

# Testing The FDI Hypothesis Of Location Advantage In The Case Of Kuwait

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## ABSTRACT

*This study examines the determining factors of FDI inflows in Kuwait. Data sample covers the period from 1975 to 2013. In this study, estimates are tested using Augmented Dickey and Fuller, Johansen Co-integration tests and Error Correction Model (ECM). Results of the Johansen test show that all variables are co-integrated with the Kuwait's FDI inflows in the long run. Interestingly, factors of market size, economic development, financial deepening, number of population, infrastructure development, openness, and oil rent have long run relationship with the FDI inflows in Kuwait. In the short run, findings also show that the short-run models are in equilibrium.*

**Keywords:** FDI; Kuwait; Oil Countries; Johansen Test

## I. INTRODUCTION

 Economists have traditionally considered the foreign direct investment (FDI) as a mechanism of economic globalization through the existence of multinational companies. FDI generates many benefits to countries such as transferring technology, creating jobs, and enhancing competitive market environment. FDI has seen significantly in developing countries in the period after World War II especially in sectors of extraction and production of natural resources, mineral particular ones, and more particularly oil, which had a negative impact on the sovereignty and economic and political stability. After, the FDI has been noticed in an increasing rate in the sixties and seventies and eighties of the last century. In the nineties of the past decade, flows of FDI have been shifted significantly from developed countries to developing countries.

Foreign investments take place in a country when a foreign entity invests directly in facilities to produce a product in another country. FDI is defined by Agiomirgianakis et al. (2003) as capital inflow by foreign firms in other countries as a result of highly integrated market as well as the existence of different investment treaties that are bilaterally signed between countries. There are several factors affecting the flows of FDI in developing region such as market size, GDP growth, size of customers, infrastructure development, and economic and financial development. Moosa and Cardak (2006) and Mina (2007) support the fact of influencing infrastructure factor to attract FDI flows in developing countries. In addition, the degree of trade exposure for the country to other trading partners is confirmed by many studies to have a direct effect on FDI flows toward developing nations (Erdal and Tatoglu, 2002, Awan et al., 2011, and Al-shammari and Al-sarhan, 2012). Furthermore, Sethi et al. (2003), and Samimi et al. (2011) support the effectiveness of the population factor to enhance FDI flows.

According to latest IMF outlook, the future prospects of rich oil economies such as Gulf Cooperation Council (GCC) countries is strong despite the consequences of latest global financial crisis, and the volatility of oil prices and the political situations in the Middle East. Regarding Kuwait, it enjoys a high degree of political stability and decent economic environment leading to boost foreign investors' confidence to start foreign investment projects in Kuwait. These foreign investments in Kuwait are realized through government spending on infrastructure projects and the provision of services which contributed to the expansion of the size of the market production of national products and goods, as well as the re-export of those goods and products to foreign markets and the diversity of strategic partnerships with various different economies in all international continents.

Theoretically, determinants of FDI are identified by three classifications. These are a resource seeking, efficiency seeking, and market seeking or strategic seeking. According to the case of GCC countries which they depend highly on a petrochemical sector, FDI is largely dominated as a resource seeking FDI.

This study investigates major location factors of FDI inflows into Kuwait. Studying the case of Kuwait is important as examining a special case of a main oil exporting country in the world. Examining such a case is crucial for several reasons. First, up to our knowledge there are few studies that have examined the FDI determinants in the case of Kuwait, and none of these studies have used the theory of location factor hypothesis to tackle such case for Kuwait. Also, studying the FDI inflow in Kuwait may help government of Kuwait to specify main factors influencing the decision of foreign investors to invest in Kuwait especial the FDI authority is just recently established in Kuwait. In addition, the study contributes to the literature in examining the case of Kuwait using a large number of dataset to accurately identify main location factors of FDI inflow in Kuwait. Furthermore, the study modifies the estimated model adopted by Dunning (1981) by including a control variable for oil rent to capture the impact of oil rent in a highly oil dependent country toward the FDI programs.

The study examines the determinants of FDI inflow into Kuwait using data sample from 1975 to 2013. The study examines estimates using Augmented Dickey and Fuller, the Johansen Co-integration tests and the Error Correction Model (ECM). Findings show that all the variables are co-integrated with the Kuwait's FDI inflows in the long run. Findings of the short run indicate that the short-run models are in equilibrium.

The rest paper is constructed as follows. Section II briefly contains related determinants of FDI literature as well as an overview of FDI trend in Kuwaiti in Section III. Section IV contains the methodology and model specification. Data description is provided in Section V. The empirical results and discussion of results are explained in Section VI. The conclusion and policies implications are provided in Section VII.

## **II. RELATED LITERATURE**

Hsin-Hong and Shhou-Ronne (2010) investigate the determinants of FDI in Brazil by building multiple regression models using the data for the period from 1970 to 2010. The results indicate that the market size and inflation rate are significant and positively affecting FDIs, however trade openness is not showing the expected positive impact of foreign capital inflows. Demirham and Masca (2008) take an average value of cross-sectional data on 38 developing countries for the period from 2000 to 2004. They find that growth rate per capita and degree of openness are significant and positively influencing the FDI flows for developing countries. Although the inflation rate and tax rate are statistically significant, both estimated coefficients hold a negative sign. They find that better infrastructure in the developing countries attracts more FDIs; also growing economies do attract more FDIs. Cevis and Camurdan (2007) examine a panel data set of 17 developing and transition economies for the period from 1989 to 2006 and they conclude that FDI is affected positively by interest rates, growth rates, trade rates, and the previous period of FDI inflows but inversely related to inflation rates.

A study by Aqeel, Nishat, Bilquees (2004) investigates different variables that lead to growth in FDI for the case of Pakistan over the period from 1961 to 2003 using the co-integration and error-correction techniques. They conclude that all variables of tariff rate, exchange rate, and credit to private sector are statistically significant with the expected signs except for wage rate and share price index. Another study by Okafor, Piesse and Webster (2013) examines the main factors affecting FDI in the least recipient countries specifically in Sub-Saharan Africa (SSA) and MENA countries using a panel data for 20 countries in SSA, and 11 countries in MENA for the period from 2000 to 2010. Their findings set clearly that the openness to trade, infrastructure, return on capital, and control of corruption can largely influence FDI into these countries' groups.

AW and Tang (2009) aim at exploring the effects of being a member in WTO and the role of corruption on the inward FDI for the case of Malaysia. Using data over the period from 1970-2001, they find that for the long and short-term the openness of the country, interest rate, inflation rate, level of corruption and the joining of China into the WTO are major factors that affect FDI in Malaysia. A study by Jadhav (2012) uses a panel unit-root test and multiple regressions for a panel data over the period from 2000-2009 for the BRICS countries. The results show that trade openness, natural resource availability, rule of law and accountability are all statistically significant factors to

positively affecting FDI, except the sign of the natural resource availability factor which turns to be a negative indicating that FDI is not motivated by resource-seeking purpose in BRICS.

Obida (2010) uses the error correction technique in order to analyze the determinants of FDI in Nigeria by selecting data over the period from 1977 to 2006. According to empirical results, market size, deregulation, political instability and exchange rate depreciation are the major determinants that shape Nigeria's inward FDI.

Roberts and Almahmood (2009) use a gravity-type model for a panel of 33 countries over the period from 1980-2005. They conclude that the size of the host country is positively related to FDI, while the distance is negatively related to FDI. Also economic freedom and past investments are positive and significant factors that attract FDI. Abdel- Rahman (2007) uses a causality tests and conventional regression models for the data from 1970 to 2000. The results show that GDP levels affect FDI in a significant and a positive way. The study shows also that exports and socio-political risk variables are statistically significant but have a negative impact on inward FDI in Saudi Arabia.

El Sayed (2011) selects a panel data of 19 countries in the MENA region over the period from 1995-2009 and applies them to a fixed effects panel technique. The results show that less tariff, lower level of tax rates, higher fiscal freedom and lower corruption have a very important role in attracting capital inflows into the MENA region. However, the lack of trade openness and poor performance of institutional factors are hindering their ability to attract foreign capital inflows. Another study by Al-Shammari and Al-Saran (2012) investigates the FDI determinants in countries of developing Asia within the period of 1975 to 2009. They use a panel approach according to the location advantage hypothesis. Their results show that the market size, infrastructure development, trade openness, financial developing, GDP growth and human capital are important determinants of FDI in Asian developing countries.

Al-Hallaq and Behbehani (2014) use a simple ordinary least square method for the period between 1985 and 2011 to investigate the relationship between outward FDI and the economic growth in Kuwait. Results show that the outward FDI is not helping in raising the economic growth due to Kuwait uses of the outward FDI as a substitute for the local investments instead of using the vertical FDI strategy. They conclude that the Kuwaiti government should spend more on value added investments if the country wants to create more jobs and achieve sustainable GDP growth rate and gross fixed capital formation growth. Another study by AL-Awadhi (2013) adopts a conceptual framework which has been answered using data that are collected from survey, semi-structured interviews, and secondary data. The findings show that Kuwait's investment opportunities are not expressed in a clear way for the multinational companies in the Gulf region and that the mixed role of the formal and informal institutions in Kuwait is the main reason behind the high rejection rate of FDI applications.

### **III. OVERVIEW OF FDI IN KUWAIT**

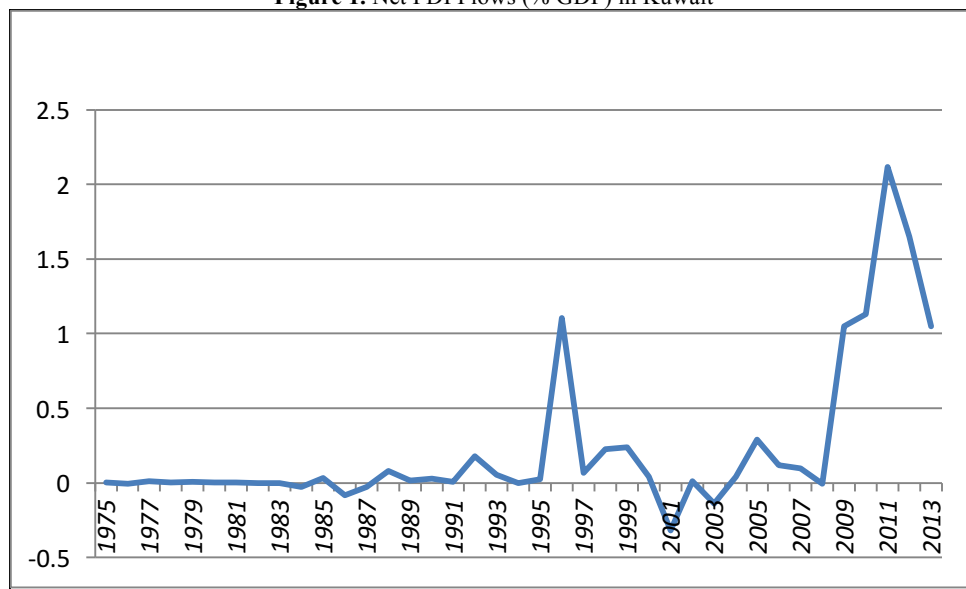
In early eighties, nations have started stimulating incentive regulations toward promoting FDI inflows through liberalizing their investment regimes. Although the decent historical steam of FDI inflows into the small Kuwaiti economy, the government of Kuwait has started lately amending investment legislations toward creating more opportunities for foreign investors to invest directly into Kuwait. Foreign investors were used to practice their business in Kuwait according to the commercial Law No. 68 of 1980 (the "Commercial Law") that allows foreigners to do commercial business but must have a Kuwaiti partner. This is as the Kuwaiti partner must own by law at least 51% of the company. However, if a Kuwaiti partner is not needed by the foreign investor to establish the commercial entity, then such foreign investor may need to use a Kuwaiti agent to practice the business in Kuwait.

In year of 2001, there was an adoption of law No. 8 of 2001 with regard to the regulation of direct investment of foreign capital in Kuwait. This law was designed to secure and promote direct foreign investment into the Kuwait market where such law includes an exception to the commercial law through allowing foreigners to own up to 100% of a company in Kuwait. The efforts toward more encouraging FDI legislations in Kuwait were finally well framed in establishing the Kuwait Direct Investment Promotion Authority (KDIPA) in 2013.

According to figure (1), the average net of FDI inflows as a percentage of GDP is displayed for Kuwait during the period from 1975 to 2013. The overall trend illustrates a low and stable net FDI inflow during the period from 1975

to 1995. This is due to restricted policies adopted by the government during that period. However post the year of 1995 until 2008, Kuwait has experienced volatility in the FDI inflow which had reached negative numbers or outflows from 2000 to 2004. One reason for the FDI outflows was a result of ending investment contracts for foreign investors with the Kuwaiti government. After the period of 2008, the net FDI inflows have reached high and positive numbers compared to the period prior 2007 reflecting the latest legislations and laws implemented by the Government to encourage foreigners to invest locally.

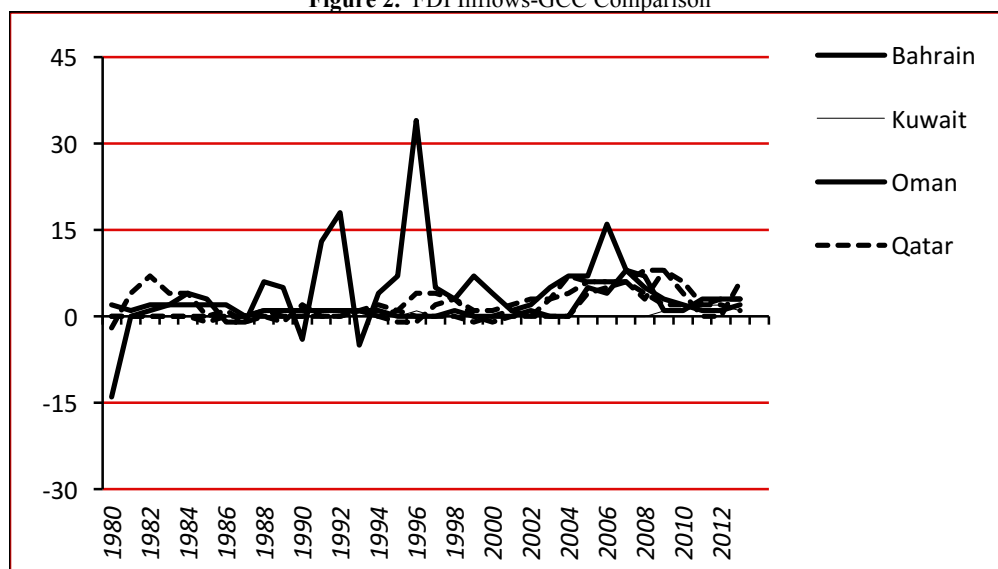
**Figure 1. Net FDI Flows (% GDP) in Kuwait**



Source: World Bank

Based on figure (2), Kuwait FDI inflows are on average less than other GCC countries. The average net FDI inflows are around 5% of GDP for all GCC countries except Kuwait which has relatively the lowest value. In addition, Kuwait is ranked as the second lowest country among all Middle East and North Africa region in attracting FDI (UNCTAD Statistics).

**Figure 2. FDI Inflows-GCC Comparison**



Source: Authors' Calculations

Although the limited FDI inflows into Kuwait over time, Kuwait has many advantages that would support attracting foreign investments locally. These include the strategic geographic location, moderate inflation, strong currency, simple export procedures, low import tariff on inputs and equipment that foreign investors may need. In addition to that, there are no restrictions on current or capital account transactions indicating a freedom for secure fund transfers which most foreign investors look for. In fact, these advantages are promising candidates for attracting FDI into Kuwait. However, Kuwait has some obstacles as mentioned previously regarding the high exposure of the fiscal budget to oil revenues, high current spending compared to lack of capital spending, the heavily subsidized social services and utilities, and high level of government employment, which all can be received negatively by the foreign investors.

Also there are other difficulties which may face foreign investors. These may include FDI regulations that prohibit foreigners investing in some specific sectors such as the petroleum and real estate sectors. Other difficulties are the long delays to start new businesses, the local environment that is based on clan and family relationships, the chance that they may not get benefit from the economies of scale because the market size in Kuwait is small. In addition, the tax level in Kuwait tends to be high if compared to other GCC countries. Also the Kuwait Offset Program (KOP) that provides no obvious guidance on how to fulfill its requirements, as well as the privatization program which has some chapters in its law regarding the protection of the rights of Kuwaiti employments which may be received as discourage for foreign investors from investing locally.

#### IV. METHODOLOGY & MODEL SPECIFICATION

This paper examines factors of FDI inflows in Kuwait according to the location advantage hypothesis of Dunning (1981). The framework of the Dunning's theory is based on the decision for the firm to invest abroad depending on the host country specific, besides other factors. These country specific factors comprise of the size of market, natural resources availability, and other important business environment. The study follows the theoretical framework of the FDI inflows model based on the location advantages hypothesis by Dunning (1981) at which the long and short run relationship between FDI inflow and its factors is estimated. The theoretical framework of Dunning (1981)'s model is described by the following expression:

$$FDI = f(\text{Market, Infrast, Money, Openness, Population, Economic Development}) \quad (1)$$

Where the "FDI" represents the net FDI flows; the variable "Market" explains the size of market; the variable "Infrast" denotes the infrastructure development; "Money" represents the financial deepening in the economy; "Openness" denotes the trade policy in the country; the variable of "Population" accounts for the number of buyers in the country, and the variable of "Economic Development" denotes how well the economy is developed.

The above theoretical model is rewritten to account for a country specific factor related to Kuwait. The study contributes to the literature through accounting for oil rent. Therefore, the log-linearization model is expressed by the following estimated equation:

$$\text{Log}(FDI) = \beta_0 + \beta_1 \text{Log}(GDP) + \beta_2 \text{Log}(INFR) + \beta_3 \text{Log}(OPN) + \beta_4 \text{Log}(M) + \beta_5 \text{Log}(POP) + \beta_6 \text{Log}(OIL) + \beta_7 \text{Log}(Dev) + \varepsilon \quad (2)$$

Where  $\beta_0$  is the intercept; coefficients of  $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6$  and  $\beta_7$  are the slopes of coefficients of the model; the "GDP" variable indicates the GDP which measures the economy size; the variable "Infrast" denotes the infrastructure development measured by the telephone line main subscribers per 1000 people; the variable "OPN" measures the openness of the country that is the total of imports plus exports in nominal terms divided by GDP and it accounts for the trade policy in Kuwait; the variable "M" is the share of broad money to GDP; the variable "POP" measures the number of population; the variable "Oil" measures the oil rent generated by Kuwaiti government as a percentage of GDP; the "Dev" variable is GDP per capita growth which accounts for economic developments in the country; and  $\varepsilon$  is the error term.

V. DATA

Yearly long data set used in this study is from the period 1975 to 2013 for Kuwait. All data are obtained from the World Bank database (*World Economic Indicators*) and Central Bank of Kuwait. All data is measured in current US dollar. The variable of FDI inflows is measured by net FDI inflows as percentage of GDP. Money is measured by the share of money and quasi money (M2) to GDP. The trade openness is measured by the sum of merchandise and services exports and exports as a percentage of GDP. The economic development is measured by the growth of GDP per capita.

In addition, the infrastructure variable is measured by the telephone mainlines and cellular mobile phones per 1,00 people. Population is measured by the number of population in the country in millions of people. The variable of oil rents is measured as percent of GDP and it accounts for the difference between the production of crude oil and total costs of production based on world prices. All data are measured in millions of US dollars.

VI. EMPIRICAL RESULTS

The Dickey and Fuller test results are shown in Table (1). The table represents how well related the variables are to the statistical parameters particularly in mean and standard deviation of the process that do not change over time. As a result, findings show that all variables are stationary at first difference. According to Table (1), the Unit Root Tests are composed of ADF test (with drift only), ADF (with drift and trend). For ADF tests, numbers of lags used are chosen based on Schwarz information criterion. ADF test (with drift only) shows that some variables are stationary at level with different levels of significance. However, the ADF test (with drift and trend) show that the variables have unit root (deterministic trend exist). However, ADF tests (with drift only and with drift and trend) show that all variables are integrated of order 1 as they become stationary after taking their first differences.

Table 1. Augmented Dickey-Fuller Unit Root Test

ADF Test with Drift				
Variables	ADF t-statistic (in level)	Lags	ADF t-statistic (in difference)	Lags
FDI	-1.473	1	-8.666	0
Money	-2.254	1	-4.998	2
Openness	-2.941	1	-5.975	1
Oil Rent	-2.365	1	-5.103	2
Population	-2.426	2	-3.573	1
GDP Per Capita	-4.775	0	-5.154	2
Infrastructure	-3.443	3	-2.809	2
GDP	-5.087	1	-6.429	0

ADF Test with Drift and Trend				
Variables	ADF t-statistic (in level)	Lags	ADF t-statistic (in difference)	Lags
FDI	-2.264	1	-8.628	0
Money	-2.109	1	-5.152	2
Openness	-3.494	1	-5.934	1
Oil Rent	-2.397	1	-5.059	2
Population	-2.354	2	-3.565	1
GDP Per Capita	-5.067	0	-5.080	2
Infrastructure	0.072	3	-5.578	2
GDP	-5.034	1	-6.359	0

Number of lags is chosen based on Schwartz information criterion

ADF at difference is expressed as first difference \*\*\*significant at 1% \*\*significant at 5% \*significant at 10%

Table (2) shows the result using Johansen test for the co-integration with Trace to find whether a long run relationship exists between the FDI variable and the independent variables. Results of Johansen co-integration tests reveal that there exists a stable long-term relationship across FDI flows and its perceived determinants. In addition, Table (3) shows the result using Johansen test for the co-integration with Maximal Eigen value.



Both the Trace and Maximal Eigen value statistics identify the existence of a unique co-integrating trajectory among the variables as statistics indicated. Johansen test is composed of two statistics to determine whether the variables are cointegrated in the long-run or not, which are Trace Statistic and Max-Eigen value. According to the test, Trace statistic reports 4 cointegrating vectors, whereas Max-Eigen value reports 2 cointegrating vectors among the variables in the model. So it can be concluded that all variables in the model are cointegrated or exhibit a long-run relationship.

**Table 2.** JOHANSEN Co-integrations TEST-Unrestricted Cointegration Rank Test (Trace)

Null hypothesis	Eigenvalue	Trace statistic	5% Critical value	Probability **
Ho: $r = 0$ *	0.843756	232.4887	159.5297	0.0000
Ho: $r \leq 1$ *	0.688424	154.5226	125.6154	0.0003
Ho: $r \leq 2$ *	0.545696	105.5459	95.75366	0.0089
Ho: $r \leq 3$ *	0.488219	72.40840	69.81889	0.0306
Ho: $r \leq 4$	0.457769	44.27432	47.85613	0.1043
Ho: $r \leq 5$	0.232765	18.56765	29.79707	0.5243
Ho: $r \leq 6$	0.161076	7.439254	15.49471	0.5272
Ho: $r \leq 7$	0.001488	0.062557	3.841466	0.8025

Trace test indicates 4 cointegrating eqn(s) at the 0.05 level

\* denotes rejection of the hypothesis at the 0.05 level

\*\*MacKinnon-Haug-Michelis (1999) p-values

**Table 3.** JOHANSEN Co-integrations TEST-Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Null hypothesis	Eigenvalue	Max Eigen Statistic	5% Critical value	Probability **
Ho: $r = 0$ *	0.843756	77.96611	52.36261	0.0000
Ho: $r \leq 1$ *	0.688424	48.97670	46.23142	0.0248
Ho: $r \leq 2$	0.545696	33.13751	40.07757	0.2448
Ho: $r \leq 3$	0.488219	28.13407	33.87687	0.2074
Ho: $r \leq 4$	0.457769	25.70668	27.58434	0.0853
Ho: $r \leq 5$	0.232765	11.12839	21.13162	0.6345
Ho: $r \leq 6$	0.161076	7.376697	14.26460	0.4456
Ho: $r \leq 7$	0.001488	0.062557	3.841466	0.8025

Max-eigenvalue test indicates 2 cointegrating eqn(s) at the 0.05 level

\* denotes rejection of the hypothesis at the 0.05 level

\*\*MacKinnon-Haug-Michelis (1999) p-values

According to Engle and Granger (1987), co integrated variables must have an Error Correction Model (ECM) representation. The main reason for the popularity of co integration analysis is that it provides a formal background for testing and estimating short-run and long run relationships among economic variables. Furthermore, the ECM strategy provides an answer to the problem of spurious correlation.

After cointegration, ECM is estimated in Table (4) to see the short-run relationship among the dependent and independent variables in the model. Since the basic error correction model is based on two variable equations (one dependent and one independent variable), the model is estimated for each independent variable separately. The dependent variable is the FDI inflow and the independent variables are all other variables in the model. The error correction coefficient (Lerror) in the estimation output forms the EC coefficient which adjusts the model for equilibrium after any shock. It is obtained by taking the lag of errors from the cointegration equation. For the model to be in equilibrium in the short-run, the value of the EC coefficient shouldn't exceed 1 in its absolute value and should be statistically significant.

**Table 4.** Error Correction Model (Short Run)

Variable	Constant	Coefficient	t-statistic	Error Correction	Error Correction t-statistic
Money	0.0079	-0.0275	-1.24	-0.5841	-4.06
Openness	0.00803	-0.0060	-1.23	-0.5713	-4.02
Oil Rent	0.00592	-0.00041	-0.01	-0.5477	-3.80
Population	0.00838	0.0242	0.48	-0.5651	-3.83
GDP Per Capita	0.0060	-0.0088	-0.19	-0.5460	-3.80
Infrastructure	0.0261	-1.8381	-1.34	-0.538	-3.83
GDP	-0.0030	0.2180	0.42	-0.5579	-3.84

However, none of the variables appear to be statistically significant, all their EC coefficients indicate that the short-run models are in equilibrium (they are significant and their values are less than 1 in absolute value).

The above results confirm the relationship between the FDI inflow and all its determinants. Findings support the hypothesis that market size influences net FDI inflow into Kuwait. The bigger the size of the Kuwaiti economy leads to attract more FDI inflow into Kuwait as bigger economy indicates more market capacity of demand and supply. In addition, the degree of openness in Kuwait is also affecting the inflow of FDI into Kuwait. This suggests that the more open the Kuwaiti economy, the higher the FDI inflow into Kuwait. This result is consistent with the increasing number of population to influence the FDI inflow which indicates higher number of customers in Kuwait leads to higher FDI inflow into Kuwait.

Furthermore, factors of the financial deepening, infrastructure development, economic development are cointegrated with the FDI inflow in Kuwait. This suggests that Kuwaiti development in the financial sector, economy, and infrastructure leads to attract more FDI inflow into Kuwait.

Interestingly, oil revenue has a log run relationship with FDI inflow in Kuwait. This finding can be explained as the more oil revenues generated by Kuwaiti government in the long run the more opportunities to attract FDI inflow into Kuwaiti economy. This is through developing the economic structures and infrastructures that may help attracting foreign investments into Kuwait.

**VII. CONCLUSION & POLICY IMPLICATIONS**

This paper aims to investigate the determinants of FDI inflows in Kuwait through Johansen test and ECM model test using data from 1975 to 2013. This paper investigates the case of the extensively oil dependent country. The Johansen test results show that all the variables are co-integrated with the Kuwait’s FDI inflows in the long run. Interestingly, factors of market size, economic development, financial deepening, number of population, infrastructure development, openness, and oil rent have long run relationship with the FDI inflow in Kuwait. In the short run, findings also show that the short-run models are in equilibrium.

There are some policy recommendations that can be drawn from the findings of this study. The unfortunate fact for Kuwait’s economic performance has lagged behind its GCC peers. Capital expenditures to GDP ratio has been below the GCC average because of delays in the implementation of economic reforms and infrastructure projects. Social and global competitiveness (e.g., ease of doing business) indicators have also been lagging behind other GCC countries. This could be explained by the large increases in the public-sector wage bill, which resulted in public-private wage differentials, which have undermined the government’s efforts to encourage Kuwaitis to engage in the private sector. In addition, huge and outstanding efforts must be taken at all related levels, to improve the business environment and investment climate, and strengthen non-oil growth. This could contribute to the long-term objective, with the aim toward diversification and job creation for Kuwaitis in the private sector. Furthermore, building human capital, improving the efficiency of public administration, and removing impediments to physical, legal, and business infrastructure would support these goals.



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