

# **A Synthesis of the Foreign Direct Investment Effects**

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## **Abstract**

Foreign Direct Investment becomes one of the business globalization forces. It is by this meaning, a strong factor having its evident impact on tying together the economies and forcing the exchange waves between them. In this context, the advocates of foreign investment claim that it brings new technology and know-how in an attempt to increase productivity and enhance efficiency. At the contrary, the opponents of foreign investment effects claim that this investment is no more than one of the different features of the economic imperialism. This paper tends to present a synthesis of the foreign direct investment effects.

**JEL classification numbers:** F21, F43, C23

**Keywords:** Foreign Direct Investment, Effects

## **1. Introduction**

The examination of both the effects and the determinants of foreign direct investment occupied the lion share of the economic literature. The aim of this remarkable consideration is to gain a true and concrete knowledge of the conditions that ensure advantageous spillovers for both the home and the host countries. However, a good absorption of the positive effect of foreign investment is no longer guaranteed unless if the host country creates a business atmosphere capable to deal efficiently with the requisites and the outcome of this investment.

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## **2. Effects of foreign direct investment**

The literature is abundant by the studies that investigate the spillovers of foreign investment on both the home and the host countries. For instance, Andrew Schmitz and Jurg Bieri (1972) tried to analyze the relationship between the discrimination in tariffs imposition and US foreign direct investment in the EEC. Their study concluded that the imposition of the common external tariff in the EEC countries led to increase the inflows of UF FDI and decrease the US exports to that region. The researchers found also that the optimum tariff argument does not hold because of the immobility of some production factors. In addition to this, Larry Willmore (1976) focused on the link between the foreign controlled firms and the seller concentration in the Central American manufacturing industries. The sample of the study is composed of 33 pairs of firms (foreign controlled-local firms) and the data are gathered for the fiscal year of 1971. The results of the study indicated that that the foreign controlled firms are in general more expanded in their productive and export capacities than the domestic ones. In the same context, John Lunn (1980) attempted to assess the determinants of US foreign investment to EEC. The study comes up with the conclusion that many determinants are considered as important to engage in foreign investment decision like the market size, trade barriers and capital expenditure. However, FDI is based fundamentally on the view and the decisions made by the managers of the multinationals. Moreover, John Lunn (1983) undertook a research in which he expanded and improved of the ideas present by him in a previous paper (1980) about the determinants of US FDI in EEC. By adopting a model developed by Scaperlanda and Balough, the paper arrived at the conclusion that the determinants of US FDI in EEC are: market size, growth of market size and tariff discrimination. Anthony Scaperlanda and Robert S. Balough (1983) in their turns tried to identify the determinants of US foreign direct investment to the EEC. They found that the determinants of US foreign direct investment in the EEC are: market size, tariff discrimination and the fluctuation of the exchange rate does exercise an impact of the movement of FDI. Additionally, Friedrich Schneider and Bruno S. Frey (1985) analyzed the economic and political determinants of foreign direct investment in 80 Less Developed Countries for 1976, 1979 and 1980. Four models are adopted for comparison (economic model, political model, amalgamated model and politico-economic model). The study proves that the politico-economic models explain better the determinants of foreign direct investment in the sample than the other models. The results show also that per capita GNP, balance of payments, inflation, wage costs (economic factors) and bilateral and multilateral aids from Western or Communist countries, political instability and government ideology (political factors) are the main determinants of FDI to Less Developed Countries. Besides, Carlos E. Santiago (1987) presented a paper by which he tried is to show the impact of foreign direct investment on both the export structure and employment generation. The issue is analyzed during 1979 in Puerto Rico and the study variables are:  $F_k$ ,  $S_k$ ,  $K_k$ ,  $C_k$ ,  $I_k$ ,  $L_k/L_k^*$ ,

Gk/Gk\*, Pk/Pk\*, Rk/Rk\*. The study demonstrates that there is a link between the firm characteristics (Dunning view) and the decision to invest abroad. Additionally the foreign direct investment variation is influenced by the features of both the host and the source FDI regions. In the same sense, Claudy G. Culem (1988) tried to explore the locational determinants of foreign direct investment among six industrialized countries (US, Germany, France, UK, Netherlands and Belgium) during the period 1962-1982. The researcher comes up with the result that the foreign direct investment among the countries of the sample is determined by the market size, growth rate, tariff barriers, prior export flows and the production costs. In addition to this, Pan-Long Tsai (1991) seeks to represent the determinants of the foreign direct investment in Taiwan. The variables of the study are: FDI,  $\Delta Y$ , D1, D2, D3, RFDI, FDIW,  $R\Delta Y$ ,  $\Delta YW$ , RPCGDP, PCGDP, PCGDPW and the period of the investigation is 1958-1985. The study tries to highlight which factors (demand side factors: political stability, labor cost, market size, regional economic integration, and incentives of the host countries; or supply side factors: economics of scale, oligopoly reaction, product life cycle, intangible assets and internationalization) are more determinant to attract FDI. The results show that the supply side factors are the significant determinants of FDI to Taiwan. Along with the previous analyses, Stephen Martin (1991) tried to explain the determinants of the foreign direct investment in the United States. The researcher found that the foreign investment in the United States is motivated by the market structure and the transaction costs. Furthermore, Robert Grosse and Lawrence G. Goldberg (1991) discussed the issue of foreign bank determinants in the United States. The study revealed that the foreign banking presence in the US is motivated by the market size as the banks establishment is dependent fundamentally to the customers' service. Other determinants are represented by the trade volume with the US. In the same context, Lindsay N. Meredith and Dennis R. Maki (1992) tried to investigate the link between the export and foreign direct investment. The researchers found that a linkage level between FDI and export (complementary variables) is existed but it depends on some criteria like: the capacity of the production system of the host country, the diffusion of product and innovation processes and the size of the firms in the host countries. Tain-Jy Chen (1992) at the other side seeks to shed light on the determinants of the Taiwan's foreign direct investment. The study shows that large firms are more able to engage in foreign investments than small ones; and diverse determinants (microeconomic and macroeconomic) conduct the overseas investment behavior such as: the firm characteristics and scale, market size, the value of the currency and the export performance. Additionally, Tracey A. Drake and Richard E. Caves (1992) tend to explore the causes behind the Japanese foreign direct investment in U.S manufacturing industries. The study concluded that the Japanese foreign direct investments to the United States are conducted by: the volume of Japanese trade to US, the rise of Japanese research activities (R&D), the U.S trade policy and advertising intensity. Besides, Bruce Kogut and Udo Zander (1993) examined the contribution of knowledge in the theory of growth of MNEs. They revealed

that growth results from endogenous factors (the organizational capacity to transform knowledge in an attempt to create new products) and from external opportunities and threats. In addition to this, Robert E. B. Lucas (1993) analyzed the determinants of FDI in seven economies in East and South-East Asia. The study covers the period 1960-1987 and adopts the following variables: Wage, Price, Capital cost, GDP, DFI. The study illustrates that the high levels of wages have a negative impact on foreign investment inducement while the cost of capital is not of big influence on foreign investment attraction. At another side, H. H. Aswicahyono and Hall Hill (1993) attempt to explore the effect of the host country policy environment in attracting foreign direct investment. The study concluded that the policy environment of the host country matters most in the issue of attracting FDI. In this sense, the foreign ownership, the presence of state enterprises and effective protection are considerable determinants of FDI in LDC industry. Xiaohong He and Stephen E. Guisinger (1993) in their turns explored the effect of taxes and the tax competition as a determinant to attract foreign direct investment both in developed and developing countries. They found that tax rate is an important determinant of the foreign direct investment. Tax policy instruments in developed countries are more efficient to attract FDI than the developing countries (Taxes competition and convergence in developed countries is more than that in developing countries). Moreover, Catherine L. Mann (1993) examined the determinants of Japanese foreign direct investments in US manufacturing industry. The study concluded that the exchange rate is a major determinant of the Japanese foreign investment in the United States. Furthermore, Larry Dwyer and Peter Forsyth (1994) seek to describe the motives and the determinants of the tourism foreign investment in Australia. The foreign investment in tourism is analyzed in terms of eclectic paradigm view and it is found that foreign investment in tourism provides necessary financial resources and direct externalities; and its impacts on prices and consumption is not negligible. Michael W. Klein and Eric Rosengren (1994) tried to investigate the relationship between the exchange rate and the foreign direct investment inwards. The researchers found that the exchange rate exercises a significant influence on the foreign direct investment inwards through the wealth channel joined by the imperfection feature of the capital markets. In addition to this, Kamel Fatehi and M. Hossein Safizadeh (1994) seek to explore the link between the sociopolitical instability of the host country and the flows of foreign direct investment. The paper concluded that the sociopolitical instability exercises an influence on the flows on FDI but the influence is different according to the sector of FDI (Mining, manufacturing, petroleum). Besides, Le-Yin Zhang (1994) wanted to describe the program adopted by Guangdong province in China in an attempt to attract more FDI. According to the paper, the program of Guangdong province is based on special policies and flexible measure. It gives this province more power to manage DFI and foreign trade as well as a big package of incentives and supporting facilities. These procedures are joined together with the specific advantages of this province like its historical background and geographical proximity to Hong Kong led Guangdong to be a

core area of manufacturing and foreign investment. Moreover, Deborah L. Swenson (1994) tends to analyze the extent of tax impact on the foreign direct investments inwards in the US. The findings of the study confirm that the tax influences the foreign investment inwards as the increase of taxes led to more FDI inwards. In the same context, Jason G. Cummins and R. Glenn Hubbard (1994) explored the linkage between taxes and foreign direct investment. They found that tax policy affects the foreign direct decision through the channels indicated by the neoclassical model. In addition to this, Paul Azrak and Kevin Wynne (1995) examined the link between the foreign direct investment and the protectionism policy of the host country. The findings of the research revealed that the market distortions of the host country lead to more FDI in an attempt to avoid these distortions (trade barriers, unfair competition). This result means implicitly that the foreign direct investment is a mean to overcome the difficulties of the foreign markets. Shang-Jin Wei (1995) at another side assesses the Chinese potentiality in receiving the fair amount of foreign direct investment. The study shows that there is a big gap between the capacity of China to host FDI (vast size, level of development and geographical characteristics) and the effective volume of FDI received by the country especially from U.S, Germany, France, and UK. The cause of this may be beyond the economic considerations. Moreover, Pan-Long Tsai (1995) investigates the impact of the foreign direct investment on the income inequality. The analysis focuses on LDCs and the variables are the following: LNPCGP, LNPCGP2, FDIS, GOV, AGRIL, GPCGP, HCAP, GINI. The period of the study is 1968-1981 and the technique used is OLS. The results of the study indicate that the foreign direct investments bring harmful effects to the income distribution in general. The paper paves the way for further researches as the income distribution is influenced by other factors not only the foreign investment. Furthermore, Benjamin Tan and Ilan Vertinsky (1995) tried to examine the factors behind the scale expansion of the foreign firms in U.S and Canada. The results of the study show that the scale of the subsidiary is conducted by two factors: the strategic advantages of the parent firm (size, technology, exports and advertising) and the international management capabilities of the parent firm. In the same sense, Len J. Trevino and John D. Daniels (1995) tend to assess the criteria of comparison between the investors and non-investors in the U.S. The results of the study revealed that the criteria of the comparison are: the firm size, the firm profit, the technology intensity and the global industry concentration. In addition to this, Karel Jansen (1995) tends to present the macroeconomic effect of DFI taking Thailand as an example. The period of the investigation is 1970-1992 and a macroeconomic model is adopted. The outstanding variables are: Net Direct Foreign Investment, Growth, Private Investment, Growth, Balance of Payment indicators. The results of the analysis show a mixed picture but in general the export oriented foreign investment expands production capacity and implicitly leads to an increase in the economic growth. However, the increase of DFI investment leads to an augmentation in the investment income payments and consequently the adverse consequences on the balance of payments emerge. Len

J. Trevino and John D. Daniels (1995) in their turns wanted to characterize the firms that engaged in investment projects on US ground. They found that the firm patterns (firm size, firm profitability, firm R&D, global industry concentration) are major drivers of FDI into USA. Arri Kokko et al (1995) at the other side tackled the issue of policies that attract the technology flows via foreign multinationals. He comes to the result that the education and growth are determinants to the flow of technology. Additionally, Zhaoyong Zhang and Ow Chin Hock (1996) tried to examine the link between the trade interdependence and foreign direct investment between China and ASEAN countries during 1970s and 1980s. The study revealed that the interdependence of the trade leads to increase the level of foreign direct investment and a complementary mechanism to benefit more from the comparative advantages of the location (Kojima theory). Stephen P. Meyer and Milford B. Green (1996) in their turns tend to describe the behavior of the Canadian MNE across the world and within the United States. The findings of the paper show that the Canadian MNEs are motivated by the size of the foreign markets, state of trade partnership with Canada, the business environment and the distance. Furthermore, Pertti Haaparanta (1996) tried to analyze the issue of the foreign investment competition. This analysis is based on the agency theory (principal-agent). The results of the analysis are the following: the FDI inwards are affected by the competition; high wage country led to more FDI inwards, the competition may reverse the belief of the positive impact of the low production costs on the FDI inwards as the competition pushes the FDI to the locations where the production costs are high. At another side, Goldberg and Klein (1997) focused on the effects of exchange rate on FDI. They found that a real depreciation of currencies of Asian countries against the Yen leads to an increase in FDI from Japan and a decrease in FDI from USA. Fariborz Moshirian (1997) seeks to tackle the determinants of FDI in insurance services in USA. The result of the study shows that the exchange rate, the size of the source countries' insurance sector and bilateral relations are the main determinants of FDI in this industry. In the same context, Fariborz Moshirian and Alex Van Der Laan (1998) examined the determinants of banks' foreign assets for the US, UK and Germany. The findings of the study indicated that the access to bond markets by firms and the competition between private and public capital markets are the main determinants of the financial FDI. Moreover, Fariborz Moshirian et al (1998) tried to analyze the determinants of foreign investment in financial services. The study revealed that the current account balance, domestic and foreign interest rates, domestic and foreign economic activities, trade intensity and FDI in banking are the main determinants of the intra-industry trade. At another side, M. Nakamura and J. Xie (1998) tried to explore the ownership determinations for firm's international operations. The results of the study showed a positive correlation between FP's ownership and relative bargaining power reflected in its intangible assets. Jan Hatzius (1998) in his turn described the position of the labour costs as a determinant of FDI. The researcher indicated that the investment locations are more responsive to labour costs. Furthermore, E. Borensztein et al (1998)

examined the impact of foreign direct investment on economic growth. The study demonstrated that foreign direct investment contributes largely in increasing growth more than the domestic investment. In addition to this, Saskia K. S. Wilhelms (1998) analyzed the determinants of foreign direct investment in Emerging Countries. The findings of the research show that the foreign investors are more enhanced by the country sound infrastructure including four basic institutions (government, markets, educations and sociocultural institutions). In the same context, Fariborz Moshirian and Toan Pham (1999) tend to assess the determinants of Australia's banking investment abroad. The study revealed that the relative cost of capital, the size of the foreign banking market, the exchange rate and the economic growth are the important factors behind the Australia's banking investment abroad. Lehman (1999) at another side tried to highlight the impact of the country risk on the FDI attraction capacity. The researcher found that the political and the economic risks are deterrents to FDI. Marinov and Marinova (1999) in their turns focused on the motives of foreign investors in Eastern Europe. They claimed that motives are related to the strategic priorities of investing firms. Besides, Ramcharran (1999) focused on the relationship between FDI and country risk. The study shows that a significant relationship exists between FDI and country risk (political and economic determinants). In the same sense, Kreinin et al (1999) seek to examine the motives for Japanese FDI. The results of the study revealed that many motives but securing market share is the most important one to attract FDI. Furthermore, Konishi et al (1999) tend to explore the relationship between FDI and trade barriers. Their study proved that firms can jump over trade restrictions by undertaking FDI. Wu (1999) in his turn tend to explain the intra-urban FDI location in China. According to the study, the researcher claimed that intra-urban FDI can be explained according to national economic considerations. In addition to this, Fosfurri and Motta (1999) tried to clarify the impulse that leads firms to engage in FDI activities. The researchers argued that the firms embarking on FDI must possess some advantage. The study shows also that the reason behind the investment abroad is to capture local advantages through proximity of plant location. Additionally, Glodberman and Shapiro (1999) tend to examine the effects of policy changes on inward and outward FDI. The results of the study indicated that free trade agreements had a positive effect and screening of projects had no significant effect. Gyapong and Karikari (1999) focused on the causal relationship between FDI and economic performance in the African countries. They argued that the impact of economic performance on FDI depends on investment strategy. In the same sense, Tuman and Emmert (1999) tried to analyze the political and economic determinants of FDI Japanese in Latin America. The study shows that the determinants include market size, economic policies and certain types of political instability. In addition to this, Montiel and Reinhart (1999) examined the effect of capital controls on the volume and composition of capital flows. The study revealed that capital controls influence the composition of flows, but sterilized intervention influences both volume and composition. Moreover, Mody et al (1999) tried to explain the reasons

behind the choice of FDI location by Japanese MNCs. The researcher argued that trade barriers do not drive Japanese FDI into Asia. In the same context, T. K. Das et al (1999) tend to examine the choice determinants of entry mode. The results of the study indicated that riskiness of the project is a factor against joint venture. In the absence of policy intervention, licensing is dominated by FDI or ventures. Martin and Ottaviano (1999) in their turns examined the location factors of FDI. According to their research, they found that high growth rates and transaction costs are associated with FDI. In the same sense, Cleeve (2000) tend to highlight the factors that determine FDI Japanese location in the UK. The result of the study revealed that wages differences are unimportant and the production growth is important. Additionally, Ressmini (2000) tried to explore the determinants of FDI by EU in the CEEs. They found that firms heterogeneity and sector level are the main determinants of FDI destinations. At another side, Sanford and Dong (2000) examined the influence of tourism on FDI. The results of the research show a significantly positive relationship between tourism and FDI in USA. Traxler and Woitech (2000) wanted to explain the position of the labor market regime as a determinant of FDI location. The study revealed that investors do not assign high priority to labor market regime. Furthermore, Schoeman et al (2000) examined the impact of fiscal policy on FDI in South Africa. They found that FDI flows are affected by fiscal discipline and tax burden on foreign investors. List and Co (2000) in their turn analyzed the relationship between FDI location and environmental regulation. Their study argued that environmental policies do matter. Cheng and Kwan (2000) tend to shed light on the determinants of the of FDI location in China. The study shows that the important determinants are regional market size, good infrastructure and preferential policy. The research indicated also that wage cost has a negative effect. Besides, Thompson and Poon (2000) analyzed the linkage between FDI and regulatory changes in Asian countries. The results of the study expressed a significant relationship between reform expectations and FDI flows. In addition to this, Sung and Lapan (2000) stressed on the relationship between FDI and exchange rate volatility. The study argued that with sufficient exchange rate volatility, firms can increase profits by opening several plants. Ihrig (2000) at another side seeks to examine the effect of repatriation restrictions on FDI. The researchers claimed that abolishing restrictions encourage FDI inflows. Additionally, Kosteletou and Liagrovas (2000) explored the relationship between FDI and real exchange rate. The findings of the research indicated that the causality runs from real exchange rate to FDI in large countries with floating exchange rates. In other cases, the bidirectional causality is existed. In the same context, Zhang (2000) tends to describe the size of US FDI in China. The study demonstrated that small size is a result of US investors' preference for market access, China export and bilateral relations are other driving factor of FDI into China. Donnefeld and Weber (2000) tend to explore the choice determinants between FDI and exports. The findings of the research show no simple relationship between the size of tariffs and the tendency to engage in FDI. Wei (2000) in his turn stresses on the effect of taxes and corruption on FDI. The

study concluded that tariffs and corruption have negative effects on the tendency to engage in FDI. In the same context, Marcelo Brag Nonnenberg and Mario Jorge Cardoso (2000) tried to determine the driving forces of FDI to developing countries. The findings of the research show that FDI is closely associated with the economic growth, the market size, the behavior of the stock market and the country risk. In addition to this, Yue Ma et al (2000) seek to present a model describing the determinants of foreign affiliates' investment of Japanese firms. The results indicated that the market demand, relative labour cost, capital cost and the exchange rate are the main driving forces of Japanese foreign affiliates. In the same sense, Additionally, Vladimir Benaceck et al (2000) analyzed the determinants and impacts of foreign direct investment in Central and Eastern Europe. They found that market size, growth potential and stability have strong and positive relationship with FDI. Besides, Moshirian (2001) tackled the issue of FDI determinants in banking. The study shows that the major determinants include bilateral trade banks, foreign assets, cost of capital, exchange rate and other variables. Moreover, Hwy-Chang Moon and Thomas W. Roehl (2001) tried to examine the impact of the firm's internal characteristics as a factor to catch up the FDI benefits. The researchers claimed that absolute and relative ownership advantages should to be adjusted and taken into consideration in FDI issues. In the same context, Marco Mutinelli and Lucia Piscitello (2001) tend to explore the determinants of foreign direct investment in banking sector. The findings of the study revealed that banking foreign investment depends on: ownership advantages, the clientele safeguard and the opportunity to access to positive externalities of financial centers. In addition to this, Douglas E. Thomas and Robert Grosse (2001) examined the country of origin determinants of FDI in Mexico. They concluded that the level of bilateral trade, home country GDP, political risk, geographic distance, and exchange rates are related to FDI into Mexico. Alan A. Bevan and Saul Estrin (2004) seek to explore the determinants of foreign investment in Transition economies. They show that FDI flows are significantly influenced by risk, unit labour cost, host market size, and gravity factors.

### **3. Conclusion**

This synthesis tries to explore the diverse channels through which foreign direct investment impacts the host and the home countries alike. It is time to claim that the impact issue is multidimensional in the sense that it delves deeply into other macro and microeconomics variables that conduct the business behavior in general. However, the positive influence is not ensured if the host country does not prepare itself well to absorb its beneficial spillovers. In this sense, if the country does not treat foreign investment rationally, the situation turns out to be

bad for the host country and concrete measures should be taken to absorb beneficially the positive spillovers of FDI.

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