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## THEORIES OF FOREIGN DIRECT INVESTMENT (FDI) AND THE SIGNIFICANCE OF HUMAN CAPITAL

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### **Abstract:**

Not every country is able to attract the right mode of FDI, nor does every investor risks his investments without studying the conditions in the host country. The practice of FDI attraction generally incorporates numerous fiscal and monetary incentives. However, one should note that FDI attraction should be accompanied by development and an increase in the level of human capital, as a prerequisite to attract the right FDI and not every kind of foreign investment. FDI, together with human capital development, are considered among the key drivers of growth as they play complementary effects and reinforce each other. The role of human capital in stimulating FDI and vice versa is one of the controversial issues in the development literature. Human capital is the factor where the transition process has had significant and long-term implications. Human capital became a crucial determinant and a prerequisite for FDI attraction that a country, including Kosovo must have if willing to attract the right mode of foreign capital. Theory and empirical studies are inconclusive as per direct impacts of FDI in developed countries, but when it comes to transition and undeveloped economies, and Kosovo, there is more agreement on the positive effects of FDI in economic development and human capital. This paper seeks to understand the weight of human capital in different types of FDI theories.

### **Keywords:**

FDI, human capital, transition, theories.

### **JEL Classification:** A10

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## 1. Introduction

The objective of this paper is to examine theoretical background of the relationships between Foreign Direct Investment (FDI) and necessary level human stock capital, as a prerequisite to attract FDI. In general, this examination is based on FDI existing literature review but specifically on main theories of FDI. The study aims to bring attention to policy makers on possible relationships between FDI and human capital hence better positioning of governmental policies and incentives on FDI attraction, especially in case of Kosovo that is widely known for its young population but facing high unemployment and inherited difficulties in education system.

In Kosovo like in most of the countries, the transition from communism to capitalism has gone through difficult challenges and dramatic socio-economic changes. These changes are even more difficult to be managed and prioritized when countries suffer the lack of domestic investment capital. In such circumstances, the role and impact of FDI is seen essential for policy makers, hence FDI attraction is incorporated in most of the government policies.

In general, the practice of FDI attraction usually incorporated numerous fiscal and monetary incentives. However, one should note that FDI attraction should be (apart from monetary and fiscal incentives) accompanied by development and an increase in the level of human capital, as a prerequisite to attract the right FDI. Determining which kind of foreign investments a country will attract is a very important step in terms of development and orientation of available human capital stock. Because of structural problems with education system, hence human capital, Kosovo and other countries that have high unemployment sometimes attempt to attract every kind of FDI, even if it proves to be of limited help, but decreases high unemployment. Such investments (rent seekers) are not necessarily long term oriented and do not create long-term employment and sustainable development of human capital. Moreover, according to Hoti (2005), these investments, in short term, also push wage inequality hence placing strong pressure on the public sector for wage increases.

In the beginning of transition from communism to capitalism, many researchers argued that the average level of education embodied in human capital within transition economies and Kosovo was relatively high (Duczynski, 2001; Druska et al., 2002, Spagat, 2006). However, later on, a number of researchers and empirical studies from well-known international institutions suggested that transition economies lag behind compared with industrialized countries in terms of the quality of their workforce (EBRD 2008). One of them is a supply of trained and educated human capital (UNDP 2010). Since attracting FDI has prerequisites, no doubt, such situation acted as a big barrier to attract higher and qualitative FDI in these countries. Because of this, in the case of Kosovo, which is heavily populated by young people but faces high unemployment, it is very important to make strong bridges between education, economic development and FDI attraction.

The problem of human capital was not predicted in the earliest years of transition. When transition started, some researchers argued that the level of human capital in transition countries was quite high, and it did not pose a problem for these countries. The opinion was grounded on simplified proxy by comparing enrollment rates in educational institutions in transition countries to those in the developed countries. In this instance, Spagat (2001) shows that based on the educational levels one might suppose that in general transition economies are in great shape in terms of human capital. However, later it was realized that skills, knowledge and structure of education that exist might not be relevant for foreign investors from industrialized countries. A report by EBRD (2000), and confirmed also in 2008, stated that companies in transition economies lag behind those in advanced industrialized countries

in terms of the quality of their workforce. Many skilled workers are performing jobs that do not reflect their level of education and over time, their ability to perform high-level tasks will diminish. A starting point is the study by Druska et al. (2001), who confirmed the problem of qualitative availability of human capital in transition countries. In their study, Druska et al (2001) showed that there is a significant mismatch between the type of skills and competencies that the new economy demands and foreign investors and the types of skills and competencies that workers possess. As a consequence, the mismatch between the huge stock of human capital (the supply) and the necessary skills required (the demand) from foreign companies is thought to be a barrier to attract FDI, especially foreign investors that need specialized and trained human capital for their operations in host country. This phenomenon was emphasized more for transition countries that entered very late into the transition process such is case of Kosovo and FDI is seen as an important injection to boost investment capacities. More specifically, Talpos & Enache (2010) argue that FDI inflows in Central and Eastern Europe (CEE) "have specific patterns of human capital, different from the ones specific to the rest of the developing countries" (p.487).

It has been shown that the aim of development is the human being who is at the same time the actor and the beneficiary of development (Fongang, 2006). Having said this, it implies that education system and right structure of human capital and education is essential in attracting right FDI inflows. In case of Kosovo that lacks the necessary domestic capital to fulfill huge domestic investment needs and facing high unemployment, the need to increase the quality of human capital and FDI inflows are considered equally vital factors for future economic development.

## 2. Literature Review

This part targets and discusses the main theoretical aspects of existing literature review of FDI and human capital relationship. It begins by defining FDI from different perspectives, approaches, authors and institutions toward some common fundamentals that are present in all definitions of FDI hence leading to the discussions of the main FDI theories and hypothesis relative to the role of human capital.

Defining and measuring the impact of FDI is not an easy step to be undertaken especially when the literature on FDI is massive, but inconclusive in many crucial aspects of FDI. Nowadays, the flow of capital might be intangible, short-term but decisive, not always measurable but rather virtual and complex. Moreover, the literature on FDI also recognizes the challenge that explaining FDI in transition countries is easier said than done. FDI behavior, modes and forecasts are different in developed and democratic countries compared to transition countries including Kosovo, which are not only imperfect but rudimentary too. According to Vasyechko (2012), "the literature review has shown that besides well-known traditional determinants, drawn from the theory, some transition-specific factors have an explicit impact on FDI patterns in these countries" (p.119).

Generally, FDI is the course of action to transfer some important assets; this usually includes financial capital, technology, human resources, knowledge and expertise. However, the definition of FDI might differ, if perceived from perspective of host country or the foreign investor. In both perspectives, something is common: shift of capital and control through significant equity shareholder. FDI definition similarly is represented in the definitions of International Monetary Fund's Balance of Payments Manual and United Nations Conference on Trade and Development World Investment Report (UNCTAD, 2011). According to these two institutions, the main purpose of FDI, apart from profit, is transfer of resources, long and

lasting interest, control, effective voice of management, etc. The rationale behind these two credible international institutions who used ‘long term’ and ‘lasting interest’ in their definition is to make a distinction between FDI and portfolio investments which are characterized with a lack of long term commitment of foreign investor and involve high turnover of securities.

Current FDI trends and literature have not changed much about the mature definition of FDI. For example, a recent book by Theodore Moran (2012) declares the same opinion that FDI takes place “when a corporation in one country establishes a business operation in another country, through setting up a new wholly-owned affiliate, or acquiring a local company, or forming a joint venture in the host economy (p.3).

Other FDI definitions that are debated in similar terms include “control” and “lasting interest.” In this line Ragazzi (1973), describes FDI commitment “as the amount invested by residents of a country in a foreign company over which they have effective control” (p.471). Contessi and Weinberger (2009) following the IMF/OECD common definition postulates the existence of such long-term control and influence “should be assumed when voting shares or rights controlled by the multinational firm amount to at least 10 percent of total voting shares of rights of the foreign firm” (p.63).

However, one must note that shareholding or voting shares is not the only circumstance to exercise control. According to Lall and Streeten (1977) and Contessi et al (2009), it is not necessary to be the majority shareholder in order to exercise direct control as this can be achieved and exercised even with low equity share or even without an explicit management contract (Lall and Streeten, 1977; Contessi et al 2009). For example, according to latest legislation in Kosovo, an investment is considered foreign only if a foreign entity, or group of foreign entities – in the same company, holds 10 percent of total shares.

In the abovementioned definitions, the role and impact of human capital is essential but relative to the mode of investment, location, industry and long-term goals of investors. In some cases, the magnitude of human capital is the central and influential determinant of the decision making process on the location choice of the foreign investor. The relative importance of human capital, however, is not as straightforward as it might appear, because the availability of cheap human capital sometimes is not a sufficient condition. Availability of cheap labour force might be an advantage for foreign investors and host country in the stage of attraction; but in long term, it might become a significant barrier of foreign investors to expand their investments in the host country.

Theoretical literature, in general, presumes human capital among the most important ingredients of FDI inflow (Agarwal 1980; Dunning 1988; Lucas 1990; Zhang 1999; Markusen 1999; Aavik & Walsh, 2010 and Rizvanolli 2010). The impact of human capital on FDI and vice versa differs in least developed countries, developing, developed and transition countries. The role of human capital is related with operations, competencies, productivity, spillover effects of foreign investment operating in a host country. The results reported from different studies differ in respect to their measures and proxies used, estimation methods, specifications and period covered. According to Bačić, Račić and Šonje (2004), “FDI can facilitate growth of recipient country via capital formation channel directly and via positive spillovers and inclusion into international productive and innovative networks indirectly” (p.59).

Moreover, Zhang and Markusen (1997) in their empirical study found that the poorest countries attract less foreign investment share of world FDI than their share income. In the same study, the researchers found that small markets attract fewer investments per capita when compared to big markets. Their models also suggest the existence of a development trap for small, skilled-labor-scarce countries (p.19-20). In this line, Kucera (2002) in his cross-

section analysis found a positive impact of net average FDI on human capital (proxies: literacy rates, and average years of education for population over 15 years old) during the period of 1993-1999. Another study to find positive correlation between human capital and FDI inflow is the study undertaken by Shatz (2003) in 100 developing countries. The study used only one proxy; years of education for people over 15-year-old and over. The results from the study conclude that FDI is positively impacted by human capital.

The correlation between human capital and FDI is found also in a study of Teixeira (2005). His study concludes that foreign capital positively affects human capital in the education and specific skills needed to perform a job. Moreover, the same study points out that research and development (R&D) has a significant mediating role in that positive correlation between FDI and human capital intensity.

### **3. FDI Theories and Hypothesis: the Significance of Human Capital**

The latest increase volume and modes of FDI in global markets, led to various studies, theories and hypothesis that are used to explain 'general FDI theory'. Several studies provide overviews of FDI theories and hypothesis: for example, Agarwal (1980); Calvet (1981); Helleiner (1989); Cantwell (1991); Meyer (1998); Markusen (2002) and more recently, Faeth (2009) and Denisia (2010). FDI theories and hypothesis might differ substantially, if analyzing the same mode of FDI from different perspectives. For example, FDI macroeconomic point of views focuses mainly in the balance of payment, comparing to microeconomic point of view that focuses on main motivations of foreign investors.

'General FDI theory' mainly explores the main motivations to specific entry modes and locations. However, this term does not capture entire complexity of FDI, and other forms of foreign investments, thereby, is difficult to find a general framework, approach or theory that is accepted and explain everything about FDI. Even the newest theories may result in some overlap (Agarwal 1980; Lizondo 1991; Dunning 2008; Vasyechko 2012). Overall, in particular based on a classification proposed by Faeth (2009), there are numerous branches of FDI theory, such as:

- *Monopolistic advantage theory, (Hymer, 1960; Vernon, 1966),*
- *Aggregate variables as determinants of FDI (Scaperlanda and Mauer, 1969),*
- *The substitute theory (Mundell, 1968),*
- *The complement theory (Kojima, 1975),*
- *OLI paradigm (Dunning, 1981),*
- *The theory of traditional multinational activity determinants of horizontal FDI according to the proximity-concentration hypothesis and vertical FDI according to the factor-proportions hypothesis (Markusen, 1984; Helpman, 1984),*
- *The theory of horizontal FDI, vertical FDI and the knowledge capital model (Markusen, 1996, 1997; Markusen and Venables, 1998),*
- *The resource-based theory (Wernerfelt, 1984; Barney, 1991),*
- *The business network theory (Jarillo, 1988; Ebers and Jarillo, 1998),*
- *Theory of new economic geography (Krugman, 1995),*

- *Diversified FDI and risk diversification model (Rugman, 1975, 1976; Kopits, 1979; Miller and Pras, 1980), and*
- *Policy variables as determinants of FDI (Bond and Samuelson, 1986; Black and Hoyt, 1989; Haufler and Wooton, 1999; Haaland and Wooton, 1999).*

Despite numerous classifications of FDI theories, for our purposes, the standard classification and approach employed by the authors is the one followed by Agarwal (1980), discussed and analyzed in Moosa (2000) and Denisia (2010) that splits most FDI theories into two categories:

- 1) *Theories assuming perfect markets*
- 2) *Theories assuming imperfect markets*

### **3.1. Theories Assuming Perfect Markets**

The most important theories and hypothesis that assume perfect markets are: *a) the differential rates of return theory and hypothesis; b) the portfolio diversification theory and hypothesis; and c) the market size theory and hypothesis.*

#### **3.1.1. The differential rates of return theory and hypothesis**

The theory of differential rates of return is among the oldest theories that attempts to clarify why some companies run after new markets or indulge in FDI. The main idea and hypothesis of this theory is that capital flows from countries with low rates of return towards countries with higher rates of return. “The rationale for this hypothesis is that companies considering FDI behave in such a way as to equate the marginal return on and the marginal cost of capital” (Moosa 2002, p.24).

It is obvious that this theory assumes risk neutrality hence making the rate of return alone as main determinant why a foreign investor selected a specific location or mode of investment. Based on this assumption, domestic and foreign investments are perfect substitutes. Another observed problem and consistency of the main hypothesis of this theory is that countries simultaneously experience inflow and outflow of FDI. If the main hypothesis of this theory is that capital flows from countries with low rates of returns toward countries with higher rates of returns, then it will flow in one direction – only toward countries with higher returns and not vice-versa, which is not a consistent with current situation in international trade, FDI stock and location.

In this respect, some empirical studies tried to examine the correlation between relative rates of return in a number of countries and the allocation of FDI among them, but failed to provide supporting evidence (Agarwal, 1980). Among influential studies testing such hypothesis is that of Weintraub (1967), who used US data to test main hypothesis of this theory. The conclusion was that “there was no significant relationship between inter-country differences in the rate of return and the flow of capital” (Weintraub, 1967). In addition, studies by Bandera (1968) and White 1986) also rejected the main hypothesis of this theory. However, an important step in their studies is the recognition of sufficiency of return as a prerequisite for the movement of capital (Bandera, 1968; White 1986).

In terms of human capital relationship, a very interesting study is that of Barrel and Holland (2000). In their study, they found that FDI has led to increasing labor productivity, hence, to higher rates of returns in the manufacturing sector in Central Europe (CE), especially in cases when capital moved from developed to undeveloped countries. Another encouraging research study was that of Yang (1999), who tried to modify the rates of return on physical capital in order to explore for differences in human capital. This variability allowed explanations as to why some mode of FDI might be attractive also for low return countries. In contrary, the study explains why some specialized FDI in China, has been flowing to rich areas, largely coastal zones, rather than to poor inland areas, when rates of return tend to be higher.

### **3.1.2. The portfolio diversification theory and hypothesis**

The unique theoretical background of this theory can be traced back to the theory of portfolio selection of Tobin (1958) and Markowitz (1959). The impact of this theory is observed in increasing international trade, FDI and capital mobility. In contrast to the differential rates of rate of return theory, here risk is an essential determinant. According to Moosa (2002) "capital mobility and FDI will be constrained by the desire to minimize or reduce the risk, which is achieved by diversification" (p.26). In the case of transition countries and Kosovo, this theory is very helpful to explain some behavior patterns of FDI decisions and risk associated with such investments.

There are numerous ways to test the relationship between the amount of FDI and risk existence in a particular areas or a group of countries. As documented in different studies (Haufbauer, 1975; Agarwal, 1980; Moosa, 2002; Denisia, 2010), the simplest approach to test relationship between the amount of FDI and risk, is to examine the relationship between the amount of FDI going to a group of countries and two decision variables: the rate of return and risk - measured by the variance or the standard deviation of the rate of the return.

Like the differential rates of return theory, the portfolio and diversification theory does not explain why Multi National Cooperations (MNC) are the greatest contributors to FDI, and why they prefer FDI to portfolio investment. In this respect, a good explanation is given by Ragazzi (1973) that might be true also in the case of Kosovo. According to him, in the case of developing countries, financial markets are not only imperfect but also rudimentary, hence making portfolio investment less attractive than FDI (Ragazzi, 1973). Another reason might be also the degree of control. MNCs prefer FDI compared to portfolio investment because it gives more control over the assets and other financial means in the host country.

### **3.1.3. The market size theory and hypothesis**

The market size theory and hypothesis explains the volume and directions of FDI in light of the market size of the host country. According to this theory, large market size is expected to have a positive impact on FDI volume. The market size hypothesis argues that "inward FDI is a function of the size of the host country market, usually measured by GDP" (Majeed and Ahmad 2008, p.79).

A majority of the empirical studies on the determinants of FDI, in one way or another, contain some measures of market size in the host countries, typically using real GDP comparing to nominal GDP as a proxy (Moore 1993; Bajo-Rubio 1994; Sosvillo and Rivero 1994; Wang and Swain 1995; Lipsey 2000; Love & Lage Hidalgo; Bogdanova and Olovská 2008; Dunning

2008; Contessi and Weinberger 2009). These studies used either real GDP or nominal GDP as a proxy to determine the significance in attracting FDI.

An influential study that explored the relationship between market size and FDI flow, thus confirming that the size of the market matters, is the global survey made by A.T. Kearney (2000). The survey targeted 1000 of the most important and largest companies in the world by taking the views of 135 high-ranking executives. The results were affirmative. The most favored countries for investment turned out to be: The United States and China followed by Brazil and United Kingdom; which are clearly large markets.

Should this be true, then Kosovo, which has small market size and GDP, will find that efforts to attract FDI are not productive. However, this conflict with apparent “real life” results since Kosovo is a net importer of goods and services. Moreover, Kosovo is indeed a small market but being member of the Central European Free Trade Agreement (CEFTA), “small market size” is not expected to be ranked as a weighted barrier in FDI attraction.

### **3.2. Theories Assuming Imperfect Markets**

There are many FDI theories that assume imperfect markets. This section discusses the following theories and hypothesis: a) *the location theory and hypothesis*; b) *the internalization theory and hypothesis*; c) *the eclectic theory or OLI paradigm and hypothesis*; c) *the international product life cycle theory and hypothesis*

#### **3.2.1. The location theory and hypothesis**

The main idea of this theory is mobility of some factors of production, such as labor and natural resources. According to this theory and hypothesis, FDI exists because of mobility of some factors of production hence such mobility leads to location-related differences in the cost of factors of production.

One of the most important elements that can influence location related differences is human capital accounted in terms of wages paid by foreign investors. In terms of human capital, the location hypothesis attempts to argue that countries with low relative wages are a preferred destination for FDI. However, what matters, is not just the wage but also the quality and productivity of workforce that foreign investors rank very high.

Another important element for foreign investors as to selecting a specific location is the cost of the reallocation and adjustment of resources. When these costs are high, they lower the possibilities to attract foreign investors (though some researchers argue that reallocation and adjustment costs are very small and not decisive factor). Such conclusions were reached by Porto and Hoekman, (2010) and Francois et al (2011), but there have been some notable exceptions too (e.g. Cosar, 2011). Exceptions are found also in a model developed by Susan Stone, Patricia Sourdin and Clarisse Legendre (2013) postulating that “while it is widely accepted that there are adjustment costs associated with reallocation of resources, in most models these costs are assumed to be very small, more recent evidence is casting doubt on this assumption” (p.2).

In terms of human capital, the location hypothesis also emphasizes the degree of unionization by workers’ representatives in the host country, because is assumed that unionized and centralized trade unions have higher bargaining power thereby pushing future wages higher. Nowadays, involvement of MNCs in FDI would prefer flexible and non-unionized labor markets

in preference to centralized and unionized. This hypothesis is supported by Leahy and Montagna (2000), who show “that in absence of taxes and other subsidies, the MNC is less likely to locate in the host country under decentralized than under centralized wage setting regime, despite the fact that latter typically yields higher wages” (p.245).

In case of Kosovo, the abovementioned facts can be emphasized as comparative advantage in process of FDI attraction, because: *a) availability of cheap labour; and b) there is no strong unionization*; especially in private sector where most of the FDI are aimed to be attracted.

### **3.2.2. The internalization theory and hypothesis**

The main hypothesis of this theory is that FDI arises from the efforts by companies to replace market transactions with internal transactions. According to this theory, certain costs can be saved by internalization of some processes. Sometimes this theory is claimed to represent a general theory of FDI and other theories are a subset of the general theory of internalization hypothesis. Denisia (2010) argues that internalization theory also “provides an explanation of growth of MNCs and gives insights into the reasons for FDI” (p.55). Due to market imperfections, this theory is superior in explaining firm-specific advantages and demonstrates that companies are conditionally involved in FDI. According to the theory, companies will undertake FDI only if the benefits of exploiting firm-specific advantages are higher than the relative costs of the operations abroad.

The first attempts to explain the internalization theory in a national context was made by Coase (1937), then developed by Buckley and Casson (1976; 1983) and Hennart (1982). Narrowed focus only in national context was improved when Hymer (1976) developed the theory also in an international context.

Denisia (2010) identified two major determinants that are crucial when explaining this theory. These determinants are: *a) removal of competition; and b) advantages which some companies possess in particular activity* (p.56). Through these determinants, internalization theory demonstrates that MNCs “are organizing their internal activities so as to develop specific advantages, which then to be exploited” (Denisia 2010, p.56).

Eden and Miller (2004) argue that the theory should take into consideration information costs too. They discussed information costs for foreign companies with respect to local companies, currency risk, and different government treatment thereby adjustments costs when investments are made abroad. The theory recognizes the fact that FDI is a firm level strategy decision rather than a capital market financial decision.

In terms of human capital, the importance of this theory is the emphasis on R&D that companies must involve in order to survive in new markets hence development and spillover effects on human capital. Bearing in mind that level of R&D in Kosovo is lowest, comparing to other SEE countries; this might be beneficial for human capital in Kosovo when foreign companies decide toward internalization of some processes, when involved in inward FDI.

### **3.2.3. The eclectic theory or the OLI paradigm hypothesis**

The main idea of eclectic theory is integration of internalization theory, industrial organization theory and location theory into one general framework. This theory was proposed and developed by John H. Dunning (1977). According to Dunning (2008), “the eclectic paradigm seeks to offer a general framework for determining the extent and patterns of both foreign

owned productions undertaken by country's own companies, and that of domestic production owned and controlled by foreign investors" (p.95).

Eclectic theory is referred to as the "OLI paradigm," which attempts to explain the international flows and FDI in terms of what is the motive rather than what should be the level and the structure of foreign investment. The OLI paradigm includes both macroeconomic location advantages and microeconomic ownership advantages, as they are incomplete if taken separately (Straker, 2006). In addition, the OLI paradigm confirms and develops previous assumptions that apart from the structure of resources and market size, "government policy can also determine the location of FDI in a host country, also taking into account human nature as a motivation of MNCs for FDI" (Vasyechko 2012, p.130). In other words, it addresses itself primarily to positive rather than normative issues. According to Dunning (2008) "it prescribes a conceptual framework for explaining 'what is' rather than 'what should be', the level and structure of the foreign value activities of enterprises" (p.95). Eclectic theory and its framework is based on three advantages: *Ownership (O)*; *Location (L)* and *Internalization (I)*.

According to eclectic theory, "*ownership (O) advantage*" explains the "why" or motivation, of MNCs activities. Dunning (2008) postulates that "ownership advantages are defined as the degree to which a firm possess sustainable ownership-specific advantages over other firms in the market. Some examples of these advantages are: innovative capacity, access to financial resources, and organizational and marketing systems" (p.96). This includes all the specifics, often intangible assets, which a company can either create (through managerial and organizational skills and knowledge,) or purchase (e.g. brand names, patents, etc) compared to local competitors that do not posses.

Another important advantage of eclectic theory is "*location (L) advantage*" that explains the "where", or location of the companies and which are specific to the country. Examples of such specifics are: labor force (availability and quality), natural resources and societal structure (political structure and legal systems) as explained above under the heading of location theory and hypothesis. The logical consequence will be that company will supply the foreign market from home country base, but location advantage such as distributions of inputs makes it profitable for a company to exploit its assets overseas.

Finally, *internalization (I) advantage* explains the "how", or the manner, of MNCs activities. Internalization" is the degree of ownership and control. At one end of the spectrum is no control or ownership. Transactions are made at arm's length or through the market. At the other end of the spectrum is full control. The firm "internalizes" the market transactions by owning or controlling the other firm and the transactions are not arm's-length" (Dunning 2008, p.327-330). The more ownership specific advantages a company has compared to competitors the higher is the incentive to internalize their use. Details of this specific advantage are discussed and explained under the heading of internalization theory and hypothesis.

### **3.2.4. The international product life cycle theory and hypothesis.**

The international product life cycle theory started to take hold after World War II in viewing the international production as a sequential process. The theory was developed by Raymond Vernon (1966) who combined micro theory of the product cycle with trade theory. Vernon believes that there are "four stages of production cycle: innovation, growth, maturity and decline" (Denisia 2010, p.55).

In this respect Vernon (1966) explained his arguments by stating "that in the early stages of the life of a product, production is undertaken in the home country because of the need of producers to have easy access to inputs and to maintain swift communication with suppliers and competitors. At this stage, the product is highly differentiated and its demand fairly inelastic" (p.195). Producers later begin to export the product to advanced countries, which have demand and supply characteristics similar to those of home country. Petrochilos (1979) and Denisia (2010) find such hypotheses useful and central for interpretation of FDI too though recognize the fact that such hypothesis are referential particularly for products and services that are highly technological and related with income elasticity of demand.

Three stages of the products are central in explanation of this theory: 1) *the initial production* that takes place from innovating companies at home close to the customers and companies can charge high prices because the demand for the new products is inelastic; 2) *the maturity of products* hence "export of the product to countries having the next-highest level of income as demand emerges in these developed countries; and 3) *complete standardization of the product and its production process*, which is no longer an exclusive possession of the innovating company hence FDI in developing or less developed countries with lower level of incomes, in order to save costs and explore possible cost advantages. Such hypothesis are evident today where we can find many well-known innovative products switching from the country of innovation, in the beginning acting as the net exporter, but later as net importer (for example Apple products).

As we analyze these stages in terms of cost advantages, FDI and human capital becomes important considerations especially when products and services reach the stage of maturity and standardization. In this case, FDI is considered to be a defensive move of companies in order to maintain competitive position against local and foreign investors.

Finally, in case of Kosovo that has cheap labour, according to this theory and hypothesis, the importance of human capital is essential in the decision to establish production in the host country. Vernon (1979) postulated "that in the advanced stages of standardization, labor costs will become a critical consideration in production, hence less developed countries with low-cost labor will now offer a competitive advantage as a production location" (p.6).

#### 4. Conclusions

This paper provided a review of theoretical and empirical literature of FDI in general, FDI theories and the relationships with human capital. As the choice of FDI depends on preliminary analyses, factor analyses and long-term objectives of the investors, the literature review reveals a diversity of thoughts regarding the nature of the relationship between FDI and human capital.

Theory and empirical studies share different views as per direct impacts of FDI in developed countries, but when it comes to transition and undeveloped economies and Kosovo, there is more agreement on the positive effects of FDI in economic development and human capital.

The examination of literature review, found that in most of the perfect market theories and hypothesis the role of human capital is less studied compared to imperfect market theories and hypotheses. In imperfect market theories, human capital is identified as an important determinant for capital flow and FDI attraction.

Human capital matters in attracting FDI inflows and can speed up the transfer of know-how from foreign investor to host country. FDI has a positive spillover effect and productivity of

workforce in the host country. However, theory gives a significant influence of FDI on human capital, education, skill accumulation and other non-economic human development factors.

Cheap and huge availability of human capital in Kosovo might be an advantage for foreign investors and host country in the stage of attraction; but in long term it might become a significant barrier accompanied with policy implications for the host country in increasing FDI in high technology industries or automation of some industries. This is especially so in those cases where the main goal of FDI is no longer to decrease unemployment but instead to increase human capital quality and productivity.

Bearing in mind that Kosovo is heavily populated with young people but faces high unemployment and has major difficulties in education system, it is very important to make strong bridges between the education system and FDI attraction. Kosovo needs a minimum of basic schooling for all adult workers to show that the country has a sound investment climate. In today's dynamic business environment, the linkage between the theory of schooling and practice at business is very central. The type of human capital necessary to attract FDI visibly depends on the type of FDI host countries seek.

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