# DETERMINANTS OF FOREIGN DIRECT INVESMENT IN DEVELOPING COUNTRIES: AN ECONOMIC PERSPECTIVE

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**Abstrak**

Sejak decade 90-an aliran modal asing ke negara berkembang terus menunjukkan peningkatan. Hal ini memicu makin meningkatnya persaingan antar negara berkembang untuk menarik modal asing ini. Beberapa kajian empiris yang menelaah tentang faktor apa saja yang menentukan mengalirnya modal asing ini ke sejumlah negara berkembang menunjukkan hasil yang beragam.

*Kata Kunci: Modal Asing*

## A. Introduction

Since 1990 Foreign Direct Investment (FDI) flows to developing countries have increased continuously from $26.7 billion in 1990 to around $169 billion in 1997 (Loots, 1999). This rise is creating high competition among developing countries to attract FDI. The regional distribution of FDI flows to developing countries shift significantly time to time. This essay attempts to examine those factors that attract FDI based on experiences of some development countries.

This article will be presented as this following structure. The first section talks the introduction. The second section discuss briefly about some economic theories of FDI. Then the next section describes the motivation of giving FDI. While the discussion about some determinants of FDI flow in developing countries appears in the fourth section and the last section is concluding remark.

## B. Economic Theories of Foreign Direct Investment

According to Kallmeyer and Strime. the concept of FDI can be defined as "investment made to acquire a lasting interest in an enterprise operating in an economic environment other that of the investor, the investor's purposes being to have an effective voice in the management of the enterprise".

There are many theories that explain foreign direct investment. Among others they are: market/industrial organization theory, theory of the firm/growth of the firm, international trade theory, Japanese theory, and location theory (Ensign, 1995: 16-23). The market/industrial organization theory changed the

explanation of direct investment from traditional trade and finance theory to an analysis of the multinational enterprise and the imperfect market. Engaging in production activities abroad can be used as a tool for a firm to maintain control over capital. On the market side it can be explained as oligopolistic market structures creating the conducive conditions for foreign expansion. The theory of the firm/growth of the firm shows that internalization of markets across national borders results in multinational enterprises. The process of internalization is pushed by market imperfections because they make it less costly for firms to control and manage certain activities and transactions within their own organization. The third theory is international trade theory. This theory explains foreign direct investment by using a product cycle theory and a comparative cost view. The comparative cost view suggests that final product flows and capital flows can be substituted in order to get factor price equalization. The next theory is The Japanese theory, that seems more trade oriented rather than oligopolistic. When comparative disadvantage exists, FDI should occur because FDI can move factors to foreign locations where total cost of production would be lowest for any given product. The fifth theory is location theory, and it emphasizes the supply side of the market such as natural resource availability and production cost. In line with availability of natural resources, this theory advises that economic activity should focus on centers of population and natural resources.

## C. The Motivation for Foreign Direct Investment

Kojima (1978) classifies the motives for foreign direct investment into three categories; natural resource oriented, labor oriented and market oriented. Natural resource oriented investment is trade oriented and results from the investor countries wanting to push imports of their comparatively disadvantageously produced goods, and leads to growth in vertical specialization between producers of manufactures and primary products.

Labor oriented investment is also trade oriented. Because the level of wages in investor countries becomes higher over time, it becomes rational and profitable for the investor countries to contract their labor intensive industries and transfer the location of production to low wages countries. The labor oriented investment aims to establish an export base, rather than import substitution, and to develop exports to the investors' countries and third markets.

Market oriented investment is induced by trade barriers in the host countries. This category of foreign direct investment meets the host country's

interest in promoting import substitution activities.

## D. Determinants of FDI Flows to Developing Countries

Most developing countries face a shortage of capital. This means that these developing countries have insufficient saving and foreign exchange to finance their investment needs. To overcome this lack of capital they need an inflow of foreign capital. The largest single source of external funding to developing countries is FDI.

There has been a significant shift in the regional distribution of FDI flows to developing countries since 1970.

The flow of FDI to developing countries is highly concentrated in a small number of countries. The top ten developing countries that received a high percentage of FDI for the period 1992 to 1997 are ranked in Table 2.

To find the most important factors in attracting FDI, we can use the experiences of these top ten developing countries as a reference. Loots (1999) analyses these top ten countries by using a matrix format. He divides the matrix into two categories, namely economic determinant and the national policy frameworks.

Table 1. FDI Flows to Developing Countries, 1970 - 1997 (per cent)

| REGION | 1970 | 1977 | 1985 | 1992 | 1997 |
|---|---|---|---|---|---|
| Africa [1)] | 31.2 | 14.5 | 23.5 | 5.7 | 3.8 |
| Asia and the Pasific | 13.0 | 19.7 | 31.8 | 54.5 | 51.9 |
| Latin America and the Caribbean | 52.5 | 64.8 | 43.2 | 31.8 | 33.3 |
| Central and Eastern Europe [2)] | 3.3 | 1.0 | 1.5 | 8.0 | 11.0 |
| Total | 100.00 | 100.00 | 100.00 | 100.00 | 100.00 |

Source: Loots (1999)
Note: 1. Including South Africa
2. Excluding Greece

Table 2. The Top Ten Developing Country Recipients of FDI, 1992 – 1997

| Rank | Country |
|---|---|
| 1 | China |
| 2 | Mexico |
| 3 | Singapore |
| 4 | Brazil |
| 5 | Malaysia |
| 6 | Argentina |
| 7 | Indonesia |
| 8 | Poland |
| 9 | Hungary |
| 10 | Thailand |

Source: Loots (1999)

The seven criteria in economic determinants are as follow:

1. Does the country have a large domestic market? If the GDP figure exceeds US $200 billion, it will be regarded as having a large domestic market.
2. Does the country have a high and sustainable economic growth performance?
3. Is unskilled labor available at low cost?
4. Is the workforce made up primarily of skilled labor?
5. Does the labor force have a high level of productivity?
6. Does the country have access to foreign markets?
7. Is the country a member of regional groupings?

The matrix from these criteria is shown in Table 3.

The matrix result shows that the most consistent determinant is the integration of these economies in regional affiliations or groupings. Among ten countries, only one does not satisfy this criterion, which is an efficiency-seeking motive for FDI. The second criterion that is fairly also consistent is the ability to maintain a high and sustainable economic growth rate over the long term. Eight of the ten countries have an impressive record in economic growth. The country's access to foreign markets is the next criterion that is a relatively consistent determinant.

Although this matrix shows that there is no conclusive evidence for the size of market among the top ten countries,

Table 3. Matrix on economic determinants

| COUNTRY | CRITERIA | | | | | | |
|---|---|---|---|---|---|---|---|
| | a | b | c | d | e | f | g |
| China | 4 | 4 | 4 | | | | |
| Mexico | 4 | | | 4 | | 4 | 4 |
| Singapore | | 4 | | 4 | 4 | 4 | 4 |
| Brazil | 4 | 4 | 4 | | | | 4 |
| Malaysia | | 4 | 4 | | | 4 | 4 |
| Argentina | 4 | 4 | | 4 | 4 | | 4 |
| Indonesia | 4 | 4 | 4 | | | 4 | 4 |
| Poland | | 4 | | 4 | | 4 | 4 |
| Hungary | | | | 4 | | 4 | 4 |
| Thailand | | 4 | 4 | 4 | | 4 | 4 |
| Total Score | 5 | 8 | 5 | 6 | 2 | 7 | 9 |

Source: Loots (1999)

other empirical studies have different results. For example, Korbin concluded in his study that market size was found to be overridingly significant (Korbin cited in Meyer and Qu, 1995:7).

Instead of using a matrix method and regression analysis, Root and Ahmed (Root and Ahmed cited in Meyer and Qu, 1995) used a different approach, a discriminant analysis, to identify some location specific attraction of FDI. They examined 70 sampled developing countries, which were classified as unattractive, attractive, or highly attractive in terms of their annual per capita inflows of FDI. Six of 37 different economic, social and political factors, namely per capita GDP, growth rate of GDP, economic integration, extent of urbanization, commerce, transport and communication and regular executive transfer emerged as important discriminators.

Another category is criteria relating to the national policy framework.

1. Is the government committed to fiscal discipline?
2. Is the country able to ensure price stability?
3. What is the corporate tax structure? A marginal corporate tax rate of 30 per cent or below is an indication of a competitive corporate tax structure.
4. Is the government engaging in privatization programs?
5. Is the government able to maintain political stability?

Table 4. Matrix on the National Policy Framework

| COUNTRY | CRITERIA | | | | |
|---|---|---|---|---|---|
| | a | b | c | d | e |
| China | 4 | | 4 | | 4 |
| Mexico | 4 | | | | 4 |
| Singapore | 4 | 4 | 4 | | 4 |
| Brazil | | | 4 | 4 | |
| Malaysia | 4 | 4 | 4 | | 4 |
| Argentina | 4 | | | 4 | |
| Indonesia | 4 | 4 | 4 | | |
| Poland | 4 | | | | 4 |
| Hungary | N/a | | 4 | 4 | 4 |
| Thailand | 4 | 4 | 4 | | 4 |
| Total Score | 8 | 4 | 7 | 3 | 7 |

Source: Loots (1999)

The above matrix shows that FDI is highly sensitive to policies in recipient

countries. The fairly consistent determinants are fiscal discipline, the corporate tax structure, and political stability. Regarding the fiscal stability, eight of the ten countries comply with this criterion. In corporate tax structure, only three countries namely, Mexico, Argentina and Poland, do not have a marginal corporate tax rate of 30 per cent and below. Wallace stated that a study of 295 companies investing in developing countries, host state taxation was ranked second in importance after restriction on the remittance of earnings as a determinant (Wallace cited in Kallmeyer, n.d.).

Based on this above matrix a stable political environment has a contribution in attracting FDI. The other studies also found that political risk is a major determinant of foreign investment. The result of Basic's research showed that the two most important factors in the foreign investment decisions are the level of a country's instability and the size of its market potential (Basic cited in Petrochilos, 1989: 17) . Concerning political stability, Korbin's study indicated an interesting result. Three political factors, rebellion, instability and subversion, were not significant, some even had negative coefficients (Korbin cited in Meyer and Qu, 1995: 7).

Although there are mixed results in studying the relationship between a nation's instability and FDI flows, much evidence shows that even short periods of governmental instability can cause interruption to FDI flows. The Vietnamese threat to Thailand in the 1970s, Park's assassination in South Korea, political instability at the end of Soeharto era in Indonesia, disturbances in the Philippines despite Marcos' martial law, all led to a decline of FDI (Lucas cited in Loots, 1999). Bhattacharya also found similar evidence that FDI flows in Rwanda, Liberia, Zaire, Somalia and Sudan dramatically declined because of civil strife in those countries (Bhattachrya cited in Loots, 1999)

## E. Conclusion

The flow of FDI to developing countries tended to rise during the last decades. This phenomenon results in tight competition among developing countries to attract foreign direct investment. China, Mexico, Singapore, Brazil, Malaysia, Argentina, Indonesia, Poland, Hungary and Thailand are the top ten recipients of FDI.

Based on the experience of these countries, we can derive some important factors in attracting FDI such as :

1. They are participants in regional integration
2. They have high and sustainable economic growth
3. They have skilled labor
4. They have large domestic markets
5. They have access to foreign market

6. They are committed to fiscal discipline
7. They are able to maintain political stability.

In order to maintain a continuous flow of FDI to each country the policy implications concerning the above determinants of FDI flows to developing countries should be taken into account.

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