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Determinants of Foreign Direct Investment in Iran

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Abstract
This study aims to identify the economic determinants of foreign direct investment (FDI) in Iran for the period of 1991-2009. Simple econometric model and least squares technique have been used to determine the various economic factors that affect FDI inflows. Result found indicates the positive significant effects of real GDP growth, the proportion of imports to GDP, return on investment and infrastructure on FDI. While the effect of government consumption on FDI inflows has been found insignificant with unexpected positive sign.
Keywords: foreign direct investment, determinants, Iran.

Introduction
The integrative trend in global economy and economic liberalization in many developing countries led to intense competition for FDI inflows into these countries. Now, in developing countries, controls and restrictions about the entry and operations of foreign firms are substituted by policies, aim to attract FDI inflows.

Foreign direct investment refers to investment that investor resident in an economy undertakes in the foreign country in order to access a long term benefits and significant degree of influence an the management of the enterprise (Moosa, 2002: 1).

The changing perceptions to FDI and adopting more attractive policies by the host developing countries have changed the destinations of FDI flows from industrially developed countries to high growth developing countries. So that, FDI inflows to developing countries have risem from $ 41.3 billion in 1991 to $ 548 billion in 2009. In other words, FDI inflows to these countries reached to 49.2 percent from 26.1 % of total FD inflows during this period.This indicates developing countries obtained nearly half of total FDI inflows. While FDI inflows. While FDI inflows in the world have also rison from $ 157.8 billion in 1991 to $ 1114 billion in 2009, means an annual growth rate by 19.9 % . However, the world economy has experienced GDP growth rate by 5.9 % in same period. Tremendous increase in FDI inflows to developing countries led to increase in ratio of FDI inflows to GDP, nearly from 1% in 1991 to 3.9% in 2009.

The effects in order to attract more FDI stems from the belief that FDI is an instrument for transfer of technology, skills, innovative capacities and organizational and managerial practices (Afaro, et al. 2003:3). FDI not only support capital formation but also it can influence on the quantity of the capital stock. According to international monetary Fund, FDI in comparison with other capital inflows is more stable against crises (IMF, 2003: 16), because direct investors normally invest in long term and they cannot withdraw their invested capital within limited short period.

Literature indicates three main channels through which FDI can being about economic growth. The first is through the release it affords from the binding constraint on domestic savings. In this case, foreign direct investment augments domestic savings in the process of capital formation. Second, FDI is the main channel through which technology transfer take place. The transfer of technology leads to an increase in factor productivity and efficiency in the utilization of resources, which leads to economic growth. Third, FDI leads expand exports as a result of increased capacity and competitiveness in domestic production (Ajayi, 2006: 2).

Iran despite of abundance natural resources, availability of saw materials, energy and various provisions in connection with investment is not yet attractive for FDI inflows. At the beginning of 2000, country made an effort to improve investment regime through enactment of investment rules and regulations, but actually could not attract expected amount of FDI.

Following diagrams show that positive event in attracting FDI inflows, is related to decade of 2000 in which has not experienced a sustainable and increasing trend. According to UNCTAD report indices of “performance” and “potential” for attracting FDI in Iran’s economy are perfectly different. Iran’s economy in regard to performance suffer from weakness but in respect of potential possibilities and capabilities is strong (UNCTAD, 2004: 20; 2008: 13)

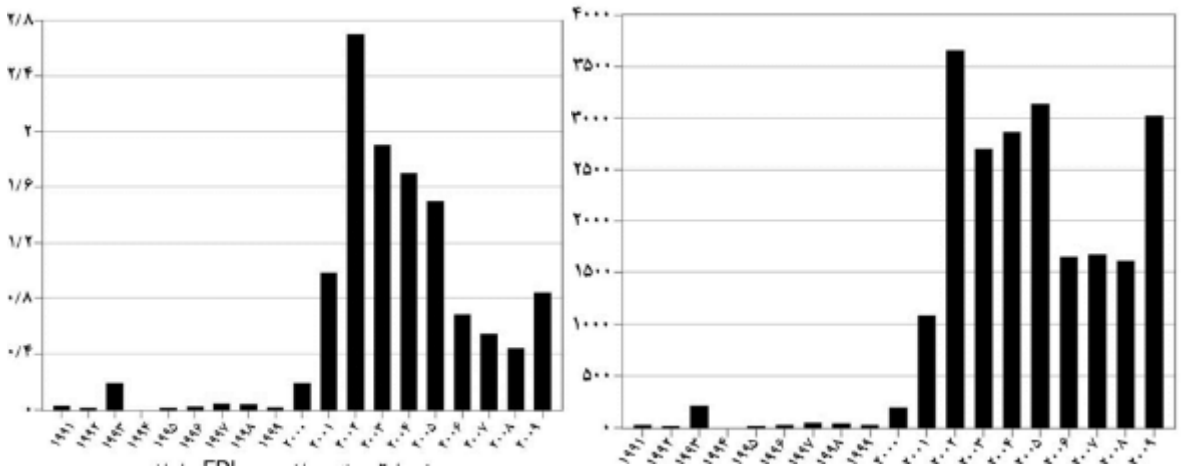

Figure (2) FDI-inflows to Iran 1991-2009 (% of GDP) Figure (1)FDI inflows to Iran 1991-2009 ($ millions)

With respect to discussion mentioned above, present research makes an effort to study economic factors affecting an FDI inflows during the period of study in Iran. It is viewed that

determining and understanding these factors can help planners and policy makers to compile precisely FDI policies.

Hypotheses:

This study focuses on testing the following hypotheses:
-There is positive relationship between real GDP growth and FDI inflows.
-There is positive relationship between import to GDP ratio and FDI inflows.
-There is positive relationship between development of infrastructures and FDI inflows.
-There is positive relationship between return on investment and FDI inflows.
-There is negative relationship between government consumption and FDI inflows.

Theoretical explanations of FDI

Several theories have been presented in order to study the factors affecting FDI and their effects. Among of them, the internalization hypothesis believes that firms undertake FDI in order to choose interfirms transactions instead of market operations.The basis of this theory is founded on coause viewpoint.He argues due to existence of some transactions cost, firms would rather inter-firms transactions than market operations.

In the industrial organization hypethosis, Hymerbecause that firms operating in a foreign country are at a disadvantage compared to the domestic firms. This disadvantage is a result of operating in a foreign environment. Usually, the domestic firms are assumed to have lower costs of operation, since they are more familiar with local conditions such as legislation, business culture, language and so on. Therefore, a foreign firm must have an offsetting, or firm – specific advantage allowing it to compete with domestic firms. Firm-specific advantages include superior technolog, scale economic, brand name, managerial skills and marketing (Johnson, 2005: 18-19)

In eclectic paradigm, Dunmingbelievers' that transnational corporations (TNCs) invest abroad when three sets of relative advantages are present:

Ownership specific advantages

This kind of advantages are based on the concept of firm – specific advantages. To cancel out the disadvantage of operating in a foreign country, a firm must possess an ownership advantage. The ownership advantage comes in the form of asset reducing the firm's productions cost and allows it to compete with domestic firms in the foreign economy despite the information disadvantage. Ownership specific advantages can be categorized:

a)Monopoly advantages in the form of privileged access to markets through ownership of natural limited resources, patents and trademarks;
b)Technology and knowledge to contain all forms of innovation activities;
c)Economies of large size such as economies of scale and greater access to financial capital (Demisia, 2010: 57)
In order to provide an ownership advantage, the possessing firm has to be able to exclude competing firms from using the asset. To create conditions for FDI, ownership advantages

also have to be transferable to a foreign country and possible to use simultaneously in more than one location (Johnson, Zaor: 19)

Locational specific advantages (L)

Locational advantages of different countries are accounted as main factors in deter to distinguish the host country for transnational corporation activities.Since, the host country make an effort to generate for TNC affiliates locational advantages that arise from direct access to domest market, lower unit labour costs, reduced transportation and communication costs, avoidance of tariffs and non-tariffs barriers, and also direct access to raw materials, low-cost unskilled labour and intermediate products.

Locational advantages can never be transferred to another location but can be used by more than one firm simultaneously. For example, a supply of cheap labor can provide a location advantage for several labour-intensive firms.

Internalization specific advantages

The existence or non-existence of an internalization advantage determines how the firm chooses to use its ownership advantage. Existence of an internalization advantage implies that the firm's most efficient alternative of using an ownership advantage is through exports or FDI. If an internalization advantage is missing, it is more profitable for the firm to exploit its ownership advantage through selling the right of its use to another firm through licensing.Existence or non-existence of an internalization advantage determines a firm choice between own production and licensing of the production to an external firm.

Empirical evidence on the determinants of FDI

Theoritically, it is viewed that FDI is positively correlated to economic growth. However, the empirical evidence show that FDI effects on domestic firms are mixed. But on balance, the literature on FDI agrees that the positive effects of FDI tend to outweigh the negative effects (Lim, 2001: 4-10). Nonemberg and mendonca (200) used economic model based on panel data analysis for 38 developing countries and found market size, GDP growth rate, degree of openness, inflation, risk and stock market performance are important determinants of FDI inflows.Mottaleb (2007) analyzed panel data from 60 less developed countries and found that market size and GDP growth rate, business environment, modern communication facilities significantly affect the FDI inflow and FDI positively and significantly affects the GDP growth of a country. Khachoo and khan (2012) examined the determinants of FDI based on a sample of 32 developing countries for the priod of 1982 – 2008.

The study found that these is positive relationship between FDI and level of GDP, total reserves and infrastructure while labour lost has negative effect on FDI and trade also openness does not affect on the fDI inflows into developing countries.

Asiedu (2002) in a research "on the determinants of foreign direct investment to developing countries: is Africa different"? by using least square method for all estimations has shown that trade openness, return on investment, size of market and infrastructure are significant

variables for FDI fostering, while political risk found insignificant. Hisarciklilar, et al. (2006) analyse the locational drivers of FDI, with an emphasis on the sale of market potential in MENA countries. The results imply that FDI in the MENA region is market oriented as well as aiming at the domestic market in the host economy, it also utilizes trade opportunities within the region. Ancharaz (2003)

In a research has studied comparatively determinants of FDI in sub saharam Africa with another regions. The results indicate that larger domestic markets, higher average GDP growth, and greater openness are important magnets for FDI flows. While, larger government, high levels of transfer risk and policy and political instability deter FDI.

Abdel-Rahman (2002) examined the determinants of FDI flows into the kingdom of Saudi Arabia.Results show that GDP level has positive significant; GDP growth rate has positive but mainly insignificant; exports and imports have negative significant; social-political risk have mainly significant impact on FDI inflows. Also, research findings indicate that generally determinants of FDI in Saudi Arabia are economic, social and political factors and particularly are related to level of activities in economy along with variables related to structure of return on investment, degree of openness and environment of macro economic. Shahabadi and mahmoodi (1385) studied the determinants of FDI inflows in Iran. Results indicate that natural resources, human capital and infrastructure have positive significant, variable of political rights and dummy variable of Islamic revolution have inversely and significant; openness has positive insignificant; government consumption, has negative insignificant impact on FDI flows into Iran.

Jafarnejadet. Al (2011) examined determinants of FDI in Iran, using time series datafor the period of 1991-2006, two models were developed.The results drived through the first model indicated that openness of trade and GDP per capita have a significant positive impact on FDI in Iran while inflation, oil extraction and production had a negative correlation with FDI. The results also show that infrastructural factors, market size, research and development (R&D), education and scientific output encourage FDI inflows in Iran. The second model output estimates revealed that the business factors promote FDI and once more the oil factor proved to have a negative impact on the FDI inflows to Iran. According to the finding of this research, FDI in Iran is more market-seeking and resource-seeking than an efficiency seeking.

Determinants of FDI

Determinants of foreign direct investment are usually divided into two groups: the supply side determinants and the demand side determinants (Asiedu, 2002: 109-110).
Ownership advantages and internalization advantages are supply-side determinants of FDI and it consists of economics of scale, oligopoly reaction, product life cycle, intangible assets and internalization. While, location advantages are the demand side determinants and it's reffered to the advantages that host countries have in attracting more FDI inflows from abroad.

Though these are a number of economic determinants determining FDI on the demand side but in respect of Iran's economy conditions and on the base of studies have been carried out on the determinants of FDI, this study uses real GNP growth, import to GDP ratio,

infrastructures, return on investment and government consumption. The brief justification of these incorporated economic determinants in the study are given below:

Real GDP growth

The growth of GDP is included to capture potential future economic opportunities and the existence of economic rents (Golbosman et al. 2004: 17). This growth can be as a determinants of FDI inflows to countries (UNCTAD 1998: 107). Countries that have high and sustained growth rate receive more FDI flows than volatile economies (sanou, 2006: 38). This is due to that foreign investors look beyond the current market size and take into account the future growth potential of the market (Kahai, 2011: 45). Further, impatance of GDP growth has been confirmed in many previous empirical studies (Nonnemberg and Mendonca, 2004; Nunnenkamp and spats, 2002; Arbatli, 2011). Therfore, it is necessary to consider GDP growth an important factor regarding attracting FDI flows, although it is not the only factor influencing FDI.

It is pertinent to mention that the more successful countries, more fundamental development conditions are met: law and order, financial incentives, increasing the capability of workers through technical educations, maintaining appropriate exchange rate, inflation rate, improving infrastructure and so on. This is expected a positive relationship between this variable and FDI inflows.

Import to GDP ratio

This study also employs imports as a percentage of GDP (IMP/GDP), as a proxy for the domestic demand on foreign goods. A positive and significant coefficient of this variable will suggest that foreign firms consider economic potential of the domestic market (Hasen and Gianlvigi , 2007:11). On the other hand will signal that the firms tend to choose locations where they can easily import raw material or other supplies (Hisaciklilar, etal. 2006:9) This study also expected a positive impact of this variable on the FDI during the study period.

Infrastructure

This is considered a precondition for any sort of investment, be it domestic or foreign. Physical infrastructure not only support economic development but also has impact on capability of firms in order to operating successfully. Well-developed infrastructure improves possibilities of domestic industries, expands the inter section relation in the economy and helps to create, he conditions for efficient distribution goods and services.

The availability of well-developed infrastructure will reduce the cost of doing business for foreign investors and enable them to maximize the rate of return on investment (Morriset, 2001: 107-125). Previous empirical studies mainly indicate that the positive impact of infrastructure on FDI inflows (Kumar, 1994; sun, et al. 2002; asiedu, 2005; Ramirez, 2009). In present study, also is expected infrastructure has a positive impact on FDI inflows during the study period.

Return on investment

The profitability of investment is one of the major determinants of investment. Thus the rate of return on investment in a host economy influences the investment decision. Capital scarce countries generally have a higher rate of return. Because if it is assumed that the marginal product of capital is equal to the return on capital, then investment in capital scarce countries has higher return. Since capital scarce countries have lower per capita income, the inverse of the real GDP per capita to measure the return on capital. Therefore these is inverse relationship between GDP per capita and return on investment (Asiedu, 2002: 110-111).

Government consumption

Also, model of this study incudes the variable of government consumption as a proportion of GDP. Many researches have confirmed use of this variable (Edwards, 1990; Harrison and revenga, 1995; Ancharaz, 2003) and is expected to have a negative sign. The reason for this negative relationship is that a large size of the government expenditure may create opportunities for misuse of funds by government officials. Secondly, big government expenditure creates an elaborate and complex bureaucratic structure that makes the investment climate unattractive to FDI (onyeiwn, 2003; 6-7 and Filipovic, 2005: 21) and increase in possibility of enactment of higher taxes rate in future. Ancharaz believes that: Bigger governments typically represent more involved bureaucracies, and are often associated with administrative inefficiency and corruption, which significantly increase the hassle costs of investing in the country (Ancharaz, 2003: 8)

Methodology and data

Econometrics model

The following model is formulated in the light of literature to examine the impact of various economic determinants on FDI during the study period of 1991-2009:

$$FDI = f(GGDP, IMP, INFRA, RI, GC) \quad (1)$$

More specially equation (1) can be written as:

$$Log(FDI) = \propto_0 + \propto_1 \log(GGDP) + \propto_2 IMP + \propto_3 INFRA + \propto_4 RI + \propto_5 \log(GC) + \mu \quad (2)$$

Where
FDI= foreign direct investment
GGDP= real GDP growth
IMP= import to GDP ratio
INFRA= infrastructure, measured by paved roads (% of total reads)
RI= return on investment measured by 1/GDP per capita
GC= government consumption
μ= Error term

The explanatory variables on error term (μ) will follow the least square assumptions.

Data and estimation technique

This study is based on secondary data for the period of 1991-2009. For analysis the data have been taken from various sources: date of variables FDI, GGDP, RI collected through UNCTAD statistics, data of variable InFRA has been taken from world development indicator and data related to IMP and GC collected from Iran's central bank publications for analysis of various economic determinants influencing on FDI inflows, simple regression model and the method of least square (OLS) have been applied as an analytical technique. E. views computer software has been used for results derivation.

Empirical Results

Empirical results of the study are given in table (1) in details. The following equation shows the estimated regression equation of economic determinants:

FDI= - 28.99485 + .952132GGDP + 0.196374 IMP + 0.296468 INFRA + 8302.745 RI + 2.659441GC

Table (1) shows that rreal GDP growth proxy used GGDP has been found positively significant at %5. The study hypothesized positive relationship between GGDP and FDI and the result found strongly support the study hypothesis. The positive significant relationship between FDI and real GDP growth have also found by Mottaleb (2007) and Ancharaz (2003). Research's finding agrees with this fact that generally FDI flows into countries enjoy from growing real income and as a result their purchasing power increases. Research finding may also leads to the result that horizontal FDI (FDI seeking situation to produce for domestic market in host country) increases when domestic market is growing. Another variable is ratio of import to GDP which has been found with expected positive sign and statistically is significant at 1% level significance. Hisarciklilar et al (2006) also found this variable in their study in case of MENA region countries, with positive significant impact on FDI inflows. As expected, infrastructure has been found very significant with positive sign and statistically is significant al 1% level of significance.
Also, previous studies such as Asiedu (2005) and Ramirez (2009) indicate positive significant relationship between infrastructure and FDI. Return on investment has been found with expected positive sign and statistically significant at 5% level of significance. Asiedu (2002) has also found the positive significant relationship between return on investment and FDI. The positive significant relationship between FDI and return on investment has been emphasized by Onyeiwn (2003) in case of Non-MENA region countries. But impact of government consumption on FDI inflows has been found insignificant and with unexpected positive sign. Shahabadi and Mahmoodi (1385) have also found it's impact insignificant however Ancharaz (2003) and Edwards (1990) have found impact of government consumption on FDI inflows, significant with sign that is coinciding theory (negative).

Conclusion

The aim of the present study is to identify economic determinants of foreign direct investment in Iran. The study of these determinants is important when multinational making decision about investment in other countries. The home and host countries both have some

advantage of FDI, the home country desires to utilize the cheap labour, abundant raw materials etc. in order to maximize profit, while the host country interested to gain from the advantage of managerial skill, capital, advanced technology, generate employment opportunities and increase revenue etc. For this purpose secondary data for the period of 1991-2009 have been utilized for country of Iran. Results found show positive impact of real GDP growth, ratio of import to GDP, infrastructure and return on investment on FDI inflows during the study period. While, government consumption has positive insignificant impact on attracting FDI. The positive impact of real GDP growth, ratio of import to GDP and return on investment indicate that foreign direct investment in Iran, mainly is market – seeking.

This is consistent with the finding by Jafarnejad et al. (2011)The positive significant relationship between infrastructure and FDI means that development of infrastructure promote FDI inflows to the country. FDI investors normally looking for a location that is available and convenient in infrastructure such as road, telecommunication, transportation. If a location is well-developed, investors can reduce their production cost and then increase their profits.

Table (1) OLS Estimates from 1991-2009

Dependent Variable : FDI

Method : Least Squares

Sample: 1991 - 2009

Included observations : 17

	Coefficient	Std.Error	t-Statistic	Prob.
C	-28.99485	5.187008	-5.589899	0.0009
GGDP	0.952132	0.391596	2.431412	0.0333**
IMP	0.196371	0.045771	4.290489	0.0013*
INFRA	0.296468	0.033289	8.905870	0.0000*
RI	8302.745	2858.005	2.905084	0.0143**
GC	2.659441	1.456407	1.826028	0.0951

R-squared	0.945841	Mean dependent var	5.605552
Adjusted R-squared	0.921223	s.d. dependent var	2.404609
S.E. of regression	0.674908	Akaike info criterion	2.322085
Sum squared resid	5.010515	Schwarz criterion	2.616160
Log likelihood	-13.73772	Hannan-Quinn criter.	2.351316
F-statistic	38.42086	Durbin-Watson stat	1.996437
Prob(F-statistic)	0.000001		

Asterisk * and ** show significant at 1% and 5%

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