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Determinants of Foreign Direct Investment (FDI) inflows in Nigeria's Services Sector

Basiru Oyeniran FATAI, Ph.D.

Research Fellow, Trade Policy Research and Training Programme,

Department of Economics,

University of Ibadan, Ibadan, Nigeria.

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Abstract

FDI had been identified as one of the drivers of economic growth in developing countries. This is because of the inherent spill over effects that can facilitate technological growth, managerial skill, and global market access for the recipient country. This study examines the determinants of foreign direct investment inflows in Nigeria's services sector, between 2010 and 2020. It adopted random effect model that was derived from the results of the Hausman test. The results suggest that the market size and the exchange rate are the major determinants of foreign direct investment inflows in Nigeria's services sector. Based on this, it is recommended that the policy makers in Nigeria need to consider both internal and external macroeconomic stabilities accordingly so as to increase services FDI inflows in the country.

Key words: Foreign Direct Investment, Services sector, Random effect, Hausman test
JEL classification: F21; F23

I. Introduction

Foreign Direct Investment (FDI), the mode three of services supply, is widely perceived to be one of the propelling forces for economic growth of developing countries. This can be achieved through the entry of Multinational Corporations (MNCs) that bring about a lot of spillover effects into the host countries. The spillovers could be in form of technological transfer that can boost technological growth, productive capital stock, managerial skill, and global market access (Kaliappan, et al., 2015).

Nigeria is a big economy in Africa; which serves as the hub of market seeking services FDI in Africa considering the existing market size. For instance, Sub-Saharan African countries had recorded GDP of about $1.9 Trillion in the year 2021, out of which Nigeria contributed about $511.9 Billion, which was about 27.27 per cent of the total SSA countries' GDP (World Bank, 2022).

There has been a rise in FDI to tertiary sector globally in recent decades. This trend can be linked to the rise in services economy and the need to supply services that is hitherto non-tradable through FDI (Riedl, 2010). Other reasons adduced by UNCTAD (2004) for the rise in Services FDI include the rising critical roles of services sector in respective economies[1]. The rise in services sector provision of opportunities for services FDI that is market seeking; privatization of public utilities that was hitherto owned by government agencies, which later facilitated further liberalization to foreign investment; rise in cross-border mergers and acquisitions in banking, telecommunications, and other related industries that accounted for the rise in services FDI in developed countries; an upsurge in the need for offshoring and/or outsourcing of services to perceived low-cost locations. This was caused majorly by advancement in Information and Communication Technologies (ICTs) that have facilitate tradability of services (Ramasamy and Yeung, 2010). Also, the increase in services FDI is boosted by the formation of World Trade Organization (WTO) in 1995 and the subsequent implementation of General Agreement in Trade in Services (GATS) (Kaliappan, et al., 2015).

Nigeria recorded total FDI inflows of about $1.40 billion in the last quarter of 2010, which increased to about $3.80 billion, $1.05 billion, and $2.19 billion in the last quarters of 2019, 2020, and 2021 respectively. The value of services FDI inflow was about $400 million (about 28.70% of total FDI inflow) in the last quarter of 2010. This increased to about $2.1 billion, $468 million (44.56%), and $1.2 billion (71.30%) in the last quarters of 2019, 2020, and 2021

[1] Services sector constitute above 70 per cent of GDP in developed countries, and above 50 per cent in developing countries.

respectively. Though, there was relative increase in FDI inflow across the year, but the reduction in the value of FDI inflows in year 2020 was owing to the Covid-19 pandemic (CBN, 2022).

Though, there are a lot of empirical studies on determinants of aggregated FDI flows as reviewed by Blonigen (2005); Sahiti, et al. (2018); as well as Feng and Wang (2021). With different hypotheses and combinations of variables adopted in the previous studies, their results are mixed considering statistical significance and direction of causality relationship. This could be partly because they considered overall FDI inflows. The significance of FDI determinants identified in the literature is reflected in host country's characteristics in terms of national political, economic, legal, cultural, traditional, infrastructural systems and policies (Bitzenis, et al., 2009).

However, few studies focused on specific industry or sector FDI such as banking sector (Moshirian, 2001); financial services sector (Luiz and Charalambous, 2009); advertising sector (Terpstra and Yu, 1988); legal services sector (Cullen-Mandikos and MacPherson, 2002); wind energy (IKeeley and Ikeda, 2017); as well as services sector FDI (Kolstad and Villanger, 2008; Ramasamy and Yeung, 2010; Kaliappan, et al., 2015).

But, the characteristics of services sector FDI among other factors are reasons to believe there are variances in the determinants of services sector FDI and aggregate FDI. International trade in services seems increasing, but some services appear non-tradable or expensive to trade internationally. As a result, some services that cannot be put through cross-border trade require physical presence is required to satisfy the demand for those services. Hence, services FDI appears market-seeking (Kolstad and Villanger, 2008).

FDI in services appears subjected to non-tariff measures than FDI in manufacturing, because some industries such as banking, electricity provision, telecommunications, and transportation usually undergo economic or prudential regulation by the host countries considering the strategic or sensitive nature of the industries (Jensen, et al., 2007). However, in theory services FDI are dissimilar from manufacturing FDI in nature, it is expected that services FDI can directly or indirectly boost the efficiency, productivity, and economic growth in the host countries. Hence, it is important to investigate the determinants of services FDI (Kaliappan, et al., 2015).

The services sector FDI inflows into host country necessitate structural changes in terms of services sector contribution to GDP, employment generation, and export performance. Considering the rise in services sector FDI, assessing its determinants is important for host countries FDI policy effectiveness. Accordingly, this study estimates the determinants of FDI

in services sector particularly on services sub-sectors including Transport, Travel, Insurance, communication, Finance, and other Business services in Nigeria. Following this section is the review of related literature. Section three deals with the methodology adopted in the study, while section four and five presented the empirical results and conclusion respectively.

II. Literature Review

The product life hypothesis propounded by Viner (1960) is one of the theoretical explanations of FDI. The theory suggested that at the early stage of a product life, the new goods production seems taking place in the developed countries, but later move to other economies. Also, at a particular stage of a firm's growth it tends to become multinational. As a product reaches a standard form with a developed competing product, the producer firm decide to move overseas for new markets and lower cost locations. This could bring about technology transfer from the developed countries to developing countries (Asiamah, et al., 2019).

There are microeconomic and macroeconomic theoretical underpinning for the determinants of FDI inflow. Firm's internal factors are used to determine Multinational Corporation and foreign investment status in microeconomic theories. The macroeconomic theories consider macroeconomic variables in explaining cross country FDI flows. The Eclectic Paradigm approach uses both micro and macro-economic factors such as ownership, location and internationalization advantages to explain FDI flows (Dunning, 1981; Dua and Garg, 2015).

Developing countries are observed to have been attaining attractiveness beginning from the twenty-first century owing to improved institutional quality, infrastructural development, availability of national resource, and presence of semi-skilled/skilled labor force. Such factors as commercial interest rates, domestic inflation, exchange rate, external indebtedness per capita income, Real GDP growth, and trade openness play an importance role in determining foreign capital inflows. However, the determinants of FDI depend on country-specific factors (Saini and Singhania, 2018).

The market size of the host country is a major determinant FDI inflows, because larger market can ensure economies of scale. A positive relationship had been observed between host country's GDP and FDI inflows (Asiedu, 2006; IKeeley and Ikeda, 2017). Gupta and Singh (2016) used the modified random effects model and found that industrial production index, inflation rates, unemployment rates, trade openness and real effective exchange rate are significant determinants in attracting FDI inflows in BRICS countries.

The existence of macroeconomic stability brings about less investment risk that ensures conducive environment for FDI flows. Faeth (2009) found that inflation had negative relationship with FDI. Exchange rate was observed to be a determining factor of FDI inflows in a given country (Hoang and Bui, 2015; Gupta and. Singh, 2016). Access to finance (credit to private sector) is a major determinant of FDI (García-Herrero and Navia, 2003).

Institutional factor such as Political stability brings about continuity of FDI projects, particularly those that are affected by the existing policies (Asiedu, 2002; Fazio and Talamo, 2008). Kolstad and Villanger (2008) found that institutional quality and democracy look more critical for services FDI than general investment risk or political stability. Democracy eases FDI inflows in developing countries. Thus, service FDI is market-seeking, and unaffected much by trade openness. Paul and Jadhav (2020) explored the role of institutional determinants of FDI, concluded that infrastructure quality, tariff and non-tariff barriers (trade cost), institutional quality indicators such as control on corruption, effective rule of law, political stability, and regulatory quality are important determinants of FDI in emerging markets.

Arawomo and Apanisile (2018) used Autoregressive Distributed Lag (ARDL) to examine the major determinants of FDI in Nigerian telecommunication sector. The results suggest that market size, trade openness, government expenditure, inflation and interest rate are determinants of FDI flow into the Nigerian telecommunication sector. Kaliappan, et al. (2015) used a static linear panel data analysis to estimate the determinants of services-based FDI in ASEAN countries**.** The findings suggest that services FDI inflow is determined by human capital, market size, quality infrastructures availability, and trade openness, but inflation is observed to have negative and insignificant impact.

III. Methodology

3.1. Theoretical framework and Model Specification

This study is premised on theoretical exposition of MacDougall (1958) and Kemp (1964). They opined FDI can be determined by reduced transaction cost, profitability anticipations, and macroeconomic stability in the host country. Hence, the theoretical model of the study is:

$$FDI = f(GDP, EXC, CRE, TOP, POL) \quad (1)$$

Where, FDI is Services FDI inflows, GDP measures Real GDP that is proxy for market size, EXC represents the exchange rate that measures macroeconomic stability, CRE is the credit to private sectors, TOP is the trade openness and POL signifies political stability,

which is institutional quality variable. The choice of independent variables was determined by the literature review. GDP that measures market size was observed to be a robust determinant of FDI (Artige and Nicolini, 2005; IKeeley and Ikeda, 2017). Access to finance (credit to private sector) is a major determinant of FDI (García-Herrero and Navia, 2003). Institutional factor such as Political stability allows for continuity of FDI projects affected by the existing policies (Asiedu, 2002; Fazio and Talamo (2008). Trade openness determines movement of FDI into a country (Saini and Singhania, 2018). Exchange rate was also perceived to be a determining factor of FDI inflows in a given country (Hoang and Bui, 2015; Gupta and. Singh, 2016)

Equation (1) is expressed as a panel of services sector (Transport, Travel, Insurance, communication, Finance, and other Business services), in empirical model as:

$$FDI_{it} = \alpha_i + \beta_1 GDP_{it} + \beta_2 EXC_{it} + \beta_3 CRE_{it} + \beta_4 TOP_{it} + \beta_5 POL_{it} + \varepsilon_{it} \quad (2)$$

Equation (2) describes the static panel model that implies the variable slopes (β_1, β_2, β_3, β_4, β_5) considered constant across cross-section and time. The intercept, α_i implies individual heterogeneity, which is time-invariant. Both fixed effect and random effect static models are estimated, in order to show weather α_i is correlated or distributed independently of the regressors. For fixed effect, the constant parameter in equation (2) and the omitted variables that are observed to affect the dependent variable constitute α_i and taken as 'unrelated effect' (fixed effect). But, for random effect, α_i is taken as a 'related effect' (random effect) and expressed as:

$$FDI_{it} = \beta_1 GDP_{it} + \beta_2 EXC_{it} + \beta_3 CRE_{it} + \beta_4 TOP_{it} + \beta_5 POL_{it} + (\alpha_i + \varepsilon_{it}) \quad (3)$$

$$FDI_{it} = \beta_1 GDP_{it} + \beta_2 EXC_{it} + \beta_3 CRE_{it} + \beta_4 TOP_{it} + \beta_5 POL_{it} + \nu_{it} \quad (4)$$

Equations (3) and (4) are fixed effect model and random effect static model (error component model)

Prior the estimation of the empirical model, requisite series of data stability tests such as: panel unit-root test was conducted. The study adopted both individual and common unit-root tests. Diagnostic tests such as normality test and cross-sectional dependence tests were conducted. The cross-section dependence statistic is represented in a framework as:

$$CD = \sqrt{\frac{2T}{N(N-1)}}\left(\sum_{i=1}^{N}\sum_{j=i+1}^{N}\rho_{ij}\right) \sim N(0,1)$$

The null hypothesis for the test is, no cross-section dependence in the residuals. The null hypothesis should not be rejected at 5 percent, in order to validate the absence of correlation among cross-section residuals.

3.2. Data Source

The study covers period between 2010 and 2020. Data on Foreign Direct Investment (FDI), Real GDP, Exchange rate, Commercial Bank Credit to private sector, Trade Openness (measured as share of export and Import to GDP), are sourced from CBN database. The political stability variable was sourced from World Bank, World Governance Indicator.

IV. Empirical Results

The statistical properties of the variables used in the study were obtained through descriptive statistics (Table 1). It can be observed that FDI inflows in Nigeria had an average of about ₦126,018.93 million. FDI had a positive skewness of about 1.98, with standard deviation of about ₦183,672.99 million. The kurtosis value of 6.32 of the FDI inflows suggests a leptokurtic, because it is greater than 3.0 thresholds. This implies high peaks, longer, and fatter tails to its distribution characteristics.

Table 1: Descriptive Statistics of the variables

	FDI	GDP	EXC	CRE	TOP	POL
Mean	126,018.93	66,119.08	235.27	13,903.03	395.57	-2.01
Median	54,168.42	68,652.43	197	13,568.54	386.3	-2
Maximum	778,203.37	72,094.09	381	19,818.38	559.83	-1.86
Minimum	151.27	55,469.35	148.81	9,198.17	266.79	-2.21
Std. Dev.	183,672.99	5,441.75	82.47	3,335.77	81.99	0.11
Skewness	1.98	-0.79	0.34	0.12	0.26	-0.28
Kurtosis	6.32	2.16	1.52	1.86	2.51	1.92
Jarque-Bera	73.31	8.89	7.28	3.7	1.39	4.05
Probability	0.00	0.01	0.03	0.16	0.5	0.13
Sum	8,317,249	4,363,859	15,528	917,600	26,108	-132.68
Sum Sq. Dev.	2,192,824,855,386	1,924,819,330	442,070	723,279,465	436,912	0.77
Observations	66	66	66	66	66	66

Source: Author's computation

The stability of the series included in the model of the study was measured through, Levin, Lin and Chu (LLC) and Fisher Augmented Dickey-Fuller (FADF). The results of the former unit root test suggest that all variables are stationary at levels except exchange rate (EXC) that became stationary at an integration of order 1 (I(1)). But, it can be observed from the results of the later unit root test that only Services sector foreign direct investment (FDI) inflows and EXC were stationary at first difference, Other variables are stationary at levels. Hence, the variables are mixture of I(0) and I(1) variables (Table 2).

Table 2: Panel Unit Roots Test Results

	Levin, Lin and Chu (LLC)			**Fisher Augmented Dickey-Fuller (FADF)**		
	Level	**First Difference**	**I(d)**	**Level**	**First Difference**	**I(d)**
FDI	-1.31*[a]	-	I(0)	7.72[a]	24.95***[c]	I(1)
GDP	-5.89***[a]	-	I(0)	18.83*[a]	-	I(0)
EXC	-4.47[b]	-3.69***[a]	I(1)	14.49[b]	19.05*[c]	I(I)
TOP	-5.81***[a]	-	I(0)	32.98***[a]	-	I(0)
CRE	-1.81***[a]	-	I(0)	20.60*[b]	-	I(0)
POL	-3.41***[a]	-	I(0)	36.04***[b]	-	I(0)

Source: Author's computation

Discussion of Findings

Systematic procedures were followed in the study to choose optimal result from panel estimations carried out, through the Hausman test (Table 3). Fixed effect and random effect panel analysis were carried out, and Hausman test was conducted to determine the panel data model to be considered for the study. The null hypothesis (H_0) is to prefer random model, while the alternate hypothesis is to prefer the fixed effect. The aim is to test whether the unique errors are correlated with the regressors. The null hypothesis suggests they are not. The result of the Hausman test suggests that the p-value of the Chi-sq. statistic is greater than 0.05 level of significance. Therefore, the null hypothesis is accepted and random effect model is considered as the preferred model for this study (Table 4).

Table 3: Correlated Random Effects - Hausman Test

Test Summary	**Chi-Sq. Statistic**	**Chi-Sq. d.f.**	**Prob.**
Cross-section random	0.00	5.00	1.00

Source: Author's computation

Following the outcome of the Hausman test, the results of the random effect indicate that market size (measured by real GDP) and exchange rate (EXC) have positive significant impact on services sector FDI inflows in Nigeria. Services FDI and market size have statistically positive significant relationship with services FDI inflows at 5% and 1% levels. Hence, these variables are major determinants of services sector FDI inflows in Nigeria. However, trade openness (TOP) has positive insignificant impact on FDI inflows in Nigeria's services sector. However, access to finance (CRE), and political stability (POL) have negative insignificant impact on FDI into Nigeria's services sector (Table 4). The results justify the market seeking nature of services FDI inflows.

The outcome of the study is in line with some other studies in the literature such as: IKeeley and Ikeda (2017) that emphasized the market size of the host country determinant FDI inflows; Gupta and. Singh, (2016) found that trade openness and real effective exchange rate among other factors determines attraction of FDI inflows in BRICS countries; and Arawomo and Apanisile (2018) that concluded that market size, trade openness, government expenditure and other factors are determinants of FDI flow into telecommunication services sector Nigeria.

Table 4: Regression Results

Dependent Variable: FDI				
Method: Panel EGLS (Cross-section random effects)				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
GDP	8.803	4.488	1.961	0.054
EXC	3.679	1.301	2.827	0.006
TOP	0.036	0.6	0.06	0.952
CRE	-3.569	2.958	-1.206	0.232
POL	-0.067	0.617	-0.108	0.914
C	-32.01	13.531	-2.366	0.021
Cross-section random			0.548	0.634
Idiosyncratic random			0.416	0.366
R-squared	0.579	Mean dependent Var		1.009
Adjusted R-squared	0.544	S.D. dependent Var		0.63
S.E. of regression	0.425	Sum squared resid		10.855
F-statistic	16.479	Durbin-Watson stat		0.454
Prob(F-statistic)	0.000	Pesaran CD	-1.447	0.148

		Normality Test	0.5409	0.763

Source: Author's computation

Diagnostic Test

Diagnostic tests were performed on the results obtained to support the reliability and validity of the estimates of the estimated results (Table 5). These included normality and cross-sectional dependence tests. For the normality test, the Jarcqoe-bera statistics is 0.54, with probability value of 0.76. This suggests that the null hypothesis of normally distribution is accepted at 5 percent level. This is because the probability value suggests statistical insignificance.

The result of Pesaran CD test that measures cross sectional dependence indicates that the null hypothesis can be accepted at 5 percent level. The test statistics and probability values are -1.45 and 0.15 respectively. The probability value is greater than 0.05, which verify the null hypothesis of no cross-sectional dependence in the residuals to be accepted at 5 percent level of significance.

V. Conclusion

This study examines the determinants of foreign direct investment into services sector in Nigeria. This involved the use of random effect model, with the aid of the results of the Hausman test. The outcome of the study suggests that the market size and the exchange rate are the major determinants of foreign direct investment into services sector in Nigeria. The results support the market seeking nature of services FDI inflows. The policy makers in Nigeria need to consider both internal and external macroeconomic stabilities as appropriate towards boosting inward Services FDI into the country.

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