Does the 'Ease of Doing Business' In a Country Influence its Foreign Direct Investment Inflows?

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ABSTRACT

Foreign direct investment has been studied for years. It is generally accepted as a positive influence on the domestic market and governments have begun actively seeking it out. This study is meant to possibly connect government actions, for which the World Bank's 'Doing Business Index' was used as a proxy, to an increase in foreign direct investment inflows. The goal of this study is to help governments make more informed decisions about if and how to attract foreign direct investment. The research was done by running a regression model to find a connection between changes in foreign direct investment inflows and the Doing Business rank of each country. The results of the regression show that by increasing their country's Doing Business rank one level, a government can bring in over $44 million USD. Thus, the model has proven that there is a connection between government actions and foreign direct investment; countries can actively pursue foreign investment dollars successfully. The Doing Business Index points to practical areas which are important to multinational companies, such as the time it takes to compute and pay taxes, which the government can control. Therefore, this study not only proves that it is worthwhile for governments to change in order to attract foreign investment but gives the beginning of a blueprint for what government actions bring in the most investments.

INTRODUCTION

The study of international trade has led to the development of all types of models designed to explain the movement of knowledge, goods, workers, capital, and technology across countries. Most clearly expressed in the 3 pillars from the Treaty on European Union, the ideals of an internationalized world have pushed us towards relationships such as foreign direct investment. This has led to a competition, sometimes subtle and sometimes explicit, over investment dollars. Economists have looked at a myriad number of different indicators to determine what exactly influences those decisions to invest. One factor, lowering barriers to the movements of production factors are one of the driving forces behind globalization and the integration of economic markets. Integration of markets, economists argue, benefits all parties. The free flow of information helps find best practices in every discipline. Free movement of goods and services increases consumers' options, decreases prices, and gives companies access to larger markets of customers and supplies. Unrestricted worker mobility alleviates high levels of unemployment and supplies fresh talent. The deregulation of many country's financial markets has allowed foreign capital to be used to finance new business ventures or invest in the government. FDI is considered an important part of integration. Firms are able to transfer the products, people, and cash to subsidiaries quickly, in some cases faster than the market will.

Pertinent to this paper, there are a vast number of professionals and academics that have sought to definitively identify all of the qualities that attract and encourage sustained international trade. Theoretical models are also compared to observed patterns in real life trade. Since foreign direct investment (FDI) has been accepted as positive to development of the country by most political leaders, there is a demand for knowledge about what the country characteristics will attract foreign investment. Leaders seek not only to encourage trade, but to create the long term relationship that makes FDI distinct from one time export/import contracts.

Macroeconomic factors have been a large focus of trade studies and give an important insight into the trade relationships between countries of differing sizes. For example, especially important factors to a foreign firm looking for larger customer markets, or *market-seeking* firms would be GDP, population, and population growth rate. These indicators let the firm know if the country's workers are productive enough to earn wages that can afford the product and if the size

of the potential market is adequate. *Efficiency-seeking* firms are searching to lower costs abroad and are interested in factors such as the level of education and employment rates. More educated workers tend to be more productive and create the most value for the firm. Finally, foreign firms looking to solidify relationships with suppliers or to purchase supplying firms to backwardly integrate will locate businesses near plentiful sources of natural resources and strong transportation lines to minimize transportation and warehousing costs. These are called *resource-seeking* firms.

Companies will always look for ways to make their business better, which in the business world is analogous to profitability or cost minimization. However it is very common that firms will spend a large amount of time and resources searching for opportunities to earn more profit or save more money on costs. In this highly integrating world, firms are now searching around the globe for those opportunities. The complexity of the task, however, is immense because each country has its own set of rules pertaining to business operations. While countries generally welcome foreign investors, the nature of unique regulations makes it a tricky environment to enter. (The term 'foreign investors,' for the purpose of this research paper, refers to non-native employees or business entities that engage in long term business operations on behalf of a foreign company non-native to the host country.) While governments should have rules for the conduct of business in their country to create trust in the market, they must be clear, readily available, and enforced.

The firm must spend resources determining what type of environment the domestic government has created in its market so that it is never caught unaware. Mistakes from assumptions or incorrect data can be extremely costly to firms. In many cases, firms have functioned as if the new market mirrored the domestic market of the firm so that few changes are made in the interest of cost savings before going abroad. This ethnocentric thinking tends not to create profit for the firm expanding abroad, especially when the countries have few cultural similarities. For that reason, companies accept the cost to perform thorough research on new markets and ensure that the opportunities are in actuality beneficial to the firm. Only in countries where the opportunities are not outweighed by costly pitfalls will the firm truly have an advantage over rivals.

The OLI paradigm is a way of thinking where a firm will invest abroad by the existence of certain types of advantages. The advantages are grouped into three categories: ownership, location, and internationalization. Ownership advantages are those possessed by the firm, such as patents and management style, and are transferrable to other countries. Internalization advantages are how the firm uses its ownership advantages and the degree to which they are kept within the firm. Having great internalization advantages will lead a firm to export or conduct FDI to keep activities in-house while low internalization advantages will result in a greater willingness to give licenses away to other firms. Location advantages are the attributes of any particular country that make it attractive to the firm. These, by nature, cannot be transferred so the firm must move operations to that country in order to utilize these advantages (Dunning, 1977). This type of advantage is of the most interest to governments because the location advantages are, to some extent, crafted directly by government activities and are the only component of the OLI paradigm that would make a firm chose one country as opposed to any other.

That is why governments are looking for the location advantages that they can augment in order to draw FDI. The World Bank's Doing Business Index (DBI) is an annual survey of numerous 'ease of doing business' indicators. Under subheadings such as "Registering Property" and "Trading Across Borders," the DBI scores and ranks countries based on their friendliness towards FDI. Friendliness, however, does not necessarily predict higher levels of FDI. That is why the DBI chart alone cannot explain everything about the actual levels of FDI in each country. The DBI indicators must be compared with other known data about FDI inflows so that a pattern can be found.

The World Bank's Doing Business Index (DBI) indicators are all processes or regulations relating to operation of a foreign business entity that the government can directly control, such as labor laws. If each country's change in the level of FDI inflow was compared to its DBI score of that year, one could analyze how the DBI indicators have an effect on FDI. By controlling for macroeconomic factors that also encourage FDI yet cannot be controlled by the government, this research paper seeks to find the amount of increased FDI inflows that is directly attributable to an aggregation of the DBI indicators. This will help governments find clear and concrete ways to actively encourage FDI.

LITERATURE REVIEW

Previous literature has explored the major determinants of foreign direct investment. The most influential forces are usually market-based and include gross domestic product, GDP per capita, abundance of natural resources, costs of production, and level of corruption (See Appendix A). Another important factor is the *enabling framework*, the economic system that governments create in the long term to make foreign investment an attractive prospect in their respective countries. The enabling framework is a very broad term encompassing favorable legislation, a business culture open to foreigners, and useful national institutions (McMillan, 1993). Though many countries, especially the Eastern European transition countries, have created a series of short term incentives, these are not as effective as a properly constructed and supported enabling framework (Johnson, 2006). Johnson concluded that governments should focus on creating an economy that is generally welcoming to foreign investors because market conditions cannot be controlled and firms know that special incentives can be changed away from their favor quickly. Agosin and Machado (2007) identified the most important overall indicators of FDI as market size, market growth, and the education level of the domestic workforce. However, Agosin and Machado found, that an encouraging framework for FDI was not enough to attract FDI by itself. The country also had to have some positive location advantages to experience any FDI. The ease of doing business factors studied in my report would be considered part of the enabling framework because they are long term decisions the government would make. The report will quantify the responsiveness of FDI to changes in the enabling framework that Agosin and Machado defined.

Nunnenkamp (2002) finds that in more recent years, multinational corporations are looking more for cost savings than a fresh or larger market in which to sell a product or service. This represents the beginning of a slow and steady shift away from *market-seeking* activities towards *efficiency-seeking* investments as outlined in the OLI paradigm (Dunning, 2002). Therefore, the qualities that attract FDI in developed countries have been changing from simply exploring for new customer markets to creating the most streamlined and efficient production process. Firms look for quality of infrastructure, skill level of workers, and enforceability of contracts where they once looked for the size of the national market. FDI in developing countries, meanwhile,

has remained predominantly *market-* and *resource-seeking*. Dunning's report also finds evidence that a country's openness to trade can increase its inflow of FDI.

Furthermore, showing another trend towards *efficiency-seeking* investments, von der Ruhr and Ryan (2005) establish that FDI has followed financial market liberalization. Liberalization attracts banking FDI which, in turn, is a strong pull for non-banking FDI which may have been concerned about dealing with the smaller scale domestic banks. Since government creates market imperfections, Brewer (1993) examines multinational firms as entities that activity search for beneficial scenarios. As already stated, governments can create environments that are either encouraging or discouraging to FDI. Firms vigorously seek out favorable enabling frameworks and the study concludes that governments can significantly affect the inflow of FDI. As the focus for multinational companies shifts away from factors is cannot control, like the size of the consumer market or the existence of a port, governments are seeing that they have more power to encourage FDI to their countries. My study will determine if the measures included in the ease of doing business rank do affect FDI and to what extent.

While the previous articles have discussed world trade, the following articles discuss FDI control at the national level. First, Davies (2003) studied China's framework. He lists suggestions including a stricter adherence to rule of law, less stringent local content requirements, and a more even trade balance with major trading partners. While many of these issues have been addressed during China's ascension to the WTO, Davies believes that more work is needed. He also attributes the increase in FDI in China to the efforts made up until this point.

Second, a profile of the Argentine government's efforts to encourage FDI (*Foreign Investment Policy*, 2006) shows how the country is trying to attract foreign firms after the 2001 crisis. Many temporary restrictions on FDI were enacted immediately after the crisis, but were staring to fade at the time of the 2006 report. Issues highlighted were the switch from a pegged to free floating currency in 2002, a heavily regulated labor market, limited foreign ownership in certain industries, creation of numerous Foreign Trade Zones and Special Customs Areas, and incentives for foreign investors. The decrease in restrictions five years after the crisis is expected to increase FDI, but the effects of deregulations have not been quantified in their relation to FDI inflow.

Third, in Canada, Globerman and Shapiro (1999) discover that government efforts to control FDI tended not to have an impact on the market. Domestic companies struggled slightly to deal with the increase in bureaucracy, but little new FDI was seen. Creation of the North American Free Trade Area, on the other hand, greatly increased FDI because entry into the Canadian, American, and Mexican markets was suddenly heavily discounted and would be free within a few years. This finding also fits with Rugman and Gestrin's (1994) results that FDI tends to be located regionally, even before free trade areas are created, rather than spreading evenly around the globe.

Tarzi (2005) analyzed Nigeria, Indonesia, and India's efforts to attract FDI and concluded that companies are more likely to invest in countries with the least amount of government control over their operational affairs. This includes lower corporate taxes, lower corruption, freer capital movement, and permission to own majority stake in a local subsidy. The more guidelines in existence, the more firms must 'jump through hoops' to satisfy the law. These excess government regulations also cost more for the firm and are discovered to be a deterrent to FDI flows into that country. The country-wide studies shaped the model I used to analyze the global attempt to affect FDI inflows. Considering the results of one country's efforts, my study applies the country-wide approaches to control FDI to every country of the world in a consistent manner.

In an analysis of the 2005 and 2006 Doing Business Index indicators, Blanchet (2006) finds that the aggregate rankings are much more accurate of a predictor than any of the subheading rankings. The study tries to find a significant correlation between each subheading indicator and the dependent variables chosen including France's economic performance, FDI inflow, or the Human Development Index score. The model is then run again with the aggregate indicator to determine its level of correlation with the dependent variables. This report is the closest study found that can speak to the hypothesis that will be proposed later in this paper. Blanchet, however, only studied two years in depth and only the rankings of his native country, France. He stated that there was more research needed in analysis of the aggregate indicator as a possible predictor of FDI inflow and the recent addition of other DBI subheading indicators may change some of the answers Blanchet left open in his 2006 report.

Looking at exit costs as FDI influencers, Görg (2005) studies the tradeoffs governments make in respect to two DBI indicators. Exit costs are defined as expenses incurred by a company as it exits a country, such as firing restrictions or severance package regulations. Always controlled by the government, they fall under the category of *efficiency-seeking* factors that multinational companies consider before locating their FDI in a particular country. Görg finds that the corporate tax rate and exit costs have corresponding impact on FDI. He believes firms research extensively before entering another country, so changes a government makes in exit costs will be noticed by firms and will affect FDI. Therefore, he advocates changing exit costs, particularly when a possible decrease in tax revenue is not a popular choice. Jackson and Markowski (1996) did a study about the attractiveness of countries to FDI. Covering market and non-market characteristics, the report declares that the best predictor of future FDI inflows is past FDI inflow. While interesting for academics and in historical studies, this information is difficult for governments to act on because the report does not lay out how to attract those first foreign investors to trigger the wave.

RESEARCH MODEL

Hypothesis

This paper will seek to determine to what extent government actions will increase the inflow of FDI. Using the DBI indicators as a quantitative proxy for those government actions, the inflow level of FDI in each country will be compared to the DBI indicators of the same year. The null hypothesis of this research paper is that each country's DBI will show negative or no significant relation to an increase in that country's FDI inflows. The alternative hypothesis is that the DBI indicators for each country will have a significant and positive impact on each country's FDI inflows.

The data will first be tested for correlation. Providing a significant level of correlation, a simple regression analysis will be performed and conclusions will be drawn from the fit of the line and the variability of the data.

Model

In order to test for the null hypotheses, the equation will be estimated in the following form:

$$FDI_{ct} = DBI_{ct} + [\ GDP/CAP_{ct} + MG_{ct} + EDU_{c} + PG_{c} + COR_{c}\ ] + \varepsilon_{ct}$$

The following chart explains the expected relationships of each variable. It also gives the definition and source of each variable used in the model.

Factor Descriptions			
	Expected Sign (as FDI increases)	**Definition**	**Source**
FDI	+	Long term business investment where a foreign entity has lasting control (>10%) and residency in a non-native country	UNCTAD's "World Investment Report 2009"
DBI	-	Ease of doing business rank; aggregation of indicators	World Bank's "Doing Business Index 2010"
GDP/CAP	+	Gross domestic product divided by population	UN Statistics Division
MG	+	GDP growth rate	UN Statistics Division
EDU	+	Expected number of years of schooling	UNESCO
PG	+	Estimated population growth rate	US Bureau of the Census
COR	+	Perceived level of public-sector corruption; score between 0-10, 10 being the least corrupt	Transparency International's Corruption Perception Index
c		Country	
t		Time, in years	
ε		Error term	

To control for macroeconomic factors that the government cannot directly control but that do influence FDI, the model includes several other data points besides DBI. Those control variables are GDP per capita, GDP growth rate, school life expectancy, population growth rate, and corruption.

FDI, DBI, GDP/CAP, and MG are all measured by year and country. Because the educational system is slow to change, the EDU factor will be broken down by county only, using the most

recent year data was available. Similarly, population growth rate (PG) and corruption ranking (COR) hold relatively steady year to year. Lastly, the error term per country per year is denoted by ε_{ct}.

Methodology of the Doing Business Index

The World Bank collaborates with academic professionals to craft a business case survey. This method spells out a business scenario and asks questions about how that firm would function in the host country. Annually, the survey is delivered to about 8,000 local experts per economy. These experts include lawyers, consultants, accountants, supply chain professionals, government officials, and other businesspeople routinely administering or consulting foreign firms. In addition to the business case survey, the World Bank contacts the professionals an average of four times through conference calls and visits to refine the data and clear up misinterpretations or misconceptions about the survey questions. To ensure the accuracy of the survey results, responses are compared to other data known about the economy ("Data Notes," 2009).

Limitations

Any problems with the construction of the model are likely to stem from the narrow scope of the control factors. It is impossible to include every factor that influences FDI in the model. Review of the past literature has shown that the macroeconomic terms chosen as controls are quite significant to the level of FDI inflow. Also, while FDI data exists for all countries in all applicable years and never changes in definition, the DBI indicators have changed in nature, somewhat, over the years. Originally, data was collected under four subheadings in 145 countries. Since the World Bank first published the Index in 2003, six more subheadings and almost forty additional economies have been added to those studied in the Index published 2009.

There are some limitations to the survey method of data collection performed by the World Bank when determining the Doing Business Index. First of all is that the business case profiles just one type of business, typically a limited liability company. Secondly, the case describes the same particular business transactions in every country. That precludes other types of businesses or transactions and the different legal situations firms may experience if they do not function like the case firm.

Thirdly, the surveys are distributed in the largest major business city. In very dynamic economies, such as those which are rapidly reforming the business environment, the results in the major city may not be representative of other areas of the country. For example, Shanghai, China is considered a very modern city that is supportive of foreign businesses. Western China, however, has not experienced the same pro-business reforms and the region is quite unfriendly to foreign businesses. Consequently, many fewer foreign firms have established themselves in Western China.

Fourth, the timeline of some business activities cannot be defined precisely and must be estimated by the expert respondents, leaving respondent interpretation responsible for shaping the answer. When questions such as this are analyzed, the World Bank asks the amount of time the expert assumes is needed and calculates the mean time for the DBI indicator. Finally, the last limitation of the case is that it assumes that the firm has perfect knowledge of procedure and does not waste time doing research. In the real world, firms do not have all of the knowledge. Firms may also simply choose not to follow the law when it is too burdensome to do so ("Data Notes," 2009).

Lastly, the Doing Business Index is a ranking. As more countries have been added since the original report in 2004, countries could have the same scores on subheadings yet have a lower aggregated rank. The fact that the Doing Business Index is so new thus affects the reliability of comparing information year to year.

To use the education (EDU) factor in a predictive manner, it must be assumed that the ratio of enrollment stays constant. This data also does not measure the completion of a certain grade since years of schooling includes students that repeat a grade. There is difficulty comparing each year's number country to country since the requirements for each grade level are not consistent globally. Because the factor is aggregated with others, this is unlikely to cause a disruption in the model. ("School Life Expectancy," 2009)

COR is from the Corruption Perception Index as determined by the Transparency International Organization. It is a score on a 0 to 10 scale, with 10 being the least corrupt. There is a confidence interval of 90% for each score. That means any score could be 5% higher or lower

than the score used in this study. The Index is also partially based on expert survey responses which are always subject to a small degree of subjectivity. (Transparency International, 2009)

RESULTS

The model was run in several ways. The Original Model takes the average of each country's DBI for 2008 through 2010 and backfills years 2004 to 2007 with that average. This was done so that the largest number of countries could be studied, even if they had not been included in the first publication of the Doing Business Index. The model shows that the DBI factor is significant and that moving up a rank will bring $44 million more in FDI.

In the Dumping Model, only data from 2008 to 2010 was studied. This model was run because the World Bank did not find a DBI rank for all countries studied in this report. Rather than average the rank and backfill as in the Original Model, years 2004 to 2007 were eliminated. While this model shows that moving up one DBI rank would bring in $60 million, the DBI factor is not significant to the 90th percentile.

To eliminate outliers, three more versions of the model were run: Without New Zealand and Singapore, Without China and India, and Without New Zealand, Singapore, China, and India. Singapore and New Zealand have consistently been ranked number 1 and 2 respectively since 2005. (In 2004, New Zealand was number one and Singapore was number two.) China and India have the two largest populations of the countries in the study. To multinational companies, a sizeable population can indicate a large group of customers or a large supply of labor. In each of the models, the DBI factor is significant. Also, the models indicate that if a country moved up one rank on the Doing Business Index, FDI would increase between $42 and $43 million. This is very close to the results of the Original Model. Thus, the outliers did not have much of an impact.

	Original Model	**Dumping Model**	**Original Model Without Hong Kong and New Zealand**	**Original Model Without China and India**	**Original Model Without New Zealand, Singapore, China, and India**
DBI	**-44,241,677 (.0226)**	-60,321,833 (.1192)	**-43,148,699 (.0282)**	**-42,377,545 (.0250)**	**-42,961,898 (.0238)**

GDP/ CAP	**402,637 (4.8135 E-10)**	**271635 (.0173)**	**381,362 (7.73 E-09)**	**433,594 (5.4815 E-12)**	**405,936.67 (2.22 E-10)**
MG	-734,415,457 (.9460)	-12,703,943,391 (.6416)	-353,433,924 (.9742)	-14,304,049,673 (.1771)	-12,815,657,054 (.2284)
EDU	-219,642,991 (.4303)	-85,837,745 (.8805)	-183,944,737 (.5397)	-66,879,186 (.8157)	-68,596,762 (.8129)
PG	-110,238,986,920 (.1289)	-100,883,325,070 (.4985)	-95,173,313,823 (.1970)	-66,047,620,834 (.3484)	-52,349,350,870 (.4632)
COR	138,160,826 (.8131)	1743,683,851 (.1461)	-408,814,924 (.5053)	-197,199,566 (.7357)	-1,315,512.5374 (.7064)

Numbers bolded are significant to the 90th percentile.

None of the control variables, except for GDP per capita (GDP/CAP) were significant in any of the models. MG, EDU, PG, and COR also consistently had a sign contradictory to what was expected. This indicates that the chosen control variables were not independent enough from the other factors.

The final result is that there is a real connection between foreign direct investment and the Doing Business rank. Governments can take direct action to affect the level of foreign direct investment inflows into their country.

CONCLUSIONS

The results show that there is a significant relationship between DBI and FDI. This suggests that there is a direct link between FDI and actions undertaken by the government. As explained in previous studies, national governments are already used to altering some of the DBI sub-factors because they help local businesses and can encourage FDI. Some common sub-factors such as corporate taxation rate, required local business ownership, and profit remittance rules are already used by governments to influence FDI. Labor regulations and waiting periods for government registration are other government actions that can be used to affect both domestic and international businesses.

There must be some distinctions made, though, between the types of FDI. Multinational firms that want to simply construct a distribution hub will be more interested in the cost to build the facility and the ease of trading across borders. Companies that plan to manufacture in the foreign country will likely be focused on labor laws. Finally companies that want to create a

branch will need to know about the number of procedures and length of time it takes to create and close a business. This allows governments to specifically target certain types of FDI.

If a government wants to be more business friendly, domestically or internationally, a common theme found was a streamlining of paperwork and more explicit regulations so approval time could be shorter. One aspect in particular that affects most categories in the Doing Business Index is time. Seven of the Doing Business Index sub-headings factor in time whether it is hours, days, or years. Six categories are affected by the number of procedures. Especially for smaller companies that do not have the resources to spend making mistakes or waiting around for approval, clearer processes are important. Provisions such as these are included in WTO ascension rules, and experts believe further clarification of regulations past the WTO requirements would only help increase FDI.

There are already countries that are paying attention to their Doing Business Rank. Both Poland and Georgia, for example, advertise their rank and business friendly environment. Esteemed publications have also commented on the Doing Business Index's ability to show how one country relates to its neighbor. This has encouraged reform, particularly in developing countries. The sub-headings of the Doing Business Index also point out where a country has a deficiency, so that it can be addressed, to make the country more attractive to foreign direct investment.

FURTHER RESEARCH

This paper studied the aggregate 'ease of doing business' indicator, but further research could be conducted to determine if one or another subheading was more closely related to FDI than others. Another interesting question is why the control variables chosen for this study were not significant when compared to the Doing Business rank. Previous literature had indicated that the control variables did influence FDI, but may be too weak compared to the DBI factor or were too closely related. As previously stated, governments could attempt to specifically target a certain type of FDI. What is unknown is if there are benefits to encouraging one type of FDI over another.

APPENDICES

Appendix A

Location Advantage	Ownership/Internalisation Advantage	Other Advantage	Expected Effect on FDI Inflows
Demand/profit potential			
GDP per capita			+
Market size (GDP)			+
Market size growth (GDP growth)			+
Population			+
	Rates of return		+
Institutions			
	Cultural proximity		+
Corruption			-
Country risk			-
Policies of government			+/-
Privitisation			+
Transition performance			+
Production Costs			
Capital			-
Labour			-
Information			-
Infrastructure			+
Agglomeration			+
Transaction costs			
Geographical distance			-
Non-tariff barriers			+
Tariff barriers			+
Other			
		Exchange Rates	+/-
		Firm size	+
		Natural resources	+
		Trade flows	+/-

Source: (Johnson, 2006)

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