance of the project in principle even before investigating it is also partly the result of the company's prior commitments —commitments such as to hold the market or to have a certain share of the market—and of the power structure in the company.\(^4\)

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\(^1\) Yair Aharoni (in op. cit., p. 109) notes that the on-the-spot-investigation alone may cost up to $100,000 in out-of-pocket expenses.

\(^2\) According to P. T. Haner, with a team of investigators, a company needs about two weeks of preparation in the United States and about a month of field work in the foreign country to have a reasonably reliable estimate of the potential of a project. See Haner, "Determining Feasibility of Foreign Ventures," p. 37.

\(^3\) Williams in his investigation on capital expenditure decisions of companies found this to be true of domestic investments with costly investigations. See Bruce R. Williams, "Capital Expenditure Decisions," in The Journal of Management Studies, Vol. 1, (September 1964), p. 125.

\(^4\) Yair Aharoni, op. cit., p. 125.
The decision to proceed with the investigation of a project is usually based on some hunches, confidence that it will succeed, some crude estimates of the effect on sales and profits and a judgement about the "climate of opinion" in the company. If the impact of the initiating force is strong and the company's hunch is that the project has a "good chance of success", it will investigate the project.

In the first phase of the investigation, several generally available crude indicators are consulted to form some opinion of the feasibility of the opportunity considered. The specific crude indicators used depends on the nature of the project. In general, what is attempted at this stage of the investigation process is to make some crude examination of the risks and uncertainties involved, of the market size expected and of possible conflicts of the suggested project with existing company policies and resources.

If at the end of this preliminary investigation, the company still decides to continue with the investigation, it will carry out on-the-spot-investigation. This involves company executives going abroad to determine the attitude of the foreign government, to compare government and company plans so as to obtain clues to both potential problems and unusual benefits, and, if it is to be a joint venture, to

\[ ^1 \text{Ibid., p. 91} \]
\[ ^2 \text{Ibid., p. 91} \]
evaluate local partners. It also involves company executives going abroad to carry out negotiations with foreign suppliers, manufacturers and representatives of the government of the host country. Company executives whilst abroad will also have to make a detailed analysis of the demand and supply of the product the company is going to produce, the market it intends to serve, the competition it will face, the types of incentives, both in the form of tax reductions and exemptions and in the form of subsidies and grants offered by the foreign government, and a host of other factors so as to obtain a detailed forecast of revenue and operating costs and make estimates of capital costs of the project.¹

In this process of investigation, the company's commitment to accept the project increases. The act of investigation creates new additional commitments because:

1. once the company has spent time and money on investigating the project, the executives find it hard to look at this investment of scarce resources as a sunk cost.²

2. the fact that a group of people—inside or outside the investigating organization—knows that an investigation is being carried on may cause a feeling of commitment. This results because once an investigation has begun, a decision to reject the investment proposal may create some psychologically or socially undesirable effect. The investigator may feel

¹ For a searching analysis on various aspects of on-the-spot-investigation, see Haner, "Determining Feasibility of Foreign Ventures;" Haner, "Investment Negotiations in Developing Countries;" and Williams, "Negotiating Investment in Emerging Countries."

² Yair Aharoni, op. cit., p. 132
this will be interpreted as a failure; he may think this will hamper his relations with these people or his social standing among them, or will destroy further deals.¹

3. of negotiations with prospective partners and financial institutions. Negotiations with them create new additional commitments because a decision to retreat may be perceived as harmful to future relations with all these groups.²

This suggests that once an investigation on a project is under way, for a decision not to proceed with the project, the facts as they emerge from the investigation and evaluation have to be very much against the project or the conditions inside the company and in its environment have to change very unfavourably towards it.

Company Investment Criteria and Final Decision.

Once a company has completed the on-the-spot-investigation it has to make a decision as to whether it is going to accept or reject the project investigated. In considering whether or not to proceed with a particular investment project, companies usually make use of a number of criteria as a basis for evaluation. From Polk et. al.¹'s survey, some of the commonly used criteria, which according to the companies indicate the "return on investment", include:

¹Ibid., pp. 132-133
²Ibid., p. 135
1. ratio of earnings to sales,
2. ratio of earnings to total capital employed,
3. ratio of earnings to a subsidiary net worth,
4. ratio of earnings to a parent's "total investment",
5. ratio of repatriated funds to a parent's "total investment",
6. ratio of increment in cash flow to increment in investment,
7. ratio of net cash flow to average funds employed,

and many other refinements of these basic ratios.¹

Their survey also reveals that companies whose stabilized annual sales volume tends to exceed the value of total assets employed in the enterprise and who produce and merchandise nondurable consumer goods like food, drugs, photographic and recording supplies, writing instruments and the like, tend to emphasize earnings to sales ratios as criteria for determining the acceptability of investment projects; few of these companies use the discounted cash flow method as a measure of "return on investment",² These companies also consider other financial measurements. For example, they consider the length of the payout period and whether the volume of sales is supported by an adequate investment structure but in general these other financial measures are not used as the main yardstick in their

¹Judd Polk, et. al., op. cit., p. 65
²Ibid., p. 67
evaluation of direct foreign investment projects.

Companies belonging to capital intensive industries and using manufacturing processes requiring complex plant equipment, on the other hand, use as their main financial yardsticks projected returns on company investment, which include projected return on total capital employed and projected return on total parent company investment and many of their refinements. It is this group of companies which commonly employ the discounted cash flow method and which regard the length of the payout period as a "major" consideration\(^1\) -- though there is no general agreement as to what is regarded as an acceptable "rate of return" or what is regarded as a desirable or acceptable payout period.

In addition to these basic criteria, the companies also review to see whether certain additional inducements are present. These may include the opportunity for the company to sell raw or semi-fabricated materials to the new subsidiary and the opportunity to negotiate significant royalties or technical fees, and, if it is to be a joint venture, the local partner's financial standing, marketing experience, earnings record and so on may also be explored. The company may also explore the possibility of obtaining funds locally to finance the project.

\(^1\)Ibid., pp. 70-71
Generally, once the negotiations have been concluded, the project evaluated and found feasible and informal approvals have been secured from strategically placed personnel in the finance department and at operating levels, the project is presented to top management for final approval.¹

Sometimes, in the report presented to either the Board of Directors or the top management of the company or the top management of the international division² more than one investment alternative is included in the write-ups and the decision makers are expected to select the "best" alternative out of the alternatives presented. According to Zwick, the evidence he gathers suggests that these other alternatives are not seriously contemplated and they are included merely to serve as foils to highlight the proposed scheme's desirable characteristics³ --implying that in essence only one investment alternative is considered and evaluated at a time, that companies do not make cross country comparisons of investment projects, and, that when they consider, investigate and evaluate direct foreign investment projects, they have in principle agreed right from the beginning to undertake the projects.

¹Jack Zwick, op. cit., p. 92

²These are the groups which make the final decision. See Robinson, International Business Policy, p. 216

³Jack Zwick, op. cit., p. 92
Neo-classical investment theory and most hypotheses of DPFIs implicitly assume that companies are continuously scanning foreign environments for investment opportunities. They also implicitly assume that when companies make investment decisions they appraise potential investment projects located in one foreign country alongside other foreign and domestic projects and decide in favour of the one that looks most promising.

Empirical studies made by some scholars reveal that companies in fact do not normally look beyond their national boundaries for investment opportunities. This leads one to wonder as to how foreign investment projects usually originate within companies and as to how these projects are generally considered and analyzed.

Since the behavioural theory of the firm may provide some insights into the process, some aspects of it are reviewed.

In brief, the behavioural theory of the firm postulates that company goals are stated in satisficing terms, that search behaviour within companies is generally induced only when performance falls short of the level of aspiration or

1 See Chapter Four of this study.
when the companies face some serious problems for which no satisfactory solution readily presents itself, and that when companies examine alternative solutions to solve their problems, they examine these alternatives sequentially and accept the first satisfactory solution.

Empirical studies confirm that at least with respect to direct foreign investment decisions, companies behave largely in the manner indicated by the behavioural theory for these studies reveal that:

1. companies generally only consider undertaking direct investments abroad when they are threatened with the loss either of their home or foreign market or with a reduction in their relative standing in their home market or when they are persuaded by some high ranking official or distributor or industrialists or government agencies to do so.

2. companies consider foreign investment alternatives or propositions one at a time and do not weigh one proposition against another. (This suggests that the companies adopt feasibility rather than optimality tests for investment projects.)

3. when companies consider direct foreign investment projects they agree in principle, even before the investigation, to accept the projects investigated.

4. a company's commitment to accept a project increases with the mere act of investigation.

5. different companies use different criteria for measuring the acceptability of investment projects.

6. a company uses a number of criteria to determine the acceptability of a project.
Neo-classical investment theory and most alternative hypotheses of DPFIs either implicitly assume that investment alternatives are given to firms or that firms systematically scan the globe for profitable investment projects. They also assume that: (1) there are no governmental restrictions to firms undertaking direct investments abroad, (2) firms possess financial and suitable managerial and technical resources to undertake direct foreign investments, (3) firms are generally prepared to invest their time, money and other resources in the investigation of foreign investment projects, (4) firms carefully appraise foreign investment projects in terms of costs, benefits, risks or some other criteria, and that (5) firms undertake those projects which appear most promising to them in terms of these criteria.

The theory and the hypotheses seem to suggest that it is possible to provide considerable stimulation to the flow of DPFIs by merely affecting firms' expectations of returns and risks of such investments. They suggest that what countries have to do to encourage the flow of DPFIs is to offer firms incentives such as "tax holidays", accelerated depreciation
allowances, loans with low or no interest rates and protection against competition, nationalization, war and insurrection and other political risks.

Some empirical studies of the investment decisions of firms suggest that: (1) some "hidden resistances" and "built-in-inertias" including the cost of information and investigation militate against firms normally looking abroad for investment opportunities, (2) firms generally consider investment opportunities abroad only when they are "pressured" (or "threatened") or when they are "persuaded" (or "instigated") to do so, (3) when firms consider direct foreign investment projects, they agree in principle even before the investigation to accept the projects, (4) when firms consider investment alternatives abroad, they consider these alternatives one at a time and do not weigh one against another, and that (5) firms apply feasibility rather than optimality tests to foreign investment projects.

These observations suggest that any theory of DPFIs has to recognize that direct foreign investment alternatives are not given to firms and that there is a need to incorporate the "initiating forces" into the theory. They also suggest that it is probably not possible for countries to accelerate the flow of DPFIs significantly without first devising some policy measures which will get firms to consider investment opportunities abroad for unless firms are first initiated to
consider investment projects across their national boundaries they are not likely to investigate, evaluate and undertake such projects.

**Policy Implications.**

Since firms do not normally look abroad for investment opportunities because of some "hidden resistances" and "built-in-inertias" and since firms only consider direct foreign investment projects when they are "threatened" or "persuaded" to do so, any DPFI's incentive program to be effective needs to incorporate policy measures which will help remove some of the crippling "hidden resistances" and "built-in-inertias" of firms and which will "pressure" or "instigate" them to look abroad for investment opportunities.

There are many measures which capital-exporting countries can adopt to achieve these objectives. Some of these measures are:

1. granting tariff preferences (or opening their markets) to capital importing countries.

2. organizing educational programs on various aspects of foreign operations to help remove some of the deep seated inhibitions of firms, including some of the "generally held beliefs" and some of their hobbling attitudes towards direct investments abroad.
3. providing information on the general economic, social and political characteristics of foreign economies and on specific industries.

4. presenting firms with specific direct foreign investment proposals.

5. subsidizing firms with the cost of investigation of direct foreign investment projects.

There are also many measures which capital-importing countries can take to increase foreign firms' willingness to consider or to initiate them to consider projects located within their (the capital-importing countries') borders. These measures include:

1. pressurising foreign firms to consider them by creating a customs union.¹

2. attempting to create a good image of themselves in the eyes of prospective investors by setting up investment centres charged with the responsibility of advertising their basic attributes.

3. identifying, analyzing and suggesting viable projects to foreign investors or their governments.

4. agreeing to share the cost of investigation of projects located within their boundaries and assisting foreign firms with the actual investigation of these projects.

5. introducing prospective foreign investors who are keen on joint ventures to local industrialists who have similar interests.

6. assisting local industrialists to seek out prospective foreign partners to form joint ventures.

¹This assumes that before the formation of the union, trade between the member countries and countries outside the union was significant and that the countries forming the union can come to some kind of an agreement as to what industries are to be located in each of the countries.
This study asserts that generally firms do not consider investments abroad side by side with domestic investments or investments in some other foreign countries and that they do not normally consider such investments unless "pressured" or "persuaded" to do so.

While these assertions are probably true of firms with no or few direct investments overseas, they may not be true of firms which are internationally oriented. For such firms, it may be a deliberate policy to embark on foreign operations or to allocate firm resources into high return projects without geographical limitation.

The internationally minded or oriented firms may even have a separate capital budget for foreign projects and a research and development department charged with the responsibility of continuously scanning the international environment, analyzing investment opportunities in foreign countries and presenting them to the top management for consideration. For these firms, there may be a steady flow of direct foreign investment proposals from the firms' research and development departments and the firms' overseas investments may even exceed their domestic.

For such firms, incentives such as reduction or
exemption of corporate taxes in one form or another may be effective as inducements for them to consider and undertake direct investments abroad.

The Way Ahead.

This study, having surveyed the results of past investigations into the foreign investment decisions of firms, asserts that at the present state of international business most firms probably do not normally scan the international environment for investment opportunities; DPFIs are often the result of investment opportunities "forced upon" or "presented" to the investors.

However, it admits that probably changes are taking place in the attitudes of executives and top management and in the policies of firms. And all seem to point to greater awareness and belief that profitable investment opportunities abound abroad, a willingness to search for these opportunities and a desire to undertake such investments. Many firms are probably slowly changing to make international operations an integral part of their business instead of a haphazard appendage of the domestic operation. There are many forces that seem to be bringing this about.

First, swifter communication and more rapid trans-
portation are making it easier for firms to manage and control their foreign subsidiaries and branches. This increases their willingness to undertake overseas operations and encourages them to search for investment opportunities abroad.

Second, as firms become more sophisticated and adopt modern accounting and budgeting practices and managerial principles which recognize no national boundaries in the search for investment opportunities, firms are likely to be pushed irresistibly in the direction of locating their investments in areas which promise them lower risks and higher rate of return.

Another group of factors which seem to contribute toward the internationalization of firms run from the greater availability of information, the encouragement and persuasion of governments and the ease with which complex budgetary calculations can be made with the help of the computer.

Finally, the fact that the managers of banks, mutual

funds, insurance companies and other financial institutions, rather than those managing the actual corporate property, may prove to be the group which predominate in shaping the objectives of giant corporations\textsuperscript{1} may mean that giant firms will become more profit conscious and search for investment opportunities across their national boundaries.

When firms become internationalized, capable of spreading risks and of maneuvering themselves among the shifting patterns of tariffs, taxes and exchange controls, they will be continuously scanning the international environment for investment opportunities. At such a time foreign investment incentive programs based solely on profit incentives will be effective to induce firms to undertake direct foreign investments. The question is "When?"

\textsuperscript{1}\textit{These institutional investors devote much observation and study to the policies and prospects of firms in which they have invested or may invest.}
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APPENDIX I

THE CLASSICAL THEORY OF FOREIGN INVESTMENTS.

In theorizing on the causes of the flow of private foreign investments, the classical economists did not make any distinction between direct and portfolio investments or between direct investments and other forms of international capital flows. Rather, they considered direct private foreign investments essentially as a form of capital movement along with the issuance of bonds, purchases and sales of outstanding securities and trade in short term credit instruments and looked upon the explanation for the flow of such investments as essentially the same as for the transnational movement or export of capital.

According to them, capital moves across national boundaries (or DPFIs flow from one country to another) because of international profit rate differentials. They maintained that owners of capital try to obtain the largest possible material advantage for themselves, their family and, in a less degree their friends and acquaintances from

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the employment of their capital\textsuperscript{1} and they (the owners of capital) will export their capital abroad only if the rate of return on their capital is higher abroad than at home. According to the classical economists, therefore, capital exports (including DPFIs) are undertaken because the rate of profit is higher abroad than at home.\textsuperscript{2}

Many of the classical economists who believed in the above explanation for capital exports (and for DPFIs) also thought that the rate of return on capital is a function of the capital stock of the country and that as capital accumulates within a country there is a tendency for the profit rate to fall\textsuperscript{3} so that according to them, there is an automatic mechanism directing the flow of capital (and of DPFIs) from countries where capital is abundant to countries where it is scarce.

Some of them, notably Bertil Ohlin, saw interest rate as the rate of return on investment or the profit rate

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\textsuperscript{2}The rate of profit referred to here is the "general level of profit."
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\textsuperscript{3}However, they were not in agreement as to how the accumulation of capital lowers the rate of profit. Adam Smith, for example, put it down to the excessive competition of capital within the country; T. R. Malthus to the principle of diminishing returns from investments in lands or industry; Sismondi to overproduction by capitalists and to the reduced capacity of workers to buy industrial products as mechanization proceeds; and Karl Marx to the declining proportion of "variable
and attributed capital exports and direct investments overseas primarily to international interest rate differentials. They claimed that "the immediate cause which calls forth an international capital movement is usually a difference between the interest rates of two countries, which is large enough to outweigh the costs of transfer occasioned by the obstacles to such capital flows."¹ But because they linked interest rate to the country's supply of capital relative to other factors of production (though with some qualifications) they too seem to suggest that there is an automatic flow of capital (and of DPFIs) from economies which are well supplied with to those short of capital.

To execute a feasibility study of an investment opportunity, a potential investor needs two types of information:

1. general information of the economy, including general economic data revealing the basic strengths and weaknesses of the economy, current regulations and incentives,

and

2. specific economic and technical data relating to the investment proposal.

The first type of information is best compiled and disseminated by government agencies of investing countries (or jointly by government agencies of host and investing countries) while the second by those of host countries when they write up project proposals for submission to potential investors. This is because the first type of information is subject to a great deal of interpretative analysis, and, if provided by government agencies of host countries, may be considered by potential investors as suspect and unreliable.

The kind of general information which government

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agencies of investing countries may usefully provide to potential investors so as to give them some idea of the basic strengths and weaknesses of a foreign country's economy include among others:

1. the size, structure and growth rate of the population,
2. the size and distribution of the gross national product,
3. the sensitivity of the economy to depressions and inflations;
4. a projection of growth and a description of factors that may accelerate or dampen the country's economic progress,
5. the economic and social dynamism of the people,
and
6. the size of the country's national debt, its trade balance and stability of its currency.

Beside the general information pertaining to the general strengths and weaknesses of the country's economy, the government agencies may find it profitable to provide investors with an interpretative analysis of the local foreign business framework, including:

1. the degree of state ownership of, or participation in the economy,
2. the nature of industrial concentration and climate of competition,
3. banking facilities available and nature of credit offered,
4. water, power and transport and utility facilities available and standards of service,
5. availability and cost of personnel and labour, both skilled and unskilled,
and 6. price level and price fixing mechanisms.

In addition, the general information disseminated should include an analysis of the investment climate, together with an interpretation of the current legislation, covering such things as:

1. incentives to attract foreign investors,
2. tariffs, import or export quotas,
3. local ownership requirements,
4. patents, copyright, and trademark,
5. local content of manufacture,
and 6. exchange control and transferability of profits, royalties and dividends.

As political and social factors are as equally important as economic variables in investment decisions, the information disseminated should also include an interpretive analysis of the country's:

1. present political system,
2. political parties, their relative strength in terms of votes and representation both at the national and the local levels, and their attitudes toward foreign investors,
3. local unions, their strength and influence in the life of the country,
and 4. social customs.

In addition, the general information disseminated should also outline the present government's general policies and their significance for business. Matters dealt with under
this head may include among other things:

1. the local government's stability, past record and outlook for the future,
2. attitude toward free trade,
3. trade agreements with other countries,
and
4. political and economic affiliates.

Finally, the general information should also include an analysis of the administrative structure of the country dealing specifically with such things as:

1. agencies that assist investors to analyze investment proposals, purchase land, arrange joint ventures and so on,
and
2. local standards of administration, for instance, the spread of corruption and the speed with which decisions on investment and licensing are made.