Determinants of Foreign Direct Investment

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Abstract: Foreign direct investment has become the key factor to promote economic development, the determinants of foreign direct investment is a complex problem in the global economic development, research on how to attract foreign direct investment has positive practical significance. FDI contributes to economic growth by influencing productivity growth in host countries and, in turn, by means of technology, skills and job creation. This paper studies the determinants of FDI and finds that there are three main determinants of FDI: national income, labor cost and policy. Countries with per capita middle-income status tend to attract foreign direct investment more easily. In addition, the cost of labor is also an important factor affecting Foreign direct investment. The lower the cost of labor, the more attractive it is to foreign direct investment. This paper also focuses on the impact of the host country's policies on Foreign direct investment, including legal policies, market policies and cultural policies. On the basis of the above research, this paper makes policy recommendations for developing countries and the need to introduce Foreign direct investment.

1. Introduction

In the new global economy, foreign direct investment has become a central strategy on international business. Both developed and developing country can get benefits from foreign direct investment. Foreign capital is a very important driving force for economic development. In today's world of economic globalization, the economic development of each country is closely related, and no country can exist alone without foreign trade. Capital circulates around the world, boosting the rapid development of industries, creating more jobs and increasing the income of local people, thus greatly promoting the economic development of the host countries. One of the best examples of China is that foreign investment in The country has skyrocketed since the reform and opening up, with foreign direct investment (FDI) flowing into China reaching $163 billion by 2020, which is now helping China's economy take off. Similar examples can be seen in Africa, in the history of the economy development of Africa, FDI is highly affecting on the GDP growth rate in Africa.

Table 1. Africa: growth rates of GDP trade and FDI, 2013- -2021 (Per cent)

Table II.2. Africa: growth rates of GDP, trade and FDI, 2013–2021 (Per cent)

Variable	2013	2014	2015	2016	2017	2018	2019	2020	2021[a]
GDP	1.1	3.2	2.6	1.8	3.4	3.4	2.9	-3.5	3.6
Trade	-25.2	-8.1	-4.5	3.8	13.7	4.9	1.6	-10.4	8.4
FDI	-11.3	7.6	6.2	-20.1	-13.1	12.9	3.9	-15.6	(0 to 10)

Source: UNCTAD, FDI/MNE database for FDI; UN DESA for GDP and trade.
[a] Forecasted.

Also, the renewable energy in Africa is a good example with significant increase due to the FDI. With international project finance deals increasing by 28 percent to $11 billion, from $9.1 billion in 2019. (UNCTAD, 2021) FDI shows a great benefit on stimulating the GDP for the two countries. FDI is widely regarded as an amalgamation of capital, technology, marketing, and management. (Lokesha & Leelavathy, 2012) In that case, FDI is a great strategy to develop their country with

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significant improvement. Thus, what attract FDI and what is the determinants of FDI is a considerable problem under the global economy development especially for those low-income countries. It can be seen that foreign direct investment has become a key factor to promote economic development, and it is of positive practical significance to study how to attract foreign direct investment.

According to the definition of the International Monetary and Economic Organization, foreign direct investment is an investment that has a continuing interest in an enterprise operating in a country other than the investor's home country, with the purpose of having a say in the management of the enterprise. It is a form of foreign trade, reflected in international trade as capital investment. It is generally believed that FDI contributes to economic growth by influencing productivity growth and, in turn, through technology, skills, management and job creation.

Since world War II, the emergence of globalization forces has greatly promoted the expansion of foreign direct investment (FDI)In the 1950s and 1960s, the increasing importance of transnational corporations (MNCs) and foreign investment -- especially FDI flows from the United States to European countries -- prompted many researchers to investigate the existence of transnational corporations and international production. As a result, many theories were developed to explain the international flow of capital. Theory of foreign direct investment was founded from then on, the earliest theory put forward by the world's capital markets, higher income due to capital special preference the project, what about foreign direct investment (FDI) can be interpreted as, advanced capital or capital intensive and developed countries, migrated to need capital of the country. This theory is essentially foreign direct investment from the perspective of interest rate. In the 1960s, theorists tried to explain FDI properly. Moreover, with the increasing role of transnational corporations, some scholars try to combine the activities of transnational corporations with the theory of Foreign direct investment. Since then, these theories have focused on different factors restricting the international flow of capital. Some theories believe that market incompleteness is the cause of FDI flows, while others believe that oligopoly and the benefits of complete monopoly are the cause, and some theories have linked FDI to international trade.

Based on the above theory and analysis, this paper will examine the factors influencing FDI from the perspectives of national income, labor cost and policy, and make appropriate arguments to reach the final conclusion.

2. Factor 1: Country Income

National income has a significant impact on foreign direct investment, which is established on the basis of economic theory and empirical verification. Theoretically speaking, western economics traditionally considers investment theory as a core problem that can be solved from micro and macro perspectives. The microeconomic theory of investment gives priority to the investment decision-making process at the firm level and creates a concrete and scientific method for entrepreneurs to formulate optimal investment policies. Macroeconomic investment theory studies investment issues from the perspective of national economy, paying special attention to the level of economic development of a country, focusing on the relationship between investment and savings. Macroeconomic equilibrium is based on the equality between the savings of consumers and the investment that firms deem necessary.

From a microscopic perspective, risk and return are essential factors that need to be considered. In the definition of finance, investors are risk-averse. They are not willing to take on excess risk, and are only willing to take the corresponding risk if they are compensated for it. In the evaluation of investment projects or in the selection of investment countries, they will choose the highest return under the condition of the same risk, or choose the lowest risk under the condition of the same return.

In terms of income or economic level of a country, foreign direct investment favors middle-income countries. Their economies and policies are more attractive to foreign direct investment than those of poorer countries that need more capital. The main reasons why foreign direct investment likes these countries less are:

1) In middle-income countries or such developing countries, their early economic development has laid a solid foundation for future development, especially industrialization, which plays an important role in the development of real economy, especially the return on foreign direct investment is higher than that of other countries.

2) In addition to the economic basis mentioned above, there is another very important factor at play here. That is, the infrastructure construction in these countries is basically complete and has a large space for development. The theory of development economics suggests that infrastructure plays an important role in countries that are emerging from poverty. The better infrastructure is built, the more attractive it will be to foreign investors.

3) Another important factor in the economic interpretation of FDI is the level and structure of industrial development. In the industry classification based on the academic mainstream, the industry is generally divided into the primary industry, the secondary industry and the tertiary industry. The primary industry refers to agriculture, the secondary industry is mainly manufacturing industry, and the tertiary industry is service industry. When analyzing the relevant industries of a country through FDI, the most important countries are those with more developed tertiary industry, because these countries can often provide more convenient financial services and convenient services are more attractive.

For those outflow country, country income is one of the key determinants on evaluating if they invest to one country. The introduction of foreign direct investment has the following relations with national income or economic development level, even though those low-income country seems easy to invest on their economy, the result is that those outflow country are much prefer those middle income developing country such as China, India, and Thailand.

The following empirical model also supports our theoretical analysis. Based on the research from Kotrajaras (2011), they conduct a study on how the effect of FDI to the growth rate in different country. It shows that positive relationship at 5 percent level of significance with economic growth in high income and middle-income countries. (Kotrrajaras, 2011) Those middle-income country provides a stable economy foundation with new market and opportunity. However, the low-income country with its scarce economy condition cannot support its further development, although they have extensive market opportunity.

Table 2. Estimation of Impacts of FDI and Complementary Factors on Growth in East Asia by Group

	High income		*Middle income*		*Low income*		*All economies*	
	Pool	*Fixed Effect*	*Pool*	*Fixed Effect*	*Pool*	*Fixed Effect*	*Pool*	*Fixed Effect*
LOG(labour)	0.16	0.26	0.24	0.85	1.30	1.73	0.18	0.12
	(1.10)	(2.29)	(12.41)	(6.74)	(8.86)	(3.40)	(6.91)	(4.57)
LOG(domestic investment)	0.23	0.39	0.28	0.25	0.14	0.16	0.25	0.11
	(3.18)	(3.26)	(11.37)	(11.94)	(2.34)	(3.16)	(5.60)	(4.46)
LOG(FDI)	1.60	1.50	0.15	0.39	0.56	0.37	0.46	0.59
	(3.45)	(3.47)	(3.36)	(4.80)	(0.98)	(0.83)	(7.78)	(9.15)
LOG(public expenditure on education)	4.24	3.44	0.90	0.38	0.10	0.58	0.40	0.41
	(3.07)	(5.97)	(4.74)	(3.78)	(2.51)	(2.34)	(2.00)	(2.33)
LOG(government investment)	0.57	0.42	0.26	0.18	0.69	0.45	0.59	0.27
	(2.31)	(2.57)	(1.32)	(1.28)	(2.56)	(2.07)	(2.86)	(4.60)
LOG(trade openness)	0.71	0.52	0.73	0.75	0.28	0.10	0.34	0.15
	(3.22)	(3.73)	(3.30)	(3.92)	(1.71)	(1.41)	(3.23)	(4.81)
LOG(Financial development)	0.16	0.36	0.06	0.93	2.82	2.63	0.36	0.23
	(3.77)	(4.32)	(2.16)	(2.90)	(1.14)	(1.23)	(5.56)	(3.31)
LOG(Corruption perception index)	0.68	0.41	0.44	0.32	0.19	0.15	0.50	0.14
	(3.44)	(3.68)	(3.88)	(3.57)	(1.27)	(1.38)	(6.95)	(8.11)
inflation rate	–0.17	–0.29	–0.21	–0.18	–0.40	–0.14	–0.53	–0.14
	(–2.49)	(–2.00)	(–2.06)	(–2.61)	(–0.86)	(–0.36)	(–5.59)	(–2.07)
dummy 97	–0.09	–0.10	–0.69	–0.40	–0.46	–0.48	–0.18	–0.21
	(–2.46)	(–2.50)	(–2.44)	(–2.10)	(–1.14)	(–0.97)	(–8.46)	(–9.20)
LOG(FDI)*LOG (public expenditure on education)	0.90	0.92	0.38	0.71	0.85	0.71	0.41	0.12
	(2.65)	(3.01)	(1.78)	(1.47)	(0.64)	(0.51)	(9.36)	(5.65)
LOG(FDI)*LOG (government investment)	0.64	0.50	0.33	0.32	0.17	0.17	0.48	0.86
	(2.28)	(2.57)	(1.42)	(1.93)	(1.24)	(1.76)	(8.60)	(3.63)
LOG(FDI)*LOG(trade openness)	1.81	2.10	7.61	7.59	0.87	0.59	0.54	0.18
	(3.24)	(2.82)	(3.21)	(3.50)	(2.53)	(2.24)	(3.64)	(3.77)
LOG(FDI)*LOG(Financial development)	0.34	0.30	1.36	1.24	0.35	0.31	0.45	0.30
	(3.20)	(3.47)	(2.89)	(3.51)	(1.49)	(1.84)	(7.72)	(7.31)
LOG(FDI)*LOG(Corruption Perception Index)	1.61	1.57	0.60	0.44	0.55	0.48	0.14	0.15
	(1.71)	(1.58)	(4.20)	(3.27)	(1.66)	(1.62)	(7.35)	(8.31)
Number of observations	54	54	90	90	64	64	224	224
Adjusted R-squared	0.96	0.97	0.94	0.96	0.92	0.94	0.92	0.92
Durbin-Watson	1.33	1.61	0.97	1.11	1.15	1.33	1.74	1.98

3. Factor 2: Labor Cost

In the study of international economics, the basis of international trade is the difference of comparative advantage between two countries. In the study of international economics, the basis of international trade is the difference of comparative advantage between two countries. The core content of factor endowment theory is that a country should produce and export products made with abundant domestic factors intensively, and import products made with scarce domestic factors intensively. The status of the comparative interests of each country is determined by the relative abundance of the factors of production that each country has. There are two factors that determine the cost difference: factor endowment and factor intensity. Factor endowment of production refers to the relative ownership of factors of production in each country. Generally speaking, if a country has abundant factors of production, its price will be cheap. Conversely, scarcer factors of production will be more expensive; Every country cannot have the same abundance of factors of production. The intension of factor intensity is the proportion or combination of various production factors that need to be put into use in the production of various commodities.

Generally speaking, capital-intensive countries tend to trade with labor-intensive countries. Extend the above theory to the theory affecting foreign direct investment, labor becomes an essential important factor. Because the subject of foreign direct investment performance for capital intensive countries, they have a certain capital advantage compared with the invested country, that is, more abundant capital. That means that these countries have a very big disadvantage in terms of labor force. They must invest their money in commensurately more labor-intensive countries, such as developing countries China and Vietnam.

However, when choosing labor-intensive countries, they also take into account the cost of labor. The cost of labor refers to the cost and capital paid by enterprises for labor, labor object, labor means, and employment of social labor. Labor cost is the main component of labor accounting system. Labor cost is to point to enterprise because employ social labor force and pay expense. According to the traditional view, the main motive of FDI inflow into host country is to take advantage of the cheap labor of host country. However, with the continuous increase of labor cost, the cost of labor is constantly losing, and the worry about the decrease of FDI inflow caused by the increase of labor cost also arises.

Labor cost which is one of the major components of the cost function deters FDI. (Lokesha & Leelavathy, 2012) For some high income and middle-income country, a lower labor cost is attractive for them to invest. Especially in a resourceful low-income country, foreign direct investment seems obvious and immense on manufacturing industry with its lower labor cost and resource cost. However, based on the research from South African Institute of International Affairs (2013), China is one of the host countries that investing on South Africa, but the data announce that only a few relatively developed countries in South Africa get investment, even though some other Africa countries have lower cost on labor and resources. The research from Pandya (2010) gives the result that those host country is also conduct labor skill level as other determinants on FDI evaluation since the skilled labors have a high efficacy compared to those unskilled, which help the host country to save the potential cost on labor. Meanwhile, the inflow country with skilled labor is also very willing to accept FDI from other country because the increasing from FDI. FDI increases wages by increasing labor demand; wage increases are higher for skilled labor due to the relatively high skill intensity of multinational firms' production processes. (Pandya, 2010) In that case, this balance invest circle become one of the determinants in foreign direct investment.

4. Factor 3: Policy

Additionally, policy is one of the promotions to attract foreign direct investment. Under a competitive economy background, incentive policy is a competitive strategy to attract foreign direct investment with other countries. Many east Asian economics have been particularly aggressive in using preferential tax treatments and other implicit and explicit subsidies to attract FDI, i.e, "bidding wars" or "fiscal wars". (Ramkishen,2004)

Policy or institutional environment affects the enthusiasm of investment and profoundly affects the economic development of the host country. An economy should foster a high-quality institutional environment to promote investment and economic development. The institutional environment of the host country includes norms, laws and rules that regulate individual behavior, as well as established moral norms, culture and values. The institutional factor of host country is one of the key factors that foreign investors pay attention to when making investment. There are huge risks and costs in transnational investment. A good system can create a stable transaction order for transnational investment, reduce uncertainty and ensure the success of investment activities. As there are significant differences in the level of institutional environment among host countries, these differences are likely to have a significant impact on the economic development of each country. Research shows that the institutional quality and institutional differences of host countries affect the attraction of foreign investment, and countries with better institutional quality attract more investment. This paper subdivides the policy into legal policy, market policy and cultural policy, and studies their relationship with foreign direct investment.

1) Address the question of how laws and policies affect Foreign direct investment. If the host country's legal system environment is good, it reflects that the legal provisions are sound and the quality of law implementation is guaranteed, which can reduce transaction risks and rights protection costs, thus affecting Foreign direct investment. In addition, if the host country has a poor legal system environment, there will be frequent incidents that impair the behavior of investors, such as corruption and violence. If these infringements cannot be properly resolved, the risk of foreign investment will increase. In addition, good legal system design can reduce the uncertainty in the transaction process, thus reducing transaction costs and attracting potential investors. Moreover, it is worth mentioning that a higher level of legal protection will reduce the possibility of expropriation of assets, thus reducing the investment risk of foreign enterprises, which is directly reflected in a good property rights protection mechanism will improve the efficiency of contract execution, so as to effectively guarantee the investment income of foreign enterprises.

2)Market policies also play an important role in attracting foreign direct investment. The favorable market system environment of the host country provides a free investment environment and attracts more Foreign direct investment. However, when the market investment environment of the host country is not free and the investment system is not sound, foreign direct investment will be affected. The freer the host country's market environment is, the more open it is to the outside world, and the more attractive it is to foreign direct investment. In addition, the degree of opening up of a region has a positive impact on FDI, and there are regional differences, that is, the inflow of FDI is more obvious in coastal areas with a higher degree of opening up, and places with a higher degree of opening up attract more foreign investment and have higher investment efficiency.

From the perspective of the influence of tax factors on FDI, the tax rate set by the host country is the most direct embodiment of the tax burden. But direct embodiment does not mean that there is a simple negative correlation between the two. The combination of the tax revenue and the supply of public goods of the host country determines the level of the tax base. In other words, to attract foreign investment, the host country can reduce taxes, which is to directly reduce the investment cost of investors.

In addition, the host country with a better market environment can easily obtain information, reduce enterprise risks, have more investment opportunities, and thus attract foreign enterprises to invest. In a good market environment, with the improvement of the market degree, the government intervention is reduced, the government changes to the “service” mode, the market mechanism gives full play to the role of outsiders can obtain equal investment opportunities. In a good market environment, product, factor and intermediary markets are more developed. Foreign investors can obtain a large amount of enterprise information through the information platform, select the right investment object, and reduce transaction costs.

3) Similarly, cultural policy, as an informal policy, can have a significant impact on FDI, which is more profound and lasting. World culture is varied, the various countries' culture system environment is different, discuss cultural differences influence on transnational investment, culture

plays an unique role in international trade, some countries because of cultural differences of foreign culture curious, so as to make greater efforts to buy foreign products to promote foreign investment company to enter the domestic market successfully.

However, this influence is not only positive, but also negative. Misunderstandings and conflicts between investors and investors will occur due to cultural differences, thus hindering investment behaviors. Cultural differences have a negative impact on cross-border M&A activities. The greater the cultural similarity between countries, the better the financial performance of cross-border M&A. The differences in individualism between countries will hinder enterprises from realizing synergistic benefits.

Table 3: Relative Pros and Cons of Selected Types of Fiscal and Financial Incentives

Pros	Cons
Lower Corporate Income Tax Rate on a Selective Basis	
• Simple to administer. • Revenue costs more transparent.	• Largest benefits go to high-return firms that are likely to have invested even without incentive. • Could lead to tax avoidance via transfer pricing (intracountry and international). • Acts as windfall to existing investments. • May not be tax spared by home country tax authorities.
Tax Holidays	
• Simple to administer. • Allows taxpayers to avoid contact with tax administration (minimising corruption).	• Similar to lower Corporate Income Tax rates, except that it might be tax spared. • Attracts projects of short-term maturity. • Could lead to tax avoidance through the indefinite extension of holidays via 'redesignation' of existing investments as new investments. • Creates competitive distortions between existing and new firms. • Costs are not transparent unless tax filing is required, in which case administrative benefits are foregone.
Investment Allowances and Tax Credits	
• Costs are relative transparent. • Can be targeted to certain types of investment.	• Distorts the choice of capital assets towards projects of short-term maturity since an additional allowance is available each time an asset is replaced. • Qualified enterprises might attempt to abuse the system by selling and purchasing the same assets to claim multiple allowances. • Greater administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
Accelerated Depreciation	
• Similar benefits to investment allowances and credits. • Generally does not discriminate against long-lived assets. • Moves the corporate tax closer to a consumption-based tax, reducing the distortion against investment typically produced by the former.	• Some administrative burden. • Discriminates against investments with delayed returns if loss carry-forward provisions are inadequate.
Exemptions from Indirect Taxes (VAT, Import Tariffs, etc)	
• Allows taxpayers to avoid contact with tax administration (minimising corruption)	• VAT exemptions may be of little benefit (under regular VAT, tax on inputs is already creditable; outputs may still get taxed at later stage). • Prone to abuse (easy to divert exempt purchases to unintended recipients).
Export Processing Zones	
• Allows taxpayers to avoid contact with tax administration (minimising corruption)	• Distorts locational decisions. • Typically results in substantial leakage of untaxed goods into domestic market, eroding the tax base.

Source: K Fletcher (2002). 'Tax Incentives in Cambodia, Lao PDR, and Vietnam', paper prepared for the IMF Conference on Foreign Direct Investment for Cambodia, Lao PDR and Vietnam, (Hanoi, Vietnam, August 16-17) with slight modifications.

5. Conclusion

The main objective of this study is to identify some factors that may influence FDI in a global context. The most obvious finding to emerge from this study is that there are three main determinants of FDI, including national income, Labor costs and policies. The results show that countries with middle income or per capita income are more likely to attract Foreign direct investment. In addition, the cost of labor is also an important factor affecting FDI. Generally speaking, the lower the cost of labor, the more attractive it is to FDI.

In particular, Labor costs are rising in some countries, leading to a reduction in foreign direct investment inflows. This paper also focuses on the impact of the host country's policies on Foreign direct investment, including legal policies, market policies and cultural policies. If the host country has a good legal system and operates well, foreign direct investment will be correspondingly higher.

Free and equitable market policies also play an important role in attracting foreign direct investment. Similarly, cultural policies have an impact on Foreign direct investment. An inclusive and enlightened cultural atmosphere is more likely to attract foreign investment. Of course, cultural policies vary from country to country and need to be viewed dialectically.

These factors have an impact on Foreign direct investment, the determinants of which are a continuing and complex issue in global economic development. In the study of international trade and international finance, foreign direct investment has always been a key proposition, and this conclusion is also of reference significance for the development of national economy. For a developing country, the introduction of Foreign direct investment is the most convenient way to attract capital, which will also bring great benefits to the economic construction of the host country. If you want to attract Foreign direct investment, you can raise your income level, speed up the construction of your country's infrastructure and improve the corresponding industries. In addition, labor cost is also an important factor that cannot be ignored. A country with a lower labor cost will have a stronger ability to attract foreign direct investment. However, with the investment of foreign capital and the development of its own industry, its comparative advantage in labor cost will decrease.

In addition, appropriate policies are also an important influencing factor. Compliance laws and policies, open market policies, low tax incentives, and cultural policies that are inclusive and friendly to foreign cultures are all options for policy makers to consider when introducing Foreign direct investment.

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