Institutional and Economic Determinants of Foreign Direct Investment: Comparative Analysis of Three Clusters of Countries

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Abstract : There are three types of countries, the first of which is willing to attract foreign direct investment (FDI) in enormous amounts and do whatever it takes to make this happen. Therefore, FDI pours into such countries. In the second cluster of countries, even if the country is suffering tremendously from the shortage of investments, the governments are hesitant to attract investments because they are at the hands of local oligarchs/cartels. Therefore, FDI inflows are moderate to low in such countries. The third type is countries whose companies prefer investing in the most efficient locations globally and are hesitant to invest in the homeland. Sorting countries into such clusters, the present study examines the essential institutions and economic factors that make these countries different. Past literature has discussed various determinants of FDI in all kinds of countries. However, it did not classify countries based on government motivation, institutional setup, and economic factors. A specific approach to each target country is vital for corporate foreign direct investment risk analysis and decisions. The research questions are 1. What specific institutional and economic factors paint the pictures of the three clusters; 2. What specific institutional and economic factors are determinants of FDI; 3. Which of the determinants are endogenous and exogenous variables? 4. How can institutions and economic and political variables impact corporate investment decisions Hypothesis 1: In the first type, country institutions and economic factors will be favorable for FDI. Hypothesis 2: In the second type, even if country economic factors favor FDI, institutions will not. Hypothesis 3: In the third type, even if country institutions favorFDI, economic factors will not favor domestic investments. Therefore, FDI outflows occur in large amounts. Methods: Data come from open sources of the World Bank, the Fraser Institute, the Heritage Foundation, and other reliable sources. The dependent variable is FDI inflows. The independent variables are institutions (economic and political freedom indices) and economic factors (natural, material, and labor resources, government consumption, infrastructure, minimum wage, education, unemployment, tax rates, consumer price index, inflation, and others), the endogeneity or exogeneity of which are tested in the instrumental variable estimation. Political rights and civil liberties are used as instrumental variables. Results indicate that in the first type, both country institutions and economic factors, specifically labor and logistics/infrastructure/energy intensity, are favorable for potential investors. In the second category of countries, the risk of loss of assets is very high due to governmentshijacked by local oligarchs/cartels/special interest groups. In the third category of countries, the local economic factors are unfavorable for domestic investment even if the institutions are well acceptable. Cluster analysis and instrumental variable estimation were used to reveal cause-effect patterns in each of the clusters.

Keywords : foreign direct investment, economy, institutions, instrumental variable estimation
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