Systematic Literature Review of Determinants of FDI

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Keywords: Determinants, FDI, Literature Review.

Abstract. Review of the literature on determinants of foreign direct investment (FDI) is important in identifying and characterising why MNCs’ would like to choose FDI as their main method of penetrating new market. This paper aims to offer systematical review of all possible determinants of FDI, trying to help developing countries to better understand how to attract more inward FDI, and how to facilitate domestic companies to make investment in other countries.

Introduction

MNCs’ choice of conducting FDI is based on different motives contributed by diverse elements, which constitute the determinants of FDI. Since the goals of various types of FDI are dissimilar, the market they choose to serve and the objective they attempt to achieve change accordingly.

Empirical studies on the determinants of FDI fall into three categories. The first kinds of studies mainly focus on the core factors influencing the decision to invest in a particular country or an industry. Such an approach is more micro-oriented, relying on firm level data and sometimes interviews and surveys. The second type of research is more macro-oriented. These kinds of studies rely on published data about one country in relation to various countries abroad or in particular industries. They seek to establish a functional relationship between FDI and possible determinants, including the writing of Scaperlanda [1] on the effects of tariffs and customs unions, the study of Doytch and Eren [2] on institutional environment, and the paper of Cavallari and D’Addona [3] on exchange rate volatility. The third kind of research seeks to explain why FDI is preferred to other forms of investment based on different decisions of resource allocations. For example, what is the cost of foreign investment in terms of forgone investment opportunities at home? Second, why should it take the form of direct rather than portfolio investment? Third, why should direct investment be conducted in certain mode such as exports or licensing agreements? The works of Nagano [4] and De Jesus Noguera and Pecchenino [5] belong to this category, seeking to find out why firms conduct FDI and what form of FDI should be undertaken.

Among studies of different foci, approaches and results, two main streams of factors are identified; one is firm-specific and the other country-specific. The first types of factors are endogenous factors, including technology advance, R&D intensity, advertising intensity and other micro-specific factors, which motivate MNCs to undertake FDI. The second kinds of elements are exogenous country level or industry level data. According to Dunning [6] and Bitzenis et al. [7], countries’ abilities to attract and exploit the potential economic benefits of inward FDI relate to their institutions, cultures, and infrastructures, together with the economic and political objectives pursued by host governments. All the determinants focused in this study is summarised in Table 1.

Country specific characteristics are widely accepted as the main determinants of FDI, especially the factors related to the host country market, are the most examined factors regarding their influence on FDI location decisions [2,3,8]. It is generally believed that characteristics of host markets are major driving factors of FDI flows [9]. However, fewer studies focused on home country characteristics. Therefore, the following discussed country specific characteristics are mostly concentrated on the characteristics of the host country. The country specific characteristics of the home country will be specifically singled out.
Table 1. Summary of Determinants of FDI.

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<tr>
<th>Factor</th>
<th>Dimension</th>
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<tr>
<td>Market size</td>
<td>GDP</td>
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<tr>
<td>Institutions</td>
<td>Political risk</td>
</tr>
<tr>
<td></td>
<td>Government corruption</td>
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<td></td>
<td>Protection for property rights</td>
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<tr>
<td>Physical infrastructure</td>
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<td>Nature resource endowment</td>
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<tr>
<td>Technology</td>
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<td>Taxes</td>
<td>Openness to FDI</td>
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<td></td>
<td>Openness to international trade</td>
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<td>Regional integration</td>
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<td>Market openness</td>
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<td>Inflation rate</td>
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**Market Size**

Market size is consistently considered by empirical research as a driver of MNCs’ FDI decision [10]. The larger the host market size, which means higher degree of development, the better the prospects for market growth. Moreover, the greater the prospects for market growth, the more attractive a market is, and the larger the volume of FDI [11]. Many studies support a positive relationship between host country market size and FDI, arising from large potential demand and low costs by economies of scale [12,13]. With the arising of Chinese MNCs, numerous recent studies, including Taylor [14], Deng [15], Buckley *et al.*, [16,17], Kolstad and Wiig [18] examine China’s outward FDI, and reveal that Chinese outward FDI is driven by market size. The GDP of a host economy is the most widely employed variable for market size in empirical studies of FDI [19]. Market size, usually indicated by GDP, GNP, GDP per capita, or GNP per capita, is significantly positively associated with FDI [19,20]. In addition, the economic growth rate is also utilised as an indicator for market size and is believed to be positively related with inward FDI [8].

**Institutions**

It is widely accepted that the quality of institutions is an important country level determinant of FDI activity [10], particularly for developing countries [21]. In developed countries, effective property rights protection ensures that the owner of an asset ‘has the discretion over the uses to which the asset is put and is able to appropriate returns from the asset’. On the contrary, a weak legal protection of property rights, which is often perceived in transition economies, increases the chance of losing assets, and makes firms unlikely to undertake investment in the transition economy [21].

Political risk of the host country is a crucial institutional variable in demonstrating the changes in FDI flows [19]. It is widely acknowledged that a friendly overall investment environment in the host country directly influences its ability to attract FDI. According to internalisation theory, in countries experiencing high political risk, market-oriented firms tend to substitute arm’s length servicing modes (exporting or licensing) for directly owned local production, and resource-oriented firms are discouraged from committing substantial sunk costs in the form of FDI projects [16]. Therefore, in general, high political risk is linked with small flows of inward FDI, while low political risk leads to a higher volume of inward FDI [22].

Corrupt bureaucracy is another vital aspect of institutional environment. Inspired by the large volume of inward FDI and high level of government corruption of China, Wei’s papers [23,24] show a variety of corruption indexes, indicating that those indexes are significantly negatively associated with FDI, while the study of Wheeler and Mody [25] provide no support for such correlation.
Physical Infrastructure

Several studies [26,27] point out the essential impact of available physical infrastructure in the host country on FDI decision making. Physical infrastructure is an overarching construct that captures the availability and quality of infrastructure such as roads, airports, ports, and telephone lines [10,27]. Previous empirical studies demonstrate that this overarching construct significantly affects MNCs’ decisions with the expected costs of operations in host countries, the costs of acquiring and moving raw and finished materials between the MNCs’ headquarters and affiliates.

Natural Resource Endowment of the Host Country

According to Dunning [28], acquiring natural resource is one of the major motives for resource-seeking FDI. It is not a surprise that MNCs from both developed and developing countries are attracted to countries with abundant natural resource endowments. Many studies [8,15,16] examine the outward FDI of China, and point out that natural resource exploitation is the key factor that determines the orientation of Chinese outward FDI. It is because China has been growing at a double digits pace for more than a decade, even nowadays, it still keeps a much higher growth rate than any other countries.

Technology

The level of technological development is an essential driving factor of FDI [28]. MNCs from high-tech industries tend to penetrate foreign markets to gain market share, take advantage of scale economies, and spread their cost of R&D investments. MNCs can also transfer and share their advanced technologies, skills and knowledge with indigenous corporations through foreign entry, with the hope of gaining excess profits [29]. In most empirical studies, technology level is often proxied by the ratio of R&D expenditure to total sales.

It is widely believed in recent studies that technology is one of the major forces that drive Chinese firms to conduct FDI [8,16]. However, they have offered varied explanations to why and how technology drives Chinese MNCs’ FDI. They all argue that Chinese firms are asset-seeking. Their activities are motivated by acquiring strategy assets from mature MNCs from developed countries to compensate their competitive disadvantages.

Taxes

Taxes of the host country are considered as one of possible determinants of FDI [19]. An obvious reason is that FDI is reluctant to move to countries with higher levels of tax, since taxes are a cost factor that reduces profitability. This indicates why policy makers try to reduce taxes to attract inward FDI [30].

Market Openness

Market openness consists of openness to FDI, openness to trade, and regional integration. The more open a country is to international investment, the more likely a country is a destination for FDI [4]. Aqeel and Nishat [30] consider openness to FDI in an economy a potential independent variable to explain FDI inflows, whereas Wheeler and Mody [25] find no significant correlation between FDI and openness [2].

Inflation

According to Buckley et al. [16], market-seeking FDI is unattractive to countries with unpredictable and volatile inflation rates. This is because the high rates of inflation add uncertainly to the investments, such as making price-setting difficult and increasing the difficulties in
anticipating the profit, causing problems to the long-term cooperation. Moreover, the domestic currency also devaluated by high rates of inflation, which reduces the real value of profits for market-seeking MNCs in turn when using the local currency. Moreover, due to the high rates of inflation, the costs of local source input also increase, which make the investment less profitable, or even make it more difficult to maintain a cost advantage in third markets for MNCs. Thereby, high inflation discourages export-oriented FDI.

References


