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Theoretical Evolution of Foreign Direct Investment Theory

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Abstract

Scholars have attempted to understand the ability of firms to cross borders and invest in an overseas state, as opposed to other forms of globalisation. The evolution of Foreign Direct Investment theory reflects global realities of our time, moving from the simplistic early trade-based rationale to the highly sophisticated international investment mechanisms that incorporate ownership, location, and internalisation advantages. This paper seeks to consider the historical integration and progression of FDI theorists, more precisely, Classical and Neoclassical Trade Theories, the Monopolistic Advantage Theory, the Internalisation Theory, Dunning's OLI Paradigm, Mathew's LLL Model, and, more recently, the Institution and Network- Based approaches. To anchor the theory, perspectives on how FDI has been treated in advanced and developing economies are added. Over time, theorists from economics, business, and international finance have developed multiple frameworks to explain why firms engage in FDI, where they go, how much they invest, how they prefer to enter the market, and which sectors they seek. The development of FDI theory reflects the ever-evolving nature of global conditions, empirical observations, and conceptual breakthroughs. This paper presents a chronologically organised thematic account of how FDI theory has progressed, its significant contributions, limitations, and recent directions.

Keywords: *FDI Theory, Trade Theory, Monopolistic Advantage, OLI, LLL.*
JEL Classification Codes: *F11, F12, F21 and F23*

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Introduction

Foreign Direct Investment (FDI) has become one of the primary sources of globalisation, shaping and designing the global economic pathways. It modernises the industrial sector, enhances technological capabilities, and boosts global productivity through improved collaboration and coordination. It can be defined as a firm's cross-border investment to acquire long-term interest and beneficial control in a foreign state. FDI has characteristics distinct from portfolio investment, as it entails managerial adaptation and resilient strategic planning of founding an industry or firm. Economic interdependence and connectivity grew phenomenally in the 20th and 21st centuries. This fundamentally altered the motives, patterns, and characteristics of FDI, making it a vital research topic for economists, business experts, and policymakers worldwide. For a developing country such as Pakistan, FDI offers prospects for industrial development, access to new technologies, and employment opportunities. In contrast, for developed countries, it is a means of corporate growth, diversification, and profit maximisation.

Theorists postulate various concepts that address the same phenomena in numerous ways. Initial ideas were based on the classical and neoclassical trade theories of Adam Smith, David Ricardo and Heckscher-Ohlin. They explained trade based on factor endowments and comparative advantage. These structures, however, were limited in their capacity to explain firms' cross-border activities, specifically the establishment of multinational corporations (MNCs). During the mid-twentieth century, the rise of firm- level theories such as Hymer's monopolistic advantage and Vernon's product life cycle theory was a pivotal shift, transforming the analytical focus from nations to MNCs.

As a result, after the 1960s, we saw the rise of integrative structures, such as Buckley and Casson's internalisation theory and Dunning's eclectic paradigm (OLI model). They provided details not only on why firms engage in FDI but also elucidated where and how they choose to operate in foreign nations. Mathews expounded FDI for MNCs from a developing country's perspective through his triple "L" model as Linkage, Leverage, and Learning (LLL). The institutional/network-based approaches further expanded the explanatory scope by considering the role of latecomer firms, institutional environments, and inter-firm networks in shaping FDI strategies.

This paper will critically examine the theoretical development of FDI, tracing its evolution from early trade-based theories to contemporary institutional and network perspectives. Each theoretical contribution will be scrutinised in terms of its assumptions, strengths, and limitations, with the practical examples illustrating their applicability both in developed and developing states.

A careful consideration of the theories shows that none of them, by itself, fully describes the term FDI. Therefore, a thorough comparative analysis may help readers understand the recent overseas investment patterns of MNCs. The review shows that none of them provides an intrinsic justification for FDI; instead, an integrated understanding emerges from their mutual insights.

Classical Trade Theories

The classical theorists set the intellectual roots of FDI in light of classical trade theory. Adam Smith's (1776) absolute advantage and David Ricardo's (1817) comparative advantage theory are the plausible founding FDI concepts. They explained international trade patterns as an outcome of differences in productivity and relative efficiency. Smith believed that nations should specialise in producing goods in which they have an absolute advantage. Ricardo enriched the idea of relative efficiency, suggesting that even less efficient firms can flourish by trading across borders if they specialise in areas of their respective comparative advantage.

Although they provided the fundamentals of trade flows, these theories offered little justification for multinational capital engagement or for overseas firm-level decision-making. FDI involves ownership and control of assets in foreign states, a phenomenon that is often overlooked in analyses focused solely on national-level productivity differences. Indeed, classical theories posited the immobility of capital across borders, directly contradicting the essence of FDI.

Neither concept addressed cross-border investment, which at the time was considered rare. Both theories considered capital immobility the primary friction; that is, resources move only within a country. Moreover, these frameworks failed to explain why capital did not always flow as predicted, and why firms preferred to own and control assets abroad instead of exporting or licensing. Yet, these models laid the groundwork for later theories by focusing on the benefits of global specialisation for becoming a worldwide producer.

Neoclassical Trade Theories

The neoclassical theorist developed international trade theory, particularly the Heckscher-Ohlin (H-O) model (1933), which posits that factor endowments explain trade flows. Nations export goods that widely utilise their abundant factors as raw materials and import those that require resources they lack. It's loosely related to investment. It suggested that resource-rich (Capital, Unique assets, etc.) countries would invest abroad in low-capital nations to achieve higher returns. While the H-O model identified cross-border capital movements, it failed of explain why firms, rather than individuals or banks, invest abroad. Furthermore, it is assumed to be a perfectly competitive market with free factor mobility and zero transaction costs, conditions rarely observed in practice.

These theories explained long-term capital movements, but often under assumptions of perfect markets, factor mobility, and related conditions. They had difficulty explaining why multinational firms exist or why firms prefer to own assets abroad rather than export or license.

It was also suggested that capital could move freely from capital-abundant to capital-deficient countries until the rates of return equalised; however, in reality, FDI was highly prevalent among developed countries. These gaps in the theory led firms to view investment as the primary driver of international investment. As MNCs rose in the mid-twentieth century, it was clear that new theories were required to describe firm-specific behaviours, such as ownership advantages, and the strategic nature of FDI.

Hymer's Monopolistic Advantage Theory

Stephen Hymer (1960), in his PhD dissertation, presented his Monopolistic Advantage Theory. It shows why large firms are usually engaged in cross-border businesses. His seminal work in the 1960s marked a paradigm shift by placing firms, rather than nations, at the core of FDI analysis. He realised the monopolistic advantages concomitant to proprietary technology, marketing and branding. He suggested that MNCs engage in foreign investment to exploit firm-specific advantages (FSAs), such as exclusive knowledge, management expertise, or a recognised brand. Hymer (1970) argued that FDI extends further because firms possess monopolistic advantages, such as unique technology, patent rights, and economies of scale, that enable them to compete successfully in overseas markets.

His work laid the groundwork for modern theories that consider strategic behaviour and the need to internalise control over operations in foreign markets. For example, Unilever in South America was able to transcend local competition by leveraging the firm's global brand equity, product innovation, and superior marketing capabilities. In Hymer's words, FDI occurs when firms engage in foreign production to control and correct unstable market intermediaries and safeguard intangible assets, as in the case of alienable and ethereal Brands. His insight was challenging because it linked FDI to market imperfections, which is fundamentally different from the neoclassical assumption of perfect competition (Hymer, 1982).

Nonetheless, while the theory elucidated why firms expand abroad, it offered little insight into where they invest. Moreover, it overlooked dynamic factors such as global supply chains and institutional influences that later became integral of theories. Furthermore, Hymer's model has been criticized for its focus on a firm's internal market and for paying little, if any, attention to the location-specific characteristics of the FDI host country, as well as to the relations and cooperative strategies associated with it.

Vernon's Product Life Cycle Theory

Raymond Vernon's (1966) product life cycle (PLC) theory sought to explain the spatial evolution of production and cross-border investment. According to him, new products are initially developed, produced, and sold in advanced economies, under conditions comparable to those of the home market. In other words, when a new product is first commercialised, there is a high likelihood that it will be manufactured and marketed in one of the more developed countries. As products mature and standardise, firms shift manufacturing to low-cost, efficient, and productive locations in developing nations through FDI. This framework successfully explained past patterns in industries such as consumer electronics and automobiles, in which production shifted from the United States to Europe and then to Asian republics (Vernon, 1979). Conversely, in the present era of globalised production networks, digital revolution and inventiveness, the linearity of the PLC is less evident (Vernon, 2014). Innovations now diffuse rapidly into foreign businesses, usually bypassing the static pattern postulated by PLC.

It explained the shifting geography of FDI over time, but is criticised for its limited applicability to services, digital goods, and fast-moving industries that skip stages or globalise from inception. A clear example is Apple's production sequence of the iPhone. Apple's innovation and design occur in the USA, with manufacturing in China and other Asian locations. The same is true for Pakistan's textiles sector, where industrialised nations outsource manufacturing to local firms due of lower production costs. The theory in question has high accuracy in defining the phases of innovation; however, it is overly simplistic and does not account for the complexities and interdependencies of the modern-day globalised economy. It also focuses mostly on manufacturing, older industrial models, and less so on services, digital goods, or firms that are born global and start global.

Buckley and Casson's Internalisation Theory

Internalisation Theory was developed by Buckley and Casson in 1976. It posits that firms undertake FDI when internalising cross-border transactions is more efficient than relying on external market-based contracting. This decision is driven by the desire to reduce transaction costs, avoid contract- enforcement issues, and safeguard intangible assets, such as technology and know-how. They provided a robust explanation of why firms prefer FDI to other modes of internationalisation, such as licensing or exporting. They stated that imperfections in external markets such as enormous transaction costs, weak intellectual property (IP) protection, or other IP threats such as, unreliable contracts make it more efficient for firms to internalise operations by establishing foreign subsidiaries like McDonald's opened its outlets in India etc. similarly iPhone also established it's retailers across the globe to self-provide customer care and support services.

Information asymmetry, weak enforcement, or risks of intellectual property leakage encourage firms to internalise operations by establishing subsidiaries abroad. This theory explains why firms choose FDI over licensing or exporting, especially when there is a risk of opportunism or leakage of proprietary information. For instance, Toyota invests in overseas production plants instead of licensing technology to preserve quality standards and control production processes. Similarly, Telenor Pakistan entered the market through FDI to maintain operational control and protect proprietary knowledge. This perspective pointed out the strategic logic of FDI as a governance decision. For example, pharmaceutical firms often prefer FDI across markets to protect proprietary knowledge instead of taking the risk of licensing agreements or delegating authority to others.

Critics argue that internalisation theory remains too narrowly focused on imperfect markets, efficiency considerations, etc., and ignores facts of broader institutional and strategic factors. While this theory effectively explains control motives, it underestimates external influences like host- country regulations, political risks, and institutional frameworks.

Dunning Eclectic (OLI) Paradigm

Dunning's (1973) Ownership, Location and Internalisation (OLI) framework remains one of the most widely cited concepts in international business. It integrates economic, strategic, and institutional elements, offering a comprehensive explanation for FDI behaviour. His renowned eclectic paradigm is one of the most influential models for explaining FDI. According to his Ownership, Location and Internalisation (OLI) model, firms engage in FDI when three conditions are met. The first one is Ownership (O). Advantages: the firm's unique assets, such as patents, brand recognition, managerial skills, unique technology, or processes. For example, Lenovo acquired IBM for its brand recognition and successfully competed with Dell and other MNCs internationally, thereby demonstrating that it's relatively easy to expand with a renowned brand name (Dunning, 2013).

Second are Location (L) advantages: country-specific dynamics such as market size, resources (including natural resources), and business-friendly institutions. Shell relocates its exploration activities to countries where natural resources such as oil/gas are found in large quantities. Similarly, China attracts more FDI due of affordable labour costs, a skilled labour force, and adequate infrastructure. Likewise, Toyota relocated its automobile plants to the United States to be closer to its customers and to avoid tariffs and other export costs.

The third one is the Internalisation (I) advantages: benefits of keeping control inside the MNC instead of contracting with overseas firms or local business units. The most salient example is that of the iPhone, which prefers to establish its own retail stores worldwide. A more focused example of internalisation advantage is Pfizer's establishment of wholly owned production facilities abroad. Manufacturing pharmaceuticals requires strict quality controls and sensitive, patented, proprietary knowledge. Licencing to local foreign firms will risk higher monitoring costs, patent leakage and possible lax compliance.

Dunning's OLI model is also the first to introduce mergers and acquisitions to FDI theory. For example, Nestlé bought Milk Pak Pakistan to exercise its ownership advantages in technology and brand image. It invested in Pakistan because of its proximity to a large consumer market (locational advantage) and internalised operations (internalisation advantage) to ensure quality control.

The OLI Model's strength lies in its integrative approach that combines firm-level and country-level factors. It has been widely adopted across industries, from automotive to technology (Dunning, 2015). However, it's also been observed that it just "describes" instead of predicting or suggesting. It's the same as providing you a list of FDI determinants rather than giving a precise theory[4].

Though not part of the OLI model, Dunning later introduced the Investment Development Path model, which outlines how countries evolve from FDI recipients to outward investors as they develop. It highlights the dynamic relationship between an economy's development stages and its FDI profile.

Mathews' Linkage, Leverage and Learning Theory

Mathews (2006) offered the Linkage, Leverage and Learning (LLL) model to explain the rise of multinationals from developing economies. Unlike conventional MNCs that internationalise based on pre-existing ownership advantages, new firms from Asia, Africa, and Latin America relied on external linkages (e.g., partnerships), leveraged networked resources. They engaged in rapid learning to build competitiveness in foreign markets. Examples include Chinese-based firms like Huawei in the telecom sector. It initiated a venture with the British-based Vodafone and leveraged these partnerships to access Western technology. Learning at full capacity, it soon became an international player and was the first organisation to introduce 5G in the telecom sector. Similarly, India's Tata Group acquired Land Rover to learn new technologies and techniques. It expanded operations globally through acquisitions and through learning by doing.

Likewise, as an example of South-South or developing-developing country MNC engagement, consider the partnership between Huawei, a Chinese MNC, and Engro Corporation, of Pakistani MNC. It illustrates how firms in emerging economies can enhance their capabilities through global partnerships and learning. Mathews, LLL model advances FDI theory by underlining the significance of knowledge acquisition and not just the ownership advantages of the OLI paradigm. The triple L model, thus, adopted the unique trajectories of firms from developing countries: a context often overlooked by earlier Western-oriented theories (Mathews, 2017).

4. For usage of OLI model in Empirical perspectives read Shah (2018a; b; c), Shah (2023), Shah and Tahir (2024), Shah and Sikander (2025), Shah and John (2025) and Altaf and Shah (2025).

Institutional and Network-Based Perspectives of FDI

Contemporary research increasingly strengthens the role of institutions and networks in shaping FDI. North (1990) institutional theory focused on how formal rules such as laws, regulations, and governance, and informal institutions like norms, culture, and trust affect investment decisions. For example, strong intellectual property protection in developed countries has motivated high-tech FDI, whereas weak institutions in developing countries may deter foreign investors (North, 2025). For example, Singapore has strong institutions that attracted more FDI.

Network theory focuses on the role of inter-firm relationships, clusters, and worldwide value chains. Firms have adopted production networks across nations. Therefore, FDI often shows the need to sustain or expand these connecting networks (Schoeneman, Zhu & Desmarais, 2022). For example, the massive FDI project of Silicon Valley's venture capital ecosystem. Equally important are inter-state strategic alliances for FDI, for example, the game-changing Chinese Belt and Road Initiative epitomises how networks give rise to cross-border investments.

Firms consider the political climate, the legal and regulatory environment, and the sociocultural context in their investment decisions. Lundan (2018) emphasised the role of institutions in reducing uncertainty. Peng and Meyer (2023) and Meyer and Caleb (2025) among many others have built on this to explore how institutional voids in emerging markets affect MNCs investment strategies, for example the China Pakistan Economic Corridor (CPEC) which has intensified cooperation between state based national institutions, especially, the foreign direct investment inflow from China into energy and infrastructure sectors in Pakistan. Network-based perspectives also account for why firms such as Samsung and Toyota maintain global supplier networks. These perspectives embrace both the macro and micro aspects of FDI and seek to reflect on contemporary global scenarios.

Developed and Developing Economies Context

Foreign Direct Investment differs significantly between developed and developing countries. In developed nations, firms often engage in efficiency-seeking investments or strategic asset-seeking FDI, such as European firms investing in the United States for state-of-the-art technologies. Contrary to it, in developing nations, FDI tends to be resource-seeking, for example, Chinese investment in the African mining sector, or market-seeking, for example, McDonald's arrival in India due to its large population with growing purchasing power of the middle class. Similarly, Coca-Cola's investments in the consumer goods sector in India are also aimed at capturing a share of its growing middle-class consumer base.

Theories such as Vernon's product life cycle and Dunning's OLI model have effectively elaborated on developed-country FDI but require adaptation to capture the dynamics of developing economies. On the contrary, Mathews' LLL model, along with institutional perspectives, provides a more nuanced lens for understanding the internationalisation of recent multinational activities in the developing world.

Conclusion

The evolution of the FDI concept encompasses the more primitive theories of trade and the more complex contemporary theories of firm–specific strategies and international production structures. Pioneers of economics, like Adam Smith (1776) and David Ricardo (1817), for the most part, considered cross-border capital movements on a trade canvas. But when, with the expansion of international business, it became evident that trade theory in its classical form could not explain the foreign investment behaviour of firms. It paved the way for modern FDI theories that focus on firm-specific decisions, volatile markets, and diverse institutional frameworks. The theoretical development of FDI shows the growing complexity of international business. From the classical trade theories of Smith and Ricardo, through Hymer's and Vernon's firm-level philosophies, to the integrative OLI model and the latest institutional and network approaches, scholars have significantly expanded the scope of FDI theories.

Each theory and framework offers valuable insights, but also carries some grey areas. Classical and neoclassical theories ignore firms. Firm-level theories have overlooked the potential role of institutions and the benefits of specific locations. The eclectic paradigm integrated multiple perspectives but lacked predictive power. Contemporary approaches, such as Mathews' triple L model and institutional perspectives, focused on the importance of modern strategies, networks, and institutions in the contemporary multipolar world.

In brief, no single theory fully captures the complexity of FDI. A holistic perspective requires synthesising insights across multiple frameworks, considering both firm-specific and strategic factors, and identifying the dynamic interplay between developed nations of e.g., the US, the UK, the EU, and Japan and developing nations (e.g., China, India, Brazil). The world is becoming more digitalised and multifaceted, so firms require adaptation to the ever-changing international commercial order.

For the sake of sustainability, the developed and developing economies should also familiarise themselves with evolving patterns of MNCs' behaviour. From Pakistan's perspective as a developing country, the combination of Dunning's OLI and Mathew's LLL theories is likely the most appropriate for formulating an optimal policy to attract sustainable, knowledge-driven MNCs for FDI. Geopolitical changes shape the global economy; future theories of FDI will need to address not only resource flows but also issues of technological sovereignty, green investment, and global value chain dynamics.

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