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Economic Analysis of Direct Foreign Investment (DFI) in Nigeria

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Abstract

This study focused on the economic analysis of Direct Foreign Investments (FDI) in Nigeria exploring its trends through, job creation, transfer of technology and ultimately economic growth. The study identified eight (8) methods of Foreign Direct Investment (FDI) in line with their corresponding theories. Different growth theories support the fact that FDI is either directly or indirectly beneficial to economic growth of any nation. The study went on to analyze the relationship between economic growth and FDI and the flow of FDI in Nigeria over the years 1981-2021 revealing that Nigeria ranks third in Africa for Foreign Direct Investment (FDI), behind Egypt and Ethiopia. After a comprehensive analysis of existing literatures, it reveals that FDI can have both positive and negative effects on the host economy depending on factors such as the type of investment, industry and the regulatory environment.

Keywords:

Economic analysis, foreign Direct Investment, Gross Domestic Product, Job Creation, Economic Growth.

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1.0 Introduction

By definition, Direct Foreign Investment—hereafter referred to as FDI—is the investment made by foreign businesses or individual investors in a nation so as to further their future interests. Historically, such investment has grown significantly and became one main activity between nations. But at the same time, with the advent of such phenomena, we also raised some problems regarding the repercussions of FDI, such as what would be the impact of FDI on the economic growth of a nation, and how would the effect of FDI be different in

developed and developing countries. Theoretically, certain growth theories created by renowned economists imply that the FDI is either directly or indirectly benefiting the economic development of a nation by means of the host economy's production components.
The neoclassical growth hypothesis holds that FDI largely increases the stock of physical capital in the host economy, hence boosting the host economy. On the other hand, according to the endogenous growth theory, the FDI helps to increase the economic growth of the host country by supporting the generation of new ideas or knowledge in the process of research and development or the improvement of management practice in the production of the country, which finally improves the productivity.

Especially for emerging nations, Direct Foreign Investment has been generally seen as a crucial source of economic growth. Underdeveloped nations' economic improvement is mostly driven by FDI (Edrak et al., 2014; Iqbal et al., 2012; Masron et al., 2012). FDI, says Chen et al. (2010), helps host nations expand economically in many ways: knowledge transfer, employment creation, import replacement, and the increase of export volumes. Many developing nations have aggressively adopted policies to encourage FDI in light of its recognition as a strategic tool for fostering economic growth in order to assist their long-term development goals.

1.1 Meaning Of Foreign Direct Investment

The goal of direct investment, as defined by the International Monetary Fund and the Organisation for Economic Cooperation and Development, is for a resident entity of one country (the direct investor) to acquire a permanent stake in a company (the direct investment enterprise) located in another economy. The direct investor must have a substantial amount of control over the management of the direct investment company and maintain a long-term connection with the latter in order for there to be a "lasting interest" in the investment. The term "direct investment" encompasses not just the first deal that brings the investor and business together, but also any and all future capital deals between the two parties or between related businesses, whether legally formed or not. Notably, the Balance of Payments and the IIP must also record capital transactions that do not result in settlement, such as the exchange of shares among linked entities.

1.2 Process of Foreign Direct Investment

The usual steps for foreign direct investment are as follows.

i. A possible target firm or industry in the target nation is first sought after by the investor.
ii. The next step is for them to dig deep into the target company's financials, management, market standing, and regulatory and legal landscape.
iii. The investor will discuss the investment conditions with the target firm after the analysis is finished.
iv. Among these factors may be the investment size, ownership proportion, and degree of influence over the target company's activities.

v. The investor will either establish a new subsidiary in the other nation or transfer the cash to the target firm after the agreements are agreed upon.
vi. After making a financial investment, the investor will get involved in running the target business, bringing its knowledge and resources to bear to boost profits and expand the business.

1.3 Types of Foreign Direct Investment (FDI)

Two broad categories characterise FDI, or foreign direct investment:

A. Horizontal FDI

When a business invests in a foreign nation to manufacture a product or service that is identical to what it does at home, this is called horizontal foreign direct investment (FDI). So, to cater to the local market, the corporation sets up shop in a foreign nation and runs its current activities there. Gaining access to new markets, lowering manufacturing costs, or avoiding trade obstacles are the goals of horizontal FDI.

B. Vertical FDI

Foreign direct investment (FDI) that is vertically orientated happens when a business invests abroad to get intermediate products or services, or raw materials. Alternatively, the business can set up shop in a foreign nation and sell its wares there or even export them. The goals of lowering manufacturing costs, obtaining specialised inputs, and increasing supply chain efficiency motivate vertical FDI.

There are two subsets of vertical FDI:

a) Backward Integration: As a kind of foreign direct investment (FDI), this happens when a business goes abroad to get the components it needs to make its end product. To get steel, for instance, a car manufacturer may invest in a foreign nation.

b) Forward integration: This kind of foreign direct investment happens when a business invests abroad with the intention of selling its finished goods in the local market or exporting them. Take the case of a car company that decides to invest in a foreign nation. They want to sell their automobiles in the local market and establish a dealership network.

Another way to categorise FDI is according to the investor's goals. One example of a strategic use of FDI is the acquisition of new technology, expansion into new markets, or diversification of the investor's activities. Foreign direct investment (FDI) may also be used for monetary purposes, such as pursuing greater returns, decreasing risk, or using tax concessions in the host nation.

1.4 Methods of Foreign Direct Investment (FDI)

Depending on the investment's characteristics and the investor's goals, Foreign Direct Investment (FDI) may take several forms. Some typical approaches to foreign direct investment are as follows:

i. A greenfield investment is one in which an investor from outside the host nation starts a brand-new company there. This necessitates constructing brand-new infrastructure, purchasing appropriate property, and launching operations from the ground up. Common areas for greenfield investments include manufacturing, services, and infrastructure development.
ii. M&A, or merger and acquisition, is a strategy wherein an investor from outside the host nation buys out an established local business. Investors acquire ownership and control of a company when they buy a controlling interest or the whole company. The acquisition of a company's assets, including its customers, distribution networks, and intellectual property, may pave the way to new markets.
iii. When an investor from outside the country teams up with a local firm or individual to launch a brand-new enterprise, this kind of cooperation is known as a joint venture. Partners pool their resources, knowledge, and money and divide up the risks and rewards. By forming a joint venture, two companies may pool their resources—local expertise and market knowledge and the international partner's technological know-how, managerial acumen, and access to international markets.
iv. Collaboration between international and domestic businesses towards a same goal is known as a strategic alliance. Strategic alliances, in contrast to joint ventures, do not usually lead to the establishment of a new legal company and tend to be less formal. These partnerships may take many forms, including agreements to transfer technology, work together on research and development, or share marketing and distribution responsibilities.
v. When two or more firms based in separate nations come together to become one, this is called a cross-border merger. By doing so, businesses are able to combine their resources, strengthen their positions in the market, and reap the benefits of economies of scale. Mergers that span international borders are often pursued by companies looking to increase their market presence, acquire a competitive edge, or tap into complementary skills.
vi. Some nations set up what are called special economic zones (SEZs), which are essentially enclaves inside their borders that provide investors preferential treatment in exchange for financial resources. Advantages of special economic zones (SEZs) include reduced taxes, easier regulations, financial backing for infrastructure, and access to trained labour. The excellent investment environment in these zones makes them attractive locations for foreign investors to set up shop.
vii. Privatisation: When state-owned businesses are sold off to private investors, including those from other countries, this is called privatisation. To boost efficiency, bring in foreign investment, and free up sectors that were formerly under state control, governments may choose to sell off public assets. Public offers, auctions, and negotiated transactions are all viable privatisation strategies.

viii. Buying stocks, bonds, or other financial assets in foreign governments or enterprises is known as portfolio investment, which is not the same as foreign direct investment (FDI). Unlike foreign direct investment (FDI), portfolio investors do not have a say in how the invested firm is run. However, host nations may still benefit from capital flows and the growth of their financial markets via portfolio investment.

1.5 Importance of Foreign Direct Investment (FDI)

Here are some importances of FDI:

i. Economic Growth: Foreign direct investment (FDI) is a key factor in boosting host nations' economies. Gains in productivity, employment, and economic growth may result from the influx of money, technology, managerial know-how, and access to global markets.

ii. Foreign direct investment (FDI) helps host nations with capital creation in a few ways: by funding new firms, expanding current ones, or infrastructure projects. Investment gaps are filled and economic advancement is facilitated by this infusion of cash.

iii. Foreign direct investment (FDI) often offers cutting-edge technology, specialised knowledge, and new ideas to the nations that receive it. Improving manufacturing techniques, product quality, and competitiveness in the local market may be achieved via technology transfer, which happens when foreign investors and domestic enterprises collaborate and share information.

iv. Foreign direct investment (FDI) may create jobs in the nations that receive it. The establishment of activities, factories, and offices by foreign enterprises necessitates a staff, which in turn reduces unemployment rates and improves human capital development.

v. Foreign direct investment (FDI) has the potential to increase commerce by boosting both exports and imports. Increased exports, import substitution, and integration into global value chains are all possible outcomes when foreign investors set up manufacturing facilities in host nations to serve both domestic and foreign markets.

vi. Foreign direct investment (FDI) has the potential to aid host nations in developing their infrastructure. The transportation, telecommunications, electricity, and logistics industries are attractive to foreign investors because they may boost infrastructure quality while also easing corporate operations and economic interconnection.

vii. Foreign direct investment (FDI) allows for the transfer of expertise and information from overseas investors to domestic businesses. Ability building and the development of a competent workforce in the host nation may result from interactions with international enterprises and exposure to their management techniques, organisational culture, and industry standards.

viii. Financial Stability and Balance of Payments: Foreign direct investment (FDI) flows may bolster a nation's financial stability by providing a steady and lasting supply of capital. Since FDI brings in foreign currency and decreases dependence on external borrowing, it may also help improve the balance of payments situation.

ix. Foreign direct investment (FDI) has the potential to boost host nations' economy in a number of ways, including:
x. Sectoral Development: Industrialisation, diversification, and specialisation may be fostered by strategic investments in important areas such as manufacturing, services, technology, and research and development, ultimately leading to a more balanced and sustainable economy.

2.0 Theories of Foreign Direct Investments

These are theories that explains the reasons behind FDI in any country.

2.1 Ownership-Location-Internalization (OLI) Framework

John Dunning's OLI model is among the most popular explanations for foreign direct investment. It highlights the benefits of ownership, location, and internalisation as three variables that impact FDI.

i. One reason companies seek foreign direct investment (FDI) is to take advantage of ownership benefits. These advantages might be in the form of technology, a well-known brand, skilled managers, or even access to resources. With these benefits, they may compete more effectively in international marketplaces.
ii. Physical closeness to target markets, favourable business climates, abundant resources, well-developed infrastructure, or promising market potential are all factors that influence a company's decision to set up shop in a certain country. Gaining access to markets, reducing costs, or gaining strategic advantages are all benefits of location.
iii. One benefit of foreign direct investment (FDI) is that it enables businesses to depend less on third parties and more on internal processes and systems for handling transactions and operations. Companies may gain more command over their operations, ownership of their intellectual property, and access to vertical integration opportunities by expanding into international markets.

2.2 Internalization Theory

If the costs of doing business in the market (including things like negotiating, monitoring, and enforcement) are higher than the costs of conducting business internally, then the company will internalise the activity, according to internalisation theory. According to the hypothesis, inefficiencies and transaction costs result from imperfect markets. By developing their own internal market, companies may avoid these flaws when they internalise. According to this hypothesis, companies would prefer to invest in overseas markets directly rather than rely on licensing or exporting when they have special skills or advantages that they want to keep and use.

2.3 Product Life Cycle Theory

According to Raymond Vernon's product life cycle theory, foreign direct investment (FDI) happens at several points throughout a product's lifespan. At first, domestic development and production of new items take the stage. Investment from abroad (FDI) happens when a product reaches a certain level of maturity, allowing the company to meet local demand and take advantage of cost savings by setting up shop in a foreign market.

2.4 Eclectic Paradigm

Parts of many foreign direct investment (FDI) theories are brought together in the eclectic paradigm, which is often called the "OLI paradigm.". It explains how MNEs make decisions on FDI by integrating ownership benefits, location advantages, and internalisation advantages. To maximise earnings, the eclectic paradigm says to use firm-specific advantages, look for good location variables, and do things internally.

2.5 Market Imperfections/Imperfect Market Theory

Companies participate in foreign direct investment (FDI), according to this theory, because of market defects such knowledge asymmetry, transaction costs, and entry obstacles. To get over these problems and stay ahead of the competition, FDI is a good option. Companies may reduce their exposure to risk, get access to valuable information, and forge lasting partnerships by investing directly in international markets.

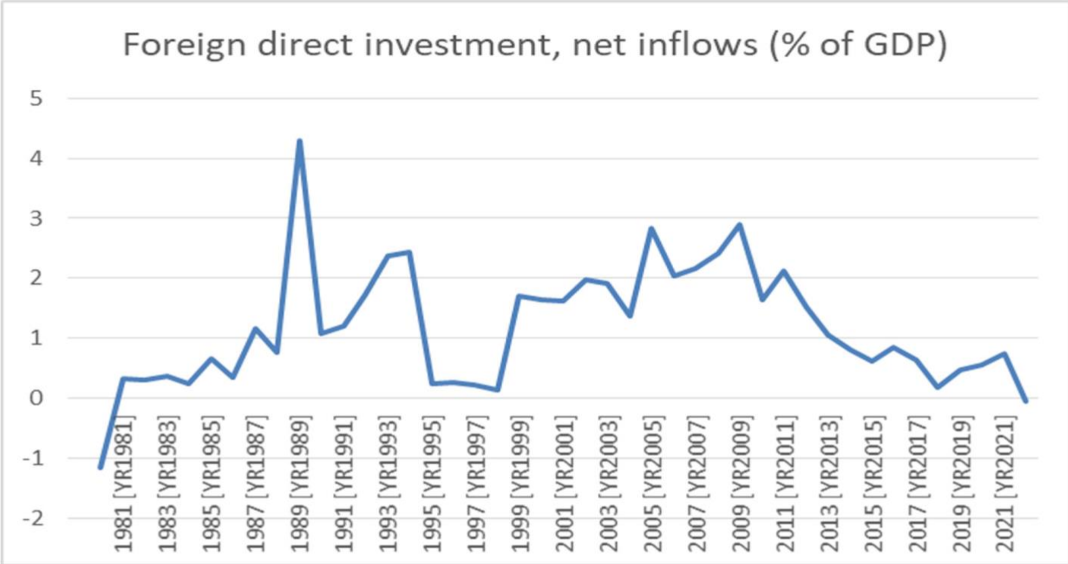
3.0 Definition of Economic Growth

Supriyanato (2016) argues that a state's economic activity is best shown by its rate of economic growth. Beyond that, it's a measure of the country's economic health as a whole. Without taking population growth into account, (Bakari & Mabrouki, 2017) defined economic growth as an increase in GDP. A genuine depiction of economic expansion, nevertheless, should furthermore account for other societal aspects. Since several metrics serve as standards for evaluating a country's economic growth, this differentiation acknowledges the many settings and phases of economic success. Typically, these metrics include things like state revenue, income per capita, workforce size, unemployment rate, and poverty rate reductions. Another, more thorough explanation is that offered by Levine (2013). In this case, economic growth is defined as falling unemployment rates as a result of higher labour productivity growth, which in turn leads to a high impact of GDP.

3.1 Relationship between FDI and Economic Growth

It has long been acknowledged that FDI plays a crucial role in shaping economic growth, especially in developing nations, via direct and indirect means. This perspective is strongly supported by a large body of academic literature. Consequently, scholars' theoretical and analytical viewpoints on the impact of FDI on economic development have diverged in recent years (Adewumi, 2006).

3.2 Economic Analysis of Foreign Direct Investment



FDI Flow in Nigeria Over the Years

There has been much discussion in the academic literature over the impact of FDI on GDP growth. Foreign direct investment (FDI) has been the subject of mixed results in academic research; some find it helps the economy expand, while others find it has a negligible impact. Nigeria ranks third in Africa for foreign direct investment (FDI), behind Egypt and Ethiopia. The US, UK, China, the Netherlands, and France are among the nations that have invested in Nigeria.

Foreign direct investment (FDI) is a key driver of economic development, according to two prominent theories: the capital formation hypothesis and the technology spillovers theory. Foreign direct investment (FDI) is seen under the capital formation theory as valuable capital. Solow (1956), a proponent of the neoclassical growth model, argues that a rise in an economy's stock of accessible capital causes production to rise, which in turn causes the growth rate of output to increase.

Foreign direct investment (FDI) provides the host nation with physical capital, hence a rise in FDI should boost the overall stock of capital available for production. Since FDI involves more capital, a neoclassical paradigm suggests that a rise in the stock of foreign-owned capital may lead to greater growth. Any growth rate boost seen after a rise in FDI stock cannot be maintained over the long term due to the law of diminishing returns on investment.

3.3 Advantages of Foreign Direct Investment (FDI)

From a national standpoint, below are a few benefits of foreign direct investment:

i. Foreign direct investment (FDI) has many benefits, one of which is the development of underdeveloped industries. Investors who think far into the future put their money into industries they expect to see rapid growth in the near future. After much guesswork and anticipation, this has become a real possibility.
ii. Foreign direct investment (FDI) significantly increases the employment rate of a country, which in turn increases job opportunities. The expansion of investment opportunities has also spurred innovation and change across several industries, including manufacturing and the service sector.
iii. Direct foreign direct investment (FDI) has a positive effect on a country's GDP growth. Building factories and manufacturing centres for certain industries is facilitated by the funds received via FDI. This opens up even more possibilities for the rapid transport of production-related manpower, materials, and equipment.
iv. One of the main advantages of foreign direct investment is that it helps train workers to be more creative and innovative in a variety of fields. As a result, the quality of human capital rises in direct proportion to the number of jobs created by investments in various sectors. What this means is that with the right education and training, workers will be more knowledgeable and competent in their chosen fields. This will prepare the country's human resources for any task or problem by building the workforce.
v. Greater Exports: When investors from other countries put their money into goods and services, both at home and abroad benefit. Consequently, there is a worldwide consuming market, and goods are often exported to other nations. They have become a formidable sector because to the enticing government subsidy and 100% Export Orientated Units and Economic Zones, which bring in investors from across the world eager to increase exports.
vi. Enhanced Economic Capital movement: The pace of FDI has a direct bearing on the movement of capital in any given country. Furthermore, the country's economic growth benefits from this influx of cash since local resources are limited. The general public and commercial sectors alike gain from increased national cash reserves, which in turn facilitate all forms of national growth.
vii. Foreign direct investment (FDI) has supported the development of various financial instruments and technology, which has led to improvements in these areas. Furthermore, local businesses are joining forces with their foreign counterparts to facilitate the development of financial instruments and platforms that will contribute to the expansion of the aforementioned sector.

3.4 Disadvantages of Foreign Direct Investment

While there are many potential upsides to Foreign Direct Investment (FDI), there are also some possible downsides. The following are a few typical drawbacks of FDI:

i. Over-reliance on foreign investors is a risk for host nations that accept a large amount of foreign direct investment (FDI). This reliance makes the system susceptible to disruptions in funding or worsening economic circumstances in the investor's home country. As a result, the host nation may feel less empowered and have less freedom to make its own decisions.

ii. Foreign investors often send their earnings back to their home nations, a practice known as repatriation. This is a reasonable ROI, but it might hurt the host country's coffers and foreign currency reserves if it leads to a drain on their finances.

iii. One potential consequence of foreign direct investment (FDI) is economic leakage, which occurs when a large percentage of the profits made by businesses controlled by foreign nationals depart the country that hosted them. This may happen in a number of ways, including the investor's home nation importing products and services, paying royalties and fees to foreign parent businesses, or repatriating earnings. The economic multiplier effect is dampened and local industry growth could be impeded by economic leakage.

iv. Foreign direct investment (FDI) may bring in big bucks for multinational corporations, but it can also hurt smaller and medium-sized businesses in the host country. Companies based in a country may find it difficult to compete with foreign investors due to the latter's access to resources such as larger capital, more sophisticated technology, and economies of scale. There are situations when domestic enterprises may find it difficult to compete, which might lead to their closure or acquisition.

v. Foreign direct investment (FDI) may affect the host country's employment market. It may lead to labour market inefficiencies even as it creates job possibilities. Limited employment opportunities for locals may result from foreign investors bringing their own personnel or depending on expatriate labour. Furthermore, certain FDI projects may raise issues about worker exploitation, working conditions, and labour rights.

vi. Depletion of Natural Resources and Environmental Degradation: Some foreign direct investment (FDI) projects, especially those in extractive sectors, might cause these problems. Communities and biodiversity may be negatively impacted by extraction operations that lead to pollution, deforestation, or ecological deterioration. To lessen the impact of these dangers, host nations must implement stringent environmental legislation and sustainable practices.

vii. Concerns about losing control of important parts of the economy and sovereignty are a real possibility in certain countries that welcome foreign direct investment (FDI). The ownership or influence of important industries, natural resources, or vital infrastructure may be significantly increased by foreign investment. This may cause some to question the host nation's capacity to choose its own economic agenda and policies.

viii. Inequitable allocation of Benefits: Foreign direct investment (FDI) may not always lead to a fair allocation of advantages inside the host nation. Income inequality and geographical inequalities could be worsened if the advantages are concentrated in certain areas or industries. There may be social conflicts and inequities if disadvantaged groups or marginalised communities do not get the same benefits from FDI.

ix. The possibility of economic instability: host nations may experience economic instability as a result of fast FDI inflows and outflows. Exchange rates, interest rates, and macroeconomic stability may be impacted by the abrupt withdrawal of foreign investments or by volatility in global financial markets. Foreign direct investment (FDI) flows need careful management by host governments, which must also establish regulations to reduce risks.

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