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Econometric Evaluation on the Impact of Foreign Direct Investment on the Economic Growth of Nigeria

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Abstract

It has been established that economies in the world are driven by policies. The government, been the centre of policy formulation is therefore saddled with the responsibility of formulating policies that will produce positive impact on the economy. The foreign investment of a nation, been one of the government's key responsibility has thus been recognized as a major driving force of the economy particularly in the area of globalization. It therefore becomes imperative that the government formulate suitable policies to attract foreign investment. The findings from this study will be useful in this direction. There is an emerging consensus that a conducive macroeconomic policy environment is not only a desideration but is in fact a sine qua non for attracting substantial amounts of foreign investment inflow in a liberalizing and globalizing world economy. Nigeria needs a massive inflow of foreign investment in order to transform its economy, upgrade dilapidated infrastructure and plug on to the electronic age of computers and the Internet. An absolute prerequisite for success is the design and implementation of policies and measures that would make the policy environment investment friendly. In creating a friendly environment of foreign investors, the public sector has a major role to play via its expenditure power. Economic theory suggests that capital will move from countries where it is abundant to countries where it is scarce. This pattern of movement will be informed by the returns on new investment opportunities, which are considered higher where capital is limited. The resultant capital relocation will boost investment in the recipient country and, as summers (2000) suggests, bring enormous social benefits. Underlying this theory is the premise that returns to capital decrease as more machinery is installed and new structures are built, although, in practice, this is not always, or even generally true.

Keywords: Foreign Private Investment, Economic Growth and Public Sector

1. Introduction

Growth in neoclassical theory is brought about by increases in the quantity of factors of production and in the efficiency of their allocation. In a simple world of two factors, labour and capital, it is often presumed that low-income countries have abundant labour but less capital. This situation arises owing to shortage of domestic savings in these countries, which places constraint on capital formation and hence growth. Even where domestic inputs in addition to labour, are readily available and hence no problem of input supply, increased production may be limited by scarcity of imported inputs upon which production processes in low-income countries are based. International capital flows (ICFs) readily become an important means of helping developing countries to overcome their capital shortage problems. One of the components of international capital flows is foreign private investment (FPI).

Other components are official flows from bilateral sources (e.g. developed and OPEC countries) and multilateral sources (such as the World Bank and its two affiliates, the international development Association (IDA), and the International Finance Corporation (IFC), on concessional and non-concessional terms Commercial bank loans including export credits).

With the advent of the third millennium, the pace of globalization has continued to accelerate. In the areas of international trade and finance, has been pushed by many factors including accelerated privatization and economic liberalization in almost every country in the world.

One important economic consequence of globalization for developing countries has been the massive and unprecedented inflows of foreign private capital during the final decades of the 20th century. Indeed during the last decade of the last century, private capital flows wrested primacy place from public flows, seizing the pre-eminent position as the source of foreign investment and development finance for developing countries. According to Weitz

and Lijane (2002) "While official flows totaled $56 billion in 1990, compared to $44 billion in private flows, by 1996, public flows had declined to $41 billion and private flows grew to $244 billion".

UNCTAD figures show that in 1997, FDI inflows amounted to US$400 billion and in 1998, reached an unprecedented level of US$440 billion (Mallampally and sauvant, 1999). Although FDI have become more widely dispersed among recipient countries in recent years, the distribution is still skewed with Asia receiving the lion's share of FDI flows going to developing countries and Africa receiving very little.

Another perspective on the skewness of the distribution is obtained when it is realized that in 1995, 81% percent of global FDI flows to developing countries went to 12 countries while 89% of all portfolio flows went to almost the same dozen countries (Weitz and Lijane, 1998).

Clearly, therefore the challenge to attract more inflows for investment in development projects has become acute in Sub-Saharan Africa, where only a small proportion of new inflows have gone. Note, the needs of developing countries particularly those in Sub-Saharan Africa have sharply increased in recent years due to the accelerating process of globalization. According to Weitz and Lijane (2001), "Opening up a country requires investment for connecting the necessary infrastructure – roads, telecommunication, power plants, and financial system."

Given the low incomes and low savings in many African countries, the investment-savings gap has widened and there is little hope of closing it without the active involvement of the private sector – both domestic and foreign. Thus, increasingly, in order to finance the investment gap, it is becoming imperative to attract foreign investment.

2. Literature Review

2.1 Foreign Private Investment: Meaning and Rationale

Foreign private investment (FPI) is a major component of international capital flows. According to Thirwall (1994), FPI refers to investment by multinational companies with headquarters in developed countries. This investment involves not only a transfer of funds (including reinvestment of profits) but also a whole package of physical capital, techniques of production, managerial and marketing expertise, products, advertising and business practices for maximization of global profits.

It is common in literature to observe that foreign direct investment (FDI) and foreign private investment (FPI) are used interchangeably. This perhaps explains why the International Monetary Fund's Balance of Payment Manual defines foreign direct investment as 'investment made to acquire a lasting interest in a foreign enterprise with the purpose of having effective voice in its management'. Another institution, WTO (1996) also observes that FDI occurs when investor based in one country acquires an asset in another country with the intent to manage that asset. FPI, therefore, should be seen as the sum of the following components;

a. New equity from the foreign company in the one country to the company in the host country.

b. Reinvested profits earned from the company; and

c. Long and short term net loans from the foreign to host country.

FPI is a two- way flow. The rationale must equally be two-dimensional recognizing the fact that two sets of interest are involved in FPI: interest of the foreign investors, and that of the host countries. World Bank (1997) observes that both domestic and international structure forces were driving private investment to developing countries since the early 1990s. In industrial countries, the primary forces revolve around the search for higher returns, and opportunities for risk diversification. While looking out for higher returns as well as avenues to diversify their risk at home, two other key developments in industrial countries reinforce the desire of foreign investors to look outwardly. First, competition and rising cost in domestic markets, along with falling transport and communications costs encourage foreign firms to look for opportunities to increase efficiency and returns by producing abroad. This has led to the progressive globalization of production and to the growth of "efficiency-seeking" FPI flows. Second, the transformation of financial markets from relatively insulated and regulated national markets to a more globally integrated market. This happens as a result of a mutually reinforcing process of advances in communications, information, and financial instruments and by progressive internal and external deregulation of financial markets. In developing countries, enabling environment for FPI has equally developed.

Since the mid-1980s, a lot of countries have embarked on structural reform programs leading to increased openness of their economies. Examples of these reforms include: the progressive lowering of barriers to trade and foreign investment; the liberalization of domestic financial markets and removal of restrictions on capital movements; and the implementation of privatization programs, thus strengthening the relevance of private sector in economic growth and development process in developing countries.

Apart from the creation of enabling environment for FPI in both industrial and developing countries, Feldstein (2000) argues that a number of advantages accrue to developing countries through FDI inflows. They include:

a. FDI allows the transfer of technology, particularly in the form of new varieties of capital inputs, which cannot be achieved through financial investment or trade in goods and services. Consequent upon technology transfer, it is possible also that FDI can promote competition in the domestic input market.

b. Recipients of FDI often gain employee training in the course of operating the new businesses, which directly contributes to human capital development in the host country.

c. Profits generated by FDI contribute to corporate tax revenues in the host country.

Despite the rationales behind FPI, particularly those that are on the side of the developing countries, some studies have revealed that developing countries should be cautious about taking too uncritical an attitude toward the benefits of FPI. It is sometimes feared whether FPI contributes to the broader aspect of development and the distribution of income in host economies. Likely reasons for caution are better examined within the framework of the link between FPI and economic growth. This is the concern of the next section.

2.2 Foreign Private Investment and Economic Growth

Economic growth results from accumulation of factors of production of from improvements in technology or both. Economic theory provides two approaches to studying the link between FPI and economic growth of the host countries. The first approach is rooted in the standard theory of international trade dates back to macdougall (1960). It involves a partial equilibrium comparative- static approach put in place to examine how marginal increments in investment from abroad are distributed. From this approach, it is believed that inflows of foreign capital–whether in the form of FPI or portfolio capital will raise the marginal product of labour and reduce the marginal product of capital in the host country. Beyond this, Macdougall argues that FDI may be connected to other potentially important benefits:

The second approach departs from trade theory of industrial organization, and was pioneered by Hymer (1960). Other contributors include Kindleberger (1969), Vernon (1966), Caves (1971), Dunning (1973), and Buckley and Casson (1976), among others.

This approach begins with an examination of why firms undertake investment abroad to produce the same goods as they produce at home. Kindleberger (1966) argue that for direct investment to thrive, there must be some imperfections in markets for goods and factors, including technology, or some interference in competition by government or by firms, which separates markets. This is being so, to be able to invest in production in foreign markets, a firm must possess some asset (for example, product and process technology or management and marketing skills) that can be used to profitably in the foreign affiliates. Firms investing abroad therefore represent something more than a simple import of capital into a host country to include diffusion of technology and knowledge, as well as impacting on market structure and competition in host countries. This sums up the indirect effects of FPI inflows.

Noorbakhsh et al. (2001) observed that, the less developed a country is, the greater are usually the expectations it places on FDI to alleviate it resource and skill constraints. Incidentally, Saggi (2002) observe that there are several important caveats to the expectation of positive impact of FDI on most countries. First, a positive correlation between the extent of FPI and economic growth in cross-country regressions may simply reflect this fact: those countries that are expected to grow faster attract FDI because it yields higher returns there. This implies that the causation could run from growth to FDI suggesting the need to estimate a simultaneous equation system to resolve the issue of which one causes the other.

Second, Multinational Corporations are in the habit of raising the required capital in the host country. When this is done, capital inflows with FDI may not be substantial after all. An optimistic view of FDI would then be restricted to

technology transfer and/or spillover as the likely mechanism through which FDI may affect growth. Along this line, it is also argued that FDI can have a positive effect on growth in developing countries by helping them bridge the idea gap with respect to industrial countries.

Although, economic theory and empirical evidence suggest that FDI has a beneficial impact on developing host countries, a number of studies have equally observed some potential risks associated with FDI. For example, Hausmann and Fernandez-Arias (2000) connect a high share of FDI in total capital inflows to a sign of a host countries weakness rather than strength. They observe that the share of FDI flows in total inflows is higher in riskier countries, with risk measured by countries credit ratings for government debt or by other indicators of country risk. This supports the argument put forward earlier that, FDI is more likely than other forms of capital flows in countries with missing or inefficient markets since such phenomenon creates rent- seeking opportunities to foreign investors.

It is obvious that there is no consensus yet in the literature regarding the growth or welfare effect of FDI, particularly in the host economies. It is indeed worthy to mention that many studies of African economies show that the impact of FDI is limited or even negative sometimes. In studies of countries such as Cote d'Ivore (Mansini et al. 1971) or Nigeria (Onimode et al. 1983) where FDI were directed to import substituting firms, the value of imports was observed to be greater than the value added produced. This type of FDI would have given rise to a twofold foreign exchange cost: outflows of investment income and the cost of imported inputs.

2.3 Determinants of Foreign Investment

Existing literature on FDI shows that several frameworks have been employed to analyze the determinants of FDI. To date, the most comprehensive framework is the one known as 'eclectic theory' of Dunning (1981) because of its flexibility and increasing popularity. The theory argues that FDI is determined by three sets of advantages namely:

a. Firm specific (or ownership) advantages (Hymer1960): this set of advantages gives a firm competitive advantage in global markets, including, technological assets, product differentiation, management skills, production efficiencies, size and concentration.
b. Internalization advantages (Buckley and Casson, 1976): these advantages exist when the internalization of cross-border transactions within a firm becomes more efficient form of servicing markets than arm's length transaction. Put differently, it is the sum of commercial benefits accruing from an FDI or intra-firm activity rather than an arm's length or licensing relationship.
c. Location advantages (Vernon, 1966): these occur when the local conditions of potential host countries make them a more attractive site for FDI operations than the home country. These advantages include large markets, lower costs of resources or superior infrastructure, among others.

Akinkugbe (2003) argues that locational advantages constitute what earlier theoretical and empirical studies classified as 'pull-factor'. The 'pull-factor' examines the relationship between host-country specific conditions and the inflow of FDI. At the center of locational advantages is the belief that, there is some specific advantage to the investor, which makes the return on investment sufficient to warrant the additional risk and uncertainty that accompanies investment outside the familiar home environment. In the case of natural resources, the incentives to FDI are clear: mineral deposit, forests and fisheries do not move to world financial centers, companies must move to them. This explains the belief that FDI is a product of rent-seeking on a global scale. Under this 'pull-factor', FDI is either classified as import-substituting; export-increasing or government initiated (Moosa 2002).

As to the 'pull-factor', Akher (1993) posits that host-country specific conditions might embrace a number of socioeconomic and political factors within a country where FDI is made. These factors tend to determine available business opportunities and pending political threats within the host countries. Among others the socioeconomic and political factors commonly cited in this strand of the FDI literature include:

- Availability of natural resources
- Infrastructure
- Market size
- Level of human capital development
- Distance from major markets
- Labour cost

- Openness of the economy of international trade
- Exchange rate
- Fiscal and non-tax incentives
- Political stability
- Monetary policies and the extent of liberalization of otherwise of the financial sector
- Availability of modern information and communication technology

However, there are new FDI determinants:

Favourable FDI environment: this is essentially a transparent and non-discriminatory regulatory environment, effective competition policies and an efficient judicial system. Low and stable tax rates are also important. Fiscal incentives may increase the attractiveness of a country but cannot substitute for lack of a healthy FDI environment.

Low transactions and business costs: these cover investment, labour and trade regulations, entry and exit rules, location and environment regulations, and tax and legal systems. They depend not so much on the rules but on the way rules are implemented in practice and on the skills of the bureaucracy in dealing with the investors, as well as on the legal and judicial system.

Supplier networks and cluster: countries with dynamic local firms have an advantage in that they can attract better 'quality' FDI that subcontracts services and components of their production process to local firms.

Support institution and technical services: essential infrastructure facilities include effective quality assurance and testing bodies, meteorology and calibration services, contract research and technical extension help for small and medium scale enterprises.

Human capital: low-cost, unskilled labor is becoming less important. There is a greater demand for qualified human capital with diverse modern skills that can cope with emerging technologies. Equally important are labour market flexibility including the use of expatriate personnel.

Low cost infrastructure: an efficient communication system as well as transportation links within and outside the country is essential to make a country attractive.

3. The Role Of The Public Sector

The key issue about the role of the Government is not whether it should intervene but the kind of intervention, including direct participation if there is insufficient capacity in the local private sector. Some macroeconomic policies and investment-friendly policies are necessary, although not sufficient in today's world of increasing competitiveness in attracting investment. The crucial role for the host Government is to create conditions as well as be proactive in developing these new drivers to attract international production and services in the light of the fact that contract manufacturing has grown rapidly to take advantage of differences in costs and logistics. This implies giving equal emphasis to promoting domestic private investment to benefit from the FDI. Simply opening up an economy is only the first step, and no longer enough to attract sustained flows of FDI and upgrade the quality.

At the minimum, foreign investors are expecting assurances of the rule of law, a commitment to be treated no less favourably than competing domestic investors and provisions for the free transfer of capital, profits and dividends, guarantees against expropriation of their assets and binding arbitration of disputes.

The report of the panel on high-level financing for development (United Nations, 2001) to the Secretary-General advised host Governments not to exempt foreign investors from domestic laws governing corporate and individual behaviour, or to use costly and discretionary investment incentives or those that eroded labour and environmental standards in a "race to the bottom". The report also said that developing countries needed to continue improving their attractiveness to FDI through positive actions (i.e., by improving standards of accounting and auditing, transparency, corporate governance and public administration) rather than through tax concessions, which should be regulated and discouraged.

An OECD study (Oman, 1999) indicates that incentives-based competition for FDI can be intense in selected industries (e.g., automobiles) or for particular investment projects. Most incentives-based competition is effectively intraregional,

The Monterrey Consensus (2002) gives a strengthened role to the State with regard to the private sector and markets, particularly in terms of setting appropriate frameworks to regulate markets. While data on direct financial/fiscal cost per job are not readily available, OECD estimates that in the automobile industry the cost in OECD as well as developing countries can exceed US$ 100,000 per job. Hence the distortion effects of incentives on a de facto basis work against local firms and against firms in sectors or types of activities that are not targeted. Undiscerning use of investment incentives and other discretionary policies by Governments to attract FDI can have a negative effect on FDI flows, partly because incentives could be viewed as unsustainable.

The competition for FDI raises the delicate question of how to ensure accountability of government officials, particularly those involved in the negotiation of discretionary incentive packages. A strong rules-based approach to attracting FDI, including safeguards for labour standards and the environment, can provide the policy transparency necessary to limit rent-seeking behaviour. Policies on FDI are also needed to counter two sets of market failures. The first arises from information or coordination failures in the investment process that can lead a country to attract insufficient FDI and more importantly the wrong quality of FDI. The second results when private interests of TNCs diverge from the interests of the host countries. This can lead to negative effects of FDI or a failure to harness fully the potential of the

FDI. The challenge for the Government is achieving the right balance in terms of promoting synergy between FDI and domestic private investment in terms of a win-win situation for the citizens. At the heart of these endeavours is improving the competitiveness of a country's economy to improve its economic fundamentals and enhance living standards. As the performance of economies, industries and firms is continuously compared and benchmarked across nations, it means that individual firms and countries must also benchmark all activities against the best of competitors in a changing world economy marked by knowledge and technology-based advantages.

In other words, apart from the series of measures to liberalize the economy and promote FDI that many countries are in the midst of implementing to varying degrees, there is a need for proactive policies aimed at shaping new industrial and service locations through a cooperative approach between the public and private sectors. The standard determinants of competitiveness are not only the economic, technological and measurable attributes such as strong economic fundamentals, political stability, technological effort, human resources development, physical infrastructure and financial and labour market flexibility. There are also non-economic factors, some of them controversial, such as the promotion of democratic institutions, human rights, corporate governance, anti-corruption and a host of other subjective criteria. Effective governance is therefore essential to encourage both sound FDI and domestic private investment.

The role of the Government spans virtually all aspects of economic development, and here, the focus of the discussion is narrowed down – only aspects that have a direct bearing on promoting FDI and domestic private sector linkages will be considered. In addition, specific government measures to nurture the domestic private sector in the deepening global integration of production will be discussed. This is not to downplay the other policy areas, which, depending on the stage of economic development and individual country circumstances, can give rise to different priorities.

4. Summary of Findings

The crux of this study is to empirically investigate the impact of foreign direct investment on the Nigerian economy, using the autoregressive approach and co-integration approaches. Thus, the objective is to identify the determinant of foreign investment in Nigeria and to examine the impact of foreign investment on Nigeria economic growth rate.

5. Recommendation

The key issue about the role of the Government is not whether it should intervene but the kind of intervention, including direct participation if there is insufficient capacity in the local private sector. Some macroeconomic policies and investment-friendly policies are necessary, although not sufficient in today's world of increasing competitiveness in attracting investment. The crucial role for the host Government is to create conditions as well as be proactive in developing these new drivers to attract international production and services in the light of the fact that contract manufacturing has grown rapidly to take advantage of differences in costs and logistics. This implies

giving equal emphasis to promoting domestic private investment to benefit from the FDI. Simply opening up an economy is only the first step, and no longer enough to attract sustained flows of FDI and upgrade the quality.

6. Conclusion

It is evident that the foreign direct investment, government expenditure, infrastructural development, population and exchange rate are the determinants vital for economic development in the Nigerian economy, while inflation fails Liberal 10% significance level. In effect, these suggest that foreign direct investment, government expenditure, infrastructural development, population and exchange rate, is effectual for the working of the Nigerian economy.

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