Asia Pacific Journal of Research in Business Management
Vol. 7, Issue 12, December 2016 Impact Factor: 5.16, ISSN: (2229-4104)
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DETERMINANTS OF FOREIGN DIRECT INVESTMENT

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ABSTRACT

The problem about the determinants of the foreign direct investment has received a lot of attention by policy makers and scholars due to its economic and policy implications. FDI is an integral part of the economic development strategies of almost all countries, especially of developing and emerging markets countries. FDI is a key element of the international economic relations as it is an engine of employment, technology transfer and improvement of productivity which ultimately leads to economic growth. The need to attract FDI pressures governments to provide favourable climate for business activities of the foreign firms as they consider the political and economic institutional framework of the host country when deciding where to invest their capitals. There is an ongoing debate among scholars about the most important factors that attract investment inflows into a country – the debate concerns different types of factors ranging from purely economic indicators like market size and natural resource endowments to legal and political factors like the quality of the institutional framework of the host country and the type of the political regime.

Keywords: FDI, Foreign Direct Investment, Institutional Framework, Determinants of FDI

Introduction

Capital and investment along with human resources are the essential hub of development. But the short supplies of domestic capital limit the growth of developing countries. Low GDP keeps the savings and investment rates low, which in turn, limit growth. Poor technological base of production is another factor impinging upon growth of the developing countries. FDI mitigates these constraints to growth of the developing and emerging countries. FDI and foreign technology also brings with them the modern managerial practices. Market size, as manifested by population size and growth environment, including economic policy, specially the reform process, prevailing growth rates and future growth potential, beside others, may together affect the level and sectoral directions of inflows of FDI into the recipient countries (Sharma and Sharma, 2003).

Three important types of FDI for developing countries are: export-oriented FDI, domestic market-oriented FDI, and infrastructure FDI. All three bring their own benefits. Export-oriented FDI links the local economy to the international economy. Openness to both imports and exports has been shown to be a powerful force for growth (Sachs and Warner, 1995), and growth has so far been the only credible means of alleviating absolute poverty. Domestic market-oriented FDI brings new products and services to market. These may be new on many dimensions-either goods and services that were previously unavailable, or goods and services that were previously available but at a different level of quality. In some cases, domestic market-oriented FDI can supply intermediate inputs that otherwise would be unavailable. This would help expand not only the efficiency and profit opportunities of local industry, but also the range of local industries that may exist. The infrastructure FDI, though riskiest for the investor, probably it is the most promising and sensitive for the country receiving the FDI. Without reliable power, telephone, transport networks, and information technology networks- a country cannot hope to increase its industrial production and economic growth. This is specially true with increased globalisation (Ahluwalia, 1998).

Each type of FDI has its own special set of attractors. However, a bird's eye view of the published literature (Lizondo, 1990) offers that despite much theoretical discussion on determinants and motivations for foreign investment flows, no single theory so far has been able to include all possible factors and motivations for investing overseas. The empirical studies also reveal the same degree of ambiguity as no fixed set of variables can help explain inter-country variations in FDI. In spite of such a

diversity in the theories and evidence on the determinants of FDI, there is a reasonable level of agreement among the researchers about some more important and significant determinants of FDI.

In 1960s, the attempts were made to explain the variations in FDI. These efforts were chiefly in the form of surveys of Multinational Enterprises to understand their expectations and reasons behind going global. However, the late 1960s saw a shift in focus. The researchers were busy in proving the hypothesis of Product Life Cycle and expanding the scope of the existing theory on FDI. Hymer (1976) made an important contribution to the FDI theory. He came out with the industrial organisation explanations of FDI, and advocated that the capital-arbitrage hypothesis of international capital movement was inconsistent with the obvious motives and patterns of multinational companies' investment. The doctoral thesis of Hymer (1976) brought out that the organisations investing abroad should possess certain ownership advantages, or firm specific advantages, to compete with the domestic firms of another country.

Location, factor costs and trade policy play particular importance in attracting foreign investment. In a comprehensive work Dunning (1993, 1993a,1998) made a scanning of the explanations of the past researchers regarding determinants of FDI. He suggested three conditions for FDI inflows. These conditions are popularly known as OLI i.e., O-wnership advantages, L-ocation advantages, and I-nternationalisation advantages. Given the nature of FDI and the fact that the main source of FDI is the developed countries in the world, the ownership advantages exist no more. Buckley and Casson (1976), recommended the application of internationalisation theory to explain the FDI based on the theory of transaction costs. As per Shatz (1999), location plays an especially large role as a determinant of investment for production of goods intended for export back to the investing country. For instance, U.S. has an enormous level of such investment in Mexico. Germany moved very quickly into Hungry during the 1990s. And Japan maintains an expanding web of intermediate-goods affiliates in developing Asia. In fact, the locational advantages for FDI arise due to the existence of certain pull factors in the recipient countries. These factors might include large and growing markets, low-wage rates, export orientation, economic and tariff policies conducive to foreign investment, open and market driven economies, the level of infrastructure, political stability, better labour laws, etc.

Review of past studies

According to Mundell (1957) (quoted in Stephen *et al*., 1993), FDI should ultimately flow into those countries that are importing goods from abroad. Heymer (1970) concluded that given the oligopolistic structure of markets and international integration, imports and the level of FDI are complementary and thus, the hypothesized relationship between imports and FDI inward flows is positive. Similarly, countries adopting the export promotion strategy, are likely to attract more FDI than countries adopting import substitution strategy, since export promotion strategy promotes a more efficient utilisation of FDI inflows (Bhagwati, 1978). Harvey (1989) and Stephen, *et al.* (1993) found that while the estimated coefficient of the previous period's imports is positive and significant, the coefficient of the previous periods exports is negative and significant. It indicates that with a smaller volume of exports from the developing country, the more likely it is that the country will receive foreign direct investment.

Market size plays a key role in attracting FDI flows. Host country market as a determinant to FDI has two facets-market size and market growth rate. Studies conducted by Hill and Munday (1992) and Lucas (1993) show that market size is a significant determinant of FDI. A recent study (Chen, 1997) of 33 developing countries also found the market size as a significant determinant of inward FDI. However, Clegg (1995) [quoted in Castro (2000)], in his study with data from 1951-1990, found that when the data for the entire period was taken, market size and growth rate, were insignificant. Interestingly, on his splitting the data into two sub-periods 1951-1972 and 1973-1990, market size turned significant in the earlier period and the growth rate in the later period. Therefore, he concluded that new investment requires for a big market and subsequent investment needs growing market.

Holland and others (2000) reviewed several studies for Eastern and Central Europe, producing evidence of the importance of market size and growth potential as determinants of FDI. Campos and Kinoshita (2003) reached the conclusion that FDI is influenced by market size, the low cost of labour and abundant natural resources.

Natural resources used to be very important determinant of FDI in past. However, recently the relative importance of this factor has decreased. The results of the studies of Achinivu (1990) on Malaysia and Taiwan indicated that the availability of raw materials was one of the significant determinants of FDI.

Soon (1990), however, in his study of German FDI in ASEAN found this factor to be insignificant. World Investment Report (1998), also shows that the relative importance of natural resources for FDI has decreased over the years. The report attributes this to the entry of increased number of domestic enterprises of the host countries into the production and distribution of primary products.

Labour costs play an important role in attracting foreign investment. Achinivu (1990) and Lucas (1993) observed labour cost to be a significant determinant of FDI. Wheeler and Mody (1992), however, concluded labour cost to be an insignificant determinant even within a developing country sample. They opined that as national income increases, market size offsets the importance of labour costs as a location factor.

Yet another factor determining FDI is the 'ability to repatriate capital and remit profits'. With regard to this factor too, there is strong statistical evidence to suggest that investors view inability to repatriate capital and remit profit as one of their main concerns (World Economic Forum, 1997). High openness would imply lesser restrictions on remittance of capital income that may be in the form of interests, dividends, profits, or capital gains.

Determinants of Foreign direct investment

In order to achieve our objective of identifying the factors having influence on inward flow of FDI, I have taken a large sample size comprising of 12 countries. All the selected countries belong to the category of developing economies, as per the classification given in the World Investment Reports, 2013, 2014 and 2015.

To determine the factors influencing FDI inward flows, the use has been made of the following step-wise multiple regression (backward elimination) equation:

$$y = a + b_1x_1 + b_2x_2 + b_3x_3 + b_4 x_4 + b_5 x_5 + b_6 x_6 + b_7 x_7 + b_8 x_8 + \mu$$

In this equation, y is the dependent variable, x_1 to x_8 are independent variables, a is constant, b_i are regression coefficients for various variables and μ = error term. The independent variables include: x_1 = per capita GDP; x_2 = GDP growth, x_3 = power consumption per capita; x_4 = exports as percentage of GDP; x_5 = external debt as percentage to exports; x_6 = adult literacy; x_7 = inflation rate, x_8 = secondary grade enrolment of females. The data on both dependent and independent variables have been collected from

the various issues of World Investment Report, World Development Report and Human Development Report. Average of data for the respective durations on the various variables is being used for the analysis. The expected nature (i.e. +ve or –ve) of relationship between the various independent variables and the dependent variables is shown in Table

Table: Expected sign of partial regression coefficients in regression analysis

Sr. No.	Variable (Abbreviation)	Expected relationship with FDI inflows
1.	GDP per capita (GDPPC)	Positive
2.	GDP growth (GDPGR)	Positive
3.	Power consumption per capita (POWCOM)	Positive
4.	Export as a percentage of GDP (EXPGDP)	Positive
5.	External debt as a percentage to exports (EXDET)	Negative
6.	Adult Literacy (ADLIT%)	Positive
7.	Inflation rate (Inflation%)	Negative
8.	Secondary grade enrolment for females (SECEDFEM)	Positive

The data is processed by considering per capita FDI as the dependent variable. SPSS software is applied to process the data pertaining to this study.

India controls foreign investment with limits on equity and voting rights, mandatory government approvals, and capital controls. Since 1991, as it has slowly implemented a program of economic reform, the government of India has gradually relaxed many of these constraints. Nonetheless, a complex array of restrictions remains, along with an undercurrent of hostility towards foreign investment from some quarters. Foreign direct investment (FDI) is still prohibited in some sectors or sub-sectors.

Since the mid 1990s, India has allowed 'automatic' FDI approval in many sectors, gradually expanding the list over time. Where applicable, foreign investors do not need government licenses or approvals and simply notify the Reserve Bank of India (RBI) of their investments. Other sectors require approval by either the Foreign Investment Promotion Board (FIPB) or the Cabinet Committee on Foreign Investment. The rules vary from industry to industry and are frequently changed. Although the changes have tended toward greater liberalization, the investment process is not always transparent or straightforward. In January 2005, for example, the government relaxed restrictions on new FDI in India by foreign partners of joint ventures. The previous rules, issued in Press Note 18 in 1998, had required a release by the

Indian partner and government of India approval for any new investment, a provision often subject to abuse. The new rules maintain restrictions on the majority of existing joint ventures, but leave new ones to negotiate their own terms on a commercial basis. A local firm's ability to restrict its foreign partner's business strategy has been reduced, but the way out of a current joint venture remains uncertain.

Equity caps for foreign portfolio investment are sometimes included in FDI caps. There are no set rules specifying the combination of FDI and foreign portfolio investment allowed in share holding of a particular company. In some cases the portfolio investment is included within the FDI cap, in other cases foreign portfolio investment is not subject to the FDI cap.

A recent amendment to the Companies Act denies voting rights to foreign investors holding preferred stock in Indian companies if their holdings exceed the FDI limit. This means that if the foreign equity participation is at the maximum permissible level in a company, the preference shareholder will not have any voting rights.

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