Most Common Potential Determinants of FDI: Review of Literature

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Abstract: The aim of this paper is to provide the critical analysis of the potential determinants of FDI. Review of the literature led to the development of research model which provides the most potential determinants of FDI. The importance of FDI is considered to be important for both developed and developing countries. In this regard, the potential determinants of FDI which have been identified as a result of literature review include market size, labour cost and productivity, political risk, infrastructure, economic growth and tax. Nearly all of these variables are reported to have an indecisive relationship with FDI, that is to say, some papers show a positive correlation between variables while other present negative or no relationship at all.

1. INTRODUCTION

One of the main issues faced by countries is that they do not have sufficient amount of funds to finance their investments. Therefore, most of the countries that lack finances are constantly looking for both direct and indirect investments. Previously, they relied on loans which were offered by international commercial banks. However, in 1980, as a result of the drying-up of commercial bank lending activities and increasing amount of debts, many countries were obliged to reconsider their investment policies in order to be able to attract more foreign capital (Ancharaz, 2003). Therefore, foreign direct investment has appeared to be one of the easiest ways of obtaining foreign capital. Thus, it can be stated that alongside with bank loans, foreign direct investment can be considered as an alternative way of getting capital flows. FDI is defined as one of the ways of obtaining capital flows (Blonigen, 2002; Kolstad, 2012). Therefore, it can be mentioned that certain type of factors which are likely to influence on firm performance may also likely to impact on the direction of FDI. In this regard, it is important to mention the benefits of investing foreign capital to other countries. Moreover, the role of government authorities can be one of the key factors for explaining the increasing flow of capital from foreign countries. Some key factors are cheap labour force, reasonable corporate taxes, special offers and tariffs for improving the role of FDI in the economy of the country. According to the report prepared by Asian Development Bank (2004), many factors have positively contributed to the increasing popularity of FDI including advances in technology, increasing number of multinational companies and their integrated supply chain networks and increasing number of tax incentives offered by developing countries that are open to foreign direct investment. Developing countries are offering income tax holidays, exemptions of import duty and market preferences and etc.

In the period of globalization and increasing use of advanced technologies, there is a huge need for developing countries to benefit from the increasing flow of foreign capital. In this regard, FDI is considered to be as one of the most efficient ways of obtaining capital that is convenient for both investors and host country members. Therefore, close attention to the ways through which FDI can be attracted is considered to be very important. Having a clear picture of potential determinants of FDI and how they are interrelated with each other can equip both investors and host country members about the critical implications which they can benefit from in the long term. Taking into consideration...
above mentioned points, this paper is going to propose the research model that can well explain the potential determinants of FDI. The uniqueness of the model can be explained by the fact that it does not only consider critical factors relevant to developed countries, but also potential variables including market size, openness, political risk and taxes can be used in the context of developing countries. Therefore, developing countries can also benefit from the understanding of necessary factors and may succeed in attracting the attention of foreign investors. Despite the several researches that have studied potential determinants of FDI (Wheeler, 1992; Anderson, 2003), the focus of those papers were targeted for the developed countries. Most of the developing countries that have reached a substantial level of economic development should be also carefully studied since nowadays FDI invested in developing countries is expected to present high expected return.

2. LITERATURE REVIEW

Many theories have been proposed to explain the determinants of FDI. ScholarsChin (2016) and Charkrabarti (2001) think that emergence of these theories can be a critical step to developing various models related to determinants of FDI. Dunning (1993) described two important types of FDI taking into consideration the perspective of investing firm. The first type of FDI is described as market-seeking FDI, which mainly focuses on serving local markets. Market-seeking FDI, also known as horizontal FDI, also deals with replication of production inventory in the foreign country. Tariff-jumping and export substituting can be the example of horizontal FDI. Horizontal FDI is mainly concerned with serving and improving the economic condition of the host country by increasing local production, size of the market and its growth. Low tariffs and transportation costs are also one of the main reasons regarding why this type of FDI is popular. Resource-seeking FDI is known as the second type of FDI. This type of FDI is common when investors try to obtain specific resources from a foreign country which are not available in their home country. These include natural resources, raw materials and cheap labour (Gastanaga, 1998). In this regard, the importance of capital flows into manufacturing sector deserves particular focus. One of the main considerations that involve FDI in the manufacturing sector is related to cost. Unlike horizontal FDI, vertical FDI, also known as export-oriented FDI is about relocating the necessary technologies and machines to foreign country. Therefore, export-oriented FDI is mainly motivated by the presence of cheap labour cost. FDI in resource sector is mainly concerned with countries which are full of natural resources.

The clear understanding of the potential determinants of FDI can be considered as a crucial step for formulating necessary model. The variables included in the model are considered to be important. For example, it is important to establish necessary rules and regulations in order to legally ensure that particular country is open for international trade and will favourable make contract with foreign investors under reasonable conditions. Therefore, it is important to have an understanding of the general and most common type of factors which is applicable to almost each type of FDI. Bearing this in mind, this paper proposes the model that can explain the potential determinants of FDI in the order as follows.

2.1 Potential Determinants of FDI and Research Model

2.1.1 Market size

According to Anderson (2003), market size measured by GDP or GDP per capita is regarded as being one of the most important determinants of FDI. Market size is considered as the main determinant for horizontal FDI. FDI is mainly relevant for countries which have growing market size and offer high purchasing power, and in return, investors can get higher return on their investment. Moreover, Ismail (2015) found that large markets with high market growth are more likely to utilize resources and benefit from the economies of scale. Therefore, the growth of market share leads to the increase of FDI. Most of the empirical studies proposed the relationship between the size of the market growth and FDI. Particularly, most of the papers supported the relationship between two variables including market size and FDI (Hausmann, 2000). These studies used GDP and GDP growth as a proxy for market size by considering some of its characteristics including average income level of population.
Studies have also discovered the negative relationship between real GDP per capita and FDI, using the income per capita as a proxy for the return on capital (Blonigen, 2002). Other researchers as Baltagi (2004) found the positive relationship between market size and FDI. Particularly, GDP per capita is considered to imply positive future prospects for the operations of the country. In other words, large market size is reported to lead to the stimulation of FDI activities to the economy.

2.1.2 Openness
Openness is measured by the ratio of exports plus imports to GDP and it is used to determine the FDI. There is a number of evidences supporting the view that openness is a critical factor and one of the determinants of FDI. Precisely, considering the fact of involvement of investment projects into different sectors, the degree of openness of the country towards international trade will play an important role in defining whether to invest or not. Anderson (2003) believes that the type of investment plays a crucial role in defining the influence of openness on FDI. In terms of market-seeking investment, many investors face trade restrictions which in turn may imply less openness of the country towards international trade. Therefore, it will have a negative impact on FDI. Researcher Wheeler (1992) claimed that a number of foreign businesses that are looking to serve the local market are more likely to decide to open their branches in host country taking into account the fact that it will be difficult for them to import their products. Compared to this, most of the international firms that are concerned with export-oriented investment are more likely to invest in an open economy where the influence of imperfections related to trade protection may lead to higher transaction costs of exporting. It has been reported that the relationship between the degree of openness and FDI may vary depending on the type of sector. For example, Baltagi (2004) revealed a positive relationship between these two variables in manufacturing sector but a negative correlation in electronic sector. Anchaz (2003) found the positive link, while Hausmann (2000) reported negative one. The study conducted by Deng (2004) implied that open economies are a key factor in encouraging more foreign direct investment.

2.1.3 Labour Costs and Productivity
The study conducted by Gastanaga (1998) mention that the amount of wage paid to the labour is one of the most potential determinants of FDI. Generally, the large amount of FDI is mainly directed to those countries which have cheap labour force as they quickly attract the attention of foreign multinational companies. On the other hand, studies (Baltagi, 2014) have found a positive relationship between labour intensive industries. However, the insignificant amount of wage is certain to influence the decision of investors regarding the location of FDI. Schneider and Frey (1985) studied the inflows of FDI using the case of 54 less developed countries during 1977-1980. The results of their study show that the countries with high wages have low flow of FDI. Jun and Singh evaluated the inflow of FDI for the case of 31 less developed countries using the case of 1970-1993. Their model showed statistically significant negative relationship between FDI and wage. The relationship between FDI and labour cost can be different in terms of the industry. For instance, the study conducted by Wheeler and Mody (1992) found a significant positive relationship between FDI and wage for the electronics industry, however, manufacturing industry taken as a whole showed no relationship between FDI and wage.

2.1.4 Political Risk
There is a huge disagreement among scholars regarding the importance of political risk in affecting FDI decision. It is reported that investors are certain to increase the inflow of foreign capital as long as there is availability of natural resources no matter the political stability of the country (Anderson, 2003). For example, the political instability in Nigeria and Angola is compensated as a result of the high return of capital. Generally, when investors are confident about the profitability of their investment without a high degree of risk, they are going to increase the amount of foreign inflow. The relationship between political instability and FDI flow is still unclear. Charkrabarti (2001) found a positive relationship between these two variables while Blonigen (2002) found negative relationship stating that political risk has a negative impact on FDI. Greene (2002) divided political risk into two dimensions including political violence and political instability. Political instability is explained by the probability of the government change while violent riots, strikes and political assassinations are used.
to explain political violence. The results show that political instability was found to be significant while political violence reported being insignificant.

2.1.5 Infrastructure
Infrastructure consists of roads, ports, railways and it can also include the institutional development such as accounting, marketing and legal services (Deng, 2004). Studies show that poor infrastructure can be considered as an obstacle or an opportunity for the investment (Greene, 2002). Mainly, countries with low income consider their poor infrastructure as the main obstacle and most of the host countries always look for the ways of increasing foreign direct investment in order to improve their infrastructure. Blonigen (2002) stated that high quality of infrastructure is reported to influence positively on the potential of growth of FDI, thus, resulting in high inflows of capital towards the country.

Supportive infrastructure is considered to be essential for ensuring the smooth development of the business activity. Good infrastructure is reported to decrease a significant amount of overhead costs and can positively influence on investors’ decision of location (Shah and Ahmed, 2003). Studies questioned the importance of telephone density as a possible infrastructure. However, the emergence of international trade and establishment of multinational companies in international level significantly highlights the importance of telephone density and internet access as the crucial means of communication that fall under the category of infrastructure. Good internet access and telephone density is reported to decrease the coordination costs between companies and their subordinates (Campos and Kinoshita, 2003).

2.1.6 Tax
Tax incentives are provided for enterprises in order to persuade them to invest in a particular sector or project in a country. Possible examples of tax incentives include rates of reduced tax on profit, tax holidays, and decreased amount of tariffs on imported tools and machinery. Different forms of tax incentives are provided in the literature including income-based, capital investment based, labour-based, sales-based, value added, import and export based (UNCTS, 2000). Both international and public economists have shown great interest to analyse the influence of taxes on FDI. Most of the studies conducted in this field stay indecisive regarding the influence of tax incentives on FDI. Generally, investors are likely to consider the tax incentives offered by the host country in making their decision alongside with the other factors. However, studies conducted by Deng (2004) found no influence of tax on FDI decisions. Furthermore, some papers reported that high taxes may have negative impact on FDI decisions, discouraging the inflow of foreign capital. Review of the literature shows that tax incentives are not the main factor which may significantly influence on investors’ decision (Deng, 2004, Chin, 2016). However, mainly developing countries take advantage of offering tax incentives to attract the attention of investors.

![Figure 1: Proposed research model: Potential Determinants of FDI](image-url)
3. DISCUSSION

FDI is described as an investment from one particular country to another made by firms with the purpose of acquiring tangible assets and stakes of the business in the host country. Moreover, it is also defined as the purchase of income generating asset in the foreign country that gives the owner the ability to control the operations of the firm. FDI is regarded as the key element of the economy as it helps for the development of the host country. The development of the technology and emergence of the multinational companies promoted the worldwide presence of FDI in many different ways. It has been stated that three important conditions should be met for the successful execution of FDI including ownership advantage, location advantage and internalisation advantages. Ownership advantage indicates that the business starting to operate in a foreign country should have its number of advantages in terms of strategy, marketing, personnel and funding. Local advantages that are necessary for the FDI is that geographic area offering tax incentives, low-cost labour, good infrastructure and logistics to access the market. In other words, there is no agreement whether it may increase or decrease according to the type of investment. However, some key discussion can be put forward regarding their role. That is to say, tax incentives are not likely to influence negatively on the decision of FDI and at the same time they are not going to generate positive results. Moreover, some of the investors are reported to prioritize the factors according to their importance. In other words, the political and economic environment of the host country can be the most important factors that investors consider. Therefore, no matter how much tax incentive will be offered, investors are unlikely to increase the flow of foreign capital to that country if they are not sure about good political and economic environment. This implies that when there is an equality of political and economic factors, the importance of tax incentives may then be realized and taken into consideration. It is true that tax incentives are more likely to bring more profit in investment flows. However, at the same time, the fiscal revenue may be negatively affected due to the tax incentives and allow for the emergence of illegal tax behaviour which is mainly observed in international companies. It is worth to mention that the tax policies of different countries vary based on the specificity of the firm. For instance, mobile firms that operate globally in different market may take the advantage of tax incentives by offering their products in different markets and at the same time exploring the tax regimes of different countries. The increasing popularity of advanced technology enabled both developed and developing countries from the increasing flow of foreign capital. The critical factors mentioned in the model can be applicable in the case of developing countries as well. These potential determinants and their interrelations can be beneficial in deriving policy implications in terms of attracting the attention of investors and increase the flow of foreign direct investment.

4. CONCLUSION

The objective of this paper is to identify and analyse the importance of potential determinants of FDI. The review of the literature has enabled us to identify a number of potential determinants which can be used to explain the precedents behind FDI. These variables include market size, openness, growth, infrastructure, taxes and political risk. Moreover, it is worth to mention that most of the papers are indecisive regarding the influence of these determinants on FDI.

Policymakers can benefit from the outcomes of the model in various ways. First of all, the model provides them with the overall picture of variables which are likely to influence the FDI decision. Furthermore, the review of the literature and model explains the possible relationship between these variables. The practical implications of the paper can also be useful for the economies of the developing countries since they can implement rules and regulations by ensuring the openness of their country and the participation of their countries in international trade, which is quite an important factor which may influence an FDI decision. Current research framework developed through reviewing different literature is expected to increase its implications when it is tested in using the sample cross-country data from developing countries. Therefore, the future research is going to be focused on ensuring the validity of the model through statistical analysis.
REFERENCES