The Eclectic (OLI) Paradigm of International Production: Past, Present and Future

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ABSTRACT This article describes the origins, and traces the subsequent evolution of the eclectic paradigm from the mid-1950s to the present day. It does so in the light of the changing characteristics of MNE activity and of the global economic scenario. The article concludes by asserting that the eclectic paradigm still remains a powerful and robust framework for examining contextual specific theories of foreign direct investment and international production.

Key words: Eclectic paradigm; FDI; MNEs; Strategy; International production; Alliances.


1. Its Origins

Although the eclectic paradigm (or the eclectic theory as it was initially called) of international production was first put forward by the present author at a Nobel Symposium in Stockholm in 1976, its origins can be traced back to the mid-1950s. At that time, I was writing my PhD thesis, later to be published as a book (Dunning, 1958), on US direct investment in British manufacturing industry. Earlier research by Rostas (1948), Frankel (1955) and some Anglo–American study teams had shown that the labour productivity in US manufacturing industry was, on average, 2 to 5 times higher than that in UK industry. The question this fact posed in my mind was: was this difference in productivity a reflection of the superior indigenous (and immobile) resources of the US (cf. the UK) economy; or was it due to the more proficient way in which the managers of US firms (cf. UK firms) harnessed and organised these resources? — a capability which, I argued, at least to some extent, might be transferable across national boundaries.

This article draws on various past contributions of the author, but most particularly on those of Dunning (2000a and b).

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The hypothesis of my thesis then was, if the superior productivity was entirely managerially related, US manufacturing affiliates in the UK should perform at least as well as their parent companies, and fare considerably better than their indigenous competitors. This I identified as the ownership-specific effect, as the productivity differences were presumed to rest on the spatially transferable intangible assets of the parent companies. If, however, the US affiliates in the UK recorded no better performances than their UK competitors, and hence, much poorer than that of their parent companies, I hypothesised that this would be due to the non-transferable (i.e. immobile) characteristics of the US economy. This I called the location specific component of any productivity differential.

As might be expected, I discovered that US affiliates were not as productive as their parent companies, but were more productive than their local competitors. This then suggested that, in the 1950s, at least, Anglo-American productivity differences were partly explainable by location (L) and partly by ownership (O) specific characteristics. However, my study omitted to ask a follow-up question, namely, to what extent was the origin of the O advantages of US firms themselves home country specific? Neither did it attempt to distinguish between those O advantages that arose as a consequence of US direct investment in the UK, and those that the US firms possessed prior to engaging in foreign production.

I took up the theme of ownership and location advantages again in two papers written in the early 1970s. The first (Dunning, 1972), concerned the likely impact of Britain’s membership of the European Common Market (ECM). In it, I suggested that while the removal of tariff barriers would cause some realignment of the location of economic activity within the ECM, it would also be likely to affect the competitive position of firms of different national origins and, in consequence, the ownership of production in the ECM.²

The second paper (Dunning, 1973) was an attempt to review the various attempts which had been made to explain the activities of firms outside their national boundaries over the past decade. In that contribution I tried to integrate the industrial organisational and locational determinants of international production. I argued, like Hymer (1960; 1976) that while the first was necessary to explain why the affiliates of foreign firms could compete successfully with domestic firms in supplying the latter’s markets, the second was relevant to explaining why the former firms chose to supply their markets from a foreign, rather than from a domestic, base.

In 1975, I was asked to present a paper at a Nobel Symposium on the International Location of Economic Activity which was held in Stockholm in June 1976. This symposium was organised by Bertil Ohlin and attended by leading international economists, economic geographers, and regional scientists. For the most part, the seminar was oriented towards an evaluation of country-specific factors influencing the changing distribution of international economic activity, but the starting-point of my paper was that a country’s economic space could be considered in two ways. The first was the value of output produced within its national boundaries independently of the ownership of that production. The second was the output produced by its own firms, including that part produced outside its national boundaries. This further distinguished between the competitive advantages of countries and that of firms which I have been at pains to stress in several of my writings.³

In explaining the activity of firms outside their national boundaries, I extended the O and L advantages identified in my earlier research to include
another set of choices available to firms, which related to the way the firms organised the generation and use of the resources and capabilities within their jurisdiction and those they could access in different locations. In other words, I acknowledged that, to explain fully the extent and pattern of the foreign value-added activities of firms, one also had to explain why such firms opted to generate and/or exploit their O specific advantages internally, rather than to acquire and/or sell these, or their rights, through the open market. Such advantages I referred to as internalisation (I) advantages; and these became the third leg of the ownership, location and internalisation (OLI) tripod in explaining the scope and geography of value added activities by multinational enterprises (MNEs).

I would be the first to admit that, in my work on I advantages, I was considerably influenced by my colleagues Peter Buckley and Mark Casson of the University of Reading, who were in the process of writing *The Future of the Multinational Enterprise* (1976), although my first exposure to the concept of internalisation, as applied to the MNE, came in 1972 when I read an article by J.C. McManus (1972) in Guy Paquet’s edited volume on *The Multinational Firm and the Nation State*. A year later, on a visit to Uppsala in Sweden, I had conversations with Nils Lundgren, a Swedish economist who was thinking along the same lines in his attempt to explain the growth of Swedish foreign direct investment (FDI). Nevertheless, I regarded this new insight as a useful addition to my own approach in explaining the determinants of the foreign production, and not a replacement of it, a view I still hold today.

Over the past two-and-a-half decades, I have benefited enormously from the comments of friends and colleagues on the eclectic paradigm of international production. I accept that in my earlier work I did tend to look at I advantages more as those that arose from the way O advantages were exploited rather than as a market replacement activity which conferred its own hierarchical advantages. While, as set out in my book *Multinational Enterprises and the Global Economy* (Dunning, 1993a), I still prefer to think of O advantages as any kind of income-generating asset that allow firms to engage in foreign production, I readily acknowledge that these may arise as a direct consequence of cross-border market-replacing activities. But, even where this is the case, I believe that a firm’s ability to benefit from such activities must be related to the assets which it possesses prior to the act of internalisation.

The economies of common governance arise because a firm integrates its existing activities with new activities. For example, a firm that is currently producing in country A, and believes it will benefit from the economies of scope and by the diversification of risks if it produces in country B, will gain from such diversification, only if it produces in both country A and country B! A firm that benefits from the cross-border economies of scope or scale will only do so if the new investment is in addition to its existing investment. A firm that makes a foreign acquisition to obtain new and up-to-date technology or managerial capabilities presumably does so because it believes it can use such assets along with its existing core competences in a way which will protect or augment its competitive position. This may seem an obvious point, but to me at any rate, the distinction between the benefits that accrue from the gains to be had from internalising the market of an existing asset and those that arise from coordinating existing assets with new assets, *vis-à-vis* some alternative use which might be made of those assets, is an important one.
2. The Key Propositions of the Eclectic Paradigm

Let me now reiterate the propositions of the eclectic paradigm. The subject to be explained is the extent and pattern of international production, i.e. production financed by FDI and undertaken by MNEs. The paradigm asserts that, at any given moment of time, this will be determined by the configuration of three sets of forces:

(1) The (net) competitive advantages which firms of one nationality possess over those of another nationality in supplying any particular market or set of markets. These advantages may arise either from the firm’s privileged ownership of, or access to, a set of income-generating assets, or from their ability to co-ordinate these assets with other assets across national boundaries in a way that benefits them relative to their competitors, or potential competitors.

(2) The extent to which firms perceive it to be in their best interests to internalise the markets for the generation and/or the use of these assets; and by so doing add value to them.

(3) The extent to which firms choose to locate these value-adding activities outside their national boundaries.

The eclectic paradigm further avers that the significance of each of these advantages and the configuration between them is likely to be context specific, and in particular, is likely to vary across industries (or types of value-added activities), regions or countries (the geographical dimension) and among firms. Thus there are likely to be country-specific differences in the ownership advantages of (say) Korean firms compared with (say) Canadian firms. The extent of market failure influencing whether or not the market for technology is internalised is likely to be different in (say) the wood and pulp industry than in (say) the semi-conductor industry; while the relationship to the comparative locational advantages of Thailand and Taiwan as a manufacturing base for motor vehicles may be differently regarded by (say) the Toyota than (say) the Honda Corporation.

In my more recent writings, I have argued that the eclectic paradigm is best regarded as a framework for analysing the determinants of international production rather than as a predictive theory of the MNE qua MNE. I have frequently asserted that no single theory can be expected to satisfactorily encompass all kinds of foreign-owned value-added activity simply because the motivations for, and expectations from, such production vary a great deal. The variables necessary to explain import-substituting FDI are likely to be different from those that explain resource-oriented FDI; and both are likely to be different from those that explain rationalised or strategic asset-seeking investment. In formulating operational hypotheses about the relationship between individual OLI variables and the level and pattern of international production, it is important to specify the context in which this relationship is being examined. But, similarly, as I have opined elsewhere (Dunning, 1995), no single theory of international trade can satisfactorily explain all forms of cross-border transactions in goods and services.

3. Some Criticisms of the Paradigm

Let me now turn to some criticisms of the eclectic paradigm and particularly those put forward in the 1970s and early 1980s.
3.1 A Shopping List of Variables?

First it has been claimed that the explanatory variables identified by the paradigm are so numerous that its predictive value is almost zero. There is a modest (but only a modest) amount of truth in this contention. In our defence, however, we would make three important points. The first is that each and every OLI variable identified by the eclectic paradigm is well grounded in economic or organisational theory. For example, all the L variables – be they labour costs, tariff barriers, the presence of competitors or agglomerative economics – rest on the tenets of one or other contextually related location theory, and also the assumption that firms will seek to site their value-added activities at the most profitable points in space.10 Similarly, the I-specific variables all relate to the costs and benefits of different modalities of coordinating multiple economic activities. Here the paradigm draws heavily upon Coasian, Williamsonian and Penrosian theories of the firm (or the growth of the firm); and, like these scholars, we argue that the higher the net innovating, production and transaction costs (or the lower the net benefits) of using cross-border markets, relative to those of internal administrative fiat, as a mechanism for coordinating resource usage, the greater will be the incentive for firms to engage in FDI.

Second, as I have already explained, the purpose of the eclectic paradigm is not to offer a full explanation of all kinds of international production but rather to point to a methodology and to a generic set of variables which contain the ingredients necessary for any satisfactory explanation of particular types of foreign value-added activity.

Third, much of this kind of criticism can be directed toward other general theories of FDI and MNE activity. The kinds of market failure relevant to explaining resource-based investment are totally different from those explaining rationalized investment. Partial theories do not suffer from this same deficiency; however, unlike the general theories, they can only explain some kinds of foreign direct investment. For example, the product cycle theory has little relevance to resource-based FDI. Knickerbocker’s follow-my-leader or oligopolistic interaction approach (Knickerbocker, 1973) is entirely dependent on the existence of a particular type of market structure. Kojima’s normative macro-economic theory (Kojima, 1978; 1982) cannot easily encompass intra-industry investment. Alberr’s theory (1970; 1971) is only relevant for explaining multinational activity in different currency areas. The risk diversification thesis (see for example Rugman, 1980, 1997) cannot readily explain much of strategic asset-seeking FDI. And so on!

3.2 Interdependence of OLI variables?

It has been suggested that it is misleading to suggest that the triumvirate of variables which make up the eclectic paradigm are independent of one another. For example, a firm’s response to its exogenous locational variables might itself influence its ownership advantages, including its ability and willingness to internalise markets. A particular R&D strategy, intended to strengthen a firm’s competitive position may require a reappraisal of the siting of its existing innovatory facilities; while a change in a firm’s organisational structure may directly affect its ability to penetrate the markets of its competitors. Over time, the separate identity of the variables becomes even more difficult to justify.
Accepting, as I have done, the logic behind this criticism, I nevertheless believe there is something to be said for separating those reasons for MNE activity which are primarily due to the unique resources and capabilities possessed or accessed by firms of a particular ownership – including their ability to choose the right location and mode of organisation to exploit or augment these assets – from those to do with the location-bound resources and markets of the countries in which they operate. The policy implications of a decline in FDI which results from a reduction in the attractiveness of the former, are very different from those that reflect the strengthening competitive position of a country’s indigenous, relative to foreign-owned, firms. An increase in outbound FDI due to the integration of markets allowing the better exploitation of the economies of common governance (e.g. as is encouraging more Pan European direct investment) flags a very different message to the governments of home countries than where such investment is driven out by uncongenial conditions in the domestic market (e.g. as was the case in India for most of the 1970s and early 1980s, South Africa and the Philippines in the mid-1980s and Indonesia in the late 1990s).

In my more recent writings (Dunning 1993a, b, 1995b, 1997, 2000b), I have fully acknowledged the ways in which the OLI variables determining the foreign production of firms and countries may be linked to one another. Thus, as is set out more formally in the next sub-section, FDI based upon the O advantages of the investing firms in time \( t \) may well affect the L advantages of the host country in time \( t + 1 \); while the response of firms, by use of either a ‘voice’ or an ‘exit’ strategy, to market failure (Hirschman, 1970) and/or their choice of location for their innovating activities, might critically affect the shape of their future O advantages. Indeed, I would go further and suggest it is the successful coordination of the O advantages of foreign and domestic firms with their own L advantages, and how each affects and is affected by the modality of resource deployment, that determines the extent to which a particular country is able to sustain, or upgrade its wealth-creating capacities over a period of time.\(^{11}\)

3.3 No Role for Strategy: A Static Approach?

It has also been argued that the eclectic paradigm insufficiently allows for differences in the strategic response of firms to any given configuration of OLI variables. This criticism may be coupled with another that suggests the paradigm is couched in static (or comparatively static) terms and offers little guidance as to the dynamics of the internationalisation process of firms (or of countries). In my book *The Globalisation of Business* (Dunning, 1993b), I took on board this criticism (which, incidentally, may also be levelled at the internalisation theory of the MNEs). My reasoning is as follows. At a given moment of time, the extent and pattern of MNE activity represents a point on a set of trajectories towards (or, for that matter, away from) their internationalisation path. That trajectory itself is set by the continuous and iterative interaction between the OLI configuration over successive time periods and the strategy of firms in response to these configurations that, in turn, will influence the OLI configuration in a subsequent moment of time. Let \( \text{OLI}_0 \) be the OLI configuration in time \( t_0 \), \( \text{OLI}_1 \) the OLI configuration in time \( t_1 \), \( S_{t,n} \) the past (i.e. pre \( t_0 \)) strategies of firms still being worked out, and \( \Delta S_{t_0} \rightarrow t_1 \) any change in the strategic response of firms to that configuration between time \( t_0 \) and \( t_1 \). Then, *ceteris paribus*:
\[ OL_i t_1 = f (OLi_0S_{t-n} \Delta S_{t_0} \rightarrow _{t_1}) \]  

If we extend the analysis to a second time period \( t_2 \), then:

\[ OL_i t_2 = f (OLi_1St-n \Delta S_{t_1} \rightarrow _{t_2}) \]

This analysis further suggests that \( S_{t-n} \) and \( S_{t_0} \rightarrow t_2 \) determine the path of the movement from \( OLI_0 \) to \( OLI_2 \).

Strategic response is, of course, just one of the many endogenous variables which might affect the OLI configuration of firms (mainly by its impact on O and I advantages). Others include: technological and/or organisational innovations; changes in the composition of senior management; increases in labour productivity; new marketing techniques; mergers and acquisitions; and so on. No less significant are exogenous changes, such as changes in: population; raw material prices; exchange rates; national government policies; actions taken by international agencies; and so on. If we take all endogenous variables other than strategy to be \( EN \), and all exogenous variables to be \( EX \), and we assume that changes in \( EN \) and \( EX \) do not affect the firms’ strategies, then we can rewrite equation (1) as:

\[ OL_i t_1 = f (OLi_0S_{t-n} \Delta S_{t_0} \rightarrow _{t_0} \Delta EN_{t_i} \rightarrow _{t_1} \Delta EX_{t_0} \rightarrow _{t_1}) \]  

Equation 2 can be similarly reconstructed and it is easy to incorporate any change in strategy which embraces the response to \( \Delta EN \) and \( \Delta EX \) if it occurs before \( t_1 \) is reached by adding * to \( \Delta S_{t_0} \rightarrow _{t_1} \) in the equation.

Of course, it may be argued that this drives a coach and horses through the generality of eclectic paradigm; as the nature of the interaction between the value of most exogenous and endogenous variables likely to affect international production and the strategy of firms are difficult to predict. Yet, from the time of Vernon (1966) onwards, economists and business analysts have been trying to do just that. In one of his later writings, Vernon (1974), for example, suggested that both the strategy of firms and the locational advantages of at least some value-added activities associated with the production of a product change as that product moves through its cycle. Thus a firm’s O and L position affecting investment in time \( t + 1 \) (e.g. the mature stage of the product cycle) is affected both by its OL configuration in the early (i.e. the innovating) stage of the cycle, and by the changes in the exogenous variables, e.g. demand by the foreign customers, and endogenous variables, e.g. the presence (or absence) of economies of plant size, and any changes in the strategy of firms consequential upon these eventualities.

Later scholars have more explicitly introduced a time- and strategy-related dimension into their analysis. Again, reinterpreting Knickerbocker’s analysis in terms of the OLI paradigm, we may say that firms are prompted to go overseas, in part at least, because they consider their O advantages are (or could become) threatened, if they do not follow their competitors’ lead or because their advantages would be less without their presence. In other words, the strategy followed by firms in response to a given OLI configuration in time \( t_0 \) is governed by their desire to protect or influence that configuration in \( t_1 \). (This incidentally does not necessarily mean that all firms will engage in more FDI.)
3.4 The Kojima Criticism of the Eclectic Paradigm

Let me next turn to Kiyoshi Kojima’s criticism of the eclectic paradigm (Kojima, 1982). To Kojima, my approach, and that of the internalisation scholars, is purely a micro-economic phenomenon. Indeed, he seems to assume that the internalisation and eclectic paradigms are trying to explain the same phenomenon. They are not. As far as I am aware, no one from the internalisation school has sought to explain the changing propensity of countries to invest, or be invested in, over time.

Nevertheless, Kojima is right in supposing my macro-economic perspective is different from his. Let me given an analogy: suppose the subject for explanation is the trade in goods. Kojima would be interested in answering the question, ‘Why does one country export certain types of goods and import other kinds of goods?’, whereas I would be concerned with explaining whether a particular country was a net importer or exporter of particular types of goods or of all goods. And, I admit that, at a macro level, the latter is a somewhat meaningless question, as in the last resort, and over a sufficiently long period of time, the balance of payments must balance. But, this is not the case with the stocks and flows of international investment.

Moreover, most investment owned and controlled by MNEs is a different phenomenon from foreign portfolio investment (but see section 4.4 of this article). So, indeed, is trade conducted within MNEs different from trade between independent parties. In other words, as I have elaborated on elsewhere (Dunning, 1993a), organisational issues do inject the need for a set of analytical tools different from those offered by traditional trade theory.

This is where I think Kojima’s criticism of the eclectic paradigm falls down. He insists upon applying a strictly neo-classical framework of thought to explain a phenomenon that is outside that framework of thought. Moreover, like neo-classical theory, his approach to explaining FDI is more normative than mine. However, in various of my writings (see, for example, ch. 10 of Dunning, 1988; and ch. 13 of Dunning, 1993a), I have attempted to give some normative content to the eclectic paradigm by suggesting the conditions for optimising the benefits which host countries might secure from inbound FDI.

4. Extending and Reconfiguring the Eclectic Paradigm

4.1 The Investment Development Path (IDP)

One of my first applications of the eclectic paradigm was to examine its relevance in explaining the changing international position of countries as they passed through different stages of development. The concept of the investment development cycle (or path) was first put forward in 1975 and has since gone through various iterations (e.g. Dunning, 1981, 1988, 1993a; Dunning and Narula, 1996; Narula, 1996; Dunning et al., 2001). The basic hypothesis of the IDP is that as a country develops, the configuration of the OLI advantages facing foreign-owned firms that might invest in that country, and that of its own firms that might invest overseas, undergoes change, and that it is possible to identify both the conditions making for the change and their effect on the trajectory of the country’s development. The concept also suggests the ways in which the interaction between foreign and domestic firms might itself influence the country’s investment path; but only
recently has this aspect been incorporated in the literature.\textsuperscript{14} The IDP identifies several stages of development a country might pass through. The first stage is one of pre-industrialisation, in which a country is presumed to have no inbound or outbound investment, in the first case because it has insufficient locational attractions, and in the second because its own firms possess few or no ownership advantages. Depending on its resources, government policy, the organisation of activity, and the strategy of firms, the OLI configuration changes so as first to attract inward investment in resource-based sectors, in the traditional and labour-intensive manufacturing sectors, in trade and distribution, in transport and communications, construction and perhaps in tourism.

Depending on the extent to which the country is able to create a satisfactory legal system, commercial infrastructure and business culture, and to provide the business sector with the transport and communications facilities and human resources they need; and depending on its government's policy toward inward direct investment (cf. Japan, which largely disallowed such investment in the 1960s, with Germany, which adopted an open-door policy towards it), its locational attractions will increase, and because foreign firms are likely to have more experience in manufacturing the goods and services now likely to be demanded (and have probably penetrated the local market by imports in any case) inward investment will continue to grow. Gradually it, and any investment by indigenous firms, will affect both supply and demand conditions for the products supplied by foreign firms and their desire to internalise their markets for the competitive advantages.

The improvement in the L advantages of countries may also help indigenous firms to upgrade their own competitive advantages. The growth of Japanese outward investment and, more recently, that of several developing countries is entirely consistent with a reconfiguration of the OLI advantages of indigenous firms brought about by the development process.\textsuperscript{15} Once again, changes in the value of both exogenous and endogenous variables affect each of these components. In this early stage, the role of the home government is especially important. In various of his writings (see, for example, Ozawa, 1989, 1992, 1996), Terutomo Ozawa has demonstrated the critical role of the Japanese government in influencing the ability of Japanese firms both to generate competitive advantages relative to their competitors and to locate their value-added activities outside of Japan. It has also affected the strategy of the Japanese companies themselves.

As countries move along their development path, the OLI configuration facing outward and inward investors continues to change. Some foreign (and domestic) firms, which earlier found a country attractive to invest in because of its low labour costs or plentiful natural resources, no longer do so. In other cases, its L advantages have become more attractive as an indigenous technological infrastructure and pool of skilled labour is built up. This, in turn, makes it possible for domestic firms to develop their own O advantages and begin exporting capital.

Next, as countries reach some degree of economic maturity, the OLI configuration facing their own firms may be such that their propensity to engage in outward direct investment exceeds that of foreign-based firms to engage in inward investment. Again, whether or not this happens rests on the strategy of firms and the policies of national governments to generate the competitive (and especially innovatory) advantages of their own firms and to make their own locations attractive to both domestic and foreign investors.

The literature is replete with examples of the kinds of variables likely to influence the OLI configuration over time and the determinants of the value of these
variables. Predictions for individual countries are difficult because they require forecasting the behaviour of governments. Different countries at the same stage of their development paths seem to display different propensities to engage in outward and inward FDI. Others may display similar propensities for different reasons. Thus, in the late 1980s, both Sweden and Japan were significant net outward investors, but whereas the Japanese push outwards represented a positive restructuring to make way for the upgrading of its domestic industry, in the Swedish case, it was more symptomatic of the falling competitiveness of the domestic economy. By the mid-1990s, however, Swedish inbound investment was rising quite rapidly, in part, because of Swedish accession to the European Union in 1995 (Zander and Zander, 1996).

The final stage of the IDP occurs when there is a fluctuating balance between outward and inward direct investment. This arises when there is some degree of convergence between the level of development and the economic structure of countries, and also where firms engage in FDI, not only to exploit their existing O advantages in a foreign location, but also to augment these advantages by acquiring complementary assets or new markets. In the mid-1990s, this stage has been reached by the more advanced industrial economies, whose wealth creation and productivity growth are increasingly based on their ability to harness and effectively utilise all forms of knowledge or intellectual capital. At this stage too, the role of government is often of critical importance in influencing the quality of L-specific advantages; and in setting the competitive environment for their own firms to effectively exploit the opportunities offered by the global economy (Dunning and Narula, 1996; Narula, 1996).

I have illustrated at some length from the IDP, because it does introduce (albeit at a macro level) a dynamic element into the eclectic paradigm. Moreover, it confirms that the equation(s) set out in section 3.3 do seem to make sense. The configuration of OLI variables affecting the (say) Japanese firms in the world economy in 1997 is a function of the OLI configuration facing them in (say) the mid-1980s and the changes in the endogenous and exogenous variables which have affected their behaviour in the intermediate period. Of these, there is strong evidence that the way in which these two sets of variables interact is, itself, an important factor determining the movement towards a new OLI configuration. We also believe that the concept outlined is very relevant in explaining the recent growth of outward investment from Third World countries, especially from South Korea, Singapore, Taiwan and Mexico (Van Hoesel, 1999; Dunning et al., 2001).

4.2 Acquiring a Competitive Advantage Through Foreign Direct Investment

Over the last decade or more foreign direct investment intended to augment the existing O or competitive advantages of firms has become an increasingly important form of cross-border economic activity, as, indeed, has the growth of inter-firm strategic alliances. Both forms of transborder economic involvement reflect the perceived need by firms domiciled in one country not only to capture the technological and marketing synergies offered by firms in other countries, but also, more generally, to harness or tap into the created assets of foreign competitors, suppliers, customers and those offered by national educational and innovatory systems.

Recent technological advances, more intensive interfirm competition, the opening up of new markets and the increasing mobility of some kinds of firm-
specific assets have, then, led to new motives for foreign production not only as a means of exploiting the existing \( O \)-specific advantages of the investing firms, but also as a vehicle for augmenting these advantages. In the second half of the 1990s, cross-border acquisitions and mergers accounted for by far the greater part of new MNE activity (UNCTAD, 2000), while non-equity alliances, particularly those geared towards innovatory activities have become an increasingly important component of corporate strategy. Nowhere is this more clearly demonstrated than in the sourcing of technological assets. Several recently published studies\(^{16}\) have shown that MNEs from all countries, are increasingly reaching beyond their national borders to create or gain access to resources and capabilities which complement their existing core competencies. These same studies have also suggested that the locational requirements of strategic asset-seeking FDI are different from those of natural resource-, market- or efficiency-seeking FDI, in as much as the former is attracted less by the need to reduce production costs, overcome trade barriers, and exploit economies of scale, but more by the presence of high-quality physical and human infrastructure and a favourable political and commercial ethos towards M&As and cooperative alliances.

Other research seeking to explain the outward FDI by MNEs from developing into developed countries has questioned the ability of traditional theories to explain this phenomenon. This is particularly the case where the \( O \) advantages of the investing firms are not easily transferable outside their home countries.\(^{17}\) While I would accept that a key goal of asset-seeking investment is to protect or augment the investing firm’s core competences I still would contend that it is a combination between these and those that directly arise from the FDI, including the access to new resources and capabilities, and the ability of the investing firm to manage these which make up the \( O \) advantage. Without some contribution from the acquiring MNE, the FDI would, in effect, be a foreign portfolio investment.\(^{18}\)

The theory of asset-augmenting (cf. asset-exploiting) MNE activity is still in its infancy, but it seems likely to challenge researchers in the next decade. Some useful insights have already been made by scholars such as Tom Wesson (1993, 1997, 2001) and Shige Makino (1998), while other parallels between asset-seeking FDI and foreign portfolio (FPI) investment are explored later in this article. Certainly it would be difficult to deny that the variables determining the current wave of intra-Triad M&As are the same as determining inbound greenfield FDI into China or Vietnam, or indeed the spate of acquisition of Korean by US and European firms since 1997. But does this mean that the tenets of the eclectic paradigm are no longer relevant?

For reasons I have set out elsewhere (Dunning, 2000b), I believe although the search for newly created assets adds a new dimension to our thinking about the rationale for FDI, and can only be explained by a reconfiguration of traditional OLI variables, the essential postulates of the eclectic paradigm still remain intact and valid irrespective of the motive for MNE activity, its extent, pattern and form still rest on the interaction between the \( O \) -specific advantages of investing firms – including the willingness and ability of such firms to access new assets and coordinate these with their existing assets – and the advantages of countries and also on the relative costs and benefits of engaging in this interaction by alternative modes of governance and noticeably that of administrative fiat (i.e. \( I \) advantages).
4.3 Extending the Eclectic Paradigm to Embrace Non-Equity Alliances

This brings us neatly to an extension to the eclectic paradigm which I first set out in an article published in the *Journal of International Business Studies* in 1995 (Dunning, 1995b). The title of the article was ‘Reappraising the Eclectic Paradigm in an Age of Alliance Capitalism’, and its main theme was that as cooperation and competition are increasingly becoming complementary modalities for resource creation and allocation in market-based economies, so the concept of the individual firm as the sole or independent source of intellectual capital is no longer sustainable. Rather, it is better viewed as an organiser of a collection of created assets, some of which it generates internally and others which it accesses from other firms, yet the deployment of which it exercises some kind of influence or control.

Accepting this view, then, the O-specific advantages of MNEs will depend not only upon those internally generated, but also upon their competence to seek out, harness and influence the innovation, price and quality of assets of other institutions with which they have an ongoing cooperative relationship. Such a relationship may take various forms, such as a strategic technological or marketing alliance between two or more competitors; a sub-contracting agreement between a firm and one (or more) of its suppliers; or a licensing or franchising agreement between a firm and one (or more) of its customers.

Similarly, in its choice of a foreign site for its value-added activities, an MNE will be influenced not only by how location-bound resources and/or markets affect its direct costs, but also by how they affect its ability to acquire and exploit the O-specific assets of related firms with which it has some kind of coalition. The costs and benefits of accessing these latter assets by some form of cooperative agreement, rather than by a direct acquisition or merger, will determine the modality by which the O advantages of firms of one country are coordinated with those of another and also with the L advantages of that country; hence the ‘T’ component of the eclectic paradigm, as initially applied to the markets versus hierarchies choice, needs to be widened to embrace more ‘voice’-orientated strategies of firms, which are directed to capturing the benefits of quasi-integration offered by transborder coalitions and cooperative relationships.

In short, the content and significance of the OLI configuration affecting the determinants of international production need to be reconsidered in the light of the emergence of alliance capitalism and contemporary technological developments, all of which are pointing to the need of firms to embrace a plurality of intra- and inter-firm cooperative relationships if they are to be successful competitors in the global marketplace.

4.4 The Relevance of the Paradigm to Explaining Patterns of Trade and Portfolio Investment

In my 1976 Nobel Symposium presentation, I argued that the contents of the eclectic theory could be equally used to explain the level and pattern of trade. This was taken up further in 1995 in a paper entitled ‘What’s wrong and right with trade theory’ (Dunning, 1995a). There I suggested that firms would export goods and services from a production base in their home country whenever the L advantages of creating or utilising their O-specific advantages were greater than servicing the foreign markets from a foreign location. The extent to which exports were internalised within the firm (*intra*-firm exports) or sold to third parties (*inter*-firm exports)
exports) would reflect the relative transaction costs of the two modes of servicing the foreign markets.

Similarly, the extent to which firms imported goods and services, as compared with producing them in a domestic location, would depend on relative location-bound assets offered by the exporting and importing countries, and the relative O advantages of the importing firm (and/or its affiliates).

I believe that by acknowledging the role of the O advantages of firms – in addition to the L advantages of countries, together with the relative costs and benefits of accessing or exploiting these two sets of advantages by way of intra-firm rather than inter-firm cross-border transactions – trade theory can be, and is to some extent, considerably enriched.\(^{19}\)

More recently I have attempted to use the eclectic paradigm to help our understanding about the determinants of foreign portfolio investment (FPI). In a paper, written jointly with John Diliary, and published in Transnational Corporations (Dunning and Diliary, 1999) I argued that while the major explanatory differences between the two kinds of capital exports rested on the kind of O advantages possessed by the two groups of investors and the extent to which such advantages were coordinated with those of the potential host countries, via internal fiat (in the case of FDI) or the external market (in the case of FPI), there were others – notably those to do with locational choice – that were very similar. Thus, for example, the geography of intra-Triad cross-border M&As over the past decade has been closely paralleled by that of FDI, while the same risk factors that are important in determining FDI in the developing countries are also those which explain FPI. Moreover there is increasing evidence (set out in Dunning and Diliary, 1999) that the two kinds of foreign investment are complementary rather than substitutable to each other, with FDI tending to lead (private) FPI, at least in the early stages of a country’s IDP.

4.5 E-Commerce and Relational Assets

Finally I wish to make brief mention of two further extensions of the eclectic paradigm which take particular cognisance of contemporary trends in the globalising economy. The first by Cliff Wymb and myself has been to consider how one of the most dramatic and far reaching technological innovations of the 1990s, namely, the advent of E-commerce and the Internet, is affecting our explanations for MNE activity. In this article we identify both the specific attributes of this new means of information harnessing and communication, and how they are affecting our understanding about the OLI variables affecting firms, and their strategic response to them. Second, and moving along a rather different trajectory of thought, but as a natural extension of our earlier writings on asset-seeking FDI and alliance capitalism, we have begun to explore the likely impact of the growing importance of relational assets (R-assets)\(^{20}\) both at the corporate and social level, on the OLI configuration affecting MNE activity (Dunning, 2001). In particular we have argued that as the access to exogenous resources and capabilities and the organisation of these with the internally owned resources and capabilities becomes a more important determinant of commercial success, so the willingness and ability of firms to conduct harmonious value-adding and/or exchange relationships is becoming a more critical advantage. Such advantages are often cumulative, and arise from previous or current dyadic or network relationships.\(^{21}\) It is also apparent that at a macro level, social relational capital measured \textit{inter alia} by the lack of crime, bribery, corruption and terrorism is becoming a more important factor influencing
the location of economic activity by MNEs, while the balance of costs and benefits in owning or accessing resources and capabilities is affecting the way in which they are organised.

In examining the implications of these two developments – the one relating to the innovation and deployment of new technological assets, and the other, that of human assets – I believe the eclectic paradigm provides a powerful analytical framework. Within that framework it also offers up a number of new contextually related hypotheses, as a result of which received theories of the firm and the location of economic activity may need reappraisal.

5. Concluding Remarks: A Look Towards the Future

Let me conclude by re-emphasising a number of points. The first is that, although I have sometimes illustrated the eclectic paradigm by reference to the individual firm, my main focus of interest is in explaining the international production of all firms from a particular country or group of countries. Because of this, I contend that it is inappropriate to compare the merits and demerits of the eclectic paradigm with that of internalisation and other theories of the firm.

Second, I accept that some O-specific advantages are directly the result of firms internalising the market for its intermediate products across national borders. However, since this very act of internalisation puts the internalising firms at an advantage relative to non-internalising firms, I think it appropriate to refer to this benefit as an advantage and to internalisation as the modality by which this advantage is realised.

Third, I acknowledge that the eclectic paradigm, as originally conceived is uncomfortable in dealing with the dynamics of international production. However, I would argue that it can help to explain why an industry’s or country’s international investment profile may be different in two points of time. To link these two points, one needs to introduce changes in the exogenous or endogenous variables, including strategy and how these in turn affect the OLI configuration. I have illustrated from the IDP how this may be done at a macro level. At an industry or micro level, only a detailed examination of the profile of individual firms can resolve this problem. The reclassification of firms into strategic groups (McGee and Thomas, 1986) is helping to show us that the type of strategic behaviour is not an idiosyncratic variable but can be related to certain characteristics of firms (or groups of firms).

Fourth, I have endeavoured to explain differences between my approach and that of Kiyoshi Kojima, and I hope I have made it clear that this is primarily a difference in emphasis and perspective rather than of reasoning between us.

Fifth, I have emphasised that as strategic asset-acquiring FDI and non-equity alliances have become more important forms of international economic involvement, so the OLI configuration of the eclectic paradigm requires some reappraisal. In particular, I acknowledge that, without knowing whether a firm is contemplating an FDI to exploit a competitive strength or to overcome or counteract a competitive weakness, it is difficult to offer any prediction. Only by treating the cumulative process of sustaining and advancing the core competences of firms (rather than a discrete and once-and-for-all transaction) can this conundrum be resolved. This then suggests that in future, the eclectic paradigm might better address itself to explaining the changing characteristics of international production than to its level and composition at a particular moment of time.
Finally, while accepting there are other paradigms which seek to offer general explanations of the internationalisation process of firms and/or their international management strategies, we do not consider these to be competing paradigms to our own. Managerial-related paradigms, for example, are interested in explaining the behaviour of managers in harnessing and utilising scarce and non-imitable resources, not the overall level and pattern of FDI or MNEs activity (or changes to same). Organisational paradigms are directed to evaluating the costs and benefits of alternative institutional mechanisms for organising a given set of resources and capabilities, independently of the location of these assets. Paradigms offered by marketing scholars usually focus on the process and/or form of international market entry and/or growth. Technologically and network-related paradigms of international production come nearest to our own approach, but cannot comfortably explain some kinds of FDI in developing countries and in some service sectors. With a few exceptions modern paradigms of international trade ignore or downplay the significance of firm-specific advantages. Finance-related paradigms can offer only limited insights into the growth of corporate networks and cross-border strategic alliances.\(^\text{22}\)

We conclude then, that an add-on dynamic component to the eclectic paradigm, an extension of its constituent parts to embrace asset-augmenting FDI and cross-border non-equity ventures, and a more explicit acknowledgement of increasing role of the access of ownership of resources and capabilities can do much to uphold its position as the dominant analytical framework for examining the determinants of MNE activity. We believe that recent technological and economic events, and the emergence of new explanations of MNE activity have added to, rather than subtracted from, the robustness of the paradigm. While accepting that, in spite of its eclecticism (sic), there may be some kinds of foreign-owned value-added activities which do not fit comfortably into its construction, we do believe that it continues to meet most of the criteria of a good paradigm and that it is not yet approaching its own ‘creative destruction’ (Foss, 1996).\(^\text{23}\)

**Notes**

1. As reviewed by Graham Hutton (1953).
2. Which, indeed, is exactly what has transpired. For an examination of the impact of European economic integration on transatlantic FDI flows see Dunning (1993b).
4. The only English source of Lundgren’s thoughts on this matter is his comment on my paper for the 1976 Nobel Symposium in Ohlin et al. Birgitta Swedenborg took up and extended the theme in her excellent study on Swedish MNEs (Swedenborg, 1979).
5. For an explanation of the difference between a paradigm and a theory see e.g. Dunning (1988, chs 1 and 2, 1993a, ch. 4, 2000b).
6. If there is no synergy between a firm’s existing assets and those it acquires, it is difficult to see how this can be thought of as a direct investment; although I readily admit there are such investments which are classified in this way.
8. It is worth noting that such advantages may stem from the forces of monopoly or of (dynamic) competition. Most references to the competitive advantages of firms embrace both types of advantages, and it is in this sense we use ownership advantages.\(^\text{9}\)
10. Profitable, that is, from the viewpoint of the investing companies. We also use the word ‘profitable’ in a generic sense to embrace the long-term commercial goals of these companies.
11. Witness, for example, the case of Singapore and the way in which the Singaporean government has used the O advantageous of foreign investors in conjunction with those of its own firms and with the
L attractions of its own immobile resources and capabilities, to advance its post-war economic prosperity (Haley et al., 1996).

12. For example, by their competitors capturing markets which might otherwise be theirs.

13. By Peter Buckley and I at a conference of the UK chapter of the Academy of International Business at Manchester.


15. But see our remarks about asset-seeking FDI in section 4.2.


17. That is to say are based on the L advantages of the home country.

18. Which, de facto is sometimes the case, with MNEs behaving as holding companies.


20. At a corporate level R-assets are defined as the willingness and capacity of a firm – or more correctly persons within a firm – to conduct (on behalf of that firm) beneficial relations, both with other persons within the firm and between themselves and persons in other institutions.

21. The contribution of spatial et al. networks to the O advantages of firms is now being closely studied by scholars. See, for example, Chen (2000) and Enright (2000).

22. References relating to the above paradigms are given in Dunning (2000b). For a recent attempt to incorporate finance-specific variables into the eclectic paradigm more explicitly see Stonehill and Oxelheim (2001).

23. For a somewhat different, and highly refreshing, approach to some of the concepts dealt with in this paper, see a recently published article by Boddewyn and Iyer (1999).

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