Attractiveness of Foreign Direct Investment: Case of Digital Economy

Attractivité des Investissements Directs Etrangers : Cas de l'Economie Numérique

KAMBOU Porobayiré
Doctorant
Faculté des Sciences Juridiques, Economiques et Sociales - Souissi
Université Mohammed V de Rabat
Laboratoire de Recherche en Compétitivité Economique et Performance Managériale
Maroc
porobayire.kambou@um5s.net.ma

KHARISS Mohammed
Enseignant-Chercheur
Faculté des Sciences Juridiques, Economiques et Sociales - Souissi
Université Mohammed V de Rabat
Laboratoire de Recherche en Compétitivité Economique et Performance Managériale
Maroc
m.khariss@um5s.net.ma

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Abstract

Foreign direct investment is now one of the determinants of economic growth. Nowadays, however, we are witnessing the development of a new form of economy: the digital economy, whose mode of production differs from traditional modes of production. We are in the digital age and we are witnessing the birth of digital MNE. These giants of the digital economy are sometimes barely 20 years old (Facebook was created in 2004 and Google in 1998) and yet the capitalization of each of them flirts with $1 trillion. It therefore seems necessary to question the investment potential of the digital economy and especially how a territory can attract FDI from companies in the digital economy. By highlighting the specific characteristics of companies in the digital economy in terms of FDI, on the one hand, and, on the other hand, by proposing actions to be taken to attract these companies to a given territory, this paper aims to contribute to the development of theoretical solutions and reflections.

Keywords: FDI; Attractiveness; Digital Economy; Investment Policies; MNE.

Résumé

L'investissement direct étranger est aujourd'hui l'un des facteurs déterminants de la croissance économique. Cependant, nous assistons aujourd'hui au développement d'une nouvelle forme d'économie : l'économie numérique, dont le mode de production diffère des modes de production traditionnels. Nous sommes à l'ère du numérique et nous assistons à la naissance des entreprises multinationales numériques. Ces figures de proue de l'économie numérique sont parfois âgées d'à peine 20 ans (Facebook a été créé en 2004 et Google en 1998) pourtant la capitalisation de chacun d'entre eux frôle les 1 000 milliards de dollars. Il semble donc nécessaire de s'interroger sur le potentiel d'investissement de l'économie numérique et surtout sur la manière dont un territoire peut attirer des entreprises de l'économie numérique. En mettant en évidence les spécificités des entreprises de l'économie numérique en termes d'IDE, d'une part, et en proposant des actions à mener pour attirer ces entreprises sur un territoire donné, ce document vise à contribuer à l'élaboration de solutions et de réflexions théoriques.

Mots clés : IDE; Attractivité; Économie numérique; Politiques d'investissement; FMN

Introduction

The emergence of the digital economy in recent decades has had a major impact on several aspects of the global economy. The digital economy has become an integrated part of the global economy. With the emergence of digital MNEs such as Google, Facebook, Microsoft and Apple, several paradigms of the international economy need to be reviewed. The digital economy is not constrained by geographical limitations or physical distance, and through the virtualization of economic activities, we are witnessing a reorganization of commercial activities (Sampler, 1998).

As a result of all these changes, the economic and social development of nations is affected. This economic and social development is achieved through the new tools provided by the digital economy, which aim to address the chronic social and economic problems faced by several countries (UNCTAD, 2017). Thus the digital economy has become very important for many nations, which must do their utmost to promote its development. One way to do this is to attract digital firms to their territory via FDI.

Attracting digital firms to a territory is a major challenge insofar as the digital economy has its own characteristics that differ from those of the traditional economy. It is therefore imperative to think about possible solutions that would allow states to create environments suitable for the development of digital firms. This paper aims to provide some suggestions for answering the following question: How can a territory attract FDI from companies in the digital economy?

On the basis of a document-based research and a literature review on the subject, this paper attempts to provide answers. To do this, the first part of this paper will focus on a reminder on the concept of FDI and attractiveness. The second part will discuss in detail the concept of the digital economy and its particularities in terms of FDI. To conclude, the third part will be devoted to the proposed solutions to enable countries to attract digital MNEs to their territory.

1. Attractiveness of Foreign Direct Investment

1.1. Definition of Foreign Direct Investment (FDI)

In the International Monetary Fund Balance of Payments Manual, 6th edition (2009) FDI is defined as a type of cross-border investment involving a foreign economic operator with a significant degree of control over the management of a business that is resident in another economy.

The control in question is obtained either directly, by holding a part of the capital that gives voting rights, or indirectly by controlling another entity with voting rights in the target company. On the basis of all that has been said, the term FDI is used when a foreign investor holds a significant share of a company and can exercise its voting rights in order to effectively control the management of the company in question. The required management control factor differentiates FDI from portfolio investment, which is another type of international investment. FDI is therefore a long-term investment that necessarily implies a long-term interest on the part of the foreign investor.

According to Wajid & Zhang (2017), FDI is an enabler by which an enterprise located in a country acquires ownership of the assets of another enterprise in another country, where the latter can exercise control over production, manufacturing, distribution and all the activities of the enterprise. These FDI inflows allow the host country to boost its economy and growth (Akanegbu and Chizea, 2017; Ait Soussane and Mansouri, 2019; Okwu et al. 2020). In order to do so, the different countries try to attract foreign investors to their territory. Madura and Fox (2014) state that a variety of factors contribute towards greater FDI inflows, such as the strategy to penetrate international markets, resource and operational efficiency, shareholder wealth, etc.

1.2. The concept of Attractiveness

According to Angeon and Rieutort (2007), the attractiveness of a territory represents its ability to attract activities, skills and entities, based on the resources available in the aforementioned territory, while ensuring the well-being of the local population.

The concept of attractiveness therefore covers several aspects. In this paper, only the attractiveness of a territory for international investment will be discussed. It is the capacity and ability of a geographical territory at attracting foreign capital. For Michalet (1999), the attractiveness of international investment "is the result, on the one hand, of the demand by firms for location advantages that will enable them to strengthen their competitiveness on the world market and, on the other hand, of the partial or total offer of these advantages by the various territories". In fact, it is the set of policies put in place by the public authorities to attract FDI.

1.3. Conditions for attracting FDI to a territory

For a territory to be attractive to foreign investors, certain conditions must be observed. Michalet (1999) distinguishes two types of conditions: preconditions and necessary conditions.

The preconditions concern the stability and sustainability of the macro-political and macroeconomic framework, the investment climate and the existence of the rule of law.

Political stability and the legal and judiciary system are the most important preconditions given that if a country presents a significant political risk and does not offer any legal protection, the foreign investor will not consider it as a possible destination for its commercial activities. Macroeconomic stability is taken into consideration once the political aspect has been verified and validated. Lastly, the investment climate is the third precondition that investors are considering.

Following the validation of the preconditions, foreign investors focus on the four necessary conditions: the size and growth rate of the market, the communication and telecommunications system, the availability of qualified human resources and the existence of high-performance companies (Hmioui, 2011).

Some structures calculate a country attractiveness index, the best known being the Kearney FDI Confidence Index. This index is designed by A.T. Kearney, a consulting firm. The index classifies nations from 0 to 3 depending on their attractiveness for foreign direct investment. For the year 2020, the top 5 ranking is as follows: with a score of 2.26/3 the United States of America has a strong attractiveness towards FDI, followed by Canada (2.20/3), Germany (2.15/3), Japan (2.14/20) and France (2.09/3) (Peterson and Laudicina, 2020).

2. FDI in the digital economy

2.1. Definition and Architecture of digital economy

Although the literature is varied and substantial, there is no exact definition of the digital economy. As a matter of fact, it is not necessarily linked to a specific industrial sector and embraces a wide range of concepts.

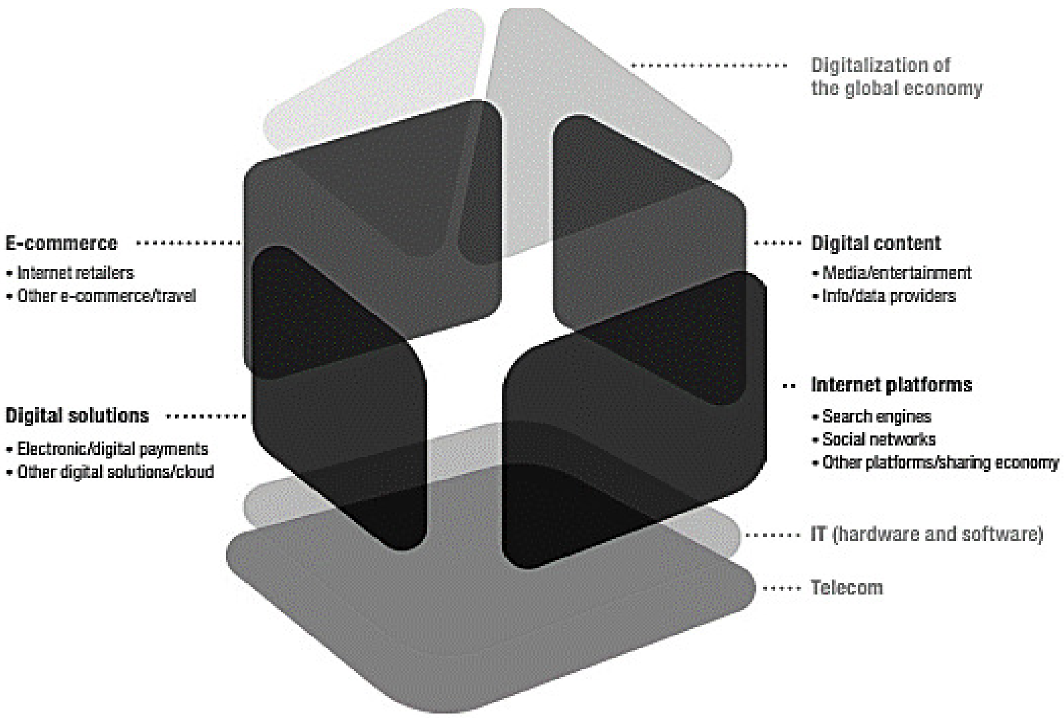
The digital economy is the result of the widespread use of new technologies, first and foremost in the field of information and communication. But it has evolved into a universal technology that has had implications far beyond information and communication technologies (ICTs). It has had an impact on all economic sectors, on the growth and productivity of States, as well as on the business environment, individuals, households and their behavior. The use of the Internet, for example, has brought people and resources together by dematerializing physical distance to create, develop and share their ideas leading to new concepts, new content and consequently to the birth of a new generation of entrepreneurs and markets.

According to "The Australian Bureau of Statistics" the digital economy is: "the global network of economic and social activities that are activated by platforms such as Internet, mobile and sensor networks, including electronic commerce. Also activated by efforts to achieve efficiency and productivity in production processes, stocks and knowledge management."

To better analyses the importance of the digital economy, it is necessary to determine its architecture precisely. And even if the debates on the subject do not necessarily lead to unanimous conclusions, the UNCTAD (2017) presents the following elements as part of the architecture of the digital economy:

- E-commerce: through internet retail sales as well as travel and other types of e-commerce.
- Digital tools: electronic or digital payments, the cloud and other digital tools.
- Digital content: including multimedia and entertainment as well as information and data providers.
- Internet platforms: these include search engines, social networks and other platforms.
- IT: Hardware and software.
- Telecommunications.

Figure N°1: Architecture of the digital economy



Source: Word Investment Report 2017, UNCTAD, p.167.

2.2. Particularities of the digital economy in terms of FDI

While the importance of the digital economy for economic and social development has been highlighted by several authors, researchers have only recently taken an interest in the issues of international investment in the digital economy. Firms in the digital economy have several particularities in terms of FDI compared to traditional MNEs:

2.2.1. A limited physical presence on international markets

By facilitating the delivery of a variety of products and services in digital form; for instance, music, publications and services spanning the spectrum from architectural design to retail distribution could henceforth be supplied worldwide in digital form. Physical goods can be made for customers in foreign marketplaces simply by forwarding digital files to 3D printers situated in such countries.

From the point of view of international investment, the main implication is that "the trade-off between exporting FDI and market research as an entry mode for the delivery of products to host countries can evolve towards export" (Eden, 2016).

2.2.2. Different motives from traditional MNEs

Theories on FDI have long-established that business investment decisions are based on different motivations and have subsequently identified the main motivations underlying foreign activity. Different authors categorized the various motives into five main categories: market seeking, resource seeking, efficiency seeking, and export seeking and strategic-asset seeking.

Although the motivations discussed above are accepted for traditional firms, the same cannot be said for digital firms. By providing remote access to resources, employees and customers, digital technology eliminates the importance of physical location and weakens the traditional assumed link between physical location and value creation. This dissociation of physical location from value creation could affect many of the traditional reasons for foreign direct investment, such as access to fixed resources or lowering overall expenses (Zaheer and Manrakhan, 2001). The five motivations mentioned above will be reviewed from a digital economy perspective, based on the work of Nashum and Zaheer (2002).

- **Market seeking**

Market seeking investments are intended to serve particular markets through local production and distribution, rather than through exports from the country of origin or a third country. The idea is to reduce transaction costs while having access to a larger market. But in the case of the digital economy, since physical presence is no longer required, transaction costs are no longer necessary. Furthermore, more and more digital products are being produced on a global basis and not locally (Nachum & Zaheer, 2002 citing Katz and Shapiro 1994), eliminating the need for local adaptation to effectively serve individual customers. On this basis, it is recognized that market research is not an important motivation for FDI in the digital economy (Nashum & Zaheer, 2002).

- ❖ **Resource seeking**

Resource seeking investment is motivated by the need to acquire resources that are not available in the home country of companies that invest or that are available at a lower cost elsewhere. Two types of resources must be distinguished: (i) tangible resources such as raw materials and (ii) intangible resources (e.g. human capital). In the digital economy, intangible resources are the most important as firms are constantly looking for new expertise. Intangible resources in this case can be considered as strategic assets. Based on this distinction and observation, Nashum and Zaheer (2002) argue that the search for intangible resources as well as the search for strategic assets can be a motivation for FDI in the digital economy and the search for tangible resources a little less.

- ❖ **Efficiency seeking**

Efficiency seeking is motivated by the intention to geographically dispatch value-added activities in order to take advantage of differences in the availability and costs of factor allocations in different countries. For the digital economy, the search for efficiency can be an important motivation (Nashum and Zaheer, 2002) since it increases the benefits of centralizing a single activity in a given location while capitalizing on the benefits of multiple locations at the same time. This increases the potential for exploiting the economies of scale resulting from the concentration of a particular economic activity in certain areas.

- ❖ **Export seeking**

This type of FDI is undertaken by companies seeking an economic base on which to rely on export markets to cope with rising costs in their home countries. But since in the digital economy products can be transferred from one place to another at a low cost, this motivation becomes obsolete (Nashum and Zaheer, 2002).

In conclusion, and based on the work of Nashum and Zaheer (2002), the main motivations for FDI in the digital economy seem to be efficiency and intangible assets seeking, while market research and low-cost export platforms seeking do not appear to match the firms in the digital economy.

2.2.3. Low impact of digital MNEs on the host territory while they enjoy a high international exposure

According to the UNCTAD (2017), digital MNEs have a lower impact on host countries in terms of physical investment and employment creation. Indeed, the headquarters of digital multinationals are concentrated in a number of developed countries. Since digital MNEs do not need a physical presence in a territory to exert their influence, the latter limits the physical investments in the territories they target. According to the UNCTAD (2017), 40% of multinational digital subsidiaries are located in the USA compared to 20% of the subsidiaries and parent companies of traditional MNEs.

2.3. Foreign Direct Investment trends in the digital economy

Foreign Direct Investment in the digital economy contributes a relatively small proportion of worldwide FDI flows. In 2013, although investments in digital capital were estimated at USD 6 trillion (Bughin et al, 2013), digital sector companies generated only USD 153 billion in cross-border M&A during 2017 (13% of total international M&A). The 100 largest multinationals in the digital economy accounted for only 1% of international mergers and acquisitions in 2017 (UNCTAD, 2017). It should be noted, however, that even if this share is very small, since 2010, the annual growth rate of international mergers and acquisitions of digital companies has been around 30%. The 100 largest digital companies identified by UNCTAD increased their cross-border acquisitions by an average of 90% per year over the same period (Gestrin & Staudt, 2018).

FDI in the digital economy is concentrated between a number of countries, namely developed countries and a few emerging countries. Over the 2013 - 2017 period, the United States and the United Kingdom each received more than USD 100 billion in inward investment in digital asset mergers and acquisitions. Together, they account for 49% of all cross-border digital mergers and acquisitions. They are followed by countries such as France, Israel, China, Germany, India, Japan, Canada (Gestrin & Staudt, 2018).

It is important to note, however, that overall statistics on FDI in the digital economy are difficult to access or even non-existent for some developing countries.

3. Policies making implications: How to Attract Digital MNEs to a Territory?

The attempt to answer this question is part of a global reflection to propose solutions for developing countries, especially African countries, which would allow them to attract more companies to their territory. Since the 1980s - 1990s, and even with the implementation of the SAP, these countries have still not succeeded in industrialization and have remained on the margins of FDI. As Ait Soussane and Mansouri (2019) noted, the impact of FDI on host economies lies in financing the gap between desirable investment and existing savings, and in the possibility of stimulating competition between national firms by strengthening their productive capacity and techno-economic efficiency. It is therefore clear that African countries need FDI and the digital economy could be an interesting alternative to stimulate development in these countries.

In Africa, for example, only 10 countries account for 80% of Internet users, for a penetration rate of 31%. The level of portability has increased from -10% in 2002 to 80% in 2017. Despite this delay due to the small number of Internet users, a strong potential of the African market is emerging in perspective. This growing trend in connectivity, with Africa ranks second continent in the world, is a good example of the potential of this market (Katayama, 2017). There is therefore a potential that should be exploited by attracting digital MNEs. So how can these countries attract digital MNEs to their territory? Several actions are to be implemented based on the recommendations made by the UNCTAD (2017). However, before taking specific actions for the digital economy, it is essential to create an attractive investment climate. The above-mentioned preconditions and conditions for attractiveness must be fully respected. As a reminder, an indispensable and attractive climate is essential to arouse the interest of MNEs in general. Once a country has met all the necessary prerequisites and conditions, it is called upon to make an additional effort. The aim is to enhance the attractiveness of the country and its sites by deploying an active promotion policy targeted at the foreign investment community. In the present case of digital MNEs, this refers to action in favor of the digital economy.

3.1. Investing in digital infrastructure

Universal access to the Internet is a concern for developing countries today. The UNCTAD (2017) in the World Investment Report argues that the investments needed for adequate connectivity are not so onerous. Indeed, according to the UNCTAD, taking into account only universal access to 3G, total infrastructure investment to ensure access for all should be around $100 million. It is true that network access points are generally set up by private companies, but governments should provide support and assistance to these firms to encourage investment over digital facilities and infrastructure. To attract digital economy firms to its territory, it is essential to have sufficient infrastructure to carry out the activities of the firms in question.

3.2. Establishment of a digital sector

Investment into digital infrastructure should ensure access to connectivity and the Internet for the entire population. However, still not enough. Still in its 2017 World Investment Report, the UNCTAD notes that connectivity is much more developed than the use of networks in developing countries. So the UNCTAD advocates accelerating digital development, promoting investment in local digital services to stimulate demand. This will be done through the establishment of a regulatory framework protecting digital societies. This regulatory framework should be accompanied by support and assistance measures such as, the creation of technology poles, innovation centers and incubators to improve e-government services to lead the way, stimulate demand for services from local developers and lower commercial costs, support venture capital and other innovative financing means, such as participatory financing, and create capacity building programs (UNCTAD, 2017).

3.3. Finding an equilibrium between political concerns and investor interests of a digital sector

FDI is the subject of public interest debates in the sense that the ownership of strategic assets by a foreign entity in a territory can cause security problems for the government. Moreover, some countries are introducing laws to protect consumers and especially local businesses. In terms of FDI from firms in the digital economy, this problem is even more persistent. For example, FDI in the field of digital data in a territory may be undesirable to the government in place in the sense that the data to be processed by the firm may contain sensitive information about the privacy of local consumers or even sensitive military information (Fontanella-Khan, 2017). Thus, while the digital development of the territory may be detrimental to certain activities or sectors or actors in the territory, it is up to political decision-makers to take the necessary measures to mitigate this damage and strike the appropriate balance between public concerns and investors interests.

3.4. Consider the particularities of the economy in the elaboration of investment policies

Digital MNEs have characteristics that differ from traditional economics. It is therefore necessary to take these particularities into account in the formulation of investment policies. The impact of a digital MNE cannot be assessed, for example, on the basis of its material investments and job creation in a territory. It is therefore necessary to adjust policies to the characteristics and motivations of the digital firm. For the UNCTAD (2017), it is therefore important to have a clear policy framework for digital investment. This policy framework has to guarantee the integration of digital development into both investment policies and digital development plans (UNCTAD, 2017).

Conclusion

The digital economy has become one of the key drivers of the global economy. With the digitalization process underway, many investment opportunities are emerging. For developing countries that have not been able to start their development through industrialization, the digital economy can be an alternative. To do this, it is necessary to make the necessary investments in digital infrastructure and to attract the most digital MNE.

FDI plays an important role in growth and attracting a digital MNE such as Google, Microsoft, Apple or Facebook to a territory can only be advantageous. To attract these firms, decision-makers, especially in developing countries, must take the necessary actions. Based on the 2017 UNCTAD World Investment Report and a cross-review of the literature between economics and FDI, we proposed four essential actions: investment in digital infrastructure, the development of a digital sector, balancing political concerns and investor interests, and taking into account the specificities of the economy in the elaboration of investment policy.

The main contribution of this research is the highlighting of the peculiarities of the digital economy as well as the solutions to attract digital MNEs. It is by no means empirically verified that the solutions proposed in this paper are viable and achievable. But they provide a basis for interesting theoretical solutions to create a high-performance digital environment in developing countries in particular.

Nevertheless, this article has limitations that should be noted. Indeed, there is a lack of data for an in-depth analysis of FDI in the digital economy. Also, the theoretical aspect of the proposed solutions remains a limitation that can be overcome through empirical research. In addition to this, several other questions remain unanswered:

- What is the real impact of digital MNEs FDI on the real economy growth?
- Are FDI of the digital MNEs more efficient than FDI of traditional MMEs?
- Are the solutions proposed in this paper to attract digital MMEs applicable and effective everywhere?

A research perspective would be empirical research to test the feasibility of all the solutions highlighted in this article and to provide answers to pending research questions.

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