

# Determinant of Foreign Direct Investment and Its Effect on Economics Growth: Evidence from Nigeria

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## Abstract

The Paper focus on the determinant of FDI in Nigeria, it covered the period of 1980-2013, using OLS to determine the effect of independent variable on the dependent variable, the variables are integrated of order one I(1). Per capita, economic growth, education and trade openness has positive impact in attracting FDI, significant and has expected signs, wage rate is significant but not consistent with priori expectation, infrastructure has negative effect on FDI and significant and depreciation of Naira also has negative effect on FDI, has expected sign and significant. The independent variables has 86 percent ( $R^2$ ) 86 percent explanatory power on dependent variable, the residual is stable and white noise, the model is stable, no functional form misspecification, no serial correlation (autocorrelation) in the regression, the residual is homogenous and normally distributed. We proffered the following recommendation; (1) Government should try to improved or speed up the economic growth rate as it has positive in attracting FDI into the economic (2) Policy to encourage flow of FDI in other sectors of the economy other than resource sector should put in place (3) Infrastructure facilities should be put in place to promote business and reduce the cause of doing business in the country (4) Exchange rate policy that aims at stabilizing the value of the Naira will improve the FDI inflow into the economy (5) Government should continue to increase on the education of the populace and improve the quality of the education in the economy.

**Keywords:** FDI Determinant, Effect on Economic Growth, evidence Nigeria.

**JEL CLASSIFICATION CODE: F210**

## 1. Introduction

Nigeria is a capital deficient country, hence the need for foreign direct investment (hereinafter refers to as FDI) cannot be overemphasized owing to the important role of capital in economic take off of any nation, it is on this backdrop that government is leading a drive on FDI inflow into the country worldwide by visiting and organizing FDI sensitization in many countries to increase FDI inflow into the economy. The determinant of FDI has attract huge attention in recent passed, however, there is no consensus as to the variable that are to be including when access this phenomenon, this is a result of theoretical postulation and evidence from the empirics analysis presenting contradictory outcomes.

Foreign direct investment inflows have been growing enormously over the course of the last decade, from USD 1.14 billion in 2001 to USD2.1 billion in 2004. Nigeria FDI reached USD 11 billion in 2009, according to UNCTAD making the country the nineteenth greatest recipient of FDI in the world and it went down substantially due to the global economic meltdown and at present FDI inflow in 2013 stood at USD 5.6 billion.

Despite this effort FDI remain small in comparison to other developing economies of the World. FDI serves as an important engine for growth in developing countries through two modes of action: (i) expanding capital stocks in host countries and (ii) bringing employment, managerial skills, and Technology.

The Nigerian Government adopts several policies to attract FDI in this globalized era. Particularly, in 1995, the Nigerian Investment Promotion Commission Act laid out the framework for Nigeria's investment policy. Under the Act, 100 percent foreign ownership is allowed in all industries except for oil and gas, where investment is constrained to existing joint ventures or new production-sharing agreements. Investment from both Nigerian and foreign investors is prohibited in a few industries crucial to national security: the production of arms and ammunition, and military uniforms. Investors can repatriate 100 percent of profits and dividends. The government implemented IMF monitored liberalization of its economy, welcomes foreign investors in the manufacturing sector, offers incentives for ownership of equity in all industries except key industries like military equipment. The incentives like tax relief are available to investors and concessions for local raw material development. In line with its economic reforms, starting from the 1980s, Nigeria undertook a far reaching privatization program. This change starts in 1989 and onwards due to several policies like introduction of Structural Adjustment Program in 1986, Export Processing Zones Decree in 1997. FDI inflow was low in pre-1990's but post 1990's it remarkably changes especially in the 21st century. FDI inflows to Africa in 2013, it ranked Nigeria third behind Mozambique and South Africa in terms of FDI inflows to Africa last year, Nigeria slumped from its number one position in 2012 to achieve \$5.61billion in FDI inflows last year (Eromosele, 2014).

The paper has five sections. Section two reviews the empirical literature on determinant of foreign

direct investment, section three is devoted to the empirical methodology employed and the description of the data used, section four discusses the results obtained from the empirical analysis, section five concludes the paper by summarizing the main findings of the paper and policy recommendations.

## 2. Literature Review

Obadan (1982) supports the market size hypothesis confirming the role of protectionist policies (tariff barriers). The study suggests taking the cognizance factors such as market size, growth and tariff policy when dealing with policy issues relating to foreign investment to the country. Anyanwu (1998) study of the economic determinants of FDI in Nigeria also confirmed the positive role of domestic market size in determining FDI inflow into the country. This study noted that the abrogation of the indigenization policy in 1995 significantly encouraged the flow of FDI into the country and that more effort is required in raising the nation's economic growth so as to attract more FDI. Dinda (2009) used co-integration technique to find out the long run relationship between FDI and resource flow time and also used Vector Error Correction model with or without exogenous factor to find the long run relation of the variables. While investigating on the factors attracting FDI into Nigeria between 1970 to 2006 found that the market size proxies by the GDP was not significant during this period despite its important as part of the major determinants of FDI inflow in all countries. It was also discovered that the bulk of FDI inflow into a country were mostly resource seeking FDI, while natural resources, inflation and exchange rate were significant. Iyoha (2001) examined the effects of macroeconomic instability and uncertainty, economic size and external debt on foreign private investment inflows. He shows that market size attracts FDI to Nigeria whereas inflation discourages it. The study confirms that unsuitable macroeconomic policy acts to discourage foreign investment inflows into the country.

Anyanwu (1998) and Iyoha (2001) have studied on the determinants of FDI in Nigeria. Major limitations of these studies are the traditional econometric technique and non-consideration of natural resource in determination of FDI inflow. Using time series econometric technique on annual data of Nigeria, this study examines the effect of the country's natural resource export, along with openness, market size and macroeconomic risk variables like inflation and foreign exchange rate on FDI inflow during 1970-2006. Omowumi and Abel (2014) find a long run relationship amongst the Foreign Direct Investment variables. It also shows that Foreign Direct Investment into Nigeria has been relatively low and not encouraging given the high Inflation rate, Lack of Openness and Poor Economic Growth caused by Frequent Political Instability Factors, Insecurity, Poor Infrastructure, Internal Conflict and Corruption. Nwankwo (2006) made use of data between 1962–2003 to identify the main determinant of FDI in Nigeria and discovered that a strong market, macroeconomic stability and natural resources promote FDI in Nigeria while political instability and the transition to democratic regime has a negative effect. Olumuyiwa (2003) state that they results confirm the controversy in the literature about the extent and direction of effects of volatility. It also found that parallel market exchange rate is an important driver of real economic process in Nigeria. Gordon (2001) using a simple theoretical model, show that subsidies to FDI are likely to be warranted where multinationals are intensive in the use of elastically-supplied factors, the arrival of multinationals to a market does not lower the market share of domestic firms, *and* FDI generates strong positive productivity spillovers for domestic agents.

Adegbemi (2012) Find that FDI has a significant effect on output of the economy but that the growth effects of FDI differ across sector. Nurudeen and Abu (2010) made use of OLS and ECM techniques to empirically analyze the determinant of FDI as to which of the determinant are most important and the effect of deregulation on FDI in Nigeria. The study laid emphasis on deregulation as part of the factors that encourages or discourages the inflow of FDI. However the results illustrate that openness of the economy and inflation are statistically insignificant but positively related to FDI. Similarly, the results show that infrastructural facilities have an insignificant effect on FDI in Nigeria. Eregba (2011) discovered that FDI inflow substitute domestic investment between 1970-2008 in the ECOWAS region as export, import and openness contributed positively and negatively respectively to domestic investment. In a paper published by the Overseas Development Institutes (1997) in low income countries, it was indicated that shortages of financial resources, technology and skills as the main obstacle to the flow of FDI in low income countries between 1970-1996. Ayanwale (2007) used an augmented growth model through the OLS and 2SLS method to empirically investigate the relationship between non extractive FDI and economic growth in Nigeria. Results suggest that the determinants of FDI in Nigeria are market size, infrastructure development and stable macroeconomic policy while openness to trade and available human capital are not inducing. It was found also that FDI in Nigeria contributes to economic growth, though all the overall effects are not significant. Ekpo (1997) on the other hand examined the relationship between FDI and some macro-economic variables between 1970-1994 and concluded that the political regime, real income per capital, rate of inflation, world interest rate, credit rating and debt services accounted for variance of FDI inflow to Nigeria, Udoh and Egwaikhide (2008) through their estimation result (GARCH) indicated that exchange rate volatility, inflation, uncertainty exerted significant negative effect on FDI in Nigeria between 1970–2005 and

concluded that infrastructural development, appropriate size of the government sector and international competition are crucial determinants of FDI inflow to the country.

Pan-Long (1994) using a simultaneous equation model, the study explicitly takes the simultaneity problem into consideration. It is shown that domestic market size and trade balance are two key determinants of FDI, though economic growth and labor cost are also important. While there are geographical differences in the impact of FDI on economic growth, in general neither modernization arguments nor dependency assertions are supported by the empirical findings.

Dunning's (1988) 'eclectic theory' provides a flexible and popular framework where it is argued that Foreign Direct Investment (FDI) is determined by three sets of advantages which direct investment should have over the other institutional mechanisms available for a firm in satisfying the needs of its customers at home and abroad. The first of the advantages is the ownership specific one which includes the advantage that the firm has over its rivals in terms of its brand name, patent or knowledge of technology and marketing. This allows firms to compete with the other firms in the markets it serves regardless of the disadvantages of being foreign. The second is the internationalization advantage that is why a 'bundled' FDI approach is preferred to 'unbundled' product licensing, capital lending or technical assistance (Wheeler and Mody, 1992).

Dar, Presley and Malik (2004) studied the causality and long-term relationship between Foreign Direct Investment (FDI), economic growth and other socio-political determinants. Although a considerable literature gives the evidence of relationship between FDI and economic growth. Their paper considers economic growth, exchange rate and level of interest rates, unemployment, and political stability as determinants of the level of FDI inflows for Pakistan over the period 1970-2002. Almost all variables are found to have the theoretically expected signs with two-way causality relationship. The present study also estimates an error correction model by ordinary least squares, based on cointegrating VAR. Nunnenen (2002) argues that there is a startling gap between, allegedly, globalization-induced changes in international competition for foreign direct investment (FDI) and recent empirical evidence on the relative importance of determinants of FDI in developing countries. He shows that surprisingly little has changed since the late 1980s. Traditional market-related determinants are still dominant factors. Among non-traditional FDI determinants, only the availability of local skills has clearly gained importance, as concerns the interface between trade policy and FDI, he finds that the tariff jumping motive for FDI had lost much of its relevance well before globalization became a hotly debated issue.

### 3. Methodological Framework

An analysis of FDI determinants starting from a simple partial adjustment process as used by Singh and Jun (1995) for studying FDI determinants in developing countries and Campos and Kinoshita (2003). The specifications for the model are given below. Following the steps of Khan and Bamou (2006) we state as follows:

#### 3.1 Model Specification

FDI flows are likely to require time to adjust to the specific constraints faced by multinational companies. The FDI adjustment process can be stated as follows:

$$FDI_t - FDI_{t-1} = A(FDI_t^d - FDI_{t-1}) \dots\dots\dots(1)$$

where  $FDI_t^d$  is the level of desired FDI at time  $t$ .

The equation shows that change in actual FDI will respond only partially to the difference between desired FDI and past values of FDI. In any given period a desired level of FDI may not be completely realized (as actual FDI in the next period) because of physical and procedural constraints faced by MNCs. The parameter  $A$  captures the speed of adjustment to a desired FDI level. Further transformation of Equation 1 gives;

$$FDI_t = AFDI_t^d + (1-A)FDI_{t-1} \dots\dots\dots(2)$$

The desired level of FDI is based on a number of host country factors denoted here as  $H$ , and a random error term  $e_t$ . The  $H$  factors are those that influence the decision of foreign investors invest in Nigeria. The desired FDI is presented as follows:

$$FDI_t^d = \alpha_0 + \alpha_1 H_t + e_t \dots\dots\dots(3)$$

When we substitute  $FDI_t^d$  from Equation 3 into 2, we obtain:

$$FDI_t = \beta_0 + \beta_1 H_t + \beta_2 FDI_{t-1} + z_t \dots\dots\dots(4)$$

where  $\beta_0 = A\alpha_0$ ,  $\beta_1 = A\alpha_1$ ,  $\beta_2 = (1-A)$ , and  $z_t = Ae_t$

The host country ( $H$ ) factors to be included as FDI determinants in Nigerian include: inflation, exchange rate, market size, economic growth, openness of the economy, the level of education, political risk, infrastructure, wage rate, external debt.

Our basic FDI model will be constituted by three variables that have been found to regularly influence FDI in previous studies: market size, openness of the economy and infrastructure development. The specified FDI model with the variables to be tested is given as:

$$FDI_t = \beta_0 + \beta_1 GDP_t + \beta_2 OPEN_t + \beta_3 EXCH_t + \beta_4 GR_t + \beta_5 EDU_t + \beta_6 INFRAS_t + \beta_7 INF_t + \beta_8 POL_t + \beta_9 FTZ_t +$$



that are expected to grow faster will tend to attract higher levels of inward FDI. We therefore hypothesize a positive relationship between inward FDI and economic growth in Nigeria.

#### **Infrastructure**

The infrastructure development of a region is also important, since it indicates how difficult and costly it may be to do business in the country. The more developed the road system in a country, for example, the easier the access to markets and the lower the transportation costs, and, thus, the greater the incentive to invest in that country. The multidimensional nature of infrastructure makes it difficult to measure, however. It comprises roads, telecommunications, railways and so on. It is difficult to capture the many aspects of infrastructure development, and the data available are limited. We choose to use in our models Gross fixed capital investment as defined by World Bank as the measurements of infrastructure. We expect a positive coefficient.

#### **Human Capital**

In their decision whether or not to invest (and how much to invest), foreign investors are also influenced by both the costs and the quality of the labor to be found in the host country. Countries where wages are higher, or where the labor force is less skilled, should find it more difficult to compete with other countries in attracting foreign investment. A more educated labor force can learn and adopt new technology faster, and the cost of training local workers would be less for investing firms. We measure the quality of labor using the share of the population enrolled in secondary education (*EDU*). While labor quality is expected to positively influence FDI flows, higher labor cost is expected to have a negative effect.

#### **Macroeconomic Stability**

One indicator of a stable macroeconomic environment is a record of price stability. A history of low inflation and prudent fiscal activity signals to investors about the commitment and credibility of the government. We measure macro-stability as the change in the CPI, and expect a negative effect on FDI flows.

#### **Political Stability**

The importance of political stability in creating a climate of confidence for investors must not be underestimated. Whether perceived or real, political instability constitutes a serious deterrent to FDI as it creates uncertainties and increases risks and hence costs of doing business in the country. We use a combination of the two indexes of political freedom (political rights and civil liberties) as compiled by Freedom House to assess the effect of political risk on FDI.

Freedom House combines these two indexes to classify countries into three categories: free, partially free and not free. Higher values for this index imply less political freedom. We find average of the two indexes to obtain a composite index of political risk in Nigeria. We expect that a higher political risk will deter foreign investors.

#### **External Debt**

Given Nigeria huge external debt, investors perceive that future taxes may have to be increased so as to finance large external transfers to service the debt (problem of debt overhang). The size of the debt burden is expected to have a negative effect on FDI flows.



#### 4. DATA PRESENTATION AND ANALYSIS

**Table 4.1 Unit Root Test Result**

VARIABLES	ADF	CRITICAL VALUE	RESULT
LFDI	-3.355765 ( 0.0774)	-3.574244	<i>I(1)</i>
LCPI	-3.358699 (0.0751)	-3.557759	<i>I(1)</i>
GDP	-4.371858 ( 0.0015)	-2.954021	<i>I(0)</i>
LEXCH	-1.852283 ( 0.6561)	-3.552973	<i>I(1)</i>
LEXTDEB	-2.374807 ( 0.3848)	-3.557759	<i>I(1)</i>
LPOL	-0.929309 (0.3067)	-1.951332	<i>I(1)</i>
LINFRAS	-2.964907 ( 0.1581)	-3.568379	<i>I(1)</i>
LPCGDP	2.068296 ( 1.0000)	-3.568379	<i>I(1)</i>
LEDU	-2.307139 ( 0.4187)	-3.552973	<i>I(1)</i>
LOPEN	-2.493951 ( 0.3279)	-3.603202	<i>I(1)</i>

**Note:** Figures within parenthesis indicate Mackinnon (1996) one-sided p-value. 5% critical value for rejection of hypothesis of unit root applied.

**Source:** Author's estimation.

Table 4.1 Shows that all the variables has unit root at level except GDP, this can be seen by comparing the computed values (in absolute terms) of the ADF test statistics with the critical values (also in absolute terms) at 5% level of significance. Result from table 4.1, provides strong evidence of unit root in the variables. Therefore, the null hypothesis is can't be rejected and we can safely say the variable are integrated of order one *I(1)* with the exception of GDP which is *I(0)*, it is sufficient to conclude that there is a presence of unit root in the variables at levels.

**Table 4.1.1 Unit Root Test Result**

FIRST DIFERENCE			
VARIABLES	ADF	CRITICAL VALUE	RESULT
LFDI	-2.091579 ( 0.0371)	-1.953381	<i>I(0)</i>
LCPI	-5.775736 (0.0000)	-1.952066	<i>I(0)</i>
LEXCH	-3.943140 ( 0.0003)	-1.951687	<i>I(0)</i>
LEXTDEB	-4.178746 ( 0.0001)	-1.952066	<i>I(0)</i>
LPOL	-7.540738 ( 0.0000)	-1.951687	<i>I(0)</i>
GDP	-5.775736 (0.0000)	-1.952066	<i>I(0)</i>
LINFRAS	-2.835171 (0.0062)	-1.952473	<i>I(0)</i>
LPCGDP	-8.308886 ( 0.0000)	-3.557759	<i>I(0)</i>
LEDU	-5.842972 ( 0.0000)	-1.951687	<i>I(0)</i>
LOPEN	-4.384155 (0.0001)	-1.952473	<i>I(0)</i>

**Note:** Figures within parenthesis indicate Mackinnon (1996) one-sided p-value. 5% critical value for rejection of hypothesis of unit root applied.

**Source:** Author's estimation.

Table 4.2 shows unit root test result, all the variables were differenced once, the ADF reveals that all the variables became stationary at first difference, this can be seen by comparing the test statistics and the critical value as presented in 4.2 where the test statistics is greater than the critical value at 5% significance. Hence, the null hypothesis of unit root at first difference is rejected and we can safely conclude that the variables became stationary after first difference. This implies that the variables are integrated of order one, that is I (1).

Estimate of equation 5.

$$\begin{aligned} \text{LFDI} = & 14.08 + 0.33\text{LPCGDP} + 0.0027\text{GDP} + 1.61\text{LEDU} + 0.23\text{LCPI} + 1.23\text{LOPEN} - 0.41\text{LINFRAS} \\ & (1.75) \quad (1.28) \quad (0.26) \quad (2.7) \quad (2.80) \quad (1.79) \quad (1.08) \\ & - 0.20\text{LEXTDEB} - 0.40\text{LEXCH} \\ & (1.05) \quad (2.49) \\ R^2 = & 0.86, \quad \text{Adj. } R^2 = 0.82, \quad \text{D.W. } 2.10, \quad n=34 \end{aligned}$$

The result of equation 5 show that a one percent in per capita income FDI inflow will growth by 0.33 percent and significant in attracting FDI into Nigeria economy it is consistent with our a priori expectation, a one percent rise in the growth of rate of the economic will lead to 0.003 percent increase in FDI inflow though is consistent with our a priori expectation but it not significant but Wald test reject the redundancy of the variable in the model and hence the need to include it, a one percent increase in secondary educational attainment will increase FDI inflow by 1.6 percent and significant in attracting FDI to the economy consistent with our priori expectation, one percent increase in wage rate will lead to an increase of 0.23 percent in FDI inflow, significant in attracting FDI into the economy but not consistent with priori expectation and really puzzling as literature always point to negative relationship between FDI and wage rate, however, the assumption is that wage increase with rise in CPI but in reality in Nigeria wages are very sticky, not as flexible as the theory envisage, a one percent increase in trade openness will increase FDI by 1.23 percent into the economy, significant in attracting FDI in the economy and consistent with our a priori expectation, a one percent increase in infrastructure will lead to decrease in FDI by 0.41 percent into the economy is significant but is not consistent with our a priori expectation and also opposite of the theory this may not be unconnected with believe that most FDI are resource seeking FDI and in most case infrastructure are not one of the consideration, an increase of one percent in the external debt will lead to decrease of 0.20 percent in FDI inflow, significant in affecting FDI inflow into the economy and consistent with our a priori expectation and a one percent depreciation of Naira will lead to 0.41 percent decrease in FDI inflow, significant in affecting FDI and also consistent with our a priori expectation. The initial estimation includes other variables and the stock of FDI but are all not significant and the Wald test on these variable proved that they are indeed in relevant in the Model, hence they were removed from our analysis. The independent variables explained the dependent variable by 86 percent ( $R^2$ ) and the adj.  $R^2$  is 82 percent, because the regression was done with variable at level but the variable were not stationary so we run the unit root test on the residual and the result of the unit root test ADF is 6.079 p-value (0.000) implies that the variable are co-integration hence the regression is not spurious, the regression is stable as CUSUM test fall within the upper and lower band of the graph, no formational form Misspecification as Ramsey reset test 1.237 p-value (0.277) implying correct functional form, the LM test for serial correlation is 3.862 p-value (0.145) it implies that there is no serial correlation (autocorrelation) in the residual, B-P test for homoskedasticity is 7.439 p-value (0.590) ARCH heteroskedasticity test is 0.103 p-value (0.9503) means both the normal and squares residual are homoskedastic and the normality test shows the residual is normally distributed with p-value (0.794).

## 5. CONCLUSION AND RECOMMENDATION

The Paper focus on the determinant of FDI in Nigeria, it covered the period of 1980-2013, using OLS to determine the effect of independent variable on the dependent variable, the unit root result shows the variables are integrated of order one I(1).

Per capita income has a positive impact on FDI inflow and significant in attracting FDI into Nigeria economy it is consistent with our a priori expectation, growth rate of the economic has a positive impact on FDI inflow it has the expect sign but not significant, education has positive effect on FDI inflow, is significant and has expected sign, wage rate has a positive effect on FDI inflow, significant in attracting FDI into the economy but not consistent with priori expectation and really puzzling as literature always point negative relationship between FDI and wage rate, however, the assumption is that wage will increase with rise in CPI but the reality in Nigeria is that wages are very sticky and most of the FDI flows to resource sector which is unresponsive to wage rate, trade openness has positive impact in attracting FDI, it's significant and consistent with our a priori expectation, infrastructure negatively impact on FDI inflow, is significant but is not consistent with our a priori expectation this is also a paradox of the theory of FDI and depreciation of Naira has negative effect it's has the expected sign and significant in attracting FDI into the economy. The independent variables explained the dependent variable by 86 percent ( $R^2$ ), the residual is white noise, the regression is stable, no serial correlation in the estimate and the residual is normally distributed.

## 5.1 RECOMMENDATIONS

1. Government should try to improve or speed up the economic growth rate as it has positive impact in attracting FDI into the economy.
2. Policy to encourage flow of FDI in other sectors of the economy, other than resource sector should put in place.
3. Infrastructure facilities should be put in place to promote business and reduce the cause of doing business in the economy.
4. Exchange rate policy that aims at stabilizing the value of the Naira should be put in place as this will improve the FDI inflow into the economy
5. Government should continue to increase on the education of the populace and improve the quality of the education in the economy.

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