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Is the Importance of Location Factors Different Depending on the Degree of Development of the Country?

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A B S T R A C T

The increasing importance of Foreign Direct Investment (FDI) in the global markets and its unequal distribution throughout the world have been the source of studies on the importance of country factors in determining where foreign investors choose to invest. Our paper aims to provide a better understanding of the location factors of FDI. Based on the Investment Development Path (IDP) we study how the importance of these country factors, such as location advantage, varies depending on the degree of development of the host economy. We consider a broad set of well-known location factors (13) and we analyze them using panel data for a broad set of economies (117) over the period 2006–2013 (8 years). Our results establish that most of the location factors studied are not only decisive in attracting FDI, but also that their importance is moderated by the host economy's stage of development.

1. Introduction

The increasing significance of Foreign Direct Investment (FDI) in the global markets and its unequal distribution throughout the world have been the source of studies on the importance of the country factors in determining where the foreign investor chooses to invest.

The importance of country factors in attracting FDI has been unquestioned in the literature since the initial contributions of classical macroeconomic theory that justified international trade by the existence of absolute or comparative advantages, or by the unequal endowment of factors among the countries. Initially, researchers focused on macroeconomic factors such as resource endowments, factor prices and productivity. However, these factors may provide only a partial explanation of FDI location (Van Wyk and Lal, 2010).

Different theories have emerged to explain the internationalization of the firm, but they have also contributed to answering the question of where to locate abroad. Recent studies such as Blonigen (2005), Faeth (2009) or Assunção et al. (2013) present a complete and complementary review of the most important determinants of FDI and its location. The literature provides a long list of FDI location determinants or, following Dunning's terminology, location advantages. These include infrastructural support, the role of the institutions, macroeconomic policies, human capital, capital flows, exchange rates, market size, and technology, among others. The research considers all those specific conditions or properties of host countries that make them attractive because they provide potential benefits to foreign direct investors. However, although there is theoretical consensus that these factors attract FDI, the results obtained in the empirical literature are not conclusive. For example, while there is certain consensus

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that market size is a determinant factor (Buckley and Casson, 1992; Vogiatzoglou, 2008), others such as labor costs yield no conclusive results (Na and Lightfoot, 2006).

This lack of consistency among the results may be due initially to researchers' focus on those developed countries or regions that traditionally attract more FDIs, such as USA, Japan or Europe. However, since the last decade of twentieth century, emerging economies such as China, Brazil or India have become significantly more important as host countries. This has given rise to a large body of research, most of it context-specific, interested in providing new insights into the determinants of FDIs in less developed countries. Thus, individual factors applied to different countries and timeframes could yield contradicting results (Tahir and Larimo, 2004). However, from previous studies we can also derive that location factors are different depending on the degree of development of the country or region. As Blonigen (2005, p. 397) said, "*the factors that determine FDI into developed countries is simply much different than into less-developed countries, and that these differences are still not captured adequately*" in the empirical research.

In this paper, we want to go a step further. Based on the theoretical and empirical literature, we start with the assumption that the country factors considered in the literature are important as location advantages for FDI. However, our proposal is that their influence will be moderated by the degree of development of the host economy. We believe that there are some location factors that will be more influential in less developed countries (e.g. resource endowments or infrastructure), others in transition economies (e.g. quality of human capital) and still others in the most developed countries (e.g. innovation). Therefore, our arguments build primarily on the dynamic interaction between FDI and the level of development of a given economy put forward by the Investment Development Path (IDP) approach (Dunning, 1981, Dunning and Narula, 1996; Narula and Dunning, 2000, 2010) and categorized in five stages. As Nayak and Choudury (2014, p. 11) summarize, "*the basic hypothesis is that when a country develops, the conditions encountered by foreign and local firms change. This will affect the flows of inward and outward FDI. This, in turn, will have an impact on the economic structure of the country. Thus, there is a dynamic interaction between the two*". Thus, the IDP supports that the importance of the location factors would vary depending on the stage of development of the host country.

Although there are several empirical studies based on the IDP, they focus mainly on the relationship between the stage of development and the net outward investment (NOI) applied to a set of countries at a particular stage (Durán and Úbeda, 2005), to geographic areas (Narula and Guimón, 2010 for Eastern Europe), or to specific countries such as Austria (Bellak, 2001), China (Liu et al., 2005), Spain (Galán et al., 2007), and India (Verma and Brennan, 2011), among others.

However, references to location factors using the IDP approach are scarce (Li and Clarke-Hill, 2004), with the exception of Galán et al.'s (2007) study, which partially confirms that the impact of location factors depends on the stage of development of the host country.

Unlike previous studies, our paper seeks to determine if the degree of development of the host economy moderates the influence of its location advantages for FDI by applying it to 117 economies over a period of 8 years (2006–2013). The approach used is also applied to regional sub-samples in order to better understand the complexities of the study and also as a measure for the robustness of our findings.

Thus, our study contributes to, and complements, prior research in several ways. First, it explains the reasons why certain location factors are more influential in attracting FDI in some stages, and why other factors are more important in others. It explores the interaction between location advantages and degree of development by way of the IDP, increasing the explanatory power and understanding of the complex phenomenon that is the location of FDI. Second, it includes most of world's economies instead of being context specific, although we also provide results by regions. Third, it is not a cross-sectional study that is affected by the moment of the analysis, but rather a longitudinal study. Finally, it analyzes a broad set of well-known location factors (13) using homogeneous data that allows us to make comparisons across most of world's economies, solving the problems raised by Pantelidis and Nikolopoulos (2008).

As far as can be ascertained, this is the first study that dynamically analyzes a broad set of location factors applied to a large number of economies, differentiated by their stage of economic development, over a long period of time. We believe this paper will contribute to a better understanding of the country factors that determine the destination of FDI, the importance of which, as pointed out by both Meyer, Mudambi and Narula (2011) and Narula and Santangelo (2012), continues to be significant.

2. Location factors

The importance of country factors in attracting FDI has been unquestioned in the literature since the first contributions of classical macroeconomic theory that justified international trade by the existence of absolute (Adam Smith) or comparative advantages (David Ricardo), or by the unequal endowment of factors among the countries (Heckscher-Ohlin). Since then, the study of these location factors has progressed through contributions from different theoretical approaches thus providing a very broad and rich literature on this issue; however there is still no generally accepted theory (Villaverde and Maza, 2015). In the following lines we concentrate on the main FDI theories in order to present a brief theoretical context that will help us to better understand the location advantages (and in particular, the country factors) that an economy can offer foreign investors.[1]

Initially, the Neoclassical trade models focused on macroeconomic factors such as resource endowments, factor prices and productivity as location advantages. But these theories of international trade proved to be inadequate for explaining the changing

[1] Blonigen (2005), Faeth (2009), Assunção et al. (2013) or Nayak and Choudhury (2014) presented a more complete review of the FDI determinant literature.