Analyzing the Factors Affecting the Incidence of Foreign Direct Investment (FDI)

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I. Introduction

Headlines such as "Korean phone manufacturer opens new factory in Germany," "London fashion brand expansion into Brazil," "Mexican automotive industry shocked by decision of United States to Close Mercaderos" (Dojan S-A, 2023) seem unrelated at first glance. However, they share one common theme: foreign direct investment.

Beginning with the colonial development of European powers, foreign direct investment (FDI) has played a pivotal role in the global economy for centuries. The current era of FDI began in the aftermath of the Second World War with post-conflict reconstruction initiatives, such as the Marshall Plan, gaining prominence. This momentum was subsequently propelled by events like the fall of the Berlin Wall and the growth of globalization (United Nations, 2017). The decade following the demise of the Soviet Union marked a transformative period characterized by reduced trade barriers, increased economic cooperation, and a movement towards a greater free exchange of ideas (Boughton, 2002).

Liberalization and globalization facilitated an upswing in foreign direct investment, a term the International Monetary Fund defined as, "cross-border investment in which an investor resident in one economy establishes a lasting interest in and a significant degree of influence over an enterprise resident in another economy" (IMF Glossary). Today, the top recipients of FDI are the United States, China, and Brazil, accounting for $109 billion, $21 billion, and $20 billion respectively. The top outflows of FDI include the United States with $110 billion and Germany with $57 billion (OECD, 2022).

As FDI continues to experience a boom with the reopening of superpowers like China after the lifting of Covid restrictions, work needs to be done to better understand the factors affecting the incidence of FDI. This empirical research paper attempts to do just that, as we look for indicators of foreign direct investment.

II. Literature Survey

Frameworks

Foreign direct investment takes on various forms, broadly categorized as horizontal, vertical, platform, and conglomerate. Horizontal FDI involves establishing a branch in a new country, replicating existing operations. Conversely, vertical FDI occurs when a company acquires an auxiliary entity in a new country to strengthen a specific aspect of its original operations. Platform FDI entails setting up manufacturing facilities in a new country and exporting the produced goods to a third nation. Lastly, conglomerate FDI refers to investing in an entirely unrelated business in a foreign country (Hintošová, 2021). An example of this category is the American company Walmart making a bid for the Indian company Tata Motors.

Numerous studies have explored the frameworks commonly underlying the process of FDI; one prominent model that has emerged is Dunning's Ownership, Location, Internalization(OLI) model, also known as the eclectic paradigm. This three-step framework is often employed by companies to assess the potential benefits of investments in specific countries (Sharmiladevi, 2017).

Ownership, the first branch of the model, pertains to a company's ability to maintain a competitive edge within the country it ventures into. This encompasses rights to brand protection, copyright laws, and patent rights, among others. The location aspect, perhaps the most pivotal factor, considers geographic proximity to a labor force, tax incentives, natural resource availability, and shipping potential. Additionally, the gravity model of FDI, described in a study by Bikash Mishra of Ravenshaw University, correlates FDI flows with the size of the host and source countries and the distance between them (Mishra, 2019).

The third dimension of Dunning's model, internalization, focuses on an organization's capacity to internally produce goods rather than outsourcing to third parties. This internalization advantage often leads businesses to engage in staff augmentation

to ensure an optimal workforce (Sharmiladevi, 2017).

FDI also aligns with different frameworks based on the objective it serves within a country. Market-seeking FDI involves firms investing in foreign markets to expand their consumer base and establish a foothold in new markets. Conversely, resource-seeking FDI centers on companies investing specifically for resource extraction purposes (Caon, 2020). For instance, a British company investing in a diamond mine in the Democratic Republic of the Congo exemplifies this type of FDI, aiming to extract resources for commercial gain.

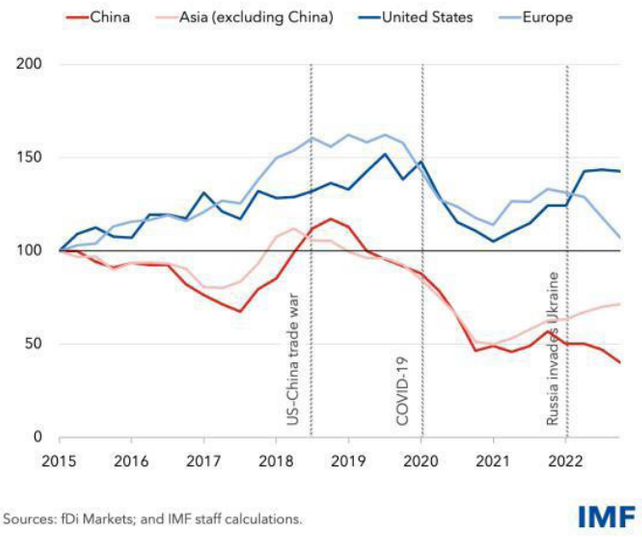
Impacts of FDI

FDI serves as a catalyst for economic growth in host countries, yielding substantial benefits. Notably, FDI inflows are directly linked to capital accumulation, demonstrating a significant 2.31% average increase in capital for every percentage rise in FDI (Ezo Emako et al. 2023). This influx not only introduces technical knowledge of industry but also spurs economic output by introducing innovative capital goods. Moreover, multinational corporations, often associated with FDI, tend to create employment opportunities with superior working conditions and higher wages, prompting local firms to enhance their efficiency, thus bolstering the economy (IMF; Razin et al., 2001).

However, while FDI positively impacts human capital, contributing to a remarkable 2.38% increase (Ezo Emako et al. 2023), its social implications exhibit a complex interplay. Sectors like mining and agriculture, reliant on low-skilled labor (including child labor), show a decrease in school enrollment due to FDI (OECD 2007). Conversely, FDI in manufacturing typically enhances educational access. Despite the overall improvement in living standards facilitated by FDI, challenges surface in its wake. Corporations might exploit unfair competition, leveraging low wages and labor standards (OECD 2007). Additionally, concerns arise regarding human and labor rights violations, particularly in countries where governance and enforcement mechanisms are inadequate.

FDI and Policy Effects

Amidst the global disruptions caused by the COVID-19 pandemic, researchers scrutinized the intricate relationship between Foreign Direct Investment (FDI) and policy making. Imad A. Moosa Ebrahim Merza conducted a study highlighted in the



Winter 2022 Future Business Journal, revealing how the pandemic's chaos reshaped fundamental dynamics of FDI politics. The breakdown of global supply chains forced a profound recalibration, compelling companies to pivot toward domestic sourcing, redefining proximity as a new focal point for supply. Concurrently, governments recognized the imperative of bolstering local production, particularly evident in the production of essential medical supplies, like vaccines (Moosa, 2022).

This pivot towards localized production acted as a catalyst for FDI, especially in the realm of vaccine development and delivery. The study discovered a discernible global shift, characterized by burgeoning anti-globalist and anti-FDI sentiments. This trend found validation in movements like America First in the United States and echoed in the rise of right-wing leadership across various nations.

The study's core lies in its belief that the pandemic, despite its detrimental impact on FDI flows, catalyzed a pivotal moment for reflection. Moreover, this transformative period foretells a trajectory away from peak globalization, a perspective echoed by Gray. His assessment paints the pandemic as more than a temporary disruption; instead, it heralds a turning point in history, fundamentally reshaping the global landscape (Moosa, 2022).

One example of the reshaping of the global landscape is the significant regulatory measures imposed by the Biden Administration on semiconductor chip exports to China in early October 2023. These measures included a ban by the U.S. Department of Commerce, encompassing H100, A800, and H800 series advanced artificia intelligence

chips destined for China (Freifeld, 2023). While proving detrimental to China in terms of Foreign Direct Investment, this move has sparked contrasting perceptions within the country itself.

Amidst these stringent regulations, some within China perceive this as an opportunity for domestic growth and technological self-sufficiency. More than 1,500 companies are already entrenched in the semiconductor industry, and they anticipate leveraging their existing foothold by spearheading their domestic production of integrated circuits and AI chip training. Interestingly, this turn of events has drawn FDI comparisons among some in China to the historic Great Leap Forward era under Mao Zedong (LoC, 2015). During that period, millions of Chinese peasants united in an ambitious drive to boost domestic production, famously employing homemade backyard furnaces to manufacture steel (LoC, 2015). Mao had envisioned catapulting China to the forefront of global steel production, spurring nationwide efforts to achieve this goal. Ultimately, the Great Leap Forward caused social and economic devastation, with crippling outcomes for the Chinese society.

III. Methodology

Data Collection

Building upon our comprehensive literature review, this paper aims to better understand the intricate factors steering the incidence of FDI. In order to achieve this, data was collected from a number of databases on the factors we viewed as viable. This was not always a simple process due to the complexity of FDI and the limited amount of data available in public databases.

Nevertheless, during the collection process, we found data provided by existing literature on the incidence of FDI in a given economy longitudinally. Due to both the rapidly changing nature of the modern economy, and to the increasing sparseness of data moving backwards in time, we chose to focus our study only on the incidence of FDI inflows over the course of the past 25 years of available data, from 1998 to 2022. This longitudinal data on FDI was sourced from the World Bank, which provides comprehensive information on global economies and political environments in a number of publicly available data banks on their website. We chose to analyze the 190 economies which these databases could provide information. A full list of the countries analyzed can be found in the appendix.

We sourced our response variable of net FDI inflows in USD from the World Bank's dataset categorizing "world development indicators." Additionally from this source, we gathered data on GDP (in constant 2015 USD), GDP per capita (PPP measure), trade as a percentage of GDP, employment in industry as a percentage of total employment, and natural resource rents as a percentage of GDP. These variables reflect, respectively, the size of the market in the receiving country, the level of openness to trade, the level of industrialization in a given economy, and the availability of material inputs, which are all theorized to be positively correlated with FDI incidence (Lim, 2001). Additional data was sourced from the World Bank's "governance indicators" dataset, which contains data on government effectiveness and openness. We took data on the World Bank's measures of Control of Corruption, Government Effectiveness, Rule of Law, Political Stability and Absence of Violence/Terrorism, Voice and Accountability, which are each measured on a scale of -2.5 to 2.5. These measures were chosen as indicators of the investment climate, since "an unstable political situation, or economic instability would make the host country less attractive for all types of FDI" (Lim, 2001).

Finally, we wanted to take into account historical factors which may affect the incidence of FDI in a given economy. Specifically, we wanted to take into account the potential effect of the fall of the eastern bloc on the incidence of FDI. In our model, we constructed an indicator variable termed "Communist" to delineate countries that had experienced a communist government for over a decade during the twentieth century. The prevailing literature indicates that the "shift from a communist regime doesn't inherently guarantee the establishment of a robust market economy" (Fabryand Zeghni, 2006). These transitioning nations undergo swift micro and macro reforms to foster internationally competitive environments, nurturing the growth of market economies and facilitating private sector development. Seeking integration into the global economy, many such nations opt to join organizations like the European Union or ASEAN, expediting their transition.

Moreover, the aforementioned studies emphasize the pivotal role of increased inward FDI for these transitioning countries to maintain pace with global economic developments. They underscore how FDI contributes to modernization across various spheres by introducing Western technologies (Fabry and Zeghni,

2006). Our objective lies in comprehending whether a nation's historical experience with communism has an effect on FDI inflows today.

Model and Variables

Due to assumptions of non-linear relations between variables and for the sake of interpretability, some of the variables analyzed underwent transformations over the course of the modeling process. Rather than using raw FDI inflows as a response variable, we took the log of this variable, in order to be able to interpret coefficients in terms of percent changes rather than unit changes, which in this case would have come in the form of U.S. dollars. We also took the log of GDP, as well as GDP per capita, for similar reasons. Not only was this done due to the expected consistency of elasticity between these terms and FDI, but also for the sake of interpretability; this transformation allowed us to determine that a percent change in GDP will have the effect of producing a 0.95 percent change in FDI.

Additionally, rather than using the value of GDP for a given year in the model, we created a lag variable for GDP in order to address issues of reverse causality that occur when regressing FDI on GDP; essentially, FDI inflows are determined by the market size, but FDI inflows also change the size of the market. A lag of five years was chosen to overcome this issue, as evidenced by the fact that institutions developing investment plans were likely to use data from four or five years prior to the date of investment.

The creation of this lag variable resulted in a decline in the number of available observations by approximately 20% since five years is one fifth of the total time analyzed. This decline in observations, and the general lack of consistently reported data in all countries over the course of the past 25 years should be kept in mind when looking at the results of our regression analysis.

We chose to use a robust ordinary least squares regression model to model the relationship between our response variable (bet FDI inflows), and GDP, GDP per capita, Average Governance Indicator Score, Employment in Industry, Trade as a percentage of GDP, Natural Resources, and a nations' status as formerly communist. This model is shown below:

$$(lFDI)i = \beta0 + \beta1(\text{logged value of GDP laglGDP}) + \beta2(lPPPCapita) + \beta3(GovIndicator) + \beta4(IndustryEmployment) + \beta5(Trade) + \beta6(NaturalResources) + \beta7(Communist) + Ui$$

This model represents our best attempt at accurately modeling the factors that influence foreign direct investment globally, using the data and methods available to us. Descriptions and summary statistics for the variables used in this model can be found below.

IV. Data Description

VARIABLE AND MODEL DESCRIPTIONS

Variable Name	Definition	Scale	Database
lFDI	The log net value of Foreign Direct Investment inflows into a given economy. **This is our response variable.**	Numeric (logged)	World Bank Governance Indicators
GovIndicator	Average Value of a country's score on five measures of state capacity and liberality: control of corruption; Government Effectiveness; Rule of Law; Political Stability and Absence of Violence/Terrorism; Voice and Accountability.	-2.5 to 2.5	World Bank Governance Indicators
laglGDP	The log value of Gross Domestic Product, measured in constant 2015 USD, lagged by five years to address issues of reverse causality	Numeric (logged)	World Bank Development Indicators
lPPPCapita	The log value of Gross Domestic Product per capita measured using a purchasing power parity conversion rat2 tied to 2017 USD	Numeric (logged)	World Bank Development Indicators
IndustryEmployment	The percentage of the total working population employed in industrial processes.	Numeric	World Bank Development Indicators
Trade	The value of international trade in a country as a percent of GDP.	Numeric	World Bank Development Indicators
NaturalResources	The value of natural resource rents in an economy as a percentage of GDP, calculated by estimating the price of units of specific commodities and subtracting estimates of average unit costs of extraction or harvesting costs	Numeric	World Bank Development Indicators
Communist	A dummy variable indicating whether a country has had a communist government for more than a decade during the twentieth century	0 for non communist, 1 for formerly communist	World Population Review

SUMMARY STATISTICS

Log FDI Summary Statistics:

```
. sum lFDI
```

Variable	Obs	Mean	Std. dev.	Min	Max
lFDI	4,349	20.39004	2.622714	10.36072	27.32154

Government Indicator Summary Statistics:

```
. sum GovIndicator
```

Variable	Obs	Mean	Std. dev.	Min	Max
GovIndicator	4,665	-.071186	.883251	-2.381896	1.980171

Lagged Log GDP Summary Statistics:

```
. sum laglGDP
```

Variable	Obs	Mean	Std. dev.	Min	Max
laglGDP	3,654	24.09874	2.257053	18.63164	30.57148

Log GDP (PPP) Summary Statistics:

```
. sum lPPPCapita
```

Variable	Obs	Mean	Std. dev.	Min	Max
lPPPCapita	4,511	9.225272	1.193515	6.370018	11.96783

Industry Employment Summary Statistics:

```
. sum IndustryEmployment
```

Variable	Obs	Mean	Std. dev.	Min	Max
IndustryEm~t	4,270	19.46766	8.298363	2.195539	59.5787

Trade Summary Statistics:

```
. sum Trade
```

Variable	Obs	Mean	Std. dev.	Min	Max
Trade	4,154	87.77725	54.01988	2.698834	442.62

Natural Resources Summary Statistics:

```
. sum NaturalResources
```

Variable	Obs	Mean	Std. dev.	Min	Max
NaturalRes~s	4,440	7.099953	11.12232	0	88.59235

Formerly Communist Summary Statistics:

```
. tab Communist
```

Communist	Freq.	Percent	Cum.
0	3,600	75.79	75.79
1	1,150	24.21	100.00
Total	4,750	100.00	

V. Results

FIGURE 1

VARIABLES	(1) Foreign Direct Investment
laglGDP	0.95***
	(0.01)
lPPPCapita	0.09**
	(0.04)
GovIndicator	0.18***
	(0.04)
IndustryEmployment	-0.02***
	(0.00)
NaturalResources	0.00
	(0.00)
Trade	0.01***
	(0.00)
Communist	0.62***
	(0.05)
Constant	-3.62***
	(0.33)
Observations	2,837
R-squared	0.78

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

A few things should be kept in mind with regard to the interpretation of the results of our regression model. First of all, foreign direct investment is an extremely broad topic, as evidenced by our literature review, and the result of this model gives us little information about the details of any specific investments in any given country. Essentially, our model tells us nothing about what factors might influence a corporation's decision to build a piece of physical infrastructure specifically, or to purchase an existing factory, or undertake any other specific type of FDI. It only tells us what factors affect FDI broadly.

Additionally, although we believe our model to be robust and broadly indicative of FDI incidence, there were several additional factors that we would have liked to consider, and which could warrant further investigation. This will be explored in more detail in the conclusion section of this paper.

As for the results of our OLS regression analysis, Figure 2 shows the full interpretable results of each variable, holding all else constant. Probably the most surprising finding is the high p-value for natural resource rents within the model. The coefficient of .00337 and robust standard error of .00332 suggest that natural resource rents are not statistically significant when holding all other factors constant,

and that we cannot reject the null hypothesis that natural resource rents have no effect whatsoever on the incidence of FDI. This is an interesting finding due to the ample literature that connects FDI to cheap material inputs in the receiving country. This result suggests that extractive economies are not those that are most attractive to foreign investment.

With the exception of natural resource rents, all other variables were found to be statistically significant, with a p value of less than .05, and low standard errors. One such statistically significant result was the coefficient of communism dummy variable. This coefficient of .62 suggests that having a communist history, holding all else constant, is associated with a nearly 86% increase in FDI when compared to a non-communist nation. This could be the result of the massive comparative influxes of FDI into formerly communist countries in the aftermath of the fall of the Iron curtain.

Another interesting result is that of industrial employment, which is slightly negatively associated with FDI. While this runs counter to existing literature which ties FDI to national level of industrialization, it is not all that surprising, when you consider that many highly industrialized countries have extremely low industrial employment. The United States, for instance, has the most advanced economy, and attracts large amounts of FDI, but has less than 10% industrial employment. Further work should be conducted to determine if high industrial employment is positively associated with FDI under any circumstances, or has a non-linear relationship with it.

FIGURE 2

Numeric (logged)	FDIbill	
-2.5 to 2.5	Gov Indicator	A 1 point increase in the Government Indicator yields a 0.200% increase in FDI
Numeric (logged)	laglGDP	A 1% increase in GDP yields a 1.593% increase in FDI
Numeric (logged)	lPPPCapita	A 1% increase in GDP Per Capita (PPP) yields a 0.097% increase in FDI
Numeric	IndustryEmployment	A 1 percentage point increase in Industry Employment (as a % of GDP) yields a 2.222% decrease in FDI
Numeric	Trade	A 1 percentage point increase in Trade yields a 0.895% increase in FDI
Numeric	NaturalResources	A 1 percentage point increase in Natural
		Resources yields a .332% increase in FDI
0 for non communist, 1 for formerly communist	Communist	A change from 0 → 1 in the Formerly Communist Indicator yields a 85.967% increase in FDI

FIGURE 3

VARIABLES	(1) Foreign Direct Investment
laglGDP	0.93***
	(0.01)
Constant	-1.76***
	(0.24)
Observations	3,393
R-squared	0.72

Robust standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

Despite the results above, what is perhaps our key finding is an unsurprising one; the single factor with the most explanatory power to explain Foreign direct investment inflow is market size, in the form of GDP. A simple regression of FDI on GDP, shown in Figure 3 above, shows that differences in GDP between countries can explain more than 70% of the variation in FDI inflows between countries on its own. This value only rises to 78% when all other variables are included in the analysis. This does not mean that other variables are important in explaining net foreign direct investment inflows, but only that GDP is the most important factor by far.

Additionally, the coefficient for GDP hardly changes with the presence of other variables. With the simple regression model of FDI on GDP shown above, a 1% increase in GDP is associated with a 1.539% increase in FDI; in the full multiple regression model we used, it is associated with a 1.593% increase in net FDI inflows. This is further evidence that market size remains a paramount factor in determining the incidence of foreign direct investment, regardless of other factors.

VI. Conclusion & Further Research

Foreign direct investment (FDI), an influential force, has traversed the globe for centuries, originating from the dawn of nation-states, progressing through the era of the Silk Road, and persisting till present times amidst unprecedented levels of globalization. Following the conclusion of the Covid-19 pandemic, nations have been swiftly unveiling their borders at rates previously unimaginable.

Through this process, we took data from the World Bank Governance Indicators, World Bank Development Indicators, and World Population Review to determine what factors are the most influential and significant for determining the incidence of foreign direct investment in a given economy. Our results suggest that market size is the single most important factor for determining FDI inflows, but that other factors, such as GDP per capita, trade as a percentage of GDP, and a nation's communist history, also play an important role.

Our results raise questions for further research. As previously stated, foreign direct investment is a term which encompasses a broad range of economic activities, and our results give little indication of what sort of FDI is associated with what sort of factors. Thus, further research might involve creating different models for different types of FDI, though this would require finding and using different data sources.

Another question for further analysis would have to do with different sources of FDI. Different nations and different corporations may be influenced by different factors when it comes to making decisions about investing abroad, and it would be eye-opening to analyze these different sources of FDI separately, to determine if this is the case.

Finally, a third question to examine would be the impact of FDI within different income brackets. Investment in a developing economy may be associated with different factors (such as the aforementioned natural resource rents) when compared to investment in a developed economy. This question would be related in many ways to the first question about types of FDI, as investments in capital rich countries such as the U.S. are likely of a markedly different type than investment in labor rich developing economies such as Guatemala.

With our background in the literature and analysis of the results, we have arrived at a conclusion that tackles the initial concept we aimed to address. However, the closure of one door has unexpectedly revealed numerous new avenues, signaling the potential for a more intricate study in our group's future endeavors. This expanding lens presents an opportunity for policymakers, and businesses to navigate the complex landscape of FDI—its varied types, behaviors, and studies—to optimize its potential benefits. Our aspiration is for this project to transcend academic enrichment, resonating through its practical implications in helping to foster sustainable economic growth and promoting greater equity in global development.

VII. Appendix

List of Countries Analyzed

Afghanistan
Albania
Algeria
Angola
Antigua and Barbuda
Argentina
Armenia
Australia
Austria
Azerbaijan
The Bahamas
Bahrain
Bangladesh
Barbados
Belarus
Belgium
Belize
Benin
Bhutan
Bolivia
Bosnia and Herzegovina
Botswana
Brazil
Brunei
Bulgaria
Burkina Faso
Burundi
Cabo Verde
Cambodia
Cameroon
Canada
Central African Republic
Chad
Chile
China
Colombia
Comoros
Congo, Democratic Republic of the
Congo, Republic of the
Costa Rica
Côte d'Ivoire
Croatia
Cyprus
Czech Republic

Denmark
Djibouti
Dominica
Dominican Republic
East Timor (Timor-Leste)
Ecuador
Egypt
El Salvador
Equatorial Guinea
Eritrea
Estonia
Eswatini
Ethiopia
Fiji
Finland
France
Gabon
The Gambia
Georgia
Germany
Ghana
Greece
Grenada
Guatemala
Guinea
Guinea-Bissau
Guyana
Haiti
Honduras
Hungary
Iceland
India
Indonesia
Iran
Iraq
Ireland
Israel
Italy
Jamaica
Japan
Jordan
Kazakhstan
Kenya
Kiribati
Korea, North
Korea, South
Kosovo
Kuwait
Kyrgyzstan
Laos
Latvia
Lebanon
Lesotho
Liberia
Libya
Liechtenstein
Lithuania
Luxembourg
Madagascar
Malawi
Malaysia
Maldives
Mali
Malta
Mauritania
Mauritius
Mexico
Moldova
Monaco
Mongolia
Montenegro
Morocco
Mozambique
Myanmar
Namibia
Nepal
Netherlands
New Zealand
Nicaragua
Niger
Nigeria
North Macedonia
Norway
Oman
Pakistan
Palau
Panama
Papua New Guinea
Paraguay
Peru
Philippines
Poland
Portugal
Qatar

Romania
Russia
Rwanda
Saint Kitts and Nevis
Saint Lucia
Saint Vincent
Samoa
Sao Tome and Principe
Saudi Arabia
Senegal
Serbia
Seychelles
Sierra Leone
Singapore
Slovakia
Slovenia
Solomon Islands
Somalia
South Africa
Spain
Sri Lanka
Sudan
Sudan, South
Suriname
Sweden
Switzerland
Syria
Taiwan
Tajikistan
Tanzania
Thailand
Togo
Tonga
Tunisia
Turkey
Turkmenistan
Uganda
Ukraine
United Arab Emirates
United Kingdom
United States
Uruguay
Uzbekistan
Vanuatu
Venezuela
Vietnam
West Bank and Gaza
Yemen
Zambia
Zimbabwe

VIF test for Regression Model

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. vif
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Variable	VIF	1/VIF
lPPPCapita	4.84	0.206630
GovIndicator	3.08	0.325130
laglGDP	1.85	0.539923
IndustryEm~t	1.81	0.552202
Trade	1.43	0.697390
NaturalRes~s	1.27	0.788344
Communist	1.17	0.852788
Mean VIF	2.21	

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