Why do firms invest abroad?

Outward direct investment, international production, and corporate size are closely related. The most successful companies in the world are also those who are very active in cross-border direct investment flows and international production. Therefore multi-country presence is an international best practice for fast growing companies. The rapid expansion in FDI flows during the 1990s and the 2000s has revived considerable interest among academics and policy makers globally in the reasons why companies make foreign direct investments abroad.

Ownership, location and internalization advantages

FDI occurs to exploit a profit potential that cannot be captured in one's own country. Of the many theories put forward to explain why a firm chooses to engage in FDI activity, Dunning's [Dunning (1980), Dunning (1988)] eclectic paradigm of international production has often been used to explain FDI. According to this theory, pattern and growth of value added activities by MNEs depend on their competitive advantages relative to local firms. They are of three types: ownership advantages, location advantages and internalization advantages.

The ownership advantages manifest themselves as mobile, intangible assets which are exclusive or proprietary to their owners. Examples of these are human capital including marketing expertise, organizational and technical know-how, product differentiation, brand image, product quality, and property rights including patents, formulae and trademarks. These advantages can be exploited abroad and give the firm a market power in the foreign market.

The location advantages are the exogenous and non-exclusive assets which are captured from the environment — foreign country or region — in which the firm's capital and goods are transacted. They might be in the form of better access to consumers, savings in transport or tariffs, lower cost of production, market structure (i.e., number of firms and product differentiation), and proximity to natural resources.

The internalization advantages are the advantages of administering international transactions within the same firm through a subsidiary rather than licensing or selling its product or process to an unrelated foreign firm. By internalizing activities within the firm and across countries, multinationals are able to reduce transaction costs related to market imperfections. For example, by using affiliates instead of exports to serve foreign markets, MNEs are able to avoid costs associated with tariffs and exchange rates. Transaction-cost economizing is the term often used to describe this benefit. The economies gained are both in terms of scale and synergy, and the more the boundaries of a firm are pushed out, the more important these economies become. These economies are essentially firm rather than country specific and can be associated with factors such as market rationalization, company organization, risk diversification, and the sharing of company-wide resources in terms of R&D, services, marketing, information, distribution, purchasing, and financing. Internalization also allows MNEs to better exploit and protect monopolistic ownership advantages, such as trademarks and know-how.

According to Dunning's theory, all three advantages — ownership, location, and internalization (OLI) — must be present in order for a firm to engage in FDI. Thus, a firm will invest in operations outside of its home market when it holds proprietary assets that can be efficiently exploited internally within the firm.

The link between Canadian direct investment abroad and trade

As noted above, outward investment enables firms to remain competitive. It offers Canadian firms the opportunity to be exposed to new practices and