

Attracting FDI

How Much Does Investment Climate Matter?

Business opportunities—as reflected in the size and growth potential of markets—are the most powerful drivers of foreign direct investment. But investment climate features such as strong institutions and investor-friendly regulations also matter and may even boost the development impact of the investment. Moreover, many elements of the investment climate can be reformed in the short run and at comparatively low cost. Improving the investment climate therefore offers an excellent opportunity for countries seeking to attract foreign direct investment.

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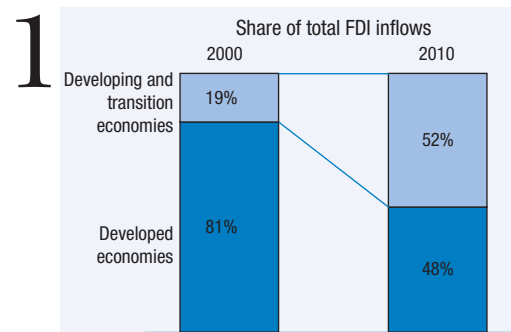
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There are promising trends in global foreign direct investment (FDI) flows for developing and transition economies. Each year more and more FDI is flowing not only from developed into developing economies but also from one developing or transition economy to another. Indeed, developing and transition economies' share of global FDI inflows rose from roughly 19 percent in 2000 to 52 percent in 2010—for the first time exceeding half the total (figure 1). And half the top 20 FDI recipients in 2010 were developing or transition economies.

This is good news, because FDI accounts for a whopping 11 percent of global GDP and more than 80 million jobs worldwide (UNCTAD 2010). Today there is greater potential than ever for developing and transition economies to take advantage of job creation and investment opportunities by attracting FDI. Global FDI inflows totaled US\$1.24 trillion in 2010 (UNCTAD 2011b). They are projected to reach US\$1.4–1.6 trillion in 2011 and

head toward US\$2.0 trillion in 2012 (UNCTAD 2011b). And senior executives of multinational corporations are becoming more optimistic about investment prospects for 2011–12, particularly about opportunities to invest in key developing and transition economies (UNCTAD 2011a).

Figure **More FDI is flowing into developing and transition economies than ever before**



Source: UNCTAD 2011b.



What drives decisions on where to invest?

Research has identified motivations driving companies to undertake different types of FDI (USAID 2005):

- *Natural-resource-seeking FDI*—to gain access to a natural resource not available in the company's home market.
- *Market-seeking FDI*—to gain access to new customers, clients, and export markets.
- *Efficiency-seeking FDI*—to reduce production costs by gaining access to new technologies or competitively priced inputs and labor.
- *Strategic-asset-seeking FDI*—to go after strategic assets in a local economy, such as brands, new technologies, or distribution channels.

However, these drivers do not highlight the importance of the quality of institutions and regulations in the host economy—that is, its investment climate. This factor may be of more importance to foreign companies investing in the services sector.

Studies suggest a diverse set of factors

In the past few decades hundreds of theoretical and empirical studies have attempted to pinpoint the main factors in investors' decisions on where to invest. Most empirical work has found that multiple factors are significantly associated with FDI inflows and that in some cases they interact. The determinants identified as significant vary depending on the countries, sectors, years, and types of investment studied. And many studies have been unable to overcome econometric identification challenges. Thus a definitive understanding of what drives investment decisions would require an understanding of the context for each FDI project.

These limitations do not mean that we cannot draw some basic conclusions from the empirical studies of FDI determinants. Looking at a set of 30 empirical studies that focus on developing and transition economies, and that have been conducted since 2000, reveals some interesting insights.¹ The studies vary in geographic coverage, with some focusing on transition economies in Eastern Europe and Asia, some on Africa or Latin America only, and some on single countries. Regardless of geographic focus, a majority of the studies find that the size and growth potential of markets are significantly associated with FDI inflows (figure 2).

More interestingly, institutional and regulatory quality (that is, the investment climate) and trade openness seem to matter. Many of the studies identify measures of these features as being significantly associated with FDI inflows. And surprisingly, none of the studies identifies availability of natural resources as significant. This may be because few of the studies focus explicitly on FDI in natural resources, however, or because there are few or no cross-country indicators that measure the availability of natural resources as a whole.

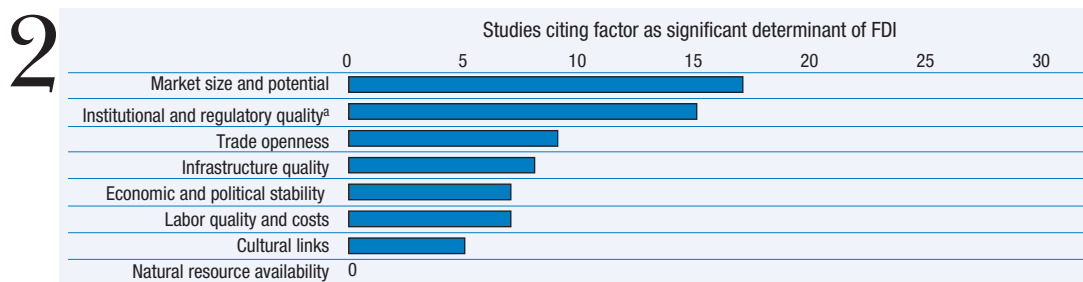
New data sources confirm findings

Analysis based on new data sources confirms the findings of the review of empirical studies.

Market size matters

There is no question that market size matters for attracting FDI. The world's largest economies attract the most FDI. Together, the world's 10 largest economies accounted for 47 percent of

Figure Empirical studies show that market size and potential are significantly associated with FDI inflows



Note: Many of the 30 studies identify multiple factors as significant. For a list of the studies, go to <http://iab.worldbank.org/data/references>.

a. Includes a wide range of indicators, such as Kaufmann governance indicators, Doing Business indicators, Investing Across Borders indicators, International Country Risk Guide (ICRG) indexes, World Business Environment Survey data, and the Freedom House Index of Economic Freedom.

Source: Authors' compilation.

all FDI inflows in 2010. The United States, the world's largest economy, remained the top FDI destination, receiving US\$228 billion. Following is China, the most populous, which received more than US\$106 billion (UNCTAD 2011b).

Market potential may matter more

For developing and transition economies, perhaps more important than market size is market growth potential. The economic growth expectations based on population and income growth prospects mean that many emerging economies offer foreign investors high potential returns on investment—and there has been an FDI boom in the world's leading emerging markets. FDI flows into Brazil, the Russian Federation, India, China, and South Africa—the “BRICS” economies—have grown by an average 28 percent a year over the past five years. These five economies accounted for 18 percent of the world's FDI inflows in 2010, with a combined US\$222 billion.

The market potential angle gives developing regions hope for future prosperity. This is especially so for Sub-Saharan Africa, given its high and relatively stable GDP growth in recent years. Research by the McKinsey Global Institute (2010) suggests that Africa has more high-return investment opportunities than any other developing region. A survey by Ernst & Young (2011) forecasts FDI inflows for Africa of US\$150 billion in 2015.

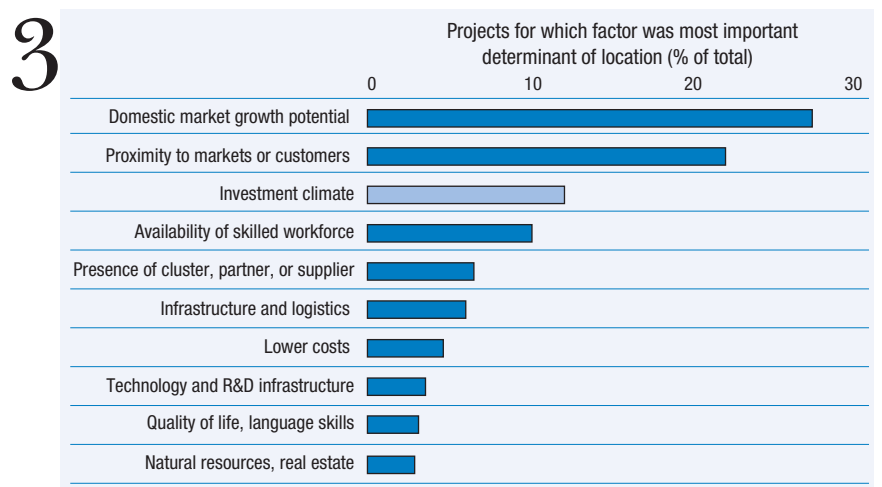
But investment climate matters too

With market size and potential held constant, what other factors seem to be important to foreign companies seeking to invest in developing and transition economies? Evidence suggests that the investment climate matters quite a bit. For nearly 30,000 FDI projects in the fDi Markets database for which a location determinant is identified, the investment climate (proxied by the dual factors of business regulations and government support) was the third most important investment motivation (cited in 12 percent of cases; figure 3).² And improvements in the investment climate across the developing world may have aided the boom in FDI in developing and transition economies. According to the World Bank Group (2010), in the past five years about 85 percent of economies made it easier to do business by reforming business regulation.

The investment climate clearly matters for the location decisions of foreign investors (Mukim and Nunnenkamp 2010). It is especially crucial in determining the effectiveness of other factors aimed at promoting inbound FDI, such as incentives. Although lowering effective tax rates can help boost FDI, the effect is eight times as strong for countries with a good investment climate (James 2009). Most important, the quality of the investment climate may better allow for the beneficial spillovers from FDI—providing the welfare gains through technology transfer to local suppliers that many economies seek (Blalock and Gertler 2008).

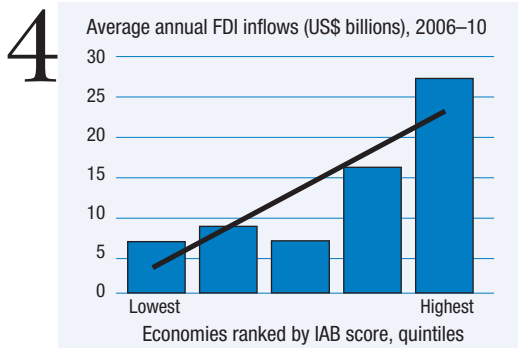
The World Bank Group's Investing Across Borders database, a new set of quantitative indicators comparing regulation of FDI around the world, allows further analysis of the importance of investment climate to FDI. Initial findings suggest that economies with poor regulations and inefficient processes for foreign companies receive fewer new FDI projects and smaller FDI inflows (figure 4). Analysis controlling for firm heterogeneity, country selection, market size, and quality of logistics infrastructure finds a statistically significant relationship between FDI regulations and the value of inward direct investment (Wagle 2010). While the correlation does not imply the existence or direction of a causal relationship (because omitted variables may better explain the relationship), it does suggest that investment climate is an important factor in foreign investors' decisions on where to invest.

Figure Market size and investment climate matter for the location of FDI



Note: Based on 28,814 new high-value-added FDI projects between January 2003 and July 2011 for which the determinant of location was identified.
Source: Financial Times, fDi Markets database.

Figure **A good investment climate for foreign companies is associated with more FDI**



Note: Correlation is significant at the 5 percent level. The Investing Across Borders (IAB) aggregate score is the average of the share of total possible points scored per topic.
Sources: UNCTAD, FDI Statistics database; World Bank Group, Investing Across Borders database.

Conclusion

Both a review of the empirical literature and analysis using new data sources suggest that business opportunities—as represented by, for example, the size and growth potential of markets—are by far the most powerful determinants of FDI. But investment climate features such as strong institutions and investor-friendly regulations also matter for developing and transition economies seeking to attract additional FDI. In a poor investment climate foreign investors and host economies may not be able to benefit fully from business opportunities created by market size and growth potential. An economy that has a poor investment climate is therefore likely to attract both less FDI and lower-quality FDI than it otherwise could.

Moreover, many factors that are clearly important in attracting FDI, such as market size and availability of natural resources, cannot easily be influenced by public policy. And other policy-level drivers of FDI—such as human capital, the quality of infrastructure, and economic and political stability—can be influenced only in the medium to long run. In contrast, many elements of a country's investment climate—such as the quality of its laws and regulations and the efficiency of its bureaucracy—can be affected in the short run and at a comparatively low cost to government, providing an excellent opportunity for near-term benefits.

Notes

1. For a list of the 30 studies, go to <http://iab.worldbank.org/data/references>.
2. FDI Markets is an online database tracking cross-border greenfield investment in all sectors and countries worldwide (<http://www.fdimarkets.com>).

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