A Comparative Analysis of Foreign Direct Investment and Firm Level Performance in Developing Economies

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Abstract

Although there are several studies that posit a positive and significant relationship between FDI and employment generation in host countries, Nigeria still battles with high rate of unemployment in spite of its high foreign direct inflows. This study therefore attempts to investigate if the high level of FDI plays any significant role in curbing unemployment in Nigeria. By employing an ARDL bound testing approach to Cointegration and the ECM-ARDL on time series data for a span of twenty years (1984-2013), the research work reveals that FDI and unemployment in Nigeria have no cointegrating relationship in the long run. Nevertheless, there is a unidirectional causal relationship running from FDI to unemployment. It is therefore pertinent to note that though FDI aids in curbing the problems of unemployment in Nigeria, it is usually for a short time and does not have any impact what so ever in the long term. As such further research has to be carried out to investigate why the impact of FDI on unemployment doesn't have a lasting impact.

Keywords: FDI, Unemployment, Nigeria

1. Introduction

Current incidences in economic globalization has measured FDI as one of the most secure elements of capital flow (Bénassy-Quéré et al 2007) and a major stimulant of economic performance through saving accumulation, foreign exchange enhancing competition, developing of local manpower and access to foreign markets (Akinlo,2004; Rodrik ,1998;Anyawu 2007; Dunning 2001; Borensztein et al, 1998; Dupasquier and Osakwe, 2003; Anyanwu, 2003).

There has also been an extensive appreciation of FDI as an important source of domestic growth and improved standard of living through technology transfer especially in developed economies (Görg and Strobl 2001), Evidence that technology transfer from Multinational Corporation (MNC) to domestic firms in transition and developing economies however remains inconclusive (Smarzynska, 2003; Koinings, 2000). The absorption capacity often described as technological gap between source and host country has been attributed to education, skills or capital intensity of the host country.In recent times though, institutional arrangements that govern economic activities of both foreign and domestic firms in the host countries has been recognized as a major determinant of absorption rate. Although researchers have tried to examine the relationship between these variables, (Globerman and Shapiro, 2003; Kaufmann, 1999; Driffel et al 2010) the effect institutions have on the benefits of FDI have not been fully examined particularly in transition economies and Sub-Saharan Africa economies.

Hence this research hopes to fill a gap in the literature by examining and making comparative analysis in three major areas; the role of institutions on location, ownership structure and efficiency gains of FDI projects in transition economies and economies in sub-Saharan Africa, by accounting for the whole network of the affiliates of each MNC from a source country over a period of 1998-2010.

There has been no comparison to the best of my knowledge of the economic performance of economies in transition and economies in sub-Saharan Africa. These economies according to the IMF (2000) are classified as developing economies and the recent waves of globalization coupled with the collapse of the eastern bloc in the 90's has seen increase in the flow of FDI to these economies. One significant difference though between the two set of economies is the ascension of the Central and Eastern Europe states into the EU. This criterion is particularly important as institutional quality is a precondition for entry into the EU. The dimensions of institutional quality include protection of property rights, lack of administrative corruption and overall effectiveness of business regulation and financial regulation.

In the light of the foregoing, the following questions are posed:

Research Questions

•What effect does national governance structure have on firm level FDI in developing economies?

• To what extent does the national governance structure determine the mode of FDI in developing economies?

- Do the governance structures in transition economies differ from that of economies in sub-Saharan Africa? If they do how do these differences affect firm level FDI in these economies.

•Do weak governance structures have any effect on the size of the parent company holdings in foreign subsidiaries.

Research Objectives

The main objective of this study is to integrate firm level data and national level data with an outlook to compare and contrast the pattern and effects of FDI in transition economies and sub-Saharan Africa which are characterized by different institutional structures and practices. Other objectives includes with:

1.To ascertain the significance of national governance structure on the firm level FDI in developing economies

2.To determine the extent to which national governance structures determine the mode of operation of FDI.

3. To determine whether governance structures have any impact on the size of parent company holdings in foreign subsidiaries.

4. To examine the national governance structures of FDI in transition economies and economies in sub-Saharan Africa.

Scope of the Study

The study hopes to cover a sample period 1998 -2010 for 16 countries in sub-Saharan Africa (particularly West Africa) and 20 countries in central and Eastern Europe (CEEC) .This research follows the group classification as defined by the IMF and the choice of sample period is based on the availability of data and the comparative nature of research.

Significance of the Study

This study will be significant for the following reasons:

1. Available literature in this regard, rely on mostly macro level analysis that does not permit for firm or industry level effects, or differences in the way that firms seek to enter foreign markets. Since this research is based on firm level data, this gap hopes to be filled.

2. Existing literature also usually focuses on small scope of firms in one country, this research aims to carry out a comparative analysis of the way firms enter countries in transition and West African countries based on the level of national governance structure.

3. The research aims to include all sectors of the economy as most existing literature on FDI center mainly on the manufacturing sector.

4. More so, the scope of this research covers the recent economic meltdowns which have not been taking into consideration by past studies.

Limitations of the Study

The major aim of this research is to compare the impact the institutional quality has on firms' decisions to enter foreign markets. Since this research hopes to integrate qualitative analysis at macro level and qualitative analysis at micro level, making comparisons between findings a bit problematic. More so, getting access to qualitative data may stand as a challenge.

2. Literature Review

Several theories exist in an attempt to rationalize the decisions for MNC to invest in a foreign market, but Dunning (1988, 1993) is notable for his exposition on the criteria that determines investment in foreign markets as well as the motives for such investments. Explaining that a firms decision to invest abroad is based on one or all of these major motives; resources; market size, efficiency and strategy of the host country.

Considerable amount of empirical literature also exist elucidating that economies with poor institutions impede FDI. These studies are usually concentrated on low income or developing economies and the data employed are at times very spurious (Kim, 2010). Another strand of literature which focuses on FDI inflow explores the mode of entry of foreign firms into host countries particularly distinguishing between joint ventures and sole proprietorship.

But this strand of literature totally ignores the role of institutions in context. Similarly, firm level data have been used to study FDI flows in a number of contexts, but much of this is limited to case study analysis of issues such as mode of entry, or in the vast literature on the impacts of FDI in

developed countries. The major problem with these studies is that most of these studies employ macro level data and the results produced are inconclusive. For instance, Hakro and Omezzini(2011) explored the impact governance infrastructure has on FDI flows in Middle east and North African countries. They employed governance indices developed by Kauffman et al(2005)for a period of 10 years. The results presented reveal that governance in the region does really matter concluding that even if regulatory qualities of the institutions are high and the governance of the region are improved, the government of the region still require policies and institutions to promote or create conditions which can attract tangible FDI. The major shortfall in this study is the failure to account for special traits in the firm's decision to invest in the region. Also, Meyer (1998) and Brenton et al. (1999)have used several firm level variables such as, the form of privatization, capital market development and the legal framework; and country level variable such as country risk factor and corruption index to analyze the institutional characteristics of transitional economies.

Similarly, a study carried out by Globerman &Shapiro(2002)on the determinants of both inward and outward FDI for twenty emerging and transition economies in Europe (ETEE) over the period 1995-2001 with particular reference to measures of governance and institutional change including privatization reveal that political integration into developed Europe provides longer-term assurances to foreign investors that institutional changes undertaken by transition economies will not be reversed. Bevan & Estrin (2000), in examining the determinants of FDI in transitional economies between 1994 and 1998,whilst controlling for political risk and the influence of the prospects of becoming an EU member by the host country, find that foreign direct investments are determined by unit labor cost, host economy market size and EU membership prospects. Their findings are in consonance with Janicki and Wunnava (2004); Globberman &Shappiro (2004).The shortfalls with these research is their concentration on FDI flows primarily and the use mainly country-level data-sets, hence there is no direct explanation of how firms are motivated to engage in FDI in a given location.

There are limited papers that investigate institutional quality and firms traits. One of the first studies includes Hines (1995) who examined corruption and foreign direct investment of a sample of U.S. Multinational corporations. The report provided showed a negative effect of corruption on foreign investment the problem here is that, the U.S. firms employed may not be a good representation of foreign firms' worldwide.

With particular reference to sub-Saharan Africa, Asiedu (2002) compared the determinants of FDI in sub-Saharan Africa to other developing economies in the world. The results provided showed that while the return on investment within the region is high, the risky business environment and poor infrastructural facilities neutralizes the effect of FDI within the region, In spite of the substantial deposit of world natural resources. `

In addition, Dupasquier and Osakwe (2005) in assessing the performance, promotion and prospects of FDI in Africa, explain that developing economies are largely characterized by political and macroeconomic instability, stumpy growth, fragile infrastructure, poor governance, inhospitable regulatory environments, and ill conceived investment promotion strategies. As such, these economies find it difficult to attract FDI to the region and suggest the need to improve corporate governance at the macro level.

The problem with these studies is that they failed to address issues relating to the effect governance institutions had on the entry of foreign firms to the host country, the impact institutional quality had on the ownership structure.

This study therefore hopes to address these shortfalls by developing three main themes which include:

1: The effect governance institutions have on entry and location of foreign firms. These effects could be complex and would depend on the interaction between quality of institutions in the investor's country of origin and host country as Foreign ownership may enable firms to import some aspects of good corporate governance into a country that does not have it which may result in a lower cost of capital (Denis and Huizinga (2004); Filatotchev et al. (2007). This could lead to a rather high foreign ownership share in countries with low quality institutions or Foreign investors may decide to invest in a country with a poor institutional environment in order to exploit this to their own advantage and to escape the tighter corporate governance constraints of the home country.

2. Effects of institutions on ownership structure
It is also important to understand the ownership structure of FDI projects because the latter affects the incentives of the investors to apply their resources to the project.

3. Effects of FDI on efficiency: this is based on the premise that foreign firms are more efficient in the use of capital and labor. Although, little evidence exist as to how the efficiency of foreign firms in host countries could be linked to the quality of institutions, or ownership structure or to factors like market size or natural endowments.

Hence the aim of this theme is to examine the interaction between ownership and institutional quality.

3. Empirical Research Methods

Data Sources

The major sources of data for this research work would be the Amadeus database, which houses firm level data for over 52,000 firms from all sectors of the economy across European countries and this database permits us to identify assets ownership. With these data it is possible to also classify firms that have invested in for example developing countries, as well as the ability to identify capital structures of the parent firm. The data source will also compliment data from Osiris database for the remaining part of the world.

This research will also collect data from ICRG's database which provides data on world business-oriented risk model and a breakdown of the risk of investing time and money in each country; it also provides data for government stability, Socioeconomic Conditions; Investment conditions, Internal and External Conflict; Corruption; level of Bureaucracy, Religious/ethnic Tensions; Law and Order. The level of trade openness and corruption level for each country will be derived from World Bank database and transparency International corruption perception index respectively. Finally for institutional quality indices the research will rely on the World Governance Indicators (WGI) by Kaufmann et al, 2006.

Initial investigation will be to collect data of parent companies who have invested in central and Eastern Europe and sub-Saharan Africa from 1998- 2010 set them up in a panel.

Methodology

This research will make use of panel data to answer the questions posed. This will permit the study to account for variation in the behaviors of firms in different countries and also over time an approach to the first research theme is to adopt a two step model developed by Pal (2007) and augmented by Driffield et al (2008; 2010).this is because entry and location of foreign firms operating in a host country at a point depends on either of two things whether to invest at home or abroad and how to chose a location to invest. The two step model to be employed will be a bivariate probit model of FDI location choice with a decision on whether to invest abroad. The decision to invest abroad will depend on the firm's profitability, share of intangibles, corporate and financial link of the foreign firm with the host country and some country- level attributes like physical distance and the diplomatic relationship with the host country, language spoken, infrastructural facilities, labor market flexibility, labor market regulations and other institutions in the host country.

The second research theme will focus on determining foreign ownership structure. An ownership variable will be constructed to identify the fraction of equity held by foreign subsidiaries operating in a host country at a given time. Then analysis will be carried out using panel data.here, the study will control for simultaneity bias and heterogeity. Ownership structure of a given MNE across countries and over time could be a reflection of institutional environment (corruption, minority protection, investor's rights, judicial independence) in both host and investor's country of origin, investment need of the particular sector (utility, infrastructure or industrial), among other firm-specific factors (e.g., efficiency, share of intangible) in the source country. Analysis will make use of panel data regression models, after controlling for simultaneity bias (arising, e.g., from the inclusion of efficiency) and unobserved firm and country-level heterogeneity (e.g., see Makepeace and Pal, 2007).

Finally to analyze the firm's efficiency advantage the study will employ profitability and productivity as a proxy for efficiency .the paper will also control for ownership structure and institutional quality.

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