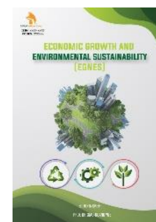
ZIBELINE INTERNATIONAL PUBLISHING
ISSN: 2821-2975 (Online)
CODEN: EGESCS

Economic Growth and Environment Sustainability (EGNES)

DOI: http://doi.org/10.26480/egnes.01.2023.09.11



REVIEW ARTICLE

UNDERSTANDING THE RELATIONSHIP BETWEEN FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH; AND ITS DETERMINANTS: A REVIEW OF LITERATURE AND EVIDENCE

Sabin Ghimire*

Agriculture and Forestry University, Rampur, Chitwan
****Corresponding Author Email: sgag471@gmail.com***

This is an open access article distributed under the Creative Commons Attribution License CC BY 4.0, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

ARTICLE DETAILS

Article History:

Received 01 January 2023
Revised 06 February 2023
Accepted 09 March 2023
Available online 14 March 2023

ABSTRACT

In the last few decades, there has been a lot of discussion in the economic literature about the link between FDI and economic growth; and its determinants. This paper reviews the literature dealing with the same. The findings presented on the particular topic show that the links between them are somehow conflicting and it is a bit difficult to draw a clear conclusion. Some of the scholars argue that FDI promotes technology transfer and spillovers; uplifts institutions, human capital, and infrastructures, and boosts market conditions. While other pessimists believe that FDI may lead to dependency on foreign capital, external vulnerabilities, and destructive competition of foreign affiliates with domestic firms. This paper also investigated on some empirical findings on the determinants of FDI and presented that tax rates, physical infrastructures, legal framework, low wage rate, trade barriers and government policies were major determinants of FDI inflow.

KEYWORDS

Foreign Direct Investment, Economic Growth, Determinants of FDI

1. Introduction

FDI is an investment made to acquire a lasting management interest (normally 10% of voting stock) in a business enterprise operating in a country other than the investor (World Bank, 1996). Similarly, The International Monetary Fund (IMF) defined (FDI) as an investment that involves a long-term relationship reflecting a lasting interest of a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor. FDI is one of the key drivers of economic growth which promotes national economic productivity, increases the use of technology, lowers unemployment by generating new jobs, and produces other positive results that set it apart from other forms of finance (Al-Eitan, 2013). It is considered that one of the pre requisites for FDI is that the investing corporations enjoy some monopolistic advantages that local rivals do not. Foreign direct investment (FDI), which is acknowledged for encouraging sustainable development in all nations, is also seen as a catalyst for economic growth, particularly in developing and emerging market economies (Ross, 2015). While poor nations deserve and need FDI and have more policy freedom to attract it, rich countries receive a larger part of it than the remaining little share in the global economy. The trade consequences of FDI on the host country depending on its objectives, such as access to natural resources, consumer markets, or utilizing locational comparative advantage. FDI is a mechanism that unites national economies to create an international economy (Kok and Ersoy, 2009). At both the national and international levels, the issue of foreign direct investments is receiving more attention nowadays as it is a good source of capital for the growth of the country, especially for developing countries. FDI can be seen as a crucial facilitation tool in the global business environment, enabling enterprises to expand into international markets and boost sales and profits. Furthermore, countries are removing trade restrictions and launching programs to promote FDI inflows as a result of a desire to profit from the resource-transfer and employment implications of FDI (Ross, 2019).The host country's economy is impacted by FDI in many additional ways. It has an impact on the recipient nation's income, output, pricing, employment, economic development, and general well-being.

2. Methodology

The various articles that have appeared in various national and international periodicals, publications and websites are the basis for this thematic article. After carefully examining the articles, research gaps were discovered. Then, a conclusion was reached after reviewing the literature. The methodology of this thematic article is, in essence, the literature review.

3. Discussion

3.1 FDI Inflows and Economic Growth

Starting with the pioneer work of who found out that FDI has both positive and negative effect on growth, initially FDI has positive impacts but in long run it exerts negative impact as the developments done with foreign investment need more foreign investments in long run due to more dependence on the foreign money causing emergence of different negative externalities like unemployment, over-urbanization and problems of income inequality and found that countries with high dependence on foreign capital lagged in economic growth in long run as compared to less-dependent economies (Kentor, 1998). Supporting the same agreed that the growth effect of FDI is positive in export-promoting countries but negative in import-substituting ones, analyzing annual cross-sectional data for 46 developing countries in a fixed effects model (Balasubramanyam, 1996). That in their study in Nigeria confirmed that FDI promoted economic growth of the country, but it could be limited by lack of proper human capital and hence uplifting infrastructure, maintaining sound macroeconomic environment and ensuring proper

Quick Response Code	Access this article online	
	Website: www.egnes.com.my	**DOI:** 10.26480/egnes.01.2023.09.11

Cite The Article: Sabin Ghimire (2023). Understanding the Relationship between Foreign Direct Investment and Economic Growth; and its Determinants: A Review of Literature and Evidence. *Economic Growth and Environment Sustainability, 2(1): 09-11.*

human capital development is obligatory for inflow of FDI (Adegbite and Ayadir, 2012). Furthermore, using cross-country regression framework with data of FDI flow from developed countries to 69 developing countries, concluded that FDI contributes to the growth of the host country in larger extent than domestic investment as it acts as a important medium for transfer of technology but they suggest that FDI is more productive than domestic investment when the host country has threshold stock of human capital (Borensztein et al., 1998). Through his empirical studies found that 1% increase in FDI in Nepal brought 7.89% change in real GDP, likewise 1.948% and 0.995 % change in export to India and third world countries and concluded that FDI in Nepal had positive contribution to real GDP but was very smaller than expected economy, the contribution of FDI to export trade to India and third world country was also positive (Bista, 2005). Also, through his empirical studies taking a panel data of 12 Latin American countries found that FDI efficiently increased the GDP of host countries three times more than the domestic investment (De Gregorio, 1992). It has also supported the same finding a strong effect of FDI on economic growth. FDI and economic growth are supported by one another as economic growth expands the size of the host country's market and boosts the incentives for market-seeking FDI and MNEs (Multinational Enterprises) provides positive impact on economic growth through technology spillovers and inflow of physical capital (Johnson, 2006; Blomstrom, 1992).

Although was unable to discover any positive relationship between FDI and economic growth, he did present evidence that the positive impacts of FDI are dependent on host countries' absorptive capacity (Durham, 2004). As a in this paper challenged the widely held notion that FDI generally contributes to economic progress in developing nations (Herzer, 2012). According his research using data for 44 developing nations from 1970 to 2005, he found that the impact of FDI on economic growth in developing countries is, on average, negative, 60% of the countries in the study had long-run decrease in GDP whereas 40% of them had long-run increase in GDP associated with increase in FDI-GDP ratio. Using error correction model (ECM) to examine the relationship between FDI and economic growth in Nigeria for the period 1970 to 2001, agreed that both private and foreign lagged capital had small and insignificant impact on economic growth (Akinlo, 2004). Most developing countries lack technology capability and FDI helps to facilitate technology transfer and reduce the technology gap between developing countries and developed countries, whereas in developed economies FDI depends on friendly environment and favorable government policies supporting globalization, innovation and entrepreneurship (Chakrabati, 2003; Kok and Ersoy, 2009). The industrialized countries receive a larger proportion of FDI in the global economy, while developing countries receive a smaller share, despite the fact that developing countries deserve and need it, and there is greater policy flexibility to attract FDI (Bista, 2005).

Which mentioned that, FDI is a significant source of capital, complements domestic private investment, is typically linked to new employment opportunities and enhancement of technology transfer and spillover, human capital (knowledge and skill) augmentation, and increases overall economic growth in host countries (Chowdhury, 2005). On the other hand, considered that positive spillovers for the host countries by FDI had weak relation (Hanson, 2001). The foreign firms focuses on the adoption of new technologies to ensure market shares for which they emphasize on localization of R&D capacities, which may help in the advancement of technology and its spillover in the receiver country. Likewise, noted that to absorb new technologies and get benefit from the diffusion of technology, countries must meet the requirement of having a certain threshold level of income (Blomstrom., 1994; Ali, 2015). FDI flow to the country, which was sufficiently wealthy and had income above some threshold level had a positive impact on economic growth, but below that income level it did not show positive effect on economic growth. The overall impact of FDI on host country economic growth is unclear; manufacturing sector spillover is favorable, whereas FDI inflows into the primary sector typically have a negative impact (Alfaro et al., 2004). In addition, in their study through sectoral data of different sectors in Nepal over 10 years (2007-2016) using regression analysis found that there is positive and significant impact of FDI of service sector and tourism sector on economic growth whereas construction sector, manufacturing sector, mining sector and agro and forest-based sectors had positive and insignificant impact on economic growth (Phuyal and Sunuwar, 2018). The COVID-19 pandemic also had an impact on foreign direct investment (FDI), which saw a drop of one-third from $1.5 trillion in 2019 to $1 trillion, the lowest level since 2005. Inflows to rich countries decreased more quickly than those to developing ones—by 58% against just 8%—but flows into developing countries in Asia, which account for more than half of the global total, actually increased by 4% last year, to $535 billion (UNCTAD, 2021).

3.2 FDI and its determinants

The performed meta-analysis to extract information on relationship between institutional factors and FDI attractiveness of host country and concluded that various positive institutional factors like political stability, democracy and rule of law attracted FDI but factors such as corruption, tax rates and cultural distance repel it (Bailey, 2017). This in their study found that FDI determinants like trade, telephone, gross capital formation and GDP per capita growth had positive impact on FDI whereas total debt service/GDP and inflation had negative impact and concluded communication (telephone mainlines) as best FDI determinant. They also supported transparency and accountability of government, and locating foreign enterprises in the incentive offering regions along with flexible domestic policies helps attracting FDI (Kok and Ersoy, 2009). As a stated, there is significant positive relationship between expansion of information and communication technology (ICT) and FDI inflows in the recipient country and suggested that improvement of ICT infrastructure is necessary for increased FDI inflows and gain stronger economic growth (Sinha, 2019).

The explains why a currency appreciation could actually lead to a firm's increasing international investment through an imperfect capital markets narrative. Because capital markets are not perfect, internal capital costs are lower than external borrowing costs (Froot, 1991). Thus, compared to equivalent companies in other countries that face currency depreciation, an appreciation of the currency increases firm wealth and gives the firm access to more low-cost funds for investment. stated that issue of double taxation faced by MNE on host and parent countries impacts on FDI and measurement of FDI activity depends on type of tax and tax treatment and firms will to respond to host countries tax rate only and not of parent country (Blonigen, 2005). They also stated that poor institutions with weak legal protection leads to poor infrastructure and chances of market failure causing decrease in profitability hence quality of institutions is an important determinant of FDI. That believed global integration as the key factor for foreign investment and foreign investors preferred investing in China for development of strategic capability of firm, this global strategy is adopted to ensure the access to Chinese market and secure the sales over the long run (Ali, 2015). The results from their study showed that especially for US firms' market was the major factor for FDI and local, export-oriented, Asian firms considered low labor as major factor for FDI. They also agreed that major obstacles for foreign firms' decision to invest were political and legal system.

In order to gain advantage of spillover from FDI, the host economy depends on the level of development of domestic financial market and their ability to absorb the technological advancements. They also discovered that economies with well-developed financial markets benefited much more from FDI, whereas nations with poor financial markets are unable to manage with capital flows and hence miss out on potential FDI benefits (Alfaro et al., 2004). Faster economic growth with inflow of FDI can only be observed when there is freedom from government intervention and business regulation with reduction in trade barriers and reduction in market-distorting policies (Herzer, 2012). According in this study with series of panel data, the flow of Chinese OFDI into eight African countries occurred specially taking consideration of advantages from natural resources of host country and various factors related to quality of infrastructure and supportive regulatory framework to (Ross, 2015). It has on his study based on sample of 122 countries, investigated relevance of governance infrastructure on patterns of FDI flow in developing countries employing World Bank's 'good governance index' highlighted that FDI flow of host country can be predicted by country-level governance infrastructure, he found that developing economies with weak governance structures had low inflow of FDI and above all in order to attract FDI, government must formulate and implement policies for good governance effectively along with good regulatory framework to enhance competitive environment for FDI (Ross, 2019).

One of the key economic drivers of FDI is the low wage rates, supporting the same (Swain, 1997) found that the relatively inexpensive labor in China and inward FDI were positively correlated (Liu et al., 1997). As a observed that Hong Kong multinationals are significantly encouraged to invest in Mainland China due to the country's relatively low labor expenses whereas no US multinational enterprises' decision to invest in China was influenced by the labor cost factor (Zhang, 2000) . In their study confirmed that MNEs along with market seeking motive, also had efficiency seeking behavior and good FDI flows are seen in the countries having better human capital development (Tariq, 2014). This argued that discriminating policies, special treatment for some projects and direct incentives to foreign investors create a unfair environment between domestic and foreign investors which may cause serious political implications and other

distortions (Gregorio, 2005). It has through statistical analyses for 122 developing countries from 1970-2000, supported that international commitments are more promising than domestic policies hence developing countries, that belong to WTO and had more participation PTAs (Preferential Trade Agreements) experienced more FDI inflows than others Tim, Buthe (Helen, 2008).

4. Conclusion

Over the past few decades, a huge amount of study has been done on FDI. Some inferences about the statistical techniques applied, the sample selected, and the main research areas from the empirical publications were presented in the study. While it is encouraging that a substantial empirical literature exists and continues to emerge around the topic of identifying the forces driving FDI, it is unclear if one can have any confidence in the results made by the research. The existing literatures have presented contradictory assumptions concerning the impacts of FDI and its effects on growth.

Scholars believed that FDI has a positive impact on economic growth pre sented that it can encourage upliftment of institutions and infrastructure, ensures human capital development, boosts market condition, helps in technology and spillovers; modernizing the host country's economy and promotes sound macroeconomic environment. Along with that it had some negative impacts like dependency on foreign capital, over-urbanization, some social and environmental impact, external vulnerabilities and destructive competition of foreign affiliates with domestic firms. This paper also investigated some empirical findings on the determinants of FDI and presented that tax rates, physical infrastructures, legal framework, low wage rate, trade barriers and government policies were major determinants of FDI inflow. However, these findings must be viewed skeptically as the study is limited and the current article is not confined to presenting empirical findings from previous studies only, but instead focuses on the researchers' perspectives on FDI inflows in long run.

References

Adegbite, E. O., and Ayadir, and F. S., 2012. The Role Of Foreign Direct Investment In Economic Development : A Study Of Nigeria.

Akinlo, A. E., 2004. Foreign Direct Investment and Growth in Nigeria: An Emperical Investigation. Journal of Policy Modeling, Pp. 627-639.

Al-Eitan, G., 2013. A dynamic model for determining inward foreign direct investment in Jordan. Perth: School of Economics and Finance, Curtin .

Alfaro, L., Chanda, A., and Kalemli-ozcan, S., 2004. FDI and economic growth : the role of local financial markets. 64, 89–112. https://doi.org/10.1016/S0022-1996(03)00081-3

Ali, S., 2015. Determinants Of Fdi In China. January 2005.

Bailey, N., 2017. Exploring the relationship between institutional factors and FDI attractiveness : A meta-analytic review. International Business Review, May, 0–1. https://doi.org/10.1016/j.ibusrev.2017.05.012

Balasubramanyam, V. N., 1996. Foreign direct investment and growth in EP . The Economic Journal, Pp. 92-105.

Bista, R., 2005. Foreign Direct Investment in Nepal: Regression analysis in aspect of GDP growth and export. Munich Personal RePEc Archive.

Blomstrom, M. L., 1992. What Explains Developing Country Growth. NBER Working Paper No. 4132.

Blomstrom, M. L., 1994. "What Explains Growth in Developing countries?". NEBR Discussion Paper.

Blonigen, B. A., 2005. A Review of the Empirical Literature on FDI Determinants. Pp. 383–403. https://doi.org/10.1007/s11293-005-2868-9

Borensztein, E., Gregorio, J. De, and Lee, J., 1998. How does foreign direct investment affect economic. 45, Pp. 115–135.

Chakrabati, A., 2003. Determinants of FDI: A Comment on Globalization-Induced Changes and the Role of. University of Wisconsin, USA.

Chowdhury, A. a., 2005. FDI and Growth: A Causal Relationship. United Nations University, WIDER.

De Gregorio, J., 1992. Economic growth in Latin America. Journal of Development Economics 39, Pp. 58-84.

Durham, J. B., 2004. Absorptive Capacity and The Effects of Foreign Direct Investment and Equity Foreign Portfolio Investment on Economic Growth. European Economic Review , Pp. 285-306.

Froot, K. A., 1991. "Exchange Rates and Foreign Direct Investment" An Imperfect Capital Markets Approach. Quarterly Journal of Economics, 106, 4, Pp. 1191-1217.

Gregorio, J. De., 2005. The Role of Foreign Direct Investment and Natural Resources in Economic Development ∗. Pp. 179–197.

Hanson, G., 2001. Should Countries Promote Foreign Direct Investment? UNCTAD: G-24 Discussion Paper Series No. 9.

Herzer, D., 2012. How Does Foreign Direct Investment Really Affect Developing Countries ' Growth ? 20(2), Pp. 396–414. https://doi.org/10.1111/j.1467-9396.2012.01029.x

Johnson, A., 2006. The Effects of FDI Inflows on Host Country Economic Growth. 58, Pp. 1–57.

Kentor, J., 1998. The Long-Term Effects of Foreign Investment Dependence on Economic Growth. American Journal of Sociology, Pp. 1024-1046.

Kok, R., and Ersoy, B. A., 2009. Analyses of FDI determinants in developing countries. International Journal of Social Economics, 36(1–2), Pp. 105–123. https://doi.org/10.1108/03068290910921226

Liu, X., Romilly, P., and Song, H. a., 1997. Country characteristics and foreign direct investment in China: A panel data analysis. Weltwirschaftliches Archiv, Pp.13-29.

Phuyal, R. K., and Sunuwar, S., 2018. A Sectoral Analysis of Foreign Direct Investment on the Economic Growth of Nepal. 3(1), Pp. 1–14.