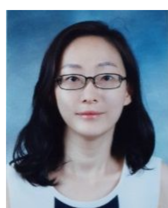
KIEP Opinions

Determinants of Foreign Direct Investment



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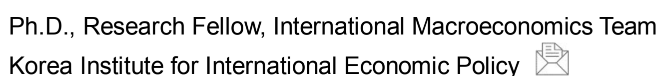

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As the world economy becomes integrated and foreign investment becomes liberalized, most governments compete to attract foreign direct investment (FDI) to their country based on the belief that foreign firms bring advanced technology, create jobs, and boost economic growth. Also, since FDI is one of the most stable capital flows, unlike capital flows in the stock and bond markets, it holds particular importance for developing countries. For these reasons, the determinants of FDI have been broadly studied from a variety of perspectives. Since FDI is determined by the behavior of multinational companies (MNEs), the motive behind the investment from the perspective of the investing firm is relevant. The first motive for FDI is to serve the local market by substituting exports from home to host country, called horizontal FDI. In this case, local market size and purchasing power strongly impact the location choice of MNEs. The second motive for FDI is to gain access to production factors including natural resources, raw materials, and human resources, called vertical FDI. In this case, availability of resources and lower factor costs play important roles. The third and last type of FDI is to relocate certain parts of production, produce goods, and then export them to third countries, which is called export-platform FDI. Since the main reason firms

seek export-platform FDI is to save production and trade costs, low labor costs, lax market regulations, and trade openness are crucial determinants.

The UNCTAD World Investment Report (1998) classifies FDI determinants into three groups: business facilitation, economic factors, and political factors. A great number of studies try to identify which factors affect the magnitude and location choice of foreign firms. As stated above, horizontal FDI is attracted to large and expanding markets with high purchasing power. Market size, measured by GDP or GDP per capita, is the most common FDI determinant and is taken into account in nearly all empirical studies on determinants of FDI. Large markets enable foreign firms to enjoy greater purchasing power, and thus a higher return on capital and benefits from economies of scale. Also, since a swiftly rising GDP growth rate indicates a rapidly expanding market and market potential, it is often considered an influential factor for FDI.

Naturally, firms are attracted to lower production costs. Therefore, lower labor costs have a positive impact on FDI. A large number of papers show that lower wages or large wage differences between home and host countries play a role in attracting multinational companies. The ODI Paper (1997) among others shows that labor cost plays a key role particularly in the case of foreign investment in labor-intensive industries and export-oriented subsidiaries. Meanwhile, some empirical papers present that labor cost is positively associated with FDI, and explain that high labor costs may suggest advanced human skills and higher productivity.

Firms are also attracted to lax labor market regulations. Since multinational firms wish to relocate their foreign affiliates in line with shifts in the market environment, they care about exit costs as much as entry and operation costs. Papers such as Gorg (2005), Javorcik and Spatareanu (2005), and Benassy-Quere et al. (2007) study the impact of labor market regulations on FDI. They generally find that host countries with flexible labor market regulations attract more foreign investment. Some papers, such as Choi (2016) and Leahy and Montagna (2000), show that the level of redundancy payments and national labor unions also affect the location choices of multinational firms. Foreign firms are more strongly attracted to a host country with lower redundancy payments and a less-unionized economy. In fact, Hoover, an American multinational firm, relocated its plant from Dijon, France to Cambuslang, Scotland in 1994, and the executive mentioned that one of the reasons for the relocation was France's higher non-wage labor cost compared to Scotland.

Openness is often cited as one of the most important factors in determining FDI. Trade fosters efficient economic allocation through specialization and comparative advantage, and promotes productive efficiency through competition with high-quality goods and modern technology in the global market. Also, a high degree of trade openness enables foreign firms to avoid uncertainties related to trade barriers, and save transaction costs. This is why trade openness is particularly crucial for export-oriented FDI.

Most governments provide a variety of tax incentives and cash grants to lure more foreign firms into their country, which influence location choices made by foreign firms. For example, the State of Alabama provided $222 to $253 million worth of incentives to Mercedes Benz, and the Republic of Ireland offered a tax rate of 12.5 percent on corporate profits. According to papers that study the effect of cash grants or tax incentives on the location choices of foreign firms, lower tax rates and favorable financial incentives attract more FDI to the host country.

Institutions and infrastructure are also indicated as important determinants of FDI. Some economists focus on the impact of the institutions on FDI because good institutions mitigate uncertainty from corruption, political instability, and weak enforcement of property rights, and help secure a high expected rate of return. For example, Wei (1997, 2000) showed that corruption deters foreign investment, and Kaufman et al. (1999) proved that political instability and violence, government effectiveness, regulatory burden, rule of law and graft affect the location choices of multinational firms. In addition, Laporta et al. (1998) showed that the risk of repudiation of contracts by the government and the risk of expropriation of shareholder rights hamper FDI inflow. Other economists argue that infrastructure including roads, ports, railways, telecommunication systems, etc. also influence MNE decisions on the location of foreign plants. While poor infrastructure incurs large operational costs for foreign firms and obstructs foreign investment, well-developed infrastructure increases investment productivity and attracts more FDI.

To summarize, a combination of various factors influence the location choices of MNEs. Given that these decisions are made by firms seeking cost minimization or profit maximization, all factors which directly and indirectly affect entry, operation, and exit costs are determinants of FDI. Among them, market size, unit labor cost, labor market regulations, trade openness, governments tax incentives and financial incentives, institutions and infrastructure have been broadly investigated in literature, and have been proven to impact, to a certain degree, the location choices of MNEs. KIEP