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Determinants of foreign direct investment in services

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Abstract

This study uses industry level foreign direct investment (FDI) data from 57 countries 1989–2000, to examine the host country determinants of FDI flows in services as a whole, and in the major service industries. Institutional quality and democracy appear more important for FDI in services than general investment risk or political stability. Democracy influences FDI to developing countries only, suggesting that the absence of democracy is detrimental to investment below a certain threshold. Consistent with the observation that many services are non-tradable, we find that service FDI is market-seeking, and unaffected by trade openness. We find a strong correlation between FDI in manufacturing and FDI in producers' services such as finance and transport.

Jel classification: F23; L80
Keywords: FDI; Services

1. Introduction

A key feature of the evolution of foreign direct investment (FDI) flows in recent years, has been the expansion of FDI in the service industries. According to UNCTAD (2003), the service industries accounted for a massive 63% of world FDI flows in 2001. FDI stocks reflect the recent dominance of service sector flows, 55% of world FDI stocks in 1999 were in the service industries (UNCTAD, 2001). As argued by Harms and Ursprung (2002), changes in the aggregate characteristics of production can have substantial effects on determinants of total FDI flows. Given the growing importance of FDI in services, eliciting its determinants is vital in keeping host country FDI policies effective. Accordingly, this study uses industry level data to estimate the determinants of FDI in the service sector as a whole, and in the major service industries.

As an illustration of recent trends, Fig. 1 provides a decomposition of total FDI flows, into shares attributable to the primary, secondary and tertiary industries over the period 1986–2001. While the secondary and tertiary industries accounted for comparable shares of total FDI in the late 1980s, the figure reveals that the service industries have increased their share markedly since then. The spike in tertiary FDI in 1999–2000 is perhaps a bit exaggerated,

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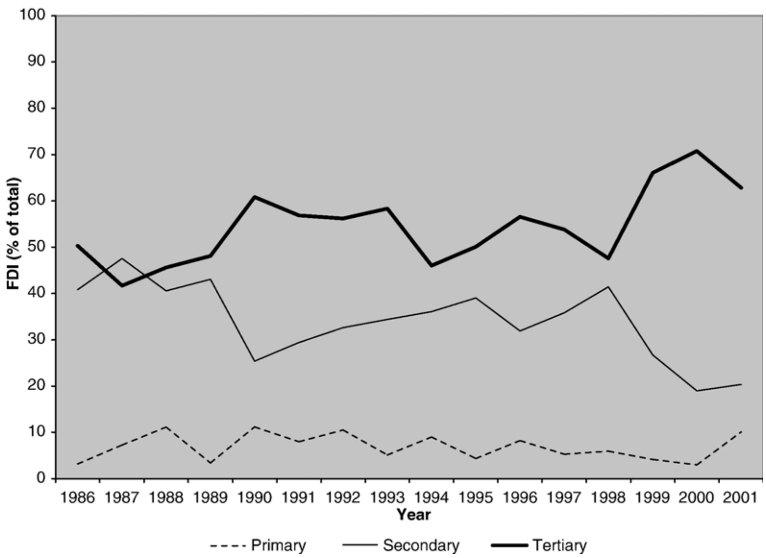

Fig. 1. A breakdown of total FDI according to the major industry groups, 1986–2001. Data source: UNCTAD.

reflecting extensive mergers and acquisitions activity in this sector, but nevertheless the trend is clear. Service sector FDI has grown more important in total FDI flows, manufacturing FDI less so. The primary sector only contributed 3–11% of total FDI in the period graphed.

Most empirical studies of FDI determinants have used data on FDI flows aggregated across industries (see e.g. Noorbakhsh et al. 2001; Blonigen 2005, for reviews, and Bengoa and Sanchez-Robles, 2003 for a more recent study). There is, however, reason to believe that the determinants of service sector FDI might differ from those of FDI in aggregate. Though international trade in services is on the rise, the fact remains that many services are non-tradable or costly to trade. And for a sector whose products to a large extent cannot be subjected to cross-border trade, the trade openness of a host country can be expected to have less of an impact on FDI inflows in that sector. Moreover, tapping the demand for services in a host country requires a physical presence when services are difficult to trade, which implies that FDI in services is likely to be market-seeking. The idea that domestic market size affects service sector FDI, whereas trade openness does not, is tested empirically in this study.

The peculiarities of service sector FDI in terms of organization and outside options, may entail a different sensitivity to public policies and institutions. Previous studies of aggregate FDI indicate that there is a relationship between broad indices of socio-political instability and institutional quality, political freedom and democracy and FDI. The basic theoretical rationale of these studies is that socio-political instability, in the form of social unrest or government upheaval, increases perceived investment risks. Institutional quality, such as the quality and corruptibility of the bureaucracy, affects the costs and/or risks of doing business in the country in question. Political freedom and democracy might reflect increased stability, and property rights might be more secure in countries ruled by impersonal laws and institutions. It is, however, an open question whether the results from studies of aggregate FDI apply to the service sector, or if FDI in this sector is influenced differently by these types of variables. This study tests empirically the impact of different political economy variables on service sector FDI, in order to identify the relevant determinants.

There are also likely to be differences in locational determinants across individual service industries. Fig. 2 maps the shares of total service sector FDI attributable to the four industries in which FDI flows are the heaviest; finance; business activities (including real estate, rentals, computer and related activities, and research and development); transport (which includes post and telecommunications); and trade (wholesale and retail). For the 1986–2001 period, these four industries have contributed 86% of total service sector FDI flows. The three largest of the service industries in terms of FDI (finance, business, and transport) are commonly referred to as producer services (Nordås, 2001). Given a global trend towards a vertical disintegration of production (Feenstra, 1998; Hummels et al., 1998), producer services are essential in binding the chain of production together. It is thus plausible that there is a positive relationship between