

## **FOREIGN DIRECT INVESTMENT AND THE DUBLIN INTERNATIONAL FINANCIAL SERVICES CENTRE**

by Keith O'Brien

In 1987 Ireland launched itself as a location for international financial services with the development of an offshore centre: the Dublin International Financial Services Centre (IFSC). While conforming to some of the established methods for attracting foreign direct investment the IFSC initiative does differ from previous schemes. It emphasizes the gradual shift from manufacturing to services in the government's search for new sources of investment with the potential for creating competitive advantage. A new departure was the targeting of Irish owned firms to be part of a cluster of foreign and domestic enterprises, the intention being to create an internationally competitive centre with a number of market niches. A further change was to confine enterprises to a specific Dublin location.

It is proposed to examine the IFSC as a location for foreign direct investment (FDI) by way of the literature on international production and Multinational Enterprises (MNEs) produced by JH Dunning. International production may be defined as: "value-adding activity owned or controlled, and organised by a firm (or group of firms) outside its (or their) national boundaries." (Dunning p1 1988).

### **THE ECLECTIC PARADIGM OF INTERNATIONAL PRODUCTION**

Dunning has attempted to develop a paradigm that explains the "why", "where", and "how" of international production. In 1976 Dunning introduced his "Eclectic Paradigm of International Production". His aim was to: "offer a holistic framework by which it was possible to identify and evaluate the significance of the factors influencing both the initial act of foreign production by enterprises and the growth of such production" (Dunning p41 1988). The Eclectic Paradigm explains international production in terms of three "advantages".

(1) Ownership advantages (O advantages): these are endowments that are specific to particular enterprises and confer advantages over those enterprises of another nationality. O advantages consist of tangible (e.g. preferential access to markets) and intangible assets (e.g. management skills) that are capable of generating a future income stream. Dunning believes that these advantages are essentially similar to the "competitive advantages" described in the work of business strategists such as Michael Porter. The issue facing firms possessing O advantages is how to

exploit them across national boundaries. The choice is whether to do so within their own organisations or to use the external method of resource allocation i.e. the market. Dunning propounds the view that firms are subject to a set of incentives to internalise their ownership advantages, it is these incentives which comprise the second element of the Eclectic Paradigm.

(2) Internalisation advantages (I advantages): these develop from a desire by firms to either protect against or to capitalise upon imperfections in the external mechanisms of resource allocation. These mechanisms consist of the market/price system and public authority fiat. Because of market failures and the distortions caused by government intervention, enterprises choose to replace the market mechanism in exploiting their O advantages. In other words, MNEs allocate resources via the extension of their own value-added chains rather than by selling the advantage or the right of use to third parties. The enterprise now possesses O advantages which in combination with I advantages suggests that the firm itself will employ these advantages through trade or foreign direct investment (FDI), rather than contractual exchanges such as licensing, technical assistance, franchising and so forth. The question is whether foreign equity investment will be chosen over exports; this choice depends upon the third and final element of the Eclectic Paradigm.

(3) Location Advantages (L advantages): these comprise endowments that are external to enterprises i.e. they are country-specific as opposed to firm-specific. Location-specific advantages are effectively the same as comparative advantages and include input prices, investment incentives and infrastructure provision. An enterprise will engage in foreign direct investment when such L advantages favour a foreign as opposed to a domestic production base.

Together these three sets of advantages embody the OLI configuration, the basis of the Eclectic Paradigm. The configuration purports to explain (in terms of advantages) the "why" (O advantages), the "how" (I advantages), and the "where" (L advantages) of international production (Dunning p30 1988).

## **THE ECLECTIC PARADIGM AND THE IFSC**

The IFSC was developed conceptually as a location for international production. In 1993 the centre is a reality with in excess of 200 firms granted licenses to establish operations; over two thirds of the licensees are non-indigenous. Dublin's IFSC has become a successful site for FDI by financial services firms, it is worthwhile examining the centre using the OLI configuration.

(1) Ownership advantages: in financial institutions they should include the firm's capital, professional reputation and image, market knowledge, technology, specialist information and the expertise of their employees. Given that a sizeable proportion of IFSC licensees are well established financial services organisations with large international networks, it follows logically that they have certain firm-

specific endowments not easily replicated by rivals. The presence (and indeed success) of IFSC licensees such as Baring Brothers, Deutsche Bank, Daiwa Securities and *Crédit Lyonnais* in other major financial services centres should constitute *prima facie* evidence of O advantages within those institutions. This argument is also advanced by Dunning in his work with Norman (1982, 1987) with regard to the presence of American services companies in the UK, Belgium and France.

(2) Internalisation advantages: it has to be determined whether financial services firms internalise the market for their O advantages or resort to contractual mechanisms. The difficulties in licensing or selling the rights associated with O advantages are obvious: enforcement of quality of service, safeguarding of proprietary knowledge, the cost of supervision and maintenance of licensee's image etc.. Financial services MNEs are as one with other multinational services firms in their preference for complete ownership of their foreign affiliates. In other words, internalisation via the extension of value chains and control procedures is the preferred method for international financial services companies in utilising their O advantages. Virtually all the subsidiaries of non-indigenous firms operating in the IFSC are 100% owned by their parent companies; see *The Finance Directory of the IFSC* (O'Brien and Vaughan 1991). Therefore, the parent companies which have decided to locate activities in Dublin have chosen to internalise their O advantages.

(3) Location advantages: the last element in the configuration is the location of the firms value-adding activities. Unlike the previous two variables L advantages are country-specific and external to the firm. A nation attracts overseas industry on the basis of its country-specific advantages (CSAs). These advantages take two forms: artificial and natural. Artificial CSAs incorporate the taxation and investment incentives offered by Governments. Natural CSAs derive from more fundamental aspects of the economy such as availability of labour, infrastructure, and a benign cost environment. Therefore, we must search for these country-specific advantages which are responsible for establishing Ireland as a location for international financial services.

This question may be answered on the basis of an empirical survey carried out in 1991 (O'Brien ;1993); the chief executives of thirty overseas firms licensed to operate in the IFSC were interviewed. They identified and ranked the reasons for locating in the IFSC, using a weighting system eight factors emerged as particularly important. Figure 1 illustrates the principal determinants of location for foreign licensees in the IFSC.

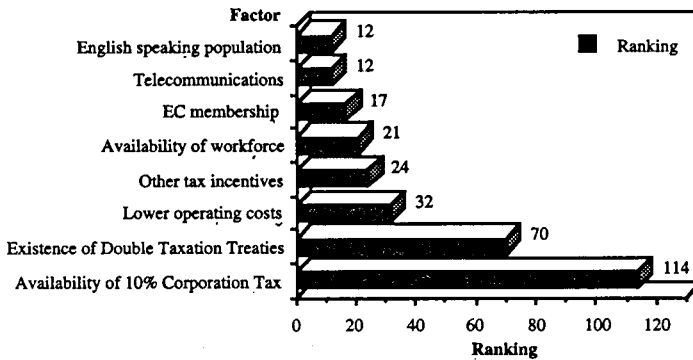


Figure 1 Determinants of IFSC location.

Ireland's main CSA is an artificial one; the 10% Corporation tax rate. Since the inception of industrial policies to attract non-indigenous enterprises in the late 1950s, MNEs have set up in Ireland on the foot of preferential taxes and government incentives (see McAlesse and Foley; 1991). In policy terms, the IFSC is a continuation of the Government's use of fiscal incentives to attract foreign direct investment. Indeed, the 10% incentive was necessary as all offshore centres, from Bermuda to Luxembourg, are based primarily on taxation concessions. Ireland's natural advantages, with the exception of lower costs, do not appear to be a major inducement.

According to the Eclectic Paradigm, Ireland as a locus for FDI can only hope to offer sufficient L advantages to attract and then maintain investment undertaken by MNEs. In relation to the IFSC, the authorities hope that having attracted overseas firms on the basis of artificial advantages, that in the period before the termination of the 10% rate in 2005, licensees will engage in organic growth linked to natural advantages. Jacobson and Andresso in a study of multinational investment observed: "The artificial country-specific advantages appear to be important in attracting insurance-finance-and-banking firms, though, in the longer term, firms in this type of industry - in which the product has an extremely high value-to-weight ratio, the skill content is essential - should be those most likely to be attracted by these natural country-specific advantages". (Jacobson and Andresso, p333-34; 1991).

Given the mobile nature of MNEs, the emphasis on FDI in industrial policy is inherently risky; Ireland's CSAs need to be constantly updated. Inward investment remains crucial for the development of a small open economy such as Ireland. In the absence of internationally competitive indigenous firms with the requisite activities and skills, the IFSC needed to bring in foreign firms to provide the

activities, expertise and market presence associated with an offshore centre. However, the IFSC also sought projects from Irish firms, who constitute the single largest source of projects. In the event of a mass withdrawal by non-indigenous firms - which is unlikely - Ireland would still maintain a core of Irish firms with the experience and market niches to provide the nucleus for a Dublin financial centre.

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