



**ADDIS ABABA UNIVERSITY**

**SCHOOL OF GRADUATE STUDIES**

**DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN  
ETHIOPIA: DESCRIPTIVE ANALYSIS**

**BY**

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This is to certify that the thesis prepared by Tayachew Mengiste, entitled: *Determinants of foreign direct investment in Ethiopia* and submitted in partial fulfillment of the requirements for the Degree of Master of Business administration (finance) complies with the regulations of the University and meets the accepted standards with respect to originality and quality.

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## **Declaration**

I hereby declare that this MSc thesis entitled “*Determinants of foreign direct investment in Ethiopia*” was carried out by me for the degree of Master of Business administration (finance) under the guidance and supervision of Ayele tirfie (Prof).

For the present of this thesis degree in Master of Business Administration, which I am submitting to the University, no diploma or degree or distinction has been conferred on me before, either in Addis Ababa University or in any other University. Moreover, I took reasonable care to ensure that the work is original, and, to the best of my knowledge, does not breach copyright law, and has not been taken from other sources document except where such work has been cited and acknowledged within the text.

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Date\_\_\_\_\_

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## Acronyms

- Bop- Balance of Payment
- ECI-Ethiopian complex index
- EIA- Ethiopian Investment Agency
- EIA- Ethiopian Investment Commission
- EPA-Ethiopian Privatization Agency
- FDRE-Federal Democratic Republic of Ethiopia
- FDI- Foreign Direct Investment
- FIAS- Foreign Investment Advisory Service
- Foreign investment commission
- GDP- Gross Domestic Product
- GNP- Gross National Product
- IFC -International Finance Corporation
- IMF- International Monetary Fund
- LDCs- Less Developed Countries
- MOFED-Ministry of Finance and Economic Development
- MNCs- Multi-National Corporations
- NBE-National Bank of Ethiopia
- None governmental organizations
- ODS –overseas development assistance
- OECD-Organization for Economic Cooperation and Development
- PSD-private sector development
- SOEs- state-owned enterprises
- TNCS- Transnational corporations
- GTP –growth transformation plan
- UN-United nations
- UK -United kingdom
- USA -United states of America
- UNCTAD- United Nations Conference on Trade and Development
- WB- World Bank
- WTO- World Trade Organization

## ABSTRACT

*Foreign direct investment has been the most reliable and largest source of external finance. It plays an important role as an engine of employment creation, technological transfer, productivity enhancement, economic intensification and more importantly, as an instrument of technology transfer, especially from developed to developing countries. The objective of this study is to identify the determinants of foreign direct investment in Ethiopia. This study employed combined research methods where both qualitative and quantitative data were used in the assessment. Questionnaire and interviews were the main instruments used to gather first-hand information from experts and FDI owners as well as key officials of Ethiopian investment offices and Ethiopia investment Commission. The sampling methods used were both probability and non-probability sampling. Purposive sampling was used to select experts with better knowledge and information from different sector offices. The study sample included 97 respondents from different foreign expert's offices, 15 FDI owner officers and 4 local (domestic) officers. Totally 116 respondents were involved in this study. The methods of data analysis were descriptive statistics by using frequency and table. The result of this study showed that availability of infrastructures, privatization policy, lower corruption, lower labor cost, availability of raw materials, political stability, investment law and regulations, geographical proximity, lower inflation rate and e-commerce are the determinant factors for foreign direct investment in Ethiopia. This study recommended that the government has to deepen its current effort in developing infrastructural facilities such as road, information and communication technologies, electricity system and improved services which are regarded as necessary conditions to draw sizable FDI.*

Key word: FDI, Host, Home, BOP, Determinants, Growth, Economic development, Investment.

# CHAPTER ONE

## INTRODUCTION

### 1.1. Background of the study

African economies can benefit from a range of external sources of finance, including Overseas Development Assistance (ODA), loans (private and public), remittances, portfolio equity investment and Foreign Direct investment (EIC, 2019).

FDI has been the most reliable and largest source of external finance. It has also been an important source of technology transfer, access to management skills, marketing network, employment and a major driver of export trade. FDI inflow into African countries has risen sharply in the last two decades, in line with improvements in economic performance and a growing global demand for African products. Ethiopia has been one of the countries that has attracted substantial amount of FDI from 1991/2 (EIC, 2019).

Investment in general and foreign direct investment in particular in Ethiopia, without doubt, has been one of the primary engines of growth and development in all economies of the country. Foreign Direct Investment (FDI) plays an important role as an engine of employment, balance of payment, competition, economies of scale, technological development, spillover or productivity enhancement, economic intensification, and more importantly, as an instrument of technology transfer, especially from developed countries to less developed countries (Jensen, 2003). However, its effectiveness rests on strong complementarities with other elements in the growth process, most notably technological progress, skill acquisition, the development of innovative capacity and adequate infrastructures. These elements make investment a natural departure for Government seeking to formulate a robust development strategy to attract foreign investors and encourage local infant industries. The link between investment and the other determinants of investment growth however is not an automatic process. It requires, among other things a favorable macro policy adjustment, specific policies and institutions aimed to encouraging saving and attracting and directing investment both in foreign and local investors to key sectors in the economy thereby enhancing the contributions of investment to skills formation, technological change, competitiveness and economic growth balance of payment and foreign transaction. A clear understanding of how such a synergy between investment policies on the one

hand and technological progress on the other hand can be taken as an essential prerequisite for designing an effective national investment policy and investment promotion strategy leads to investment in foreign and domestic investors in Ethiopia.

In Ethiopia numerous macroeconomic activity reforms have been implemented with the objective to achieving macroeconomic stabilization, growth and transformation plan since from 1991/2 in Ethiopia (NBE, 2018/9).

The macroeconomic reforms includes privatization of state owned enterprises, liberalization of trade policy, reduction of import tariff rates, elimination of tariff barriers on industrial goods , devaluation and deregulation of price & exchange rate controls, maintain of inflation and reductions of unemployment means full employment .These reforms have also been implemented with the aim of attracting foreign direct investment to the ultimate goal of poverty reduction leading to enhancing a better standard of living in developing countries like Ethiopia(UNCTAD, 2019).

Foreign investors can invest in all economic sectors in Ethiopia other than some sectors exclusively reserved for national investors and the Government. Investments like telecommunication services and manufacturing of weapon & ammunition are allowed only in joint venture with the government. To encourage indigenous entrepreneurship, the domestic private sector, the financial sector, import trade, Commercial water & road transport and several small businesses are reserved for national investors. While investments in sectors such as Manufacturing, Agriculture, Information Communication Technology, supply of Electrical Energy, railways service, Hotel and Tourism (Star designated hotel and resort motel), Health services by constructing own Hospitals, Real Estate development, Secondary and Higher education by constructing own buildings, whole sale trade thus are open for foreign investors to attract investment in Ethiopia (EIC, 2019). Therefore the main aims of the researcher have been to examine determinants of foreign direct investment in Ethiopia.

## 1.2. Statement of the problem

Globally, investment in the world has recognized that private capital such as domestic & foreign investments have vital roles to play an important economic development of the country. The UN's Millennium Declaration explicitly call as for great opportunities foreign direct investment (FDI) to Africa. Over the course of the 1990s, African countries significantly liberalized the investment environments for foreign investment of foreign investors. Nearly all countries revised their national laws of governing FDI and the vast majority lifted controls on capital (UNCTAD, 2018).

Although Ethiopia is one of the countries with the fast economic growth, even there is a persisting poverty and unemployment both in urban and rural areas (MOFED, 2016). Currently the government has been undertaking the growth and transformation plan which is a robust plan requiring significant capital investment and technology transfer. However, due to the low saving rate in the country there is financial inadequacy and investment constraining in the achievement of development goals. The government recognized the role of private investment (domestic & foreign) in particular foreign direct investment to fill the gap of the capital constraint and revised the investment proclamations several times. These facts reveal that FDI in Ethiopia is not only constrained by smaller numbers but also with the failure to commence the operation of investment different projects. The emerging economic diversification and private sector development (PSD) strategy should, therefore, start by asking two basic crucial questions ?What particular obstacles that determines the growth of private enterprises in current industry of in Ethiopia and their participation in the global market for labor- intensive and capital intensive manufactures industries ? What should be done to induce the opportunities development of more dynamic private sector especially foreign investors? (WB, 2012).

A study conducted by Adam (2007) in Addis Ababa City Administration revealed that FDI in Addis Ababa faced constraints, challenge related to market, cultural shocks and language barriers and it also assessed the opportunity to foreign investors to invest in this area. Most of the researches conducted so far focus on the role of FDI at macro level or at the national level and with greater emphasis to challenges failed by FDI and opportunities available to them.

While the recently increase in foreign direct investment (FDI) to African countries is a welcome development of the economy, the question remains as to the positive impact of the resource inflows on economic development. Ndikumana and Verick (2008) investigated a key channel of the impact of Foreign direct investment on development is through its effects on domestic factor markets, especially domestic investment, employment and market size. In this context, they analyzed the two-way linkages between FDI and domestic investment in in developing countries.

The special interest of researcher understand that firstly, FDI crowds in domestic investment, and secondly, countries has gain much and improving the domestic investment, development and saving. Thus the government should identify alternatives sources of resource endowments as a means of attracting foreign investment to non-resource rich countries via the world. Thus particular research was interest to examine the determinants of FDI at micro level of the investment in Ethiopia.

### **1.3. Research questions**

1. What are the determinants of foreign direct investment in Ethiopia?
2. What is the contribution of FDI in the development of the country?
3. What are the linkage and spillover effects of foreign direct investment?
4. What are the challenges that hinder effectiveness of foreign direct investment?
5. What are the opportunities and prospects of FDI in the country?

### **1.4. Objectives of the study**

#### **1.4.1. Overall objective**

The overall objectivity of the study is tries to assess, investigate and tackle out bottle neck determinants of foreign direct investment in Ethiopia.

#### **1.4.2. Specific objectives**

In order to accomplish the overall objective, the following specific objectives have been supports the general objectivity of the study.

1. To reviews factors that determines FDI in Ethiopia.

2. To assess the contribution of FDI in the development of the country.
3. To determine the linkage and spillover effect of foreign direct investment.
4. To identify the challenges that hinder effectiveness foreign direct investment.
5. To identify the opportunities and prospects of FDI in the country.

### **1.5. Significance of the study**

This particular research tries to assess the contributions of FDI in the economic development of the country under the specific area through different mechanisms like local employment opportunity, backward and forward linkage with domestic investment, revenue generation, technology transfer, competition effects with local firms and other spillover effects. The research also tries to investigate the challenges, determinants and negative externalities associated with foreign direct investment in Ethiopia. The intention is without proper governance an increase in investment may exacerbate or reinforce existing pattern of greedy consumption by the rich, marginalization of the poor and local firms and environmental devastation all which today characterize by the global economy of the world (EIC, 2019). Hence this research can help the government and respective bodies to take some corrective measures in managing foreign direct investment for better implementation. It can also be used as a background for other researchers who are interested in conducting research on FDI.

### **1.6. Scope of the study**

The scope of the study is delimited with in geographical are and duration which is described as follows. The geographical scope of the study is delimited to the political boundary of the Federal Democratic Republic of Ethiopia, FDRE, declared in 1991. Areas and countries other than this boundary are not the subject of this study. The time period that is covered under this study was only delimited to the time period 1992-2020. Holding other things, Investment factors that are happened out of this time period are not subject of this study. The conceptual Scope of the study; as it can be easily understood from the title of the research is; to identify the determinant factors of foreign direct investment in Ethiopia.

## CHAPTER TWO

### REVIEWS OF RELATED LITERATURE

#### 2. Theoretical point of view

##### Introduction

According to Charles (2013), foreign direct investment (FDI) occurs when a firm invests directly in facilities to produce or market a product in a foreign country. According to the U.S. college of Commerce, foreign direct investment occurs whenever a U.S. citizen, company, organization, or affiliated group takes an interest of 10 % or more in a foreign business entity. Once a firm undertakes FDI, it becomes a multinational enterprise to the countries. For example, FDI is given in the opening case about Walmart's investment in Japan. Walmart first became a multinational enterprise in the early 1990s then it was invested in Mexico. FDI takes on two main forms. The first is a Greenfield investment of FDI which involves in the establishment of a new operation in a foreign country and the second FDI, is about acquiring (merging) with an existing firm in the foreign country. For example, Walmart's entry in Japan was in the form of an acquisition. Acquisitions (merging) can be a minority where, the foreign firm takes a 10 – 49% interest in the firm's voting stock whereas, majority foreign interest 50 – 99%, or full outright stake of foreign interest of 100 %.

#### 2.1 Foreign Direct Investment in the World Economy

When discussing foreign direct investment, it is important to distinguish between the flows of FDI and the stocks of FDI. The flow of FDI refers to the amount of FDI undertaken over a given time period usually year but the stock of FDI refers to the total accumulated value of foreign-owned assets at a given time. We also talk of outflows of FDI, meaning the flows of FDI out of a country, and inflows of FDI which means the flows of FDI into a country (World Investment report, 1992-2010).

## 2.2 Trends in FDI

According to *World Investment Report (1992-2010)*, the past 30 years have seen a marked increase in both the flow and stock of FDI in the world economy. The yearly average outflow of foreign direct investment has increased from \$25 billion in 1975 to a record \$1.8 trillion in 2007. However, the outflows of FDI did contracts to \$1.1 trillion in 2009/10 in the wake of the global financial crisis, although they were forecasted to recover in 2011. In general, however, over the past 30 years the flow of foreign direct investment has accelerated faster than the growth in world output and world trade as globally. For example as we compare between 1992 to 2008, the total flow of FDI from all regions of countries increased more than eightfold while, world trade by value grew by 150 percent and world output by around 45 percent. As a result of this strong values FDI flow to different regions, by 2009 the global stock of FDI was about \$15.5 trillion. At least 82,000 parent companies had 810,000 affiliates in foreign markets that collectively employed more than 77 million people abroad and generated value accounting for about 11 percent of global GDP. The foreign affiliates of multinationals had more than \$30 trillion in global sales, higher than the value of global exports of goods and services, which stood at close to \$19.9 trillion. FDI has been grown more rapidly than world trade and world output for several reasons.

- ✓ First, despite of the general decline of the world trade barriers over the past three decades, firms still fear protectionist pressures and executives circumventing future trade barriers of FDI.
- ✓ Second, much of the increase in FDI has been driven by the economic, social and political changes that have been occurring in many of the world's developing nations. The general shift toward democratic political institutions, free market economies and different ideological views has encouraged FDI. Across much of Asia, Eastern Europe and Latin America, economic deregulation, economic growth, privatization programs that are open to foreign investors and removal of many restrictions on FDI have made these countries more attractive to foreign multinational enterprises. United nation report shows that almost 90 percent of the changes has made between 1992 and 2009 in the laws governing foreign direct investment created a more favorable economic environment for foreign direct investment across the world. However, since the early 2000s the number of

regulations that are less favorable toward FDI has increased, suggesting the pendulum may be starting to swing the other way. In Latin America, in particular, two-thirds of the reported changes in 2005 and 2009 made the environment for foreign direct investment less welcoming. Most of these unfavorable changes were focused on extractive industries, such as oil and gas market, where governments seemed focused on limiting FDI and capturing more of the economic value from FDI by applying higher taxes and royalty rates applied to foreign enterprises.

- ✓ Third Notwithstanding recent adverse developments in some nations, the general desire of governments to facilitate FDI also has been reflected in a sharp increase in the number of bilateral investment treaties designed to protect, promote and facilitate investment between across countries. As of 2009, 2,676 such treaties involved more than 180 countries. This is a nearly 15-fold increase from the 181 treaties that existed in 1980. This is the globalization of the world economy now day a have a positive impact on the volume of multinational enterprise of FDI. Many firms such as Walmart (profiled in the opening case) now see the whole world market of developed and less developed countries and they are undertaking FDI in an attempt to make sure they have a significant in many regions of the world. For reasons that we shall explore later in this document, many firms now believe it is important to have production facilities based close to their major customers. This, too, creates pressure for greater FDI (*World Investment report, 1992-2010*).

### **2.3 The Direction of FDI**

According to *World Investment report (1992-2010)*, historically, most FDI has been directed at the developed nations of the world as firms based in advanced countries invested in the others' markets. During the period 1980s and 1990s, the United States was often the favorite target for attracting the inflows of FDI to home countries. The United States has been an attractive target for FDI because of its large and wealthy domestic markets. This was first to boom their domestic investment, its dynamic and stable economy, its favorable and stable political environment and the openness of the country to FDI to hold more stocks and capital. Investors included firms based in Britain, France, Japan, Germany and Holland. Inward investment into the United States remained high totaling \$324 billion in 2008, although it fell to \$1,860 billion in 2010 in the wake

of the global financial crisis. The developed countries of the European Union have also been high recipients of significant FDI inflows, as principally from U.S. and Japanese enterprises and from other member states of the European Union. In 2007, inward investment into the EU reached \$923 billion, although it down to \$289 billion in 2010. The United Kingdom and France total record have been the largest recipients of inward FDI in long period of time. Even though other developed nations still account for the higher share of FDI inflows. Foreign direct investment in developing nations has recently also increased. From 1985 to 1990, the annual inflow of FDI into less -developed nations averaged \$27.4 billion, or 17.4 percent of the total global flow as compare to other developed countries. In the mid- to late 1990s, the inflow into less-developed nations was generally between 35- 40 percent of the total from the total share, before falling back to account for about 25 percent of the total in the 2000-02 period and then climbing to hit a record 50 percent in 2010. Most recent inflows of FDI into less-developed nations have been targeted at the emerging economies of South -East Asia countries. Driving much of the increase has been the growing importance of China as one of largest a recipient of FDI, which attracted about \$60 billion of FDI in 2004 and rose steadily to hit \$101 billion in 2010. The reasons for the strong flow of foreign investment into China are discussed in the accompanying Country Focus. Latin America emerged as the next most important region in the developing world for FDI inflows across the world. In 2008 total inward investments into this region has reached about \$141 billion. Mexico and Brazil have historically been the two top recipients of inward FDI in Latin America, a trend that continued in the late 2000s. At the other end of the scale, Africa has long received the smallest amount of inward investment in foreign investment. Although the regions did receive a record \$72 billion in 2008, investment decline to \$50 billion in 2010. In recent years, Chinese enterprises have become major principal of foreign investors in Africa, particularly in extraction different mega industries where they seem to be trying to assure future supplies of valuable raw materials for themselves and to the regions. In Africa to attract greater foreign investment is less possibility due to a reflection of the political unrest, lack of infrastructures, armed conflict and frequent changes in economic policy in the region.

Gross fixed capital formation is another way of looking for inflows of FDI to express them as a percentage share of investment to the countries. Gross fixed capital formation is defined as the total amount of capital invested in factories, machinery, stores, office buildings and the like.

Holding other things' being equal, the more the capital investment in an economy, the more favorable its future economic development prospects of the countries are likely to be. Foreign direct investment can be seen as an important source of capital investment, growth, development and a determinant of the future growth rate of an economy. During 1992-1997, FDI flows accounted for about 4 percent of gross fixed capital formation in developed nations and 8 percent in developing nations across the regions of the countries. By 2006-2008, the figure was 14 percent worldwide, suggesting that FDI had become an importantly increasing source of investment in the world's economies. These gross figures hide important across individual country differences. For example, in 2008, inward FDI accounted for some 47 percent of gross fixed capital formation in Sweden and 21 percent in the UK, 2.3 percent in Venezuela and 2.2 percent in Japan suggesting that, FDI is an important source of investment capital accumulations and thus economic growth and development in the first two countries but not the latter two. These differences can be explained by several regional and resource factors, including the perceived ease and attractiveness of investing in a nation. To the extent that burdensome regulations limit the opportunities for foreign investment in host and home countries such as Venezuela and Japan these nations may be hurting themselves by limiting their access to needed capital investments.

## **2.4 The Source of FDI**

After World War II, the United States has been the largest source and receipts country of foreign direct investment, a position it retained during the late 1990s and early 2000s. Other predominate important source countries include the United Kingdom, France, Germany, the Netherlands, and Japan respectively FDI source countries across the world. Collectively, these above six countries have recorded 60 percent of all from the total FDI outflows for 1998-2010. As might be expected, these above countries also dominate in rankings of the world's largest multinational enterprises. These nations dominate primarily because they were the most developed nations with the largest economies during much of the postwar period and therefore home too many of the largest and best-capitalized enterprises under globally. Many of these countries also had a long history as trading nations, industrialization and naturally looked to foreign markets as international for the purpose of fuel economic expansion. Thus, it is no surprise that enterprises

based there have been at the forefront of foreign investment trends (*World investment report, 1992-2010*).

## **2.5 The Form of FDI: Acquisitions vs. Greenfield Investments**

Foreign direct investment is a form of investment that can be either Greenfield or acquisition investment. Greenfield foreign investment is a new facility established in new business operations. An acquisition (merger) of foreign investment operation has occurred with an existing local firm. The majority of cross-border investments have been under the form of mergers and acquisitions rather than Greenfield investments. UN estimates indicate that some 40 - 80 percent of all FDI inflows were in the form of mergers and acquisitions between 1998 and 2009. In 2001, for example, mergers and acquisitions accounted for some 78 percent of all FDI inflows. In 2004, the figure was 59 percent, while in 2008 it was 40 percent, although the figure slumped to just 22 percent in 2009 reflecting the impact of the global financial crisis and the difficulties of financing acquisitions through the public capital markets. However, FDI flows into developed nations differ markedly from those into less developed nations. In the case of developing nations, only about one- third of FDI is in the form of cross-border mergers and acquisitions investment. Thus the lower percentage of mergers (acquisitions) may simply reflect the fact that there are fewer target firms to acquire in developing nations as compare to Developed nations.

## **2.6 Theories of Foreign Direct Investment**

According to Charles (2013), there exist several theories of foreign direct investment. These theoretical approaches have various phenomena of foreign direct investment from three complementary perspectives ways.

- ✓ One set of theory seeks to explain why a firm will favor direct investment as a means of entering a foreign market when two other alternatives, namely exporting and licensing are open to it.
- ✓ Second set of theories seeks to explain why firms in the same industry often undertake foreign direct investment at the same time, and why they favor certain locations over

others as targets for foreign direct investment. These theories attempt to explain the observed trends of foreign direct investment flows.

- ✓ A third theoretical perspective, known as the eclectic paradigm, attempts to combine the two other perspectives into a single holistic explanation of foreign direct investment.

### **2.6.1 Strategic Behavior Theory**

This theory is based on the idea that foreign direct investment flows are a reflection of strategic rivalry between investors (firms) in the global marketplace. An early variant of this theory argument was expounded by Knickerbocker, who looked at the relationship between FDI and rivalry in oligopolistic market industries. An oligopoly is an industry composed of a limited number of large firms in the industry. Examples of such industries are; which four firms' control 50 percent of a domestic market would be defined as an oligopoly. A critical competitive feature of such industries is interdependence of firms is the major players in the market. One firm can have an immediate impact on the major competitors, especially in market price forcing a response in kind. By fix prices, one firm in an oligopoly can take market share away from its rivalry, forcing them to follow with similar price cuts to retain their market share across competitor. Thus, the interdependence between rivalry firms in an oligopoly leads to imitative behavior; rivals often quickly imitate their market price and product diversifications what a firm does in an oligopoly. Imitative behavior can take many forms in an oligopoly industry market. One firm raises prices and the others also raise and one expands capacity and the rivals imitate lest they be left at a disadvantage in the future. Knickerbocker has argued that the same kind of imitative behavior characterizes FDI. Consider an oligopoly in the United States in which three firms namely, Z, X, and Y dominate the market. Firm Z establishes a subsidiary in France. Firms X and Y decide that if successful, this new subsidiary may knock out their export business to France and give firm a first-mover advantage. Furthermore, firm Z might have discovered some competitive asset France that it could repatriate to the United States to torment firms X and Y on their native soil. From these conclusions firms X and Y decide to follow firm Z and establish operations in France.

### **2.6.2 Product Life Cycle**

Product life cycle theory, also known as Raymond Vernon's product life-cycle theory, argues that often the same firms have pioneered a product in their home markets that undertake FDI to produce a product for consumption in foreign markets by distributing, licensing and supplying to the host countries. Thus, Xerox machine introduced the photocopier in the United States, and it was Xerox that set up production facilities in Japan (FujiXerox) and Great Britain (Rank-Xerox) to serve those markets. This theory views that firms have undertaken FDI at particular stages of production in the life cycle of a product that have pioneered. They have invested in other advanced countries when local demand in those countries grew large enough to support local production. Advanced countries subsequently shift production to developing countries when product standardization and market saturation were rise to price competition and cost pressures under developed countries. Investment in developing countries, where labor costs are lower, is seen as the best way to reduce costs in the production industry. Vernon's theory has merit. Firms do invest in a foreign country when demand in that country has support local production, and they do invest in low-cost locations (e.g., developing countries) when cost pressures becomes intense. However, Vernon's product life cycle theory fails to explain why it is profitable for a firm to undertake FDI at a time other than continuing to export from its home base or licensing a foreign firm to produce its product. The demand in a foreign country of investor has large enough to support local production, but does not necessarily follow that local production is the most profitable option. It may still be more profitable to produce at home and export to that country i.e., to realize the economies of scale that arise from serving the global market from one location. Alternatively, it may be more profitable for the firm to license a foreign company to produce its product for sale in foreign country. The product lifecycle theory ignores these options and, instead, simply argues that once a foreign market is large success to support local production, FDI will be attracted. This limits their explanatory power and its usefulness to business in that it fails to identify when it is profitable to invest abroad successfully.

### **2.6.3 Eclectic Paradigm Theory**

The eclectic paradigm theory has been championed by the British economist of John Dunning. Thus theory based on location-specific advantages is one of considerable importance in explaining both the rationale for and the direction of foreign direct investment based on location-

specific advantages of this theory. Dunning views that advantages arise from utilizing resource endowments or assets that has tied to a particular foreign location and that a firm finds valuable to combine with its own unique assets such as the firm's technological, marketing, or management capabilities. This theory also views that combining location-specific assets or resource endowments with the firm has its own unique capabilities often requiring foreign investors and hence firm has to establish production facilities where those foreign assets or resource endowments are located. An example of this theory argues that natural resources, such as oil and other minerals, which are by their character specific to certain locations, are valuable. Dunning suggests that to exploit such foreign resources, a firm must undertake foreign direct investment by means of multinational enterprises. Clearly, this explains that FDI undertaken by many of the world's oil companies, which have to invest where oil is located in order to combine their technological and managerial capabilities with this valuable location-specific resource.

Other obvious example are valuable human resources, such as low labor cost, highly skilled and competitive labors required to run such kind of production process. The cost and skill of labor varies from regions to regions. Labor is not internationally mobile. However, Dunning's theory has implications that go beyond basic resources such as minerals and labor factors of productions in the companies. An example is Silicon Valley which is the world center for the computer and semiconductor industry. Recently many of the world's major organizations of computer and semiconductor companies, such as Apple Computer, Hewlett-Packard and Intel have located close to each other in the Silicon Valley region of California. As a result, much of the cutting-edge research, product development and product diversifications in computers and semiconductors technology occur have there.

According to this theory knowledge being generated in Silicon Valley with regard to the design and manufacture of computers and semiconductors is available now in the world. It has commercialized knowledge diversity throughout the world, but the leading edge of knowledge generation in the computer and semiconductor industries has to be found in Silicon Valley. In Dunning's language, this means that Silicon Valley has a location-specific advantage in the generation of knowledge and research related to the computer and semi-conductor industries. In part, this advantage comes from the sheer concentration of intellectual talent in this environment,

and in part it arises from a network of informal contacts that allows firms to benefit from each other's knowledge generation.

On the other hand Dunning argued that direct investment by foreign firms in the United States biotechnology industry has been motivated by desires to gain access to the unique location-specific technological knowledge of U.S. biotechnology firms. Dunning's theory, therefore, seems to be a useful addition to those outlined above, for it helps explain how location factors affect the direction of FDI across the world .

#### **2.6.4 The Radical View**

The radical view traces on the roots of Marxist political and economic theory. Radical writers suggest that the multinational enterprises (MNE) are an instrument of imperialist domination of the regions. Radical supporters views that the MNE as a tool for exploiting host countries resources to the exclusive benefit of their capitalist-imperialist home countries. This theory argues that MNEs extract profits from the host (receiving) country and take them to their home (sources) country, giving nothing of value to the host country in transactions and exchange. For example, key technology is tightly controlled by the MNE, and that important jobs in the foreign subsidiaries of MNEs go to home-country of the nationals rather than to citizens of the host country. According to this theory, foreign direct investment of multinational enterprises of advanced capitalist nations keeps the developing countries of the world relatively backward and dependent on advanced capitalist nations for investment, jobs, and technology to generated highest rate to returns. Therefore no country should ever permit foreign corporations to undertake foreign investors, since they can never be sources of economic development, only of economic domination as monopoly firms. Where MNEs has already existed in a country, they should be immediately nationalized (Charles, 2013).

From the Second World War of 1945 until the 1980s, the radical views were very influential in the world economy globally. Until the collapse of communism between 1989 and 1991, the countries of Eastern Europe were criticized FDI. Similarly, communist countries such as, China, Cambodia and Cuba were all have criticized and opposed in principle to FDI although in practice the Chinese has started to allow FDI in mainland China in the 1970s. Many socialist countries, particularly in Africa where also one of the first actions that many have newly

independent states was to nationalize foreign-owned enterprises, also embraced the radical position. Regions whose political ideology was more nationalistic than socialistic further embraced the radical position. This was true in Iran and India, which adopted tough policies restricting FDI and nationalized many foreign-owned enterprises. Iran is one of Islamic government national state which is rejecting Marxist theory, while it's essentially embraced the radical view that FDI by MNEs is an instrument of imperialism. By the end of the 1980s, the radical positions were in retreat almost in the world. There seem to be three reasons for this:

- ✓ The collapse of communism in Eastern Europe,
- ✓ The generally abysmal economic performance of those countries that embraced the radical position, and a growing belief by many of these countries that FDI can be an important source of technology , jobs and can stimulate economic growth and economic development, and
- ✓ The strong economic performance of those developing countries that embraced capitalism rather than radical ideology e.g., Singapore, Hong Kong, and Taiwan (Charles, 2013).

### **2.6.5 The Free Market View**

The free market view theory traces its root on classical economic thought and the international trade theories of David Ricardo and Adam Smith. The intellectual case for free market view has been strengthened by the internalization explanation of foreign direct investment. The free market view concludes that international production should be distributed among countries according to the theory of economic scale and comparative economic advantage. Countries should specialize in the production of those goods and services that they can produce most effectively and efficiently. Within this framework, the Multinational enterprises are an instrument for dispersing the production of goods and services to the most efficient locations around the world. Viewed by this way, FDI by the MNE increases the overall efficiency of the world economy since developed and developing countries.

The free market view has been ascendant worldwide in recent years, spurring a global move toward the elimination of restrictions on inward and outward foreign direct investment across the world. However, in practice no country “even highly developed countries” have adopted the free

market though in its pure form just as no country has adopted the radical view in its pure form. Countries such as Great Britain and the United States are among the most open to FDI, but the governments of these countries both have still reserved the right to intervene (Charles, 2013).

### **2.6.6 Pragmatic Nationalism**

In practice, many countries have adopted neither a radical policy nor a free market policy toward multinational enterprises of FDI, but instead a policy that can best be described as pragmatic nationalism. The pragmatic nationalist theory views that FDI has both benefits and costs. FDI can benefit a host (receiving) country by bringing financial capital, management and labor skills, technology and jobs, but those benefits come at a cost. When a foreign company other than a domestic company produces products, the profits from that investment go abroad. Many countries are also concerned that a foreign-owned manufacturing plant may import many components from its home country, which has negative implications for the host country's balance-of-payments position and economic competitions. Recognizing this, countries adopting a pragmatic stance pursue policies designed to maximize the host benefits and minimize the host costs on economic of scale (Charles, 2013).

## **2.7 Benefits and Costs of FDI**

According to Charles (2013), to a greater or lesser degree, many governments can be considered pragmatic nationalists when it comes to foreign direct investment. Accordingly, their policies have shaped by a consideration of the benefits and costs of foreign direct investment. Here we explore the benefits and costs of FDI, from the perspective of the home (source) and from the perspective of a host (receiving) country.

### **2.7.1 Host-Country Benefits**

According to Charles (2013), the main benefits of inward FDI for a host country are;

- ✓ Resource-transfer effects,
- ✓ Employment effects,
- ✓ Balance-of-payments effects, and
- ✓ Effects on competition and economic growth.

### **2.7.1.1 Resource-Transfer Effects**

Foreign direct investment (FDI) can make a positive contribution to a host (receiving) economy by supplying skill, technology, capital and management resources that would otherwise not be available and thus boost that country's economic growth rate (as the opening case makes it clear, the Japanese government has currently come around to this view to adopted a more permissive attitude to inward foreign investment). With regards to capital, many multinational enterprises, by virtue of their large size and financial strength, have access to financial resources not available to host-country firms but to home (sources) countries. These funds may be available from an organization because of their reputation, large MNEs may find it easier to borrow money from capital markets than host-country firms would. Technology can stimulate economic growth, development, industrialization and globalization. Technology can take two forms, both of which are vitally valuable. Technology can be incorporated in a production process as whole. For example, the technology for discovering, extracting, and refining oil or it can be incorporated in a product like, personal computers. However, many countries lack the research, development and skills required to develop their own indigenous products and technology. This is particularly true in developing countries. Such countries must rely on advanced industrialized nations for much of the technology required to stimulate economic growth, and to attract FDI towards their countries.

Research development supports to the view that international firms often transfer significant technology when they invest in foreign nations. For example, a study of FDI in Sweden found that foreign firms increased both the labor and total factor of productivity in Swedish firms has contributed significant technology transfers had been occurred. Also, a study of FDI by the Organization for Economic Cooperation and Development (OECD) found that foreign investors invested significant amounts of capital in Research and Developed in the countries in which they had invested, suggesting that not only were they transferring technology to those countries, also have been upgrading technology or creating new technology in those countries. Foreign management skills acquired through FDI may also produce package benefits for the host country. Foreign managers trained in the latest management technical and systematical that helps to improve the efficiency and effectiveness of operations in the host country, whether those operations are acquired and Greenfield developments. Beneficial spin-off effects may also arise

when local officers who are trained to occupy managerial skill, job opportunities, financial, and technical posts in the subsidiary of a foreign multinational enterprise leave the firm and help to establish indigenous firms. Similar benefits may arise if the superior management skills of a foreign MNE stimulate efficiency and effectiveness local suppliers, distributors, and competitors to improve their own management skills.

#### **2.7.1.2 Employment Effects**

Another beneficial effect of foreign direct investment have claimed to brings job opportunities to a host country that would not be created there. The effects of FDI on employment are both direct and indirect effects through globally.

- ✓ The Direct effects of employment would arise when a foreign MNE employs a number of host-country citizens.
- ✓ The indirect effects of employment would arise when jobs are created in local firms (suppliers) as a result of the investment and also when jobs are created because of increased local spending by employees of the MNE. The indirect effects of employment are often larger than, the direct employment effects as globally. For example, when Toyota decided to start a new auto plant in France, estimates the plant would hire 2,000 direct jobs and another 2,000 jobs in support industries. Cynics suggest that in the case of employment opportunities that not all the "new jobs" created by FDI represent net additions in employment engagement have created. In the case of FDI by Japanese auto companies in the United States, some of the studies argue that the jobs created by Japanese investment have been more than offset by the jobs decline in U.S.-owned auto companies, which have decline market share to their Japanese competitors. Thus as a consequence of the effects, the net new jobs hire by FDI may not be as great as initially claimed by an MNE. The issue is net gain of the job may be a major negotiating point between an MNE wishing to undertake FDI and the host government.

When FDI takes in the form of an acquisition of an established enterprise in the host economy as opposed to a Greenfield investment, the immediate effect might have be to reduce employment

as the multinational tries to restructure the management of the operations of the acquired unit to improve its operating efficiency. However, even in 267 cases, research suggests that once the initial periods of firms tend to grow their employment base at a faster rate than domestic rivals. For example, Organization for Economic Cooperation and Development (OECD) study found that foreign investors have created new jobs at a faster rate than their domestic counterparts. In United States of America, the workforce of foreign firms grew by 1.4 percent per year, as compared to with 0.8 percent per year for domestic firms. In UK and France, the workforce of foreign firms grew at 1.7 percent per year, while employment local domestic firms fell by 2.7 percent. The same study found that foreign firms tended to pay higher (salary) wage rates than local domestic firms, these suggesting that the quality of employment was better. Another study looking at FDI in Eastern European transition economies found that although employment fell following the acquisition(mergers) of an enterprise by a foreign firm, often those enterprises were in competitive difficulties and would not have survived if they had not been acquired due to either technological or other effects . Also, after an initial period of adjustment and retrenchment, employment downsizing was often followed by new investments and employment either remained stable or increased like that of product life cycle.

#### **2.7.1.3 Balance-of-Payments Effects**

Foreign direct investment has the highest effects on a country's balance-ofpayments which is an important policy issue for both hosts and home governments. A country's balance-of-payments accounts tracks both in its payments to (debit) and its receipts from (credit) other countries. Governments normally have concerned when their country is running a deficit on the current account of their balance of payments. The current account tracks the both export and import of goods and services across the world. A current account deficit or trade deficit, as it is often called, arises when a country is importing more goods and services than it is exporting that means import greater than exports. Governments always prefer to see a current account surplus than a deficit. The only way in which a current account deficit have be eliminating in the long run by selling off assets to foreigners. For example, U.S. had been persistent balance of payment under the current account deficit since the 1980s has been financed by a steady sale of U.S. assets (stocks, bonds, and real estate and whole corporations) to foreigners. Absolutely, national governments invariably dislike seeing the assets of their country fall into foreign hands; they

prefer their nation to run a current account surplus. There are two assumptions in which FDI can help a country to achieve this goal.

- ✓ First, if the FDI is a substitute for imports of goods or services, the effect can be to improve the current account of the host country's balance of payments. For example, the FDI by Japanese automobile companies in the United States and Europe, this show as substituting for imports from Japan. Thus, the current account of the U.S. balance of payments were improved somewhat because many Japanese companies are now supplying the U.S. market to increase production facilities in the United States, as opposed to facilities in Japan. Insofar as this had reduced the need to finance a balance of payment under the current account deficit by asset sales to foreigners, the United States has clearly benefited.
- ✓ A second potential benefit arises when the MNE uses a foreign subsidiary to export goods and services to other countries. According to a UN report, inward FDI by foreign multinationals have been a major driver of export-led economic growth sector in a number of developing and developed nations. For example, in China exports has increased from \$26 billion in 1985 to more than \$250 billion by 2001 and \$969 billion in 2006 as compare to the terms of period. Much of these dramatic export growths were due to the presence of foreign multinationals that invested heavily in China during the 1990s. The subsidiaries of foreign investors account for 50 percent of all exports from that country in 2001, up from 17 percent in 1991. For example, in China the mobile phones subsidiaries of foreign multinationals-primarily Nokia, Motorola, Ericsson, and Siemens-accounted for 95 percent of China's exports.

#### **2.7.1.4 Effect on Competition and Economic Growth**

Different Economic theory suggests that the efficient functioning of markets depends on an adequate level of competition between supplies, investors and producers. When FDI takes in the form of a Greenfield investment, the result has to be establishing a new enterprise, increasing the number of players in a market and thus consumer choice. In turn, this can increase the level of competition in a national market, thereby driving decreases prices and increasing the economic welfare of the society. Gradually increased competition has tends to stimulate capital

investments by firms in plant, equipment and R&D as they struggle to gain an edge over their rivals of competition across the world. The long term results may have increased productivity growth, product and process innovations and greater economic growth. Such beneficial effects on competition and economic growth seem to have occurred in the South Korean retail sector following the liberalization of FDI regulations since 1996. Western multinational enterprise has highly discount stores, including Walmart, Costco, Carrefour, and Tesco, seems to have encouraged indigenous discounters such as E-Mart to improve the efficiency and productivity of their own operations. The results have included more competition and lower prices, better quality of products, which benefit South Korean consumers. FDI's has the highest impact on competition in domestic markets in the case of services, such as telecommunications, retailing, and many financial services, where exporting is often not an option of the service where it is delivered. For example, under a 1997 agreement is sponsored by the World Trade Organization, 68 countries accounting for more than 90 percent of world telecommunications revenues pledged to start opening their markets to foreign investment of multinational enterprise to abide by common rules for fair competition in telecommunications. Before this agreement, most of the world's telecommunications markets were closed to foreign multinational enterprise because, such market was monopolized by a single carrier, which was often a state-owned enterprise. The agreement has dynamical increased the level of competition in many national telecommunications markets, producing two major benefits.

- ✓ First, inward investment has increased competition and stimulated investment in the modernization of telephone networks around the world, leading to better service.
- ✓ Second, the increased competition has resulted in lower prices.

### **2.7.2 Host-Country Costs**

According to Charles (2013), three costs of FDI concern host countries. These are;

- ✓ Adverse effects on competition within the host nation.
- ✓ adverse effects on the balance of payments and
- ✓ The perceived loss of national sovereignty and autonomy.

### **2.7.2.1 Adverse Effects on Competition**

Host (domestic) governments sometimes worry that the subsidiaries of foreign Multinational enterprises may have greater economic power than domestic competitors. For advanced international organization of multinational enterprises in the global world, the foreign Multinational enterprise may have be able to draw on funds generated elsewhere to subsidize its costs in the host market, which could drive local companies out of business and allow the firm to monopolize the market due to highest competitive advantages global market share in case of foreign currency, technological capacity, balance of payment, price set and management skill. Thus, once the market is monopolized, the foreign MNE could raise prices above those that would prevail in competitive markets, with negative effects on the economic welfare of the domestic nation. This concern tends to be relatively larger in countries that have few large firms of their own (generally less developed countries). It tends to be a relatively rare in the most advanced industrialized nations across the world.

In general foreign direct investment in the form of Greenfield investments should increase competition, as compare to FDI takes in the form of acquisition of an established enterprise in the host nation. For example, CEMEX Company acquired RMC in Britain. Because an acquisition does not result in a net increase in the number of rivalry firms in a market, the effect on competition may be neutral. When foreign investors has acquires oligopoly, firms in a host country, and subsequently merges them, the effect may have be to reduce the level of competition in that market, create monopoly power for the foreign firm; raise prices and this reduce consumer choice. For example, in India, Hindustan Lever Ltd Company, the Indian subsidiary of Unilever, acquired its main domestic rival, Tata Oil Mills, to assume a dominant position in the both 70 percent soaps and 30 percent detergents in the markets shares . Hindustan Lever is also acquired several domestic companies in other markets, such as the ice cream makers Dollops, Kwality, and Milkfood. By merging these above companies, Hindustan Lever's market share of the Indian ice cream market went from zero in 1992 and become 74 percent in 1997. In many nations' indigenious governments have authorities to review and block any mergers or acquisitions that they view as having a detrimental impact on competition. However, such institutions are operating effectively, this should be sufficient to make sure that foreign entities do not monopolize a country's markets.

### **2.7.2.2 Adverse Effects on the Balance of Payments**

Foreign direct investment has adverse effects on a host country's balance-of-payments position.

- ✓ First a set against the initial capital inflow that comes with FDI must be the subsequent outflow of earnings from the foreign subsidiary to its parent company. Such outflows have shown up as capital outflow on balance-of-payments accounts. Many indigenous governments have responded to such outflows by restricting the amount of earnings by repatriated to a foreign subsidiary's home country.
- ✓ A second concern arises when a foreign subsidiary imports a substantial number of its inputs from abroad, which results in a debit on the current account of the host country's balance of payments.

### **2.7.2.3 National Sovereignty and Autonomy**

Many host governments is worry about FDI, which has accompanied by some loss of economic independence across the world. The concern of key strategically decisions that might have affect the host country's economy will have been made by a foreign parent that has no real commitment to the host countries, and over which the host country's government has no real control of such multinational enterprises immediately. Most economists dislike such concerns as groundless and irrational. According to the Political scientist and economists of Robert Reich has noted that concerns are the product of outmoded thinking because they fail to account for the growing interdependence of the world economy. In a world in which firms from all advanced nations are increasingly investing in each other's markets especially, under developed countries has imminently, it is not possible for one country to hold another to "economic ransom" without hurting the interest of the host countries .

### **2.7.3 Home-Country Benefits**

The benefits of FDI to the home (source) country arise from three perspective sources.

- First, the home country's balance of payments benefits from the inward flow of foreign earnings. FDI can benefit the home country's balance of payments when, the foreign investor subsidiary has creates demands for home-country by exports of capital

equipment, intermediate goods, complementary products, and distribution channels to their countries.

- Second, benefits to the home country from outward FDI arise from employment effects. Like that of balance of payments effects, positive employment effects arise when the foreign subsidiary has creates demand for home-country exports. Thus, Toyota's investment company of auto assembly operations in Europe were benefited both the Japanese balance-of-payments position and employment in Japan; because Toyota Company has imports some component parts form European-based auto assembly operations directly from Japan.
- Third, benefits arise when the home-country MNE learns valuable skills from its exposure to foreign markets that can subsequently be transferred back to the home country. This amounts to a reverse resource-transfer effect. Through its exposure to a foreign market, an MNE may have advance superior management techniques and superior product and process technologies. These resources would transfer back to the home country, contributing to the home country's economic growth rate. For example, one reason General Motors and Ford invested in Japanese automobile companies (GM owns part of Isuzu, and Ford owns part of Mazda) was to learn about their production processes. If general motors and Ford are successful in transferring this know-how back to their U.S. operations, the result might have a net gain for the U.S. economy.

#### **2.7.4 Home-Country Costs**

In additions the benefits of FDI, there is the apparent cost of FDI for the home (source) country. The important concerns are that effects cost on the balance-of-payments and employment effects of outward FDI. The receiving country's balance of payments may suffer in three reasons.

- ✓ First, the balance of payments suffers from the initial capital outflow required to finance the FDI. This effect, however, annually more than offset by the subsequent inflow of foreign earnings.
- ✓ Second, the current account of the balance of payments suffers if the purpose of the foreign investment is to serve the home market from a low-cost production location.
- ✓ Third, the current account of the balance of payments suffers if the FDI is a substitute for direct exports. Thus, Toyota's assembly an operation in the United States has

intended to substitute for direct exports from Japan, the current account position of Japan were deteriorated.

In the case of employment effects, the most serious concern has raise, when FDI is seen as a substitute for domestic production means labor by capital. This was the case with Toyota's investments in both the United States and Europe. One obvious result of such FDI had reduced home-country employment. If the labor market in the home country is already tight, with certain unemployment, this concern may not be that great. However, if the home country is suffering from unemployment, concern about the export of jobs might have been arising. For example, one objection frequently shows by U.S. labor leaders to the free trade pact between the United States, Mexico, and Canada is that the United States will lose hundreds of thousands of jobs as U.S. firms invest in Mexico to take advantage of abundantly cheaper labor and then export products back to the United States.

## **2.8 Determinant of Foreign Direct Investment**

### **1. Natural Resource endowment**

Historically, natural resources are the most important determinants of FDI. From the 19th century up to the eve of the WWII about 60% of the world stocks of FDI were in natural resources (Dnning, 1993). Birhanu (1999) noted that countries that have sufficient deposit of some minerals can attract foreign investors, particularly those involved in exploitation of natural resources.

### **2. Nature of domestic Market Size**

The size of the local market is a fundamental determinant of foreign investment. The wealth and development of a country can be used as a proxy to measure the size of the domestic market. Most commonly, per capita income which is an indicator of effective demand is used to measure the size of local market. The GDP of a regions and the size of the populations are also used as indicators to measure the size of local market. A large market can help firms producing tangible products to achieve scale and scope economies. The domestic market growth rate is measured in terms of population and GDP growth rate also determines the inflow of FDI in to a country (UNCTAD, 1998).

### **3. Privatization**

Sound privatization programs have three main characteristics, namely political commitment, business orientation and transparency. A commercial scale program has sent a signal to foreign investors that a government is taking measures to create conducive environment to FDI (IFC & FIAS, 1997).

### **4. Investment Promotion Strategy and Incentive Structure**

Investment incentives are FDI strategy instruments used to attract foreign investors. These include tax reductions & exemptions, special tax allowances, financial incentives such as low interest loans and subsidies as well as grants. Investment guarantees (e.g. guarantees for repatriation of capital and transfer of profits, and guarantees for provision of foreign currencies) can also be seen as an incentive to attract transnational cooperation. Bilateral and multilateral investment treaties are also incentives to increase investment through creating a predictable investment climate, thereby improving direct foreign investors' confidence (Birhanu and Kibre, 2003). However, investment promotions and incentive is not substitutes for other determinants like infrastructure and market size. This clearly indicates that the effectiveness of investment incentives is highly determined by the host country's level of development (UNCTAD, 2000). The researcher argues that, countries would only get their investment opportunities; as a result, investment promotion is vital particularly in least developed countries (LDCs). Image building, investment generation and investors servicing are the main elements of successful investment promotion to attract foreign investors.

### **5. Level of Infrastructure available**

Infrastructure development has a great role in the expansion and diversifications of foreign investors to wards across the world because efficient and productivity of firms. Adequate infrastructure implies better access to natural resources and potential market. According to Birhanu (1999) availability and reliability of telecommunication services, developed and adequate road, electric power supply, air transport services, reliable water, land, railway, shipment and water transportations facilities have paramount importance for the profitability of foreign companies to attracting FDI.

## **6. Low Level of labor Cost**

Neoclassical economists noted that labor cost is one of the factors that affect the investment decision of foreign investors and this fact has been proven in numerous locations. UNCTAD (2004a) reported that availability of cheap labor in China has taking jobs for both Europe and United States. In addition to cheap labor, the output labor ratio (labor productivity) also determines the inflow of FDI.

## **7. Inflation**

Through the effect of inflation, on the cost of inputs and the price outputs, it reduces the real return on investment and firms' competitiveness. Moderate and predictable inflation rate has advocate for the long term investment of both domestic and foreign companies. Therefore, high and unpredictable inflation may harmful for the inflow of FDI (Birhanu, 1998)

## **8. Foreign Debt**

Excess foreign debt is one source of instability and uncertainty in macroeconomic environment of underdeveloped countries and hence this foreign debt is likely to affect adversely the inflow of FDI. It may also signal imminent fiscal crises and foreshadow the future economic situation in a country (Serven and Solimano, 1992).

## **9. Fiscal Deficit**

The fiscal deficit of the government, whether it is financed through printing additional bank notes or through taxation, decreases the real return on investment. In addition, in many developing countries it is apparent that due to excessive government borrowing the financial resources available for the private sector are limited and the interest rate is high. Expansionary fiscal policy may be also important for the expansion of public sector investments on infrastructure (UNCTAD, 1998). Generally, the overall impact of fiscal deficit, as empirically tested by different studies, is ambiguous. However, the theory postulates that there is a negative relationship between fiscal deficit and FDI inflows (Acolley et al, 1997).

## **10. Exchange Rate Variability**

According to Goldberg and Klien (1997), frequent and erratic changes in exchange rate of the domestic currency affect the inflow of FDI. Exchange rate devaluation has two roles in explaining variations in FDI. First, the real value of foreign investors' capital increases when the host country's currency is devalued. Second, frequent and continuous declines in the value of host country's currency would decrease FDI inflows because of creating uncertainty (Accoley et al, 1997).

## **11. Legal and Regulatory Framework**

Stable, transparent and reliable legal and regulatory frameworks promote both domestic and foreign investment while an inefficient and ineffective legal system is an impediment to enforce laws and contracts (Ibid, 2003).

## **12. Tax Policy**

Fiscal policies are one of the determinant factors that general tax levels including corporate and personnel tax rates and thereby influence inflow of FDI across the world. Any change in tax rates on corporate income like dividend, royalty, technical fees and capital gains received by a foreign company is expected to influence the inflow of investment opportunities and huge market size.

## **13. Technological (E-Commerce) Environment**

Basically the evidence suggests that technologically encourages FDI either by reducing search time and related costs and /or through increases in efficiency and productivity. This works through the Internet helping to lower prices by reducing search costs for B2B, B2C, B2G,C2C,C2B and generally contributing to the efficient functioning of both domestic and export markets (OECD,2008).

## **14. Geographical Proximity**

Jinayu (1997) argued that in the recently global economic structure, geographical proximity, cultural and linguistic affinities are main determinants of foreign direct investment. The IFC&FIAS (1997) suggest that FDI, from developed to developing countries are influenced by geographical proximity. For instance, while Japanese firms tend to open subsidiaries in China

and newly industrialized Asian countries, the West European firms tend to open their subsidiary in East Europe.

### **15. Political Stability**

The economic process of a country and in particular the inflow of FDI into a country can be disrupted by unsettled, implicit or explicit, internal or external political disputes and crises. Due to unstable political conditions, whatever the economic environment may be a country's effort to create a more hospitable environment for across the investors cannot be fruitful. Political unrest can delay foreign firms away or diverts away for good (Birhanu and Kibre, 2003).

### **16. Other Determinants of FDI**

In addition to the above mentioned macroeconomic determinants, there are also other determinants. Some of them are contract law, the image of the host country, availability of investment fund, human resource development, degree of openness, urbanization, coherent and stable macro & sectorial policies, etc. (e.g. Birhanu and Kibre, (2003), Asiedu, (2002), UNCTAD, 1998).

## **2.9. Empirical Point of View**

Globally, many empirical studies have conducted to identify the factors that determinants of the inflow of FDI. Nevertheless, the variables which we identified as determinants of FDI vary from study to study and from country to country. This review focuses on the empirical studies conducted on determinants of FDI in developing countries especially sub-Saharan countries like Ethiopia.

Berrta (2003) argue that the determinants of FDI to Africa are different from the determinants to the other parts of the world. Asiedu (2004) agrees with this argument and states that the lessons from European and Latin American countries do not apply to African countries. To make it clearly that it is possible to use different research arguments in a specific manner as follows: on the determinants of FDI in Africa, most studies argue that FDI inflow is attracted largely by natural resource endowments. Almost 40% of FDI has been in the primary sector, particularly in oil and mineral extract on businesses. For instance, countries like Angola, Botswana, Namibia and Nigeria have received foreign investment focused at the oil and mineral sectors of their

economy (Basu and Srinivasan, 2002). Morisset (2000) reports that, on a survey conducted on African countries there is a high correlation between FDI inflows and total values of natural resources in each country.

Though abundant natural resource is a common determinant factor driving much of the foreign investors that inflows their investment. However, the few successful African countries have favorable economic, social and political environment of FDI (UNCTAD, 1998; Basu and Srinivana, 2002). For example, a country such as Mauritius and Seychelles has highly attracted FDI due to tailoring their FDI policies through liberalization, export orientation, tax and other investment incentives. Moreover, some countries like Lesotho and Swaziland have attracted FDI because they are near to South Africa and investors wishing to serve the large market in South Africa have located their subsidiaries in these countries (Ibid).

Empirically, Root and Ahmed (1979) also analyzed the determinants of non-extractive direct investment inflows in developing counters of African and better urbanization, better infrastructure and higher GDP per capita increase FDI inflows. Several other studies also found that countries that have a higher degree of openness attract more FDI. Singh and Jun (1995) found export orientation (export as a percentage of GDP) has be the high determinant factors which is positively correlated with FDI. Morisset (2000) find that a positive and a significant correlation between trade openness and the investment climate for African countries. Hence openness of trade attracts FDI. Using time series analysis the researcher found that openness to trade, higher income and better growth prospects, better institutional framework and infrastructure were “rewarded” with more investments. The same author, Asiedu (2003; 2006) showed that significant role of the country’s market size and natural resource endowment in enhancing FDI. Low inflation, good infrastructure, an educated population, openness, less corruption, political stability and a reliable legal system are also found to have similar positive effect on FDI flows to the continent. Moreover, Asiedu and Gyimah-Brempong (2008) have validated these findings to a large extent and noted that countries that are small or lack natural resources can attract FDI only by improving their institutions and policy environment. Linda and Said (2007) conducted a study on the determinants of FDI in North African countries and the Middle East region which concluded that country openness, return on investment and being a member of World Trade organization (WTO) are the chief driving factor of FDI inflows.

Nabende 2002, found that a countries which is focus on market growth, export oriented and liberalization as the most dominant long-run determinants of FDI in Africa.

Kandieru and Chitiya (2003) analyzed the impact of openness on FDI flows to African countries and their findings indicated that FDI responds significantly to increased openness in the whole economy in general and in the services sector in particular in local and foreign market. Obwona (2001) found market size as a significant determinant of FDI in both developing and developed counties and Chakrabarti's (2001) concluded that host country market size, measured by per capita GDP, has a positive and significant effect on the contribution of FDI inflows.

In today's globally competitive business market, inadequacy and lack of efficient infrastructure means not only high transaction costs for those that are already in business but also a barrier to entry for new firms across the regions. Infrastructure developments have high importance for the expansion towards vertical and horizontal diversifications of FDI because efficient and adequate infrastructure implies better access to natural resources and potential market profit (John, 2012). Also Abdoul (2012) concluded that to improve the returns to investment for FDI in Africa, African countries should work more on the development of infrastructure. Lydie (2006) also using a time series analysis for Cameroon, showed that the level of infrastructure appears as the most significant determinant of FDI.

Finally, human capital both in terms of quantity and quality is another important factor in promoting labor- intensive and export oriented FDI in particular. Lewis (1999) found that the more educated the population is the more likely it is for a country to attract more FDI. Sarisu (2003) also found that educational level of human capital measured by the illiteracy rate, has discouraging inflows on FDI in Ethiopia. Fayeze (2012) also concluded that availability of skilled labor force encouraged the FDI inflows.

The researcher summarize that the above all determinants factors of FDI vary from study to study and from country to country in the case of this study FDI inflow is highly attracted largely by abundant natural resource endowments.

## 2.10 Thesis Conceptual Framework

The conceptual framework in Figure below indicates the determinants of FDI in Ethiopia by considering the micro and macro-economic variables are proxy to control variables (which comprises: market size, infrastructure, liberal trade openness, inflation, political stability, tax rate, and exchange rate). The relationship is captured with the use of the control variables consider as independent variables and FDI as dependent variable and economic growth and development, technology, social wafer, employment opportunities are final output of FDI.

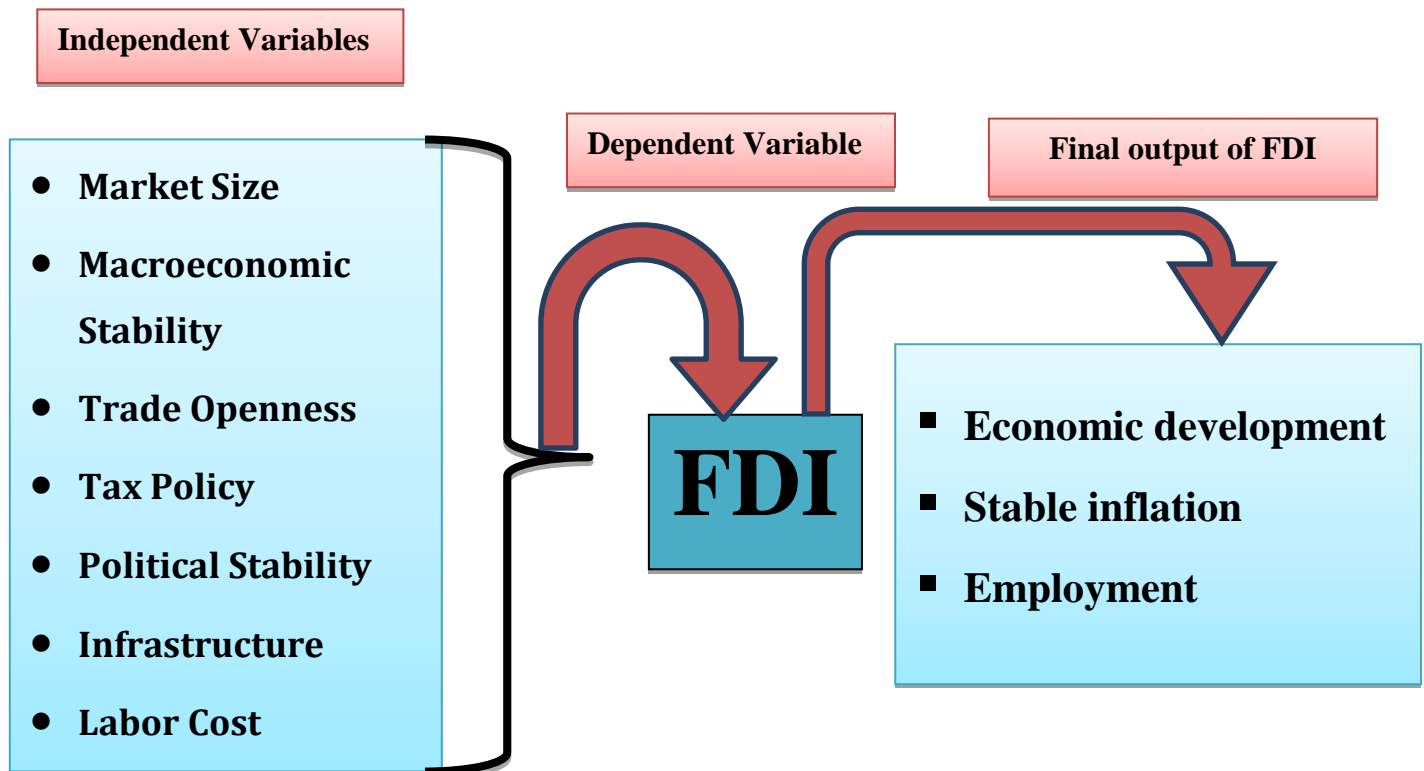


Figure 2.1: Conceptual framework constructed by the researcher, (2020)

## CHAPTER THREE

### RESEARCH METHODOLOGY

#### 3.1. Research Design and method

This research aims to assess the determinates of foreign direct investment in Ethiopia regards to the contributions of employment opportunities , revenue generation , linkage and spillover effects with local investment and it also tried to see the challenges encountered by foreign direct investments.

In the research design both deductive and inductive directions of reasons are identified. According to Saunders (Saunders, 2003), the inductive approach data is collected and theory developed as a result of data analysis where as in the deductive approach study developed a theory or hypothesis and designs a research strategy to test this hypothesis.

For this study, deductive approach, in accordance with the positivist research paradigm, where a hypothesis is developed as a research strategy is adopted as a starting point in this paper. Descriptive analyses are conducted in order to be able to test the linkage between FDI and determinant factors of investment which contributes to economic development in Ethiopia. A descriptive study enables to address new issues, to describe and explore the characteristics of the determinants variables under the situation of the study.

The empirical analysis of determinants of foreign direct investment (FDI) in Ethiopia is an explanatory research design which seeks explanations of observed problem, determine the accuracy of the theory and test a theory's predictions. Mostly, explanatory research is conducted to gain new insights, discover new ideas and/or increase knowledge of a phenomenon (Burns & Grove, 1998). It also employed a quantitative method used to test the pre- specified concepts, constructs and hypotheses that built a theory. According to Creswell, (1994) quantitative research explain phenomena by collecting numerical data that are analyzed using mathematically based methods, it allows for statistical comparisons between various groups, hypothesis testing and measure the level of occurrences, action and trends. The quantitative aspect of the research method intends to obtain data needed and based on that generalize the determinants of foreign direct investment in Ethiopia.

### 3.2. Target population, Sample Size and Sampling Technique of the study

The general populations of this study are all the foreign investment projects that are registered under three categories (pre implementation, implementation, and operation) in the Ethiopia investment commission data base. As the total foreign investment project 5,577 were then the general population of the study. The target populations for this study are the foreign investors who are actually in operation within the study period. Therefore the target population of the study includes 3150 foreign investor sunder operations.

The researcher used both probability and non-probability sampling techniques which were employed at three stage sampling techniques. First, purposive sampling technique was employed to select the best representative study area. since 82.6% (4607/5577) of FDIs of the country are found in Addis Ababa, around Addis Ababa and Oromia, then making the study in Addis Ababa and around Addis Ababa is believed to be highly representative(Ethiopian investment commission). Second stratified sampling method was used. There are 5 stratum which include; Agriculture, Manufacturing, Services, Construction and Tour Operation, Transport and Communication and Others. Then third, within each stratum, a simple random sampling technique was used to draw the individual samples with equitable representation of each stratum. Because the investments projects within each cluster are equally relevant to the study. To determine the sample size and representative of the target population, the study use statistical instrument formula.

The mathematical formula developed by Yamane (1976) was  $n = \frac{N}{1+N(e^2)}$ ,

Where, N=total target population,

n= sample size &

e= margin error.

The study assumes that the margin of error 10% and confidence level or error free of 90%. Using the above portrayed statistical formula, the sample size of study computed as follows.

Therefore, the sample size

$$(n) = \frac{N}{1+N(e^2)} = \frac{3150}{1+3150(0.10^2)} = 96.92 \approx 97 \text{ (i. e. due to round of decimal)}$$

The proportional stratified sampling for each stratum will be determined by  $n/N = 97/3150 = 0.0308$  which means that 6.89% of each clusters as calculated in the above table.

**Table 3.1: Number of investment projects which are under operation within the study period**

Stratum of investment	Number of FDI projects	Sample size @n/N = 0.0308
Agriculture	327	10
Manufacturing	1542	48
Service (education, health, hotels and restaurant, rental and consultancy service)	916	28
Construction (mining, real estate, well drilling and other types of construction)	228	7
Tour operation , transport and communication and others	137	4
<b>Total</b>	<b>3150</b>	<b>97</b>

(Source: Ethiopian Investment Commission, 2020)

The study was considered one respondent from each sector in the data collections. That can be the managing director of each organization. They are the ones who can provide the detailed information on the subject matter that are necessary to conduct the study.

### 3.3. Data types, Data sources and Methods of data collection

This study used both qualitative and quantitative data approach types and primary and secondary data sources. The primary data mainly focused on the determinant factors and impacts of FDI inflows through a qualitative assessment of the level of agreement of the respondents. Based on the need of the study, data were collected from primary sources mainly from foreign investment experts, Ethiopian investment commission and/or owners, Ethiopian investment agency (local officers), minister of finance and Ministry of Finance and Economic Development (MoFED) on the issue of foreign direct investment and determinant variables. The secondary data was collected from various sources including from Ministry of Finance and Economic Development (MoFED), Ethiopian Investment commission (EIC), international monetary fund (IMF), world trade Organization(WTO),United nations conference on trade and development (UNCTAD)and Organization of Economic cooperation and Developed(OECD). It is a time series data which was collected for the period 1992 to 2020. In order to collect the primary data, the data collection

instrument that the researcher used was structured questionnaire and interviews. To make it easily manageable each question was formulated both opened and close ended questions.

### **3.4. Methods and Tools of Data Analysis**

To analysis of data the researcher was carried out using different data analysis tools such as quantitative and qualitative. Both the qualitative and quantitative data were analyzed concurrently to arrive at dual edged sword conclusions. The primary data which were collected from the questionnaire respondents mainly focusing on the analysis research questions. For such reason a survey questionnaire of Likerts type with a five points of rating scale was prepared in which respondents are asked to rate (1) which is strongly agree up to (5) which is strongly disagree. With the help of SPSS versions 20 descriptive statistics summaries such as, percentages and frequency were used from the data collected as primary sources.

## CHAPTER FOUR

### DATA PRESENTATION, ANALYSIS AND INTERPRETATION

#### 4.1 Introduction

In this chapter an attempt was made to undertake data presentation, analysis and interpretation. The information available for this purpose was collected using different techniques such as questionnaires, personal interview and different secondary sources (both published and unpublished) were accessed. Following the data presentations in tabular form, analysis and interpretations were made based on the responses of foreign experts, FDI owners/manager officers and local officers. The responses made by the 15 interviewees (FDI owners) and 4 interviewees (local manager officers) were also used in analysis and interpretations. In this study the researcher selected 97 respondents for questionnaires out of which 94 respondents were a group of experts selected from different sectoral bureaus from government and non-government office but three of them failed to fill questionnaires. From 15 respondents of foreign direct investment owners were also provided by questionnaires and interviews and Regarding to personal interview, two officials were selected from Ethiopian Investment Commission were properly responded to the interview questions but three FDI owners failed to fill the questionnaires and four domestic officers are properly personal interviewees to .Since, from the total 116 respondents, 110 were properly responded the questioners and personal interviewees but six respondents were failed to respond it.

## 4.2. Demographic characteristics of the respondents

**Table 4.1: Socio-demographic characteristics of the respondents**

Respondent's background	Socio-demographic characteristics	Number of respondents	Percentage (%)
<b>Age</b>	20-25years	19	20%
	26-30years	27	29%
	31-35years	21	22%
	36-40years	10	11%
	above 40years	17	18%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<b>Sex</b>	Male	68	72%
	Female	26	28%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<b>Marital status</b>	Single	16	17%
	Marriage	22	23%
	Divorced	19	20%
	Widowed	24	26%
	Separated	13	14%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<b>Education level</b>	Certificate	-	0%
	Diploma	21	22%
	Degree	43	46%
	Masters and above	30	32%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<b>Work Experience</b>	0-5years	-	0%
	6-10years	31	33%
	11-15years	24	26%
	16years and above	39	41%
	<b>Total</b>	<b>94</b>	<b>100%</b>

(Sources: Survey questionnaire, 2020)

As depicted in Table 4.1 above, 72% of the respondents are males while the remaining 28% are Females. The majority of the respondent's age categories were under 26-30 and 31-35 years which correspond to 29% and 22%, the age category 36-40 is 11% and age of the respondents greater than 40 are only 18% of the respondent.

As revealed in Table 1 the marital status of the respondents categories that are single, married, divorced, widowed and separated. Those respondents with single marital status are 17%, married are 23%, divorced are 20%, widowed are 26% and separated respondents are 14%. As to the educational background of the respondents, 22% of the respondents are Diploma holders, 46% are Degree holders and 32% of the respondents are masters and above.

As shown in Table 1, the work experience of the respondents are 33% of the respondents between 6-10 years of experience, 26% of the respondents have 11-15 years of experience and 41% of the respondents have 16 and above years of experience. Therefore the respondents are qualified and experienced and hence the information provided by them is reliable. Due to these facts the investors are effective for their investment in the host country.

### **4.3. Foreign Direct Investment in Ethiopia**

#### **4.3.1. Patterns of FDI in Ethiopia**

The total net inflow of FDI was registered a total capital of\$ 3.59 billion in the past three years of GTP1 (MoFED 2014). On the other hand, according to FIC (2015) in the past three GTP1 years, 2,164 foreign investors with a total capital of \$ 187.3 billion got investment license to invest across all regions of the country. Of these, 133 projects with total capital of \$ 21.5 billion were under establishment while the remaining 637 projects with total capital of \$ 28.3 billion have started operation.

These projects reported to have created new job opportunities for 26,000 permanent and 35,000 temporary employees (FIC 2015 and MOI 2014). The net inflows of FDI were \$19.42 billion in the past three years in 2017, 2018 and 2019 but, specifically the highest inflow occurred in the year 2017 which was \$16.39 million total capital flows to our country Ethiopia (EIC, 2019).

### 4.3.2. Sectoral Distribution of FDI project in Ethiopia

**Table 4.2: Status of FDI project in Ethiopia by sector**

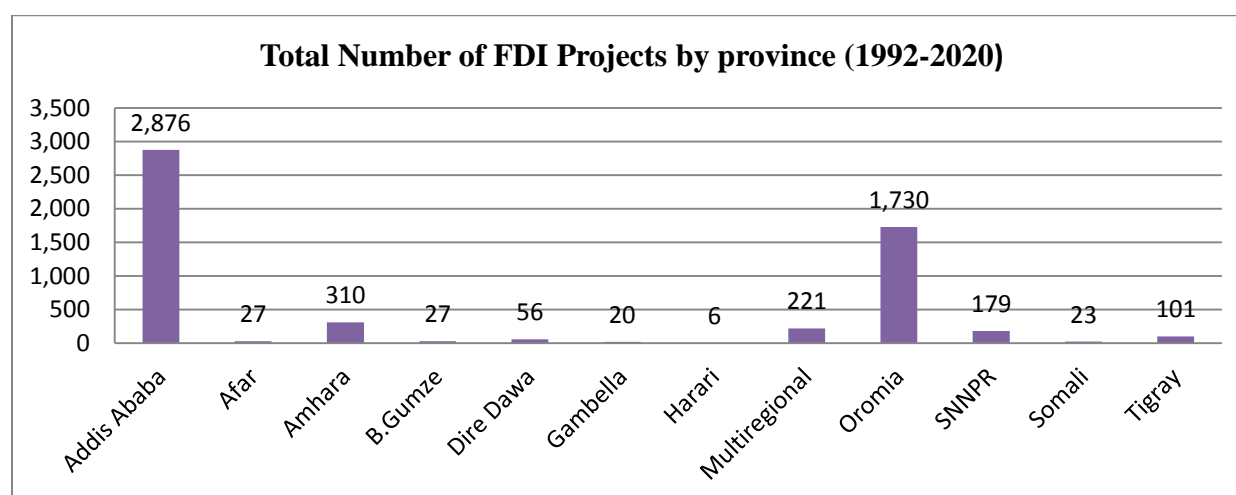
Sector	Not implement	Under construction	Operational	Total	Operational percentage (%)
Agriculture	162	134	327	622	10%
industry	754	501	1,542	2,797	49%
service	488	389	1281	2158	41%
<b>Total</b>	<b>1403</b>	<b>1024</b>	<b>3150</b>	<b>5577</b>	<b>100%</b>

(Sources: Ethiopian Investment commission, 2020)

As shown above in Table 4.2, Sectoral distribution of the licensed foreign direct investments indicates, 327 (10 percent) projects registered to engage in agriculture and related activities, while, 1542(49 percent) projects registered to produce manufacturing products and the remaining 1281(41 percent) projects licensed to engage in service. From the above table 4.2 indicated that 49 percent and 41 percent of foreign investors are registered to invest in manufacturing and service sectors respectively in unlike that of domestic investors where 82 percent of them are licensed to operate in the service sector (EIC, 2018).

### 4.3.3. Regional distribution of FDI Project in Ethiopia

**Figure 4.1: Summary of Licensed FDI Projects by Region since 1992-2020**



(Sources: Ethiopian Investment commission, 2020)

Foreign direct investment projects are well diversified in all over the country across the region of Ethiopia. Even though there has been an incentive system to encourage foreign investors to invest in the least developed regions (Gambella, Afar, Somali and Benishangul-Gumuz) of the country by providing especial benefits including provision of land free of any charge, their performance in attracting FDI has been very poor (EIA, 2018 and Solomon, 2001). This shows that the flow of FDI to Ethiopia has been unevenly distributed among the various regions.

As it is shown in figure 4.1 above, most of the FDI was destined in Addis Ababa, the capital city of the country. Over the period (1992-2020), 2,876 transactions took place in Addis Ababa, representing 57.07% of total transactions, while Oromia accounted for 29% of all investments (nine times more than the next region, Amahara). This is because of the regions' better infrastructure, stable political environment and better supply of trained man power. Oromia Region has attracted sizable number of FDI's with as shown by to the amount of capital invested. That is, of the total FDI operating in Ethiopia during 1992-2020, 29% of the capital was invested in Oromia. This may be due to the regions proximity to Addis Ababa, availability of natural resource (favorable climate) and large market size as it is the most populous region in the country. About 3% of the total FDI was invested in the Amhara region. Conversely, Harari, Gambella, Afar, Somali and Benishangul- Gumuz's performance in attracting FDI has been very poor which accounted for as per country proportion 0.03%, 0.3%, 0.4%, 0.1% and 0.2% respectively.. For example, there have been only six projects in Harari Region since the country opened its door to foreign investors from the year 1992-2020.

#### **4.4. The Contribution of FDI to the development of Ethiopia**

**Table 4.3: FDI Contribution to Development of the Ethiopia**

<b>Extent of FDI contribution</b>	<b>Number of respondents</b>	<b>Percentage (%)</b>
Very Great	15	16%
Great	21	22%
Low	58	62%
Total	94	100%

(Sources: Survey questionnaire, 2020)

As stated in literature the costs and benefits of FDI are the subject of intense debate. The levels of positive and negative impacts (benefits and cost) can vary between different countries depending on the host country itself, as well as the investing company, and the interaction between those two. Geographic location, growth domestic product, per capita income, economic environment, investment climate, economic policies and technology base might be some of the influencing factors (Grosse, 1988).

In line with the preceding statement, the researcher attempted to assess the extent of development contributed to the country by foreign direct investments. The majority of respondents from a group of experts responded that the contribution of FDI to the development of the country has been low. As presented in Table 4.4 above, from the total 94 respondents 58 of them (62%) responded that contribution of FDI to development of Ethiopia has been low. About 22% and 16% of the respondents stated great and very great respectively. The managers (owners) from Investment Commission Offices also responded that FDI contribution to the development of Ethiopia has been low despite of the potential of the country for economic growth. They enumerated different reasons for low contributions such as capital flight back to their home, remittance to their home rather than reinvesting their corporate profits, delays in commencing the actual business operation, low employment opportunity to local people, negative impacts on environment and dislocating people from their land. Thus, it could be stated that more development opportunities would have been created by FDI if they had operated to their full capacities and as well as through expanding their business by reinvesting their profits and more importantly, making the investment activities be environmentally friendly. That is the reason why most FDI projects inflows to Ethiopia have resulted low employment opportunity and low contributions to the economic development.

#### **4.5. FDI Preference to Intensify factors of Production**

**Table 4.4: Foreign Investors Preference to intensify factors of production**

<b>Factor of production</b>	<b>Number of respondents</b>	<b>Percentage (%)</b>
Labor	52	55%
Capital	23	24%
Technology	12	14%
Capital and labor in proportion	7	7%
<b>Total</b>	<b>94</b>	<b>100%</b>

**(Sources: Survey questionnaire, 2020)**

Developing countries, emerging economies and countries in transition increasingly view FDI as a source of economic development, income growth and employment. The level of importance of FDI to a country may depend on the degree of progress and availability of resources in that country. Countries with limited capacities and resources view FDI as a remedy for their constraints. Nevertheless, foreign investors are more attracted to countries with growing economies and various business opportunities because investment requires a foundation that aids in the achievement of investment goals and objectives (Shiferaw,2014).With the intention of achieving the investment objectives FDI prefer to use more of capital factor of production other than labor intensive factor of production.

According to the survey (2020), FDI in Ethiopia is preferred to use more labor than capital factors and technology. As depicted above in Table 4.5, the majority (55%) of the respondents replied that FDI in the country preferred more labor than capital and technology, while 24% of the respondents replied more capital than labor and technology. However there were few respondents corresponding to 14% and 7% that replied technology and labor and capital in proportion respectively.

**Table 4.5 Rational for preference of factors production**

<b>Rationales for preference</b>	<b>Number of respondents</b>	<b>Percentage (%)</b>
Cheap Labor	63	67%
For the sake of job opportunity	12	13%
The nature of business	19	20%
Total	94	100%

**(Sources: Survey questionnaire, 2020)**

As depicted above in Table 4.5, the experts in FDI reasoned out that availability of cheap labor and business nature are the rationale for preferred more labor than capital. Those respondents whose reason is cheap labor are 67% while those who reasoned out business nature govern the choice of factor of production are 20%. Few respondents of 13% replied that offer job opportunity is the rationale to prefer labor. Based on the secondary data ((1992-2020) of Ethiopian investment office the majority of FDI in operation are flower productions which are labor intensive in their nature of operation in the country. Moreover FDI owners are hiring more labor than using capital intensively to gain an advantage of maximizing profits. This indicates

only a relative use of more labor than capital. This does not improve the employment of enough labor in the country to reduce unemployment.

#### 4.6. FDI Local Employment Opportunity and Labor Availability in Ethiopia

**Table 4.6: Local Employment Opportunity in Ethiopia**

Employment opportunity	Number of respondents	Percentage
Very great	19	20%
Great	28	30%
Low	47	50%
Total	94	100%

*(Sources: Survey Questionnaire, 2020)*

Even though there is evidence from empirical literature, one of the motivations to attract FDI is its potential to create employment opportunity. A study conducted in Italy by Federico and Alfredo (2007) revealed that FDI is associated with faster local employment growth. But, in this study, the researcher attempted to find the employment opportunity to local people in Ethiopia by foreign investments. As inhibited above in Table 4.6, the results from respondents shows that lower input in employment opportunity, although labor is available in the country. From the total population, 50% of respondents stated that actual employment opportunity of FDI in Ethiopia has been low, while 30% and 20% perceived FDI employment opportunity to be great and very great respectively. This is also supported by the interview conducted with Ethiopia Investment commissionaire who responded that the contribution of FDI to local employment opportunity is very low unlike that of other neighboring countries. Moreover the data obtained from Ethiopia Investment Office reveals that the actual employment opportunity created in the country is 71.5% when compared to the plan in their proposals. It is possible to conclude from the unmet employment plan of FDI in Ethiopia that FDI owners plan to maximize employment opportunities lacks implementation in practice. This can be taken as one of the evidences that there is lack of effectiveness in contributing to the development of Ethiopia in terms of employment opportunity.

**Table 4.7: Availability of Skilled labor in Ethiopia**

Skilled Labor availability	Number of respondents	Percentage
Available	34	36%
Less available	49	52%
Not available	11	12%
<i>Total</i>	<i>94</i>	<i>100%</i>

(Sources: Survey Questionnaire, 2020)

As shown above in Table 4.7, the availability of skilled labor in the country 52% of the respondents replied that skilled labor is less available while 11% of respondents stated that there is no skilled labor available in the country as per the labor existed in host country. Around 36% of them responded that skilled labor is available in Ethiopia.

To sum up all, labor availability, actual employment opportunity and employment plan stated in EIC proposal. The failure to employ the labor emanates from the false inclusion in their proposal so as to obtain the investment land and the capital they require. An investment in a certain location is deemed to be a source of local employment opportunity as far as the labor is available with the intention of compensating the effect of eviction and other negative externalities. However; FDI used to employ labor from everywhere without exhaustively considering local employment opportunity.

#### 4.7. Wage and Salary Paid by FDI with Domestic Investors and Its Productivity

**Table 4.8: Wage and Salary paid by foreign investors and domestic firms**

Wage and salary of FDI Vs domestic firm	Number of Respondents	Percentage
Very high	10	11%
High	28	29%
The same	56	60%
Low	-	-
<i>Total</i>	<i>94</i>	<i>100%</i>

(Sources: Survey Questionnaire, 2020)

Here, the intention of the researcher is to find out whether the FDI operating in Ethiopia pays higher wages and salary than domestic firms in similar industries. As depicted above in Table 4.9, the responses provided by the majority of the respondents (60%) revealed that FDI pays similar wage and salary as that of domestic firms. Few respondents (29%) and 11% replied that FDI pays higher and very high salary and wage respectively when compared with the local or domestic firms. An empirical literature by Shiferaw (2014) revealed that there was a relative

increase in wages of skilled workers. The reason they found for wage inequality was a shift in production towards skill-intensive products due to capital inflow.

**Table 4.9: Wage and Salary and Productivity of FDI**

Productivity of FDI	Number of Respondents	Percentage
Excellent	-	-
Very good	18	19%
Good	68	72%
Poor	8	9%
Total	94	100%

*(Sources: Survey Questionnaire, 2020)*

As depicted above Table 4.9, regarding the productivity of FDI operating in Ethiopia, the majority of respondents (72%) replied that the productivity of FDI is good while 19% and 9% of the respondents replied very good and poor respectively. It can be concluded that if FDI were to pay higher wages and salary it would have induced the motivation of workers for highest productivity at the same time improved the income of the employed individuals.

#### 4.8. The Level of Revenue Generated to Government of Ethiopia by FDI

**Table 4.10: Level of revenue generated by FDI in Ethiopia**

Level of Revenue Generated by FDI	Number of Respondents	Percentage
Maximum	8	9%
Average	20	21%
Minimum	39	41%
Very Minimum	27	29%
Total	94	100%

*(Sources: Survey Questionnaire, 2020)*

As shown in Table 4.10, according to the respondents the revenue generated by FDI in Ethiopia is not encouraging. About 21% of the respondents confirmed that the revenue generated by FDI in the country is below the average which corresponds to minimum as responded by 41% and very minimum as replied by 29% of the respondents, While 9% of the respondents were generated the maximum revenue in Ethiopia. The revenue most relevant to the contribution of the country development is the income tax collected from employees in FDI and corporate profit taxes. That is the reason why the employment opportunity is not as it was expected. This is also

supported by interview with the two officials from Ethiopia Investment Commission. The two officials explained that the revenue generated minimum. The justifications for their response were FDIs do not implement their full capacities of their project proposals. They further explained that occasionally there are foreign investors that exploited the advantages of tax holiday for some 5 years and change their business to nature of institution. Therefore, it can be concluded that the contribution of FDI to revenue generation is not a rewarding one because of low employment opportunity.

#### 4.9. Linkage and Spillover Effect of FDI

**Table 4.11: Linkage and Spillover Effects of FDI**

<i>Linkage</i>		<i>Number of respondents</i>	<i>Percentage</i>
<b>Backward Linkage</b>	Yes	40	43%
	No	54	57%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<i>Strength of linkage</i>	Very strong	-	-
	Strong	10	11%
	Weak	56	60%
	Very weak	28	29%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<b>Forward Linkage</b>	Yes	39	41%
	No	55	59%
	<b>Total</b>	<b>94</b>	<b>100%</b>
<i>Strength of linkage</i>	Very strong	-	-
	Strong	16	17%
	Weak	48	51%
	Very weak	30	32%
	<b>Total</b>	<b>94</b>	<b>100%</b>

*(Sources: Survey Questionnaire, 2020)*

As depicted above in the Table 4.11, the linkage between foreign direct investment and the domestic firms exists to some extent. But the majority of the respondents, 57% and 59%, for backward and forward linkages respectively confirmed that there is no linkage. Regarding the strength of the linkage, those respondents that confirmed the existence of linkage responded that the bond between FDI and domestic firm is weak. Therefore, it can be concluded that there is an occasionally created linkage but with weak interaction.

As explained in many literatures foreign direct investment is highly demanded not merely for capital inflow but also for its linkage and spillover effects that bring comprehensive development. Foreign direct investments create a backward linkage when it utilizes the necessary inputs for its production from domestic firms there by encouraging local firm's capacity of supplying inputs.

On the other hand, FDI can supply finished products to local firms as market chain. Moreover when there is relationship between domestic and foreign investors, there will be spillover effects and technology transfer that enhance local productivity and domestic trade. That is the reason why foreign direct investment does not concentrate only on capital inflow to home country but also on technology transfer to enable the domestically operated firms more mechanized.

#### 4.10. Technology Transfer and Forum for Experience Sharing

**Table 4.12: Technology Transfer and Forum for Experience Sharing**

<i>Technology Transfer</i>	<b>Number of responses</b>	<b>Percentage</b>
Yes	36	38%
No	58	62%
<b>Total</b>	<b>94</b>	<b>100%</b>
<i>Forum for experience sharing</i>		
Yes	21	22%
No	73	78%
<b>Total</b>	<b>94</b>	<b>100%</b>

(Sources: Survey Questionnaire, 2020)

As depicted in Table 4.12, there is no arrangement for experience sharing among FDI and local firms. Based on the survey result the technology transfer from FDI to local firms rarely occurred in Ethiopia which was confirmed by 38% of the respondents. The majority of the respondents (62%) confirmed that there is no technology transfer at all. Literatures point out that Shiferaw (2014) technology transfer is one of the primary objectives of enhancing economic growth, capital accumulation, production and even changes in the organization of social relations. Moreover, the technology and productivity of local firms may improve as foreign firms enter the market and demonstrate new technologies, provide technical assistance to their local suppliers and customers, and train workers and managers who may be later employed by local firms.

## 4.11. Technology Transfer and Conditions on What it Depends

**Table 4.13: Technology Transfer and Conditions on What it Depends**

Extent of Technology transfer	Number of respondents	Percentage
Poor	49	52%
Good	35	37%
Very good	10	11%
Excellent	-	-
Total	94	100%
<b>Conditions on what technology transfer depends</b>		
Willingness of FDI owners	29	30%
Enforceable by agreement	55	59%
Willingness of domestic investment owners	10	11%
Total	94	100%

(Sources: Survey Questionnaire, 2020)

As responded by the 59% of the respondents technology transfer between foreign investors and the domestic firms is enforceable by the agreement. Contrary to this fact 49% of the respondents explained that technology transfer remains poor. From this it can be understood that although technology transfer is one of the criteria in FDI agreement, there is no follow up for effective implementation. Those respondents that believed in the technology transfer themselves witnessed the technology transfer to be low. In view of the fact that technology transfer is one of the contributions of FDI aimed at promoting local productivity, the low transfer of technology in Ethiopia indicates that the effectiveness of FDI in development of the country is minimal.

## 4.12. Challenges Hindering the Effectiveness of FDI

**Table 4.14: Lack of Infrastructure as a Challenge to the Effectiveness of FDI in Ethiopia**

Lack of infrastructure as an obstacle to FDI	Number of respondents	Percentage
Yes	74	79%
No	20	21%
Total	94	100%
<b>Responsible body for provision</b>		
Investors	8	9%
Town administration	12	13%
Federal Government	58	61%
Regional government	16	17%
Total	94	100%

(Sources: Survey Questionnaire, 2020)

As shown in Table 4.14, 79% of FDI respondents confirmed that lack of infrastructure is one of the factors severely inhibiting FDI effectiveness. The survey signifies that lack of infrastructures to be one of the obstacles to the effectiveness of FDI in Ethiopia. This is also supported by the information provided by FDI owners/managers. Regarding the responsibility of providing the infrastructures 61% of respondents replied that the major responsibility remains with the federal government while the town administration and the regional government holds 13% and 17% respectively. Besides these investors (9% of responses) are also responsible to provide how lack of infrastructure as an obstacle for effectiveness of FDI. Regarding the challenges of FDI, the Director of Ethiopia Investment Office has mentioned that infrastructures like power supply, access road and water supply are among the most serious challenges retarding the effectiveness of FDI implementation in the country.

As evidenced from empirical literature lack of infrastructure provision is one of the major impediments to FDI effectiveness. Since each body has its own share in the provision of infrastructures, if the body does not fully recognize its own responsibility in infrastructure provision lack of infrastructure is inevitable and lack of infrastructure in turn results in low inflow of FDI and to be a cause to the delay of the project and ultimately hamper the effectiveness of FDI in development (Tadesse, 2017).

### 4.13. Impacts of FDI on Environment and the Measures Taken

**Table 4.15: Impacts of FDI on Environment and Measures Taken**

<b>Do foreign investors carry out their business in environmentally friendly ways?</b>	<b>Number of respondents</b>	<b>Percentage</b>
Yes	23	24%
No	71	76%
Total	94	100%
<b>Is there any Measure taken against negative impacts of FDI?</b>		
Yes	68	72%
No	26	28%
Total	94	100%

**(Sources: Survey Questionnaire, 2020)**

As shown above in Table 4.15, regarding the environmental friendliness of FDI, the majority of the respondents 71 since 76% declared that FDI operations are not environmentally friendly, while 23 since 24% of the respondents witnessed that FDI operates in environmentally friendly way. The respondents enumerated some negative impacts of FDI on environment such as air pollution, water pollution political unrest and social conflict. This has been supported by the interview conducted with three investment officials. They replied that although every investor provided environmental impact assessment document at the initial stage of investment and some of the investors failed to build treatment plant to contain the environmental impacts. From these it is possible to conclude that any investment attempt that does not care for the environment is likely to bring a challenge than a contribution to the development of the country.

As evidenced in the literature that some developing countries may relax their environmental regulations as a means of attracting FDI. Foreign Direct investors, especially those with significant financial, political and negotiating power can cause damages to the host's environment. Indeed FDI in manufacturing and chemicals might cause damages to the environment through waste, emissions and smoke from their operations.

#### 4.14. FDI Challenges and Opportunities in Ethiopia forwarded by owners

In order to collect foreign investor's opinions and claims regarding their investment challenges and opportunities in Ethiopia, the researcher distributed questionnaire to 15 selected sample foreign direct investment owners operating in Ethiopia in which 12 of them properly responded. Their responses are organized and presented below and the researcher has tried to analyze their responses.

##### 4.14.1. Reasons to Select Ethiopia for Investment

**Table 4.16: Reasons to Select Ethiopia by FDI Owners**

Reasons to select Ethiopia for investment	Number of respondents	Percentage
Proximity to A.A	6	50%
Cheap labor	3	25%
Weather suitability	2	17%
Raw material availability	1	8%
Total	12	100%

**(Sources: Interview questionnaire, 2020)**

According to the responses provided by FDI owners selected as sample respondents, the reason for selecting proximity of Addis Ababa due to the capital city of Ethiopia as investment location around the city. This corresponds to 50% of the respondents. The other respondents, 25% responded cheap labor as a reason to select Ethiopia as investment center for foreign investors. The fact that Ethiopia is located at the vicinity of Addis Ababa, It creates opportunity to easily export the products to the required destinations and since Addis Ababa is the center towards which the labor migrates, labor is available for an employment in Ethiopia. From this it can be analyzed that foreign investors are very sensitive to location advantages that maximize their returns.

#### 4.14.2. Factors to be considered in any Locations

**Table 4.17: Factors for Investment Location**

Factors to be considered to invest in any location	Number of respondents	Percentage
Security	12	100%
Labor availability	10	83%
Market accessibility	11	92%
Land price	11	92%
Total	12	100%

(Sources: Interview questionnaire, 2020)

As shown in above Table 4.17, regarding the factors to be considered by FDI in selecting investment location, all of the respondents (100%) chose security as the highest priority. The rest of the respondents namely, 92%,92% and 83% replied labor availability market accessibility and land price respectively. From this it can be concluded that all the factors are important to attract FDI.

#### 4.14.3. Foreign Investors Knowledge and Satisfaction with Ethiopia Investment Policy

**Table 4.18: Foreign Investors Knowledge and Satisfaction with Ethiopia Investment Policy**

Knowledge of FDI about Ethiopia investment policy	Number of respondents	Percentage
Yes	15	100%
No	-	-
Total	15	100%
Level of Satisfaction With investment policy		
Highly satisfied	3	58%
Satisfied	7	25%
Partially satisfied	2	17%
Dissatisfied	-	-
Total	12	100%

(Sources: Interview questionnaire, 2020)

As shown above in Table 4.18, all the respondents replied that they have clear and adequate knowledge about investment policy of Ethiopia; however their level of satisfaction with the investment policy of the country is not uniform. As presented in the Table 4.18, 25% of the

respondents are highly satisfied with the current policy of Ethiopia, while 58% of the respondents confirmed that they are satisfied and 17% are partially satisfied.

#### 4.14.4. Satisfaction of FDI with Incentives of Ethiopia Investment Commission

**Table 4.19: Incentive to FDI and the Satisfaction with the Incentives**

IS there an incentive to FDI?	Number of respondents	Percentage
Yes	9	75%
No	3	25%
Total	12	100%
<b>Are you satisfied by the incentive?</b>		
Yes	12	100%
No	-	
Total	12	100%

(Sources: Interview questionnaire, 2020)

As shown in Table 4.19, the majority of the respondents (75%) recognize the incentives provided by regional and zonal Investment Office, while 27% of the respondents do not recognize the incentive provided. All of the respondents that recognize the incentive provision confirmed that they are satisfied by the incentive provided. Those who recognized the incentive provision those incentives such as ensuring secure environment, maintaining effective date of tax holidays and provision of investment land.

#### 4.14.5. Institutional Bureaucracy as Challenges of FDI

**Table 4.20: Challenges Related to Institutional Bureaucracy**

Time taken to obtain investment license	Number of respondents	Percentage
<5 hours	6	50%
5-8 hours	4	33%
9 -12 hours	2	17%
> 12hours	-	-
Total	12	100%
<b>Time taken to obtain investment land</b>		
Less than 2 months	2	17%
3-5 months	4	33%
6-8 months	5	42%
Above 8 months	1	8%
Total	12	100%

(Sources: Interview questionnaire, 2020)

According to EIA investment guide (2013), the process of obtaining an investment license takes not more than 4 hours if all the necessary requirements are fulfilled by an investor.

As shown in Table 4.20, 50% of the respondents revealed that they have taken less than 5 hours to obtain an investment license. This is almost in conformity with the standard set by EIA to provide the license. However 33% and 17% of the respondents replied that it took them 5-8 hours and 9-12 hours respectively. This shows that 40% of the investors seeking an investment license obtain beyond the standard time set by EIC. Since the standard time for provision of license is 4 hours and all respondents replied that they obtained license in one working day, it seems insignificant. However the failure to meet the standard time indicates that there is an institutional bureaucracy that limits the effectiveness of FDI.

As presented in Table 4.20, regarding the time spent to obtain land for an investment after registration, 17% of the respondents spent less than 2 months while 33% took 3-5 months. The majority (42%) took 6-8 months and 8% spent more than 8 months. This fact indicates there is more bureaucracy in obtaining the land than receiving license.

#### 4.14.6. FDI Owners Responses to the Tax Fairness

**Table 4.21: FDI Owners Responses to the Tax Fairness**

Is the tax you pay fair?	Number of respondents	Percentage
Yes	12	100%
No	-	-
Total	12	100%

**(Sources: Interview questionnaire, 2020)**

As depicted above in Table 4.21, all the respondents briefly replied that the tax they are paying is fair. Moreover, the respondents stated that taxation as a factor hindering FDI effectiveness in Ethiopia is negligible. This is in agreement with the responses offered by experts regarding the incentives available to foreign investors. The responses by experts were tax holiday, tax exemption and duty free import of goods. Here it can be concluded that taxation is not a threat. It is rather an incentive to promote foreign investors.

#### 4.14.7. Organizational Efficiency of FDI in Starting Actual Business

**Table 4.22: Organizational Efficiency of FDI in Starting Actual Business**

Time taken to start actual business	Number of respondents	Percentage
6 months	2	17%
6months-1 year	7	58%
1-1.5 year	2	17%
2 years and above	1	8%
Total	12	100 %

(Sources: Interview questionnaire, 2020)

As shown above in Table 4.22, only 17% of the business owners took 6 months to start their business. Around 58% of the respondents confirmed that it took 6 months to one year. The rest 17% and 8% of the respondents took one to one half years and two years and more respectively. In general, 83% of the respondents did not start the actual business with in the limit set to start the business. This indicates that there are some efficiency barriers that deter FDI from starting their project works. According to Ethiopia investment law FDI's are expected to start their actual business within six months after securing the investment land. However, due to organizational inefficiencies they took longer time to start their project work.

#### 4.14.8. FDI Owners Future Plan about their Investments

**Table 4.23: FDI Owners Future Plan about their Investments**

Do you have a plan to shift your business	Number of respondents	Percentage
Yes	-	-
No	12	100%
Total	12	100%
Do you have a plan to terminate your business		
Yes	-	-
No	12	100%
Total	12	100%

(Sources: Interview questionnaire, 2020)

In response to the questions whether investors have intentions to shift their current businesses to other businesses or terminate their investments, all of them responded that they do not have plan either to shift or terminate their investments. From this it is premises to conclude that the FDI is promising on the basis of business sustainability. There is no any word from the current foreign investors in transforming the current investment activities from one sector to the other sector as they want to continue with the existing business. From this it can be concluded that the

transformation from Agriculture to Industry is probably done by new entry of FDI rather than by the existing FDI.

#### 4.15 Determinants of Foreign Direct Investment

**Table 4.24: Factors that determine foreign direct investment in Ethiopia**

No	DETERMINANTS	SA	A	N	D	SD	TOTAL
1	Level of Infrastructure available	38	21	9	15	11	94
	<b>Percentage</b>	<b>40%</b>	<b>22%</b>	<b>10%</b>	<b>16%</b>	<b>12%</b>	<b>100%</b>
2	Privatization policy	33	20	8	15	18	94
	<b>Percentage</b>	<b>36%</b>	<b>21%</b>	<b>9%</b>	<b>16%</b>	<b>19%</b>	<b>100%</b>
3	Investment promotion & incentives	18	23	6	35	12	94
	<b>Percentage</b>	<b>19%</b>	<b>24%</b>	<b>7%</b>	<b>37%</b>	<b>13%</b>	<b>100%</b>
4	Bureaucracy	20	14	17	20	23	94
	<b>Percentage</b>	<b>21%</b>	<b>15%</b>	<b>18%</b>	<b>21%</b>	<b>25%</b>	<b>100%</b>
5	Lower Corruption	39	18	6	21	10	94
	<b>Percentage</b>	<b>41%</b>	<b>19%</b>	<b>7%</b>	<b>22%</b>	<b>11%</b>	<b>100%</b>
6	Availability of raw material	40	31	8	4	11	94
	<b>Percentage</b>	<b>43%</b>	<b>33%</b>	<b>9%</b>	<b>5%</b>	<b>12%</b>	<b>100%</b>
7	Lower labor cost	43	36	6	2	7	94
	<b>Percentage</b>	<b>46%</b>	<b>38%</b>	<b>6%</b>	<b>2%</b>	<b>8%</b>	<b>100%</b>
8	Political instability	39	32	9	5	9	94
	<b>Percentage</b>	<b>41%</b>	<b>34%</b>	<b>9.5%</b>	<b>6%</b>	<b>9.5%</b>	<b>100%</b>
9	Taxation policy of the country	22	24	8	25	15	94
	<b>Percentage</b>	<b>23%</b>	<b>26%</b>	<b>9%</b>	<b>27%</b>	<b>16%</b>	<b>100%</b>
10	Investment policy, laws & its regulation	32	24	16	13	9	94
	<b>Percentage</b>	<b>34%</b>	<b>26%</b>	<b>17%</b>	<b>14%</b>	<b>10%</b>	<b>100%</b>
11	Technological environment or e-commerce	20	32	4	21	17	94
	<b>Percentage</b>	<b>21%</b>	<b>34%</b>	<b>4%</b>	<b>22%</b>	<b>18%</b>	<b>100%</b>
12	Urbanization	12	20	7	32	23	94
	<b>Percentage</b>	<b>13%</b>	<b>21%</b>	<b>8%</b>	<b>34%</b>	<b>24%</b>	<b>100%</b>
13	inflation rate	38	36	4	7	9	94
	<b>Percentage</b>	<b>40%</b>	<b>38%</b>	<b>4%</b>	<b>8%</b>	<b>10%</b>	<b>100%</b>
14	Volatility of exchange rate	18	12	10	24	30	94
	<b>Percentage</b>	<b>19%</b>	<b>13%</b>	<b>11%</b>	<b>25%</b>	<b>32%</b>	<b>100%</b>
15	Level of foreign debt	15	20	10	30	19	94
	<b>Percentage</b>	<b>16%</b>	<b>21%</b>	<b>11%</b>	<b>32%</b>	<b>20%</b>	<b>100%</b>
16	Geographical Proximity	30	25	10	19	16	94
	<b>Percentage</b>	<b>30%</b>	<b>25%</b>	<b>10%</b>	<b>19%</b>	<b>16%</b>	<b>100%</b>

(Sources: Survey Questionnaire, 2020)

#### **4.15.1. Level of infrastructure available**

As evidenced from literature (Shiferaw, 2014) Infrastructure such as electric power supply, water supply, access roads, telecommunication and internet services are some of the basic facilities required by FDI. In line with this fact, the researcher attempted to assess whether the lack of these infrastructures is critical to the operation of FDI or negligible.

As shown above in Table 4.24, the majority of the respondents (38 percent) replied that availability of infrastructure in Ethiopia is highly critical for investors in FDI. Few respondents (12 percent) responded that infrastructure factors are not the only means that facilitate FDI in a given state. From this it is possible to conclude that availability of infrastructure is one of the most important factors that determine FDI in Ethiopia.

#### **4.15.2. Privatization policy**

Based on literature review, privatization serves as a potential source of foreign direct investment in Africa, specifically in sub-Saharan countries. As shown above in Table 4.25, about 36% of foreign investors responded that privatization is one of the vehicles in country's economy. Government holding huge enterprises are a hindrance. Total 19% of experts highly disagreed with privatization policy as a determinant factor for capital invested in one's country. Therefore, it can be generalized that even though there is no well-organized privatization policy in Ethiopia it still is one of the determinant factor that can attract foreign investors to bring capital into the host country.

#### **4.15.3. Investment Promotion and Incentives**

Even though investment incentives are FDI strategy instruments used to attract foreign investors. These include tax reductions & exemptions, special tax allowances, financial incentives such as low interest loans, subsidies and grants. Bilateral and multilateral investment treaties are also incentives to increase investment through creating a predictable investment climate, thereby improving direct foreign investor confidence (Birhanu and Kibre, 2003). The majority (37% percent) of respondents disagree with statement that investment incentives are a primary tool for capital flow to a given country. Total 19% of foreign investor indicated for the importance of

incentive and promotion for investment in Ethiopia. Thus, it is possible to conclude that investment incentives and promotions are not the main determinant factor for FDI in Ethiopia.

#### **4.15.4. Lower corruption**

Corruption ranges from petty to grand corruptions and usually takes place in a relatively hidden manner. It spoils good governance and diverts the resources from its planned use to personal benefits. Moreover from the virtue of business activities it affects free competition by favoring some and discouraging others. The researcher here wanted to know that how much the level of corruption is the hinder determinant of FDI in Ethiopia. According to the response of FDI owners 41% of the respondents replied the strongly agree that highly severe. Corruption is a critical challenge for investors to invest their capital in a given state. The other 11% of the respondents recognized corruption severity does not matter with their foreign investment. From this it can be conclude that corruption cannot easily be considered by the foreign investors while investing in a specific country since they may be politically corrupted with the higher officials of the country even with some share of investment are expected. That is the reason why low level of corruption can be the determinant factor for FDI in Ethiopia.

#### **4.15.5. Bureaucracy**

The fact that FDI has many contact institutions to start the investment may lengthen the duration of time to begin the actual business operation unless these institutions are efficient and effective in handling the issues of FDI. Contrary to the fact that less bureaucratic institutions are demanded by FDI owners, institutional bureaucracy is highly severe which is confirmed by the majority (60%) of the respondents. Similarly about a quarter of the respondents (25%) replied that there is institutional bureaucracy but with strong agreement. Still there are few respondents (20%) who didn't deny the existence of institutional bureaucracy but they confirmed its severity to be low. From this it can be conclude that there is institutional bureaucracy but is not considered as deferent factor by foreign investors in Ethiopia.

#### **4.15.6. Availability of raw Material**

Availability of raw materials is one of the location advantages considered by investors. In line with this intention the researcher aimed to find out if shortage of raw materials to be taken as a determinant factor for foreign investor to select a country for investment vehicle. Regarding the availability of raw materials, the majority of the respondents (43%) considered the availability of raw materials to be negligible to invest and 12% of respondents replied availability of raw materials is lower that denied investors to flow capital to host country. Hence, it can be concluded that raw materials availability in Ethiopia is one of the main determinant factors that attract foreign investors.

#### **4.15.7. Lower labor cost**

Manpower is also the basic requirement of investments especially for labor intensive activities. As confirmed by the secondary data obtained from Ethiopia investment office most FDI's are operating mainly in floriculture subsectors where cheap labor is highly demanded. The objective in here is to investigate if there is inexpensive manpower that might affect the demands of FDI in Ethiopia. As revealed in the above Table 4.25, the majority of the respondents (46%) replied that availability of cheap manpower is negligible and few respondents (8%) replied that investors don't consider low labor cost as a motivational for capital flow to a given country. Hence availability of cheap manpower is one of the demanding factors for foreign investors in Ethiopia.

#### **4.15.8. Taxation policy of the country**

Taxation is one of the instruments of collecting revenue to support government expenditures. If there is no proper tax administration, it discourages business activities. The government of Ethiopia identified areas of investment eligible for exemption of customs duty and exemption of income tax to encourage the flow and operation of FDI. The response of FDI owners indicates that taxation is not considered as negligible to be one of the factors that discourage FDI. This is supported by 27% of the respondents agree and 26% of respondents disagree more of equilibrium in ideology from tax point of view. From this it can be concluded that the government effort of relaxing tax to be paid by FDI is well recognized by FDI owners as incentive.

#### **4.15.9. Investment Policy, Law and its regulations**

The aim of this section is to assess how FDI owners feel towards investment policy, Law and investment climate. The majority of the respondents (34%) replied that there is problem related to investment climate, policy and law. Few respondents (10%) responded that investment policy, law and climate are none of the problems arises as they respond. From this it can be concluded that FDI in Ethiopia forced by investment policy, law and investment climate. As a result the Government of Ethiopia in recognition of the role of private sectors in the economy has revised over four times the investment code in the last twenty one years. It revised the previously restricted sectors to be open for foreign investors. Investment areas open for foreign investors include Manufacturing, agriculture, Information Communication Technology, Generation, transmission and supply of electrical energy, Hotel and Tourism, Construction Contracting, Real Estate Development, Education and training, Health services, architect and Engineering works, publishing, import trade, Export trade and whole sale trade (Ethiopian Investment Agency, 2018).

#### **4.15.10. Technological Environment, Urbanization and volatility of Exchange rate**

As evidenced from literature ICT encourages FDI either by reducing search time and related costs or through increases in efficiency and productivity in the country economy. Consistently the majority of (34%) of respondents replied that in Ethiopia there is no well-designed technological environment (e-commerce) while the other 18% of experts responded that if there exists as an infant stage e-commerce available in the country. Thus, e-commerce can be one of the determinant factors that encourage foreign investors to invest their capital in Ethiopia. According to Goldberg and Klien (1997), frequent and erratic changes in exchange rate of the domestic currency affect the inflow of FDI. But 32% of respondents replied that there is no exchange rate volatility in the country since there were still devalued as contrary to foreign currency. Hence, volatility of exchange rate cannot be considered as the determinant factor for FDI. When we come to urbanization, the majority (34%) of respondents conclude that urbanization is not the tool for investing in a given state rather wide area of land for investment is enough due to availability of cheap labor in the country. So, urbanization is not a factor that influences investors in Ethiopia.

#### **4.15.11. Inflation rate, foreign debt and Geographical proximity**

Based on literature evidence, high and unpredictable inflation will decrease the inflow of FDI (Birhanu, 1998). The (40%) of FDI experts replied that there is inflation problem in the Ethiopian economy that hinders them to invest due to higher cost of raw material incurred. Inflation rate highly influences the flow of capital to the given state.

Excessive foreign (loan) debt is one source of instability and uncertainty in macroeconomic environment of underdeveloped countries and this foreign debt is likely to affect adversely the inflow of FDI. But, (32%) of respondents conclude that there is no excess foreign debt that influence the flow of capital in the country. Hence, whether the level of foreign debt available in the country is higher or lower it may not be a barrier for investors unlike rare phenomena's in the country.

The recent global economic structure of multinational organizations, politically stable, geographical proximity and cultural and linguistic affinities are becoming important determinants of foreign direct investment. Consistent to the literature evidence 30% of respondents replied that there exists geographical proximity in case for cultural and environmental situations enable the foreign investors to freely invest everywhere in the country. Therefore, geographical proximity is one of the factors that inspire the foreign investors while investing in Ethiopia (Jinayu, 1997).

#### **4.16 The FDI Institutional Framework in Ethiopia**

The Ethiopian Investment Commission (EIC) is one of the autonomous government institutions and state owned organization which is responsibly to the country's Investment Board, which is chaired by the Ethiopian Prime Minister. A Commissioner, who is also member of the Board, heads of the EIC (EIC, 2019).

The EIC is restructured itself in recently with a view of to becoming more efficient and effective ways of operations to attract FDI and improving the services provided to investors.

The main services provided by EIC includes the following

- Promoting the country's investment opportunities and conditions to foreign and domestic investors.
- Hand-holding and supporting the investor during the acquisition of land and utilities (water, electrical power and telecom services) and the processing of loans and residence permit applications;
- The approval of environmental impact assessments studies for investment projects; and the issuance of a tax identification number (TIN).
- Issuing investment permits, business licenses and construction permits.
- Notarizing memorandum and articles of association and amendments.
- Issuing commercial registration certificates as well as renewals, amendments, replacements and cancellations.
- Effecting registration of trade or firm name and amendment, as well as replacements or cancellations.
- Issuing work permits, including renewals, replacements, suspensions or cancellations.
- Grading first grade construction contractors.
- Registering technology transfer agreements and export-oriented non-equity-based foreign enterprise collaborations with domestic investors.
- Negotiating and, upon government approval, signing bilateral investment promotion and protection treaties with other countries.
- Advising the government on policy measures needed to create an attractive investment climate for investors.

The Ethiopian Government is one of the engines to encourage the participation of both domestic and foreign investors in the privatization program, particularly in large state owned companies. In recent year, the Ethiopian Privatization Agency, the Public Enterprises and Supervising Agency are emerged as one to facilitate and coordinate the implantation of privatization program.

#### 4.16.1 Interview questions on the determinants of FDI by local officers (Ethiopia)

- As responded by the officer of MOFED(Ethiopia),most investors flow their capital to Ethiopia because of lower labor cost ,available of cheap abundant raw materials and tax exemption of machinery are the most attractive of foreign investors but investment policies ,infrastructures accessibility such as ,road, electric city, internet, water and railways , land available and sometimes ethnic conflicts are suffer foreign investors . From the officer point of views the researcher understand that there is no difference in the views of foreign investor managers and domestic officer managers with the respects of foreign direct investment determinants in Ethiopia .
- According to response forwarded by the officer of Ethiopian investment commission (EIC), foreign investors flow the capital from their country to Ethiopia due to abundant and rich sectoral raw materials for their industry, cheap employment availability, geographical proximity to urbanized areas and also they requires stable political system in the country but it is unusual. So the researcher address that there is similar views of both management foreign investors and Ethiopian investment commission in term of the factors that determines foreign direct investment in Ethiopia.
- The officer of Ethiopian investment agency (EIA),according to the officer response of the agency in the local point of view the determinates of FDI, foreign investors are inspired because of cheapest labor in the country ,availability of sectorial raw materials ,improvement of infrastructural availability, better economic growth rate (10%), improvement investment promotion strategies, taxation polices and privatizations ,technological improvement of market networked of international financial transactions ,strictly absence of corruption and Bureaucracy, stable of political framework, moderate inflations thus indicators are better to attracts foreign investors and it enables create employment opportunities and positive effects of balance of payment. The officer of the agent also indicates foreign investors are not targeted to invest in our country of Ethiopia how much foreign debit (deficits) and volatility of foreign exchange rates occurred in the country.

- According to the response explained by Minister of Finance (Ethiopia), the flows of capital from abroad to Ethiopia by foreign investors can be determined by available competitive labor, lower corrupted economy, consistently stable political system, natural resources as raw materials for production of an industrial input-output items, and infrastructure improvement in order to facilitate their investment as ingredients of required by foreign investors. The officer of finance not only explained what determinates those foreign investors to invest in Ethiopia but also gives explanations on those factors that determine FDI and it is formulation framework for the development of stock exchange market in the financial industrials of the country in Ethiopia.

### **Chapter Summary**

The very essence of the study was to identify the determinants of FDI in line with the development of Ethiopia and its Challenges and prospects. The researcher used the mixed methods of research where both qualitative and quantitative methods have been effectively employed to meet the research objectives. The researcher selected the samples from a group of experts working in different offices and bureaus that have stakes in investment.

The method of selections are both probability and non-probability sampling in which experts with better knowledge and information about investment were selected from respective organizations whose work is related to investment in one way or other. There were 97 sample respondents out of the total of 3150 were those that correctly responded to the questionnaires. The other samples used in this research were the 15 FDI owners that were selected from the total owners of FDI currently operating in the country. However, the sample FDI owners that were used in the analysis were 12.

In addition to the above two groups of samples, two officials from Ethiopia Investment Office and Ethiopia Investment Commission were selected for the interviews and 4 from local investment officers which facilitate foreign investors to invest in Ethiopia.

According to the data obtained from Ethiopia Investment Office, foreign investors are investing in all the three economic sectors namely Agriculture, Industry and Services. Regardless of the Ethiopia potential to investment, the actual investment activities are not as expected. The very

reason for low investment performance of the country has been that many investors did not run the operation stage even if they took the investment license. This research tried to assess the low performance and low contribution of FDI in Ethiopia and the challenges underling it.

Based on the survey result, the contributions of FDI to the development of Ethiopia is low regardless of the potential of the country. The low contributions to development were manifested by low local employment opportunity, low revenue generation, weak linkage of FDI and domestic firms in terms of technology transfer, skill development and other positive spillover effects. The level of revenue generated by FDI to local administrations is low because of low employment opportunity as the main source to local revenue is an employment income tax. The other source of revenue is profit tax which can be collected after tax holidays in which FDIs are opting to pay to either the federal or regional revenue or custom authority.

Hence, this study concluded that availability of infrastructures, privatization policy, lower corruption, lower labor cost, availability of raw material, political instability, investment law and regulations, geographical proximity, inflation rate and e-commerce are the factors that determine FDI in Ethiopia.

## CHAPTER FIVE

### SUMMARY OF FINDING AND RECOMMENDATION

#### 5.1. Summary of the paper

This study is imperative to criticize the effectiveness of FDI depending on its contribution to employment opportunity, revenue generation, technology transfer and its harmony with the environment. Because of its enormous potential to create jobs opportunities, raise productivity; enhance the transfer of technology, foreign direct investment is a vital factor in the long-term economic development of the developing countries like Ethiopia. Despite the benefits that can be derived from foreign direct investment, it should be noted that it can also bring about some negative impact like adverse competitions and balance of payment and decline national sovereignty. Based on these parameters and responses of the study the sample respondents the effectiveness of FDI in Ethiopia is constrained by both FDI organizational of internal and external factors that impeded its contribution to the development of the area of the countries.

The low contributions of FDI to the development of Ethiopia emanate from delay in operation and failures in meeting the planned full capacity productions which are mainly the result of inter organizational inefficiencies. Based on the survey results, the most pronounced determinants of FDI in Ethiopia are availability of infrastructures, privatization policy, lower corruption, lower labor cost, availability of raw material, political instability, investment law and regulations, geographical proximity, inflation rate and e-commerce.

## 5.2. Recommendation

Based on the findings of this study, the researcher addresses the following recommendations;

Sustainable economic growth is an engine of attracting FDI in order to overcome the opportunities of resources such as capital, entrepreneurship, access to foreign markets, efficient managerial techniques, technology transfers, innovation, employment opportunities and ultimately economic growth. However, as a result of the level of demand for it in Ethiopia, higher prices in the form of innovative strategies have to be paid in order to attract such investment in Ethiopia. Some strategies to attract FDI and to be benefited more from it, includes;

- A collaborated effort has to be made by the government and concerned bodies to address and stabilize the current macroeconomic instabilities ,such as inflation, interest rate hikes, balance of payments disequilibrium, mounting public debt and so forth which discourage those potential investors from entry and adversely affected the operational ones.
- Ethiopia has undertaken wider-range reforms over the past three decades. After 1992, there has been a significant yet steady reformation of the economic and political systems. There is no question that Africa suffers from lack of visibility in industrialized countries, to be at the forefront of FDI attraction, these are issues that need the swift attention of the government of Ethiopia without compromising the independence of the media. Much has been sacrificed to achieve surplus balance of payment and a positive growth rate, and these sacrifices must not go unnoticed. Although efforts have been embarked on through the government's Federal and Regional Investment Offices, more effort is needed by the government, bilateral aid agencies, multilateral agencies, development banks and, more importantly, the media to identify investment opportunities in the country and use it as a platform to create a positive image for Ethiopia and Africa at large as a good investment destination.
- The objective of investment attraction must be seen as a national objective and not only the objective of the Ethiopian government on its own. Where government comes together with organized business, labor, NGOS and community groupings on a national level to discuss and aim to reach consensus on issues of social and economic policy towards FDI,

that enables to set key objectives and to develop a working social accord between business, labor and government outside the institutional framework, i.e. one that aware both a socially acceptable and investor-friendly.

- The government has to deepen its current effort in developing infrastructural facilities such as road, information and communication technologies and electricity and improving their services which are regarded as necessary conditions to draw sizable FDI. Efforts to demarcate industrial zones might partly address the problem in this respect. However, there needs to assess as to how much this endeavor has been effectively addressing the problem in general and attracting the required volume and type of FDI in particular before additional resources are expanded.
- The government must review its fiscal police, tax, foreign investment regimes and other policies and laws in relation to other countries in Africa, where attracting foreign investors is currently underway. The objective of this review process must be to compare notes with other countries and implement policies and laws that are competitive and conducive to foreign investment. The foreign investment must perceive Ethiopia to be the right place to do business in Africa.

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# APPENDIX - 1

## Questionnaires to be responded by Experts

Addis Ababa University

School Of Graduate Studies

College Of Business and Economics

Department Of Management

Dear respondents, the objective of the questionnaires is to gather information or data on determinants of foreign direct investment and effectiveness in development, its challenges and prospects in Ethiopia. The study is required for the partial fulfillment of master's degree in Business Management. Dear respondents, you are expected to provide genuine, and reliable information with respect to foreign direct investment contributions to the development of the country and the challenges in the course of FDI implementation. Your genuine information is highly decisive to the success of this study. Therefore, the researcher assures you that the information and the data you will provide is very confidential and only serves for academic purpose. Thank you in advance for your cooperation.

### **Instructions:**

Please **circle** on the relevant alternatives of your respective answers and write your answer on the space provided.

### **Part 1: Background of the study**

1. Age: A. 20-25 B.26-30 C.31-35 D.36-40 E. above 40
2. Sex: A. Male B. Female
3. Marital status: A. Single B. Married C. Divorced D. Widowed E. separated
4. Educational Background: A. certificate B. Diploma C. Degree D. Masters Degree E. PhD
5. Work Experience: A) 0-5 years C) 11-15 B) 6-10 years D) above 16 years

### **Part 2: Contributions of Foreign Direct Investment in the Development of the country**

1. To what extent do you think the investment undertaken by foreigners contribute to the development of the country? A) very great                      B) Great                      C) Low

2. If your answer for question number 1 is low, what could be the reasons for low contribution? -----  
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3. Do foreign investors provide some social infrastructures to the community? A) yes B) No

4. If your answer for question number 3 is yes, what are those infrastructures? -----  
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5. What foreign investors prefer to use in the production process intensively? A) Labor B) capital  
C) technology D) both capital and labor proportionately

6. If your answer for question number 5 is labor intensive, what are the reasons?

A) Availability of cheap labor B) for job opportunity C) Due to the business nature

7. How do you explain the employment opportunity created by FDI to local people in the country?

A) very great B) Great C) low

8. How do you rate the availability of skilled labor in the country?

A) Available B) Not available C) less available

11. How do you compare the wage and salary paid by foreign direct investors with that of domestic investors to their employees?

A) Very high B) relatively higher C) the same as that of domestic investors D) lower

12. What is your opinion about the revenue generated by FDI operating in the country?

A) Maximum B) Average C) Minimum D) Very minimum

13. If the revenue generated by FDI in the country minimum, what do you think the reasons for minimum revenue generation?

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14. How do you Judge the productivity of FDI? A) Excellent B) Very good C) Good D) Poor

15. If the productivity of FDI is poor, what do you think the reasons?

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**Part 6: Factors that determine foreign direct investment in one's country**

Within the following table there are list of objectives that a given investor wants to achieve through overseas investment. Please rate the importance of the listed objectives (1) is strongly agree,(2) is agree,(3) is neutral,(4) is disagree, (5) is strongly disagree to your decision in investing here.

<b>Determinants</b>						
		<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>
1	Level of infrastructure available					
2	Privatization					
3	Investment promotion and incentives					
4	Institutional bureaucracy					
5	Lower Corruption					
6	Shortage of raw materials					
7	Low level of labor cost					
8	Political stability					
9	Taxation policy of the country					
10	Investment policy, law and its regulatory framework					
11	Technological environment or e-commerce					
12	Urbanization					
13	Inflation rate					
14	Volatility of exchange rate					
15	Level of foreign debt					
16	Geographical proximity					

**Thank you in advance for your cooperation!!!**

## APPENDIX- 2

### Interview questions to Ethiopia Investment Commission

Addis Ababa University

School Of Graduate Studies

College Of Business and Economics

Department Of Management

Dear respondents, the objective of this interview is to gather information on determinants of foreign direct investment in Ethiopia. The study is required for the partial fulfillment of master's degree in Business Administration. Dear respondents, you are expected to provide genuine, and reliable information with respect to foreign direct investment contributions to the development of the country and the challenges in the course of FDI implementation. Your genuine information is highly decisive to the success of this study. Therefore, the researcher assures you that the information you provide is very confidential and only serves for academic purpose.

#### Part I: General information about your enterprise

S.N	Item	Responses				
1	Position of respondents	a) General manager /manager director		b) deputy GM		
		c) Delegated				
2	Nationality of respondents	a) Ethiopian		b) not Ethiopian		
3	Name of your enterprise					
4	Home country of the enterprise					
5	What is the principal area of activity (business type)? Make X for your answer	Agriculture	Manufacturing	Mining	education	Health
		Hotel	Tour& transport	Real estate	construction	Other
6	Year of establishment					
7	Ownership	a) Wholly owned		b) joint venture		c) other

**Part II: interview question to the manager or owner of foreign direct investment**

1. How could you describe the major contributions of FDI to poverty reduction in the country?
2. Do foreign direct investors reinvest their corporate revenue or remit their capital back to their home country?
3. How do you describe the role of FDI in promoting local employment and generation of fiscal revenue?
4. Could you explain the effect of FDI on local productivity and capacity improvement through backward and forward linkages with local firms?
5. How do you recognize the effectiveness of FDI in technology transfer and skill development of local firms through spillover effect?
6. How your organization is closely monitor and work with owners/managers of FDI to facilitate the work?
7. What are the incentives provided by your organization exclusively to foreign investors to promote their inflow?
8. What is the trend of FDI in flow currently looks like in the country?
9. Are there foreign investors that delay longer time in starting actual business after taking land for investment?
10. What are the negative impacts of FDI activities on the surrounding environment?
11. What are the challenges facing the FDI that deter their normal activities?
12. What is your comment on the overall FDI effectiveness and challenges in the Zone?

**Thank you in advance for your cooperation!!!**