

How dunnings oli  
paradigm explains  
where organisations  
investment



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Critically analyse how Dunning's OLI paradigm seeks to explain the why, how and where organisations such as Burger King invest?

According to Dunning (1979: p. 274), the eclectic paradigm resulted from his dissatisfaction with existing theory of international production: the Hymer-Kindleberger approach, the product-cycle theory, and the internalisation theory. The three were considered to be partial explanations of international production. Henceforth, he proposed an alternative line of development which " tried to integrate the existing theories in a general and ' eclectic' model in which " the subject to be explained is the extent and pattern of international production" (Dunning, 1991: p. 124).

The paradigm is a blend of three different theories of foreign direct investment = O + L + I, each piece focusing on a different question. Theory states that the extent, form and pattern of multinational activity are determined by the existence of three sets of advantages.

### **Firm Specific Advantages (The O Factor)**

A MNE such as BURGER KING a multinational restaurant company if operating a plant in a foreign country would definitely face with additional costs as compared to a local competitor. The additional costs could be due to cultural, legal, institutional and language differences also due to a lack of knowledge about local market conditions and/or the increased expense of communicating and operating at a distance. Therefore, if a foreign firm as said like Burger King is to be successful in another country, it must have some kind of an advantage that overcomes the costs of operating in a foreign market. Either the firm must be able to earn higher revenues, for the

same costs, or have lower costs, for the same revenues, than comparable domestic firms.

PROFIT = TOTAL REVENUES – TOTAL COSTS – COST OF OPERATING AT A DISTANCE

Since only foreign firms have to pay “ costs of foreignness”, they must have other ways to earn either higher revenues or have lower costs in order to be able to stay in business. So if the Fast Food Business or any MNE is to be profitable abroad it must have some advantages not shared by its competitors. These advantages must be (at least partly) specific to the firm and readily transferable within the firm and between countries. These advantages are called ownership or firm specific advantages (FSAs) or core competencies. The firm owns this advantage: the firm has a monopoly over its FSAs and can exploit them abroad, resulting in a higher marginal return or lower marginal cost than its competitors, and thus in more profit. These advantages are internal to a specific firm. They may be location bound advantages (i. e. related to the home country, such as monopoly control over a local resource) or non-location bound (e. g. technology, economies of scale and scope from simply being of large size).

### **Country Specific Advantages (The L Factor)**

The firm must use some foreign factors in connection with its domestic FSAs in order to earn full rents on these FSAs. Therefore the location advantages of various countries are key in determining which will become host countries for the MNE. Clearly the relative attractiveness of different locations can

change over time so that a host country can to some extent engineer its competitive advantage as a location for FDI.

The country specific advantages (CSAs) that influence where an MNE will invest can be broken into three categories: E, S and P (economic, social and political). Economic advantages include the quantities and qualities of the factors of production, size and scope of the market, transport and telecommunications costs, and so on. Social/cultural advantages include psychic distance between the home and host country, general attitude towards foreigners, language and cultural differences, and the overall stance towards free enterprise. Political CSAs include the general and specific government policies that affect inward FDI flows, international production, and intrafirm trade. An attractive CSA package for a multinational enterprise would include a large, growing, high income market, low production costs, a large endowment of factors scarce in the home country, and an economy that is politically stable, welcomes FDI and is culturally and geographically close to the home country. Outside of Burger King's Americas group (United States and Canada), 37.0 percent of the countries and 24.6 percent of the restaurants are in the Latin American and Caribbean group, yet these countries accounted for only 13.5 percent of the non-Americas group revenue in fiscal 2009. This is largely because many of these countries have very small populations, such as the Cayman Islands, Aruba, and Saint Lucia. So why did Burger King develop a presence in these markets, even though at this writing it is not in countries with much bigger populations, such as India, Pakistan, Nigeria, Russia etc. The answer is largely due to a location factor.

## **Internalisation Advantages (The I Factor)**

How they go abroad is another issue. The OLI model argues that external, arm's length markets are either imperfect or in some cases non-existent. As a result, the MNE can substitute its own internal market and reap some efficiency savings. For example, a firm can go abroad by simply exporting its products to foreign markets; however, uncertainty, search costs and tariff barriers are additional costs that will deter such trade. Similarly, the firm could license a foreigner to distribute the product but the firm must worry about opportunistic behaviour by the licensee.

The OLI model predicts that the hierarchy (the vertically or horizontally integrated firm based on internal markets) is a superior method of organising transactions than the market (trade between unrelated firms) whenever external markets are non-existent or imperfect. The theory predicts that internalisation advantages will lead the MNE to prefer wholly owned subsidiaries over minority ownership or arm's length transactions. It is therefore the internalisation advantages part of the OLI paradigm that explains why MNEs are integrated businesses, producing in several countries, and using intrafirm trade to ship goods, services and intangibles among their affiliates.

Internalisation within the MNE is designed to reduce market failures by replacing missing or imperfect external markets with the hierarchy of the multinational organisation. One source of natural market failure is the transactions costs which are incurred in overcoming market imperfections or obstacles to trade in all external markets. The higher the costs, the smaller the volume of trade. All markets are faced with the costs of search, <https://assignbuster.com/how-dunnings-oli-paradigm-explains-where-organisations-investment/>

communication, specification of details, negotiation, monitoring of quality, transport, payment of taxes and enforcement of contracts. Secondly market failure arises because external markets fail to deal adequately with risk and uncertainty. Thirdly, when governments levy taxes, tariffs and other forms of trade barriers, these regulations create additional costs for firms that reduce profits. Although the regulations generally have a legitimate economic purpose (e. g. raising government revenue), from the firm's point of view these are exogenous factors distorting international markets. Unrelated firms trading across international borders must pay these taxes.

This means that the choice between the market and the hierarchy is not so simple. There are many different modes of engaging in international production, ranging from simple exporting on the one hand, through subcontracting, licenses and joint ventures, to the polar extreme of a wholly owned subsidiary or branch. Each has its own benefits and costs to the MNE and these vary depending on the home and host countries, potential partners, the market for the product, government and non-governmental barriers to trade, and so on.

In Summary, OLI or eclectic paradigm explaining the existence of multinationals. The O factor answers the “ why?” question; that is, why the firm goes abroad. The reason is to exploit its firm specific advantages in other markets and countries; these FSAs allow the firm to overcome the costs of transacting and producing in a foreign location.

The L factor answers the “ where?” question of location. Since international production requires the use of foreign factors in conjunction with the firm's

FSA's, the MNE chooses its where to locate its foreign operations by comparing each country's locational attractiveness in terms of country specific economic, social/cultural, and political factors.

The I factor answers the " how?" question as to what mode of entry the firm uses to penetrate the foreign location. The MNE has a variety of alternative contractual arrangements, ranging from arm's length international trade through the wholly owned foreign subsidiary, and weighs their relative benefits and costs to determine how the enterprise enters the foreign market and expands its operations over time.

The successful MNE simultaneously combines these ownership, location, and internalisation advantages to design its network of activities and affiliates in ways that maximise its market shares and growth. Finally, as Dunning suggested (1979: p. 275) if Burger King or any other MNE engages in FDI it must satisfied above three conditions.

**By mid-2009, Burger King was not in any of the following countries: France, India, Nigeria, Pakistan, and South Africa. Critically assess using appropriate economic indicators and criteria the suitability of ONE of these countries as a possible future locations for Burger King.**

Pakistan, an impoverished and underdeveloped country, has suffered from decades of internal political disputes and low levels of foreign investment from 2001-07, however, poverty levels decreased by 10%, as Islamabad steadily rose development spending. In 2004-07, GDP growth in the 5-8% range was spurred by gains in the industrial and service sectors - despite severe electricity shortfalls - but growth slowed in 2008-09 (GDP 4. 3%) and

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unemployment rose to 14%. Inflation remains the top concern among the public, jumping from 7.7% in 2007 to 20.8% in 2008, and 14.2% in 2009. In addition, the Pakistani rupee has depreciated since 2007 as a result of political and economic instability. The government agreed to an International Monetary Fund Standby Arrangement in November 2008 in response to a balance of payments crisis, but during 2009 its current account strengthened and foreign exchange reserves stabilized – largely because of lower oil prices and record remittances from workers abroad. Textiles account for most of Pakistan's export earnings, but Pakistan's failure to expand a viable export base for other manufactures have left the country vulnerable to shifts in world demand. Other long term challenges include expanding investment in education, healthcare, and electricity production, and reducing dependence on foreign donors. Political instability, terrorist attacks, power, gas and water shortage and weak law order control has led to falling trend in FDI. These are the major reasons due to which the foreign investors are not interested in investing their capital in Pakistan.

No investment exists in isolation from the overall economy. Economic indicators are data on key economic variables recorded at regular periods of time that are used to predict, identify and confirm fundamental movements in economic activity. Used judiciously, the information conveyed by economic indicators can help investors to predict the likely movements of the market. The key economic indicators are:

Gross Domestic Product (GDP).

Inflation & Consumer Price Index (CPI)

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Unemployment.

Let's have a look at some economic indicators through which we can make a prudent decision about investing in a country like Pakistan specifically for an international fast food company Burger King.

As one can imagine, economic production and growth, what GDP represents, has a large impact on nearly everyone within that economy. For example, when the economy is healthy, you will typically see low unemployment and wage increases as business demand labour to meet the growing economy. A significant change in GDP, whether up or down, usually has a significant effect on the stock market. It's not hard to understand why: a bad economy usually means lower profits for companies, which in turn means lower stock prices, like in Pakistan 4.3% GDP ratio in 2009 as I mentioned above. Investors really worry about negative GDP growth, which is one of the factors economists use to determine whether an economy is in a recession. Real GDP is the one indicator that says the most about the health of the economy and the advance release will almost always move markets. It is by far the most followed, discussed and digested indicator out there - useful for economists, analysts, future investors like here we are discussing about Burger King. The general consensus is that 2.5-3.5% per year growth in real GDP is the range of best overall benefit; enough to provide for corporate profit.

Inflation is the other important economic indicator its means ' a rise in the general level of prices of goods and services in an economy over a period of time'. Inflation rate in Pakistan was 14.2% last year. Prices of goods and

services fluctuate over time, but when prices change too much too quickly, the effects can shock an economy. The rate of inflation is important as it represents the rate at which the real value of an investment is eroded and the loss in spending power over time. Inflation also tells investors exactly how much of a return (%) their investments need to make for them to maintain their standard of living. The easiest way to illustrate inflation is through an example. Suppose you can buy a burger for \$2 this year and yearly inflation is 10%. Theoretically, 10% inflation means that next year the same burger will cost 10% more, or \$2.20. So, if your income doesn't increase by at least the same rate of inflation, you will not be able to buy as many burgers. Like in Pakistan Inflation rate is high so it could be complex decision to invest there for Burger King. Furthermore, Price increases could also be triggered by increases in costs of production. For instance increases in prices of imported raw materials will cause inflation if not managed. The Consumer Price Index (CPI), the principle gauge of the prices of goods and services, indicates whether the economy is experiencing inflation, deflation or stagflation. The CPI's results are widely anticipated and watched; the CPI plays a role in many key financial decisions, Individual investors can also benefit from watching the CPI when making hedging and allocation decisions. The CPI is probably the most important and widely-watched economic indicator, and it's the best known measure for determining cost of living changes-which, as history shows us, can be detrimental if they are large and rapid. CPI can tell investors some things about what may happen in the financial markets, which share both direct and indirect relationships with consumer prices. By knowing the state of

consumer prices, investors can make appropriate investment decisions and protect themselves by using investment products.

The unemployment rate measures the number of people available for work and seeking employment. If unemployment is on the rise or few new jobs are being created, it is a sign that companies themselves are not expanding their businesses and the economy may be slowing down. In 2009 unemployment rate of Pakistan was 14%. On the other hand, tight labour markets and large-scale job creation indicate a growing, or even overheated, economy. The reaction of markets to news about unemployment can often seem paradoxical. If the economy is doing well, investors will fear that a fall in unemployment (which you would think would be good news) will be inflationary (more people in work and spending money). Very low unemployment can also be a sign of labour shortages. On the other hand, a fall in unemployment when the economy is in recession is good news for the markets as it suggests an improvement in the overall state of the economy.

Similarly, the following factors also involve when entering another country for investment (social, cultural and political). Social/cultural include psychic distance between the home and host country, general attitude towards foreigners, language and cultural differences, and the overall stance towards free enterprise. Political include the general and specific government policies that affect inward FDI flows, international production, and intrafirm trade. An attractive package for a multinational enterprise would include a large, growing, high income market, low production costs, a large endowment of factors scarce in the home country, and an economy that is politically stable, welcomes FDI and is culturally and geographically close to the home country, <https://assignbuster.com/how-dunnings-oli-paradigm-explains-where-organisations-investment/>

but if you see all the indicators that I mentioned above in Pakistan the situation is totally opposite, this is why investing of Fast Food country such as Burger King whether it is FDI or Portfolio Investment in Pakistan would be risky enough in my opinion.

After detailed discussion on key economic indicators and social & political factors, I would say that it would be difficult for a company like Burger King is as a foreign market entry and operating strategy in Pakistan. Also, there are other competitors as well in Pakistan such as, KFC; McDonald's etc.

Undoubtedly Pakistan has big population country of over 180 million people from which urban population is 36% of total population approximately and annual rate of change is 3%, from one point of view it is good for burger king that is large population but on other side, most of population is from rural areas and trend of fast food in rural areas are less as compared to urban cities. Moreover, Pakistani peoples love to eat traditional dishes the most because they think eating fast food is not good for health as well. Therefore in Pakistan current situation and government policies, Social and cultural & Traditional factors, political instability, Law & Order Situation, War on Terrorism, Suicide attacks and Talibanisation, unemployment, inflation and GDP ratios are not suitable for MNE like Burger King because economic downturns could hit sales of fast foods. Given picture below is the Brand Symbol of Burger King the International Fast Food Company.

logo\_BURGER\_KING\_logo\_Earth\_Tones. jpg

**When entering another country, discuss the advantages and disadvantages that an international restaurant company, Specifically Burger King, would have in comparison with a local company in that market.**

A firm desirous of entering into international business has several options available to it. These range from exporting/importing to contract manufacturing abroad, licensing and franchising, joint ventures and setting up wholly owned subsidiaries abroad. Each entry mode has its own advantages and disadvantages which the firm needs to take into account while deciding as to which mode of entry it should prefer. Franchising method is mostly used by the Service and Fast Food industries. To establish business internationally firms initially have to complete many formalities which obviously are a tedious task. But to start a business locally the process is always an easy task. It doesn't require processing any difficult formalities. International business involves all commercial transactions private and governmental between parties of two or more countries. Global events and competition affect almost all firms large or small. However, the international environment is more complex and diverse than a firm's domestic environment. External environments that affect the ways in which firms operate internationally include physical, societal, and competitive factors. In fact, the amount of adjustment required in foreign operations is largely influenced by the extent to which the home and host country environments resemble one another. Below I am going to discuss the merits and demerits of international restaurant company specifically Burger King as compared to the local company while entering another country.

Operations in two or more nations always results in huge benefits. Market fluctuations can never be a hurdle in this system from gaining maximum profits. Creation of more employment opportunities, efficient use of domestic resources and exchange of foreign currency benefits the nations. Cross-national cooperation and agreements are always possible, nations cooperate more on transactional issues which in return improves the political relations among them.

Differences between local and international Company are pronounced primarily in the areas of currency, interest rates, inflation, taxation systems, government regulations, language, and cultural and economic barriers. This mode of system leads to rapid depletion of exhaustible natural resources. Although profits are huge companies need to wait for long periods. Deal with special licenses and a regulation of the different nations really makes the companies to step back at times to carry on business. Countries may interfere in the political matters of other countries, sometimes in here rich nations gain control over weaker nations. In local company skilled workers are easily available while operating international company skilled workers may be hard to find. In local business generally a single language is used but entering in any other territory different languages and dialects are involved. This method of international business also enables a company to bypass some of the difficulties associated with internationalization such as different political, regulatory, and social conditions.

Geographic Influences, The uneven distribution of resources results in different opportunities being located in different parts of the world. In

addition, geographic barriers affect transportation, communications, and <https://assignbuster.com/how-dunnings-oli-paradigm-explains-where-organisations-investment/>

distribution channels within a country. Finally, the probability of natural disasters and adverse climatic conditions make it riskier to invest and operate in some countries than others.

**Political Policies,** Politics often determine where and how international business takes place because of the influence of government leaders over the process.

**Legal Policies,** While every nation has its own body of business law, agreements between/amongst nations determine international law. Domestic business law may include regulations on home-country firms in both home and host countries regarding such matters as taxation, employment, and foreign-exchange transactions. International law may also determine how and whether firms can operate in certain locales.

**Behavioral Factors,** By studying the disciplines of anthropology (study of humanity), psychology, and sociology, managers can better understand the interpersonal norms of people in foreign countries and the reasons why operating procedures may need to be adjusted in foreign locales.

**Economic Forces,** Among other things, economics explains why countries exchange goods and services, why capital and people travel among countries in the course of business, and why one country's currency has a certain value compared to another. It also provides the analytical tools to determine the impact of foreign operations on home and host countries, as well as the effect of a country's economic policies and conditions upon domestic and foreign firms.

## **Critically assess the likely success of Burger King's strategy of using the Brazilian experience to guide its entries into Russia.**

Burger King plans to increase the number of net operating units by 3 to 4 percent per year near future, with most of that increase coming in international operations. Burger King opened its first restaurants in two of the BRICs, Brazil and China, almost simultaneously, in November and June 2004 respectively. By then, many foreign fast food franchisors had entered the markets, many without success. For the most part, failure occurred because of underestimating what it would take to succeed in such a large country. In looking for new countries to enter, Burger King looks most favourably at those with large populations (especially of young people), high consumption of beef, At least half of Russians aged 16 to 50, both male and female, purchase fast food at least once a week, a poll conducted by the “School of Russian and Asian Studies” found, availability of capital to franchisees for growth, a safe pro-business environment, growth in shopping centres, and availability of a potential franchisee with experience and resources. By looking at all of the above mentioned factors I would say that Russia is suitable for Burger King entry criteria. Now below I am going to discuss five points which a Burger King should adopt in order to be successful in entering Russia.

First, it has to develop an infrastructure before putting in restaurants.

Develop a local management team, Focus development on major cities and adjacent geographies with established shopping mall location, prevalent in Brazil's largest cities, instead of the whole country. Establish a local office,



and Support continuous development and the use of local suppliers that meet Burger King's global specifications.

“ Claiming that Russia is an exciting, active market with a vibrant economy” said Kevin Higgins, president, EMEA, Burger King Corp. Burger King's executive management is quite optimistic about the company's prospects. “ We believe that our brand's entry into Russia exemplifies our company's commitment to diversifying our global restaurant portfolio and represents a milestone in our expansion strategy in the region,” said John Chidsey, the chairman and CEO of the Burger King Corporation. “ More than 80 percent of our net restaurant growth is realized in international markets, and we are pleased with our new strategic market entry into Russia and its future expansion potential.” More restaurants will open in Moscow and other cities when the company has planned their locations and built the right infrastructure within the framework of expanding its business in Russia.” Blokhina added that Burger King will work with local suppliers when it comes to packaging, salads and sauces, and the beef for the burgers will also be produced locally. In the future, the company will expand its cooperation with the local suppliers for economic reasons. “ Considering the recent decline in fast food sales in the United States and the EU countries, it makes sense to focus the attention on new, developing markets, such as Russia, Brazil and South Korea,” said Michael Schaefer, an analyst at Euro monitor International. “ Burger King's strategy gives it the chance to establish itself as a global operator, but the company will have to follow through on every key point, such as compelling menu items, attractive outlet design, etc.” Lower rent prices on commercial real estate during the economic crisis

contribute to making the Russian market very attractive. Moreover, the popularity of fast food in Russia has grown dramatically ever since the crisis first hit the country. (Meat Trade News Daily, Accessed 07 Dec, 2010).