Foreign Re-Directed Investment: Broadening the Frame of FDI Decisions

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Abstract

An enduring challenge for international business scholars has been to understand the decision frameworks employed by business people in their foreign direct investment (FDI) decisions. In recent years, this field has burgeoned and coalesced around the work of Dunning and the OLI model. Early in this same time period, other scholars (principally Harrigan) investigated decisions to divest (also exit or harvest). These two types of decisions reveal two ends of a continuum of investment choices.

Nevertheless, little attention has been paid to the decision to redirect FDI, which represents a middle ground between investment and divestment. Given the increasing occurrence of redirected FDI (Witt and Lewin, 2007), especially for offshored activities (see the recent works of Lewin and his associates), we propose a general framework to investigate decisions to redirect firms’ foreign investments. Our work: 1) draws from institutional theory to develop the idea of national frames, 2) incorporates concepts from prospect theory forwarded by Kahneman and Tversky, and 3) employs the decision framework of Fiegenbaum in an analysis of Mexican maquilas redirecting their assets to a different national environment. Empirical findings from a small sample of Mexican maquiladora managers and a sample of Mexican managers support the framework and strongly suggest that prospect theory’s loss aversion principle influences decisions to redirect FDI. Both the theory and findings support a general framework for redirected FDI that is based on the loss aversion principle.
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Understanding how a corporation becomes a global enterprise has been enriched by the work of Penrose (1956; 1959), Hymer (1976), Dunning (1977; 1988; 1998; 2000) and Rugman (1979; 1980; 1981) to identify just four of many of the discipline’s main contributors. Their work has sought to explain the internationalization process from the narrow perspective of the firm itself. This viewpoint has done much to explain how and why multinational enterprises grow and how they interact with the various nation-states in which they operate.

Though firms and their decision makers do matter, major events of recent decades have demonstrated the increasing importance of institutional entities in the functioning of the MNE—the WTO, the EU, and NAFTA to name just a few. Iyer (1997) was one of the first international business scholars to call for the use of institutional theory to gain a better understanding of the factors that shape international business decisions and behavior. In line with this institutional emphasis, a logical extension of the OLI paradigm would incorporate the analytical concepts popularized by institutional theorists. In the final revision of his seminal book, Dunning has also emphasized the importance of institutions for the traditional eclectic paradigm as an explainer of foreign direct investment (Dunning and Lundan, 2008).

Offering insights into the new institutionalism, Powell and DiMaggio (1991:8) noted that institutionalism in organization theory rejects rational-actor models in favor of “…a turn toward cognitive and cultural explanations”. North (1990), who has studied institutions through the lens of an economist looking at historical events across countries, showed that economic rationality will quite often not be the sole determinant of a society's economic institutions. In keeping with this behavioralist approach, Scott (1995) has succinctly characterized institutions as the persistent business practices found among distinct players within an organizational field, which today often stretches beyond national borders (Guler, Guillen, and Macpherson, 2002). Thus, our understanding of foreign direct investment (FDI) practices should be enriched by examining and appropriately applying the work of institutionalists to FDI decisions.

The assumed role of economic rationality in decision making has been recast by 2002 Nobel Laureate Daniel Kahneman who developed prospect theory along with Amos Tversky (1979). Prospect theory, being descriptive, elucidates the asymmetrical nature of human preferences for gains and losses. This stands in contrast to the prescriptive assumption of expected utility theory that underpins work done to date on FDI, which invariably treats expected gains-losses as symmetrical for the international business investor. Thus, prospect theory's loss aversion principle, a construct now validated and widely employed in other disciplines, casts
doubt on the standard treatment of FDI decisions. Recent empirical support for this doubt comes from the work of Larraza-Kintana Wiseman, Gomez-Mejia and Welbourne (2007); Merriman and Deckop (2007); Devers, Wiseman and Holmes (2007) and is succinctly summarized by Cassidy (2006).

In keeping with prospect theory, the value of an expected loss has more impact on an individual decision maker than does an expected gain of equal value. When confronted with the prospect of such a loss, the decision maker becomes risk seeking in his/her behavior in order to mitigate the loss, or avoid it altogether. This universal characteristic of human cognition and action needs to be fully incorporated into our models of FDI. Witt and Lewin (2007) applied prospect theory to the case of FDI shifts between developed countries, but in order to have a more complete understanding of how decision makers choose a specific location in terms of expected gains and losses the theory needs to be operationalized for developing economies and omnipresent offshoring activities (see the ongoing work of Lewin and colleagues for evidence of offshoring’s importance).

Understanding FDI decisions in this deeper context is the purpose of this paper. To elucidate it, our manuscript has been divided into four parts. Section One summarizes the literature on investment decisions, both initial foreign direct investment and subsequent divestment decisions, and identifies an area worthy of focused investigation--the redirection of FDI (hereafter FRDI). Section Two first reviews institutional theory, which provides the necessary frames for the FRDI decision, and then discusses prospect theory and the loss aversion principle that influences and shapes judgments of expected gains-losses for competing FRDI frames. Section Three describes the context chosen for our two initial studies about FRDI, operationalizes the framing variables, and then presents the findings. Section Four summarizes the two studies, compares them with similar undertakings, and offers conclusions and suggestions for future research.