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The Location determinants for hotel foreign direct investment (FDI) in Zanzibar

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Abstract. —Zanzibar is a semi autonomous state within United Republic of Tanzania. In early 1990's Zanzibar declared tourism sector as the driver for its economic growth, replacing agricultural sector. Thus, it aims to attract a substantial number of foreign direct investments (FDI) to its tourism industry in order to alleviate the poverty. However, achieving this objective has remained a major challenge for Zanzibar as its investment promotion agencies [including Zanzibar Investment Promotion Authority] lack the knowledge and understanding of the major factors that determine the FDIs location decision in hotel sector, a sub sector of tourism industry. Being the first study of its kind in Zanzibar, this paper explored the major location determinants for the Hotel FDI in Zanzibar. We applied an email survey approach, to a sample of 44 foreign owned hotels located in Zanzibar to test the proposed set of hypotheses. The logistic analysis used to analyze the collected data. Regional tourism market, availability of diverse tourism assets, infrastructure, economic growth, political stability, and openness were found to be the principal variables that attract hotel FDI to Zanzibar. The influence of labour cost, and investment cost is moderate. The study revealed no significant relationship between hotel FDI inflows and exchange rate.

Keywords: Location determinants; FDI; Tourism; Zanzibar

1. Introduction

Elsewhere it has been stated that operating in overseas markets may allow a firm to benefit from international competition and increase its involvement in foreign markets thereby becoming a stronger player in its home country market [2, 5]. For host country, welcoming foreign companies mean to promote socio-economic development – mainly via technological transfer and employment creation [1, 2] while for firm home country, internationalisation seems to repatriate economic benefits including employments opportunities [2, 5]. The most common form of foreign market entry is FDI [3, 4, 7, 5]. Other mechanisms are exporting, joint venture and licensing [2, 5]. Zanzibar has recently declared tourism as the leading sector for its economic growth [5, 7]. For achieving such objective it has initiated a series of economic reforms including minimizing state intervention; establishing a free market economy; and integrating the economy with the global economic system [3, 9, 10]. With no doubt, the main interest is to attract a substantial number of foreign investments in the economy and therefore fight against poverty. According to Ministry of Finance and Economic Affair (MoFEA) the quality and quantity of tourism investment Zanzibar have received do not meet that expected by Government who wish to promote Zanzibar as an up market and stop over destination to compete with other islands in the Indian Ocean region [5]. However this does not pre empty the benefits that Zanzibar has already got from tourism development that mainly dominated by domestic tourism enterprises - about seventy two (72) percent of accommodation units are owned by Zanzibaris.

Though there is every indication that the government objective will not be achieved under the existing investment strategies and mechanisms, no research has been set to examine location determinants of Hotel FDI, a subsector of tourism FDI. Thus, it is more than paramount for Zanzibar government to have a complete understanding of the hotel location determinants, both general and into sector specific. With this

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purpose in mind, and incorporating several theories of international capital movement, the present study poses a number of research hypothesizes of location-related determinants of hotel FDI to be tested. The present work is organized into seven sections including introduction, overview of FDI in Zanzibar, the theoretical background; hypothesizes development; research methodology; and results and discussion. This study is the first of its kind in Zanzibar and therefore it is hoped to provide some useful insights, policy implications and recommendations for the country and international business community.

2. Trend of Hotel FD in Zanzibar

Since 1980s, the world has witnessed rapid and widespread initiatives by governments to involve the private sector in the economy [6]. In deed in the same period we have evidenced a remarkable increase in the flows of FDI in the world economy [1]. The driving forces behind an upsurge in FDIs include general decline in the trade barriers, increased trade liberalization, global political and economic reforms and increased interdependence and linkages across different firms and countries [3, 7]. The same pace of growth FDI has also been experienced in tourism and hotel industry [6]. Zanzibar is a semi autonomous state within United Republic of Tanzania. In early 1990's Zanzibar declared tourism sector as the driver for its economic growth, replacing agricultural sector. Zanzibar is a member of East Africa Community through the umbrella of United Republic of Tanzania. To put it in other ways Zanzibar seems to benefit the large tourism market available in the East African region. Zanzibar has been undertaking major economic reforms since mid 1990's [5, 7]. Among the initiatives used to promote tourism related foreign direct investment for Zanzibar include conducive macroeconomic environment - such as low and stable inflation, low fiscal deficit, trade and exchange liberalization, steady GDP growth, and maintenance of peace and political stability. Generally, the total foreign private capital in Zanzibar has surged to USD 182.9 million at the end of 2009, from USD 159.6 million recorded in 2009 implying an increase of 14.6 percent [5]. The sectoral distribution of FDI stocks was in favour of service sector, of which tourism services sub-sector accounted for over 80.0 percent due to huge investments in tourist hotels and restaurants etc.

3. Literature Review

There are many theories seeking to explain FDI because of its complex endeavor. In an attempt to organize the competing paradigms of neoclassical, behavioural and institutional theories of FDI developed by Harmer (1976), Vernon (1966), Buckley and Casson (1976), Caves (1971) others, Dunning (1993) developed an eclectic approach. According to the Dunning paradigm three conditions must exist in order for FDI to take place. These are ownership, the existence of benefits from internalizing economic activity and the existence of location specific advantage [9]. Over time a number of studies have been carried out to examine the various location determinants of FDI [3, 14]. In many cases, small countries are shown to be different from the large countries in terms of the various location factors affecting FDI [3, 6, 8, 14]. For example, the common findings for the existing FDI literature is that, due to its size, small island development state (SIDS) is unlikely to attract FDI. However, Asiedu (2003) argue that factors that have been successful in other countries may not be equally successful SIDS. Funya (2004) in this study of FDI in small countries concluded that the findings of various studies on the determinants of FDI in the context of small countries and SIDS in particular have been contradictory. From the theoretical point of view market size, plays an important role in attracting FDI. Obwona (2001) finds market size to be a significant determinant of FDI in Uganda. However, Elbadawi and Mwega (1997) argue that market size is relatively unimportant in explaining FDI flows to small Island Development States.

Obwona et al (1998) found that a depreciation of the real effective exchange rate, economic growth, an increase in a country's openness to trade and the expansionary effects of fiscal balance have positive impacts on FDI. Some commentators pointed that removing restrictions and providing good conditions for private initiative have important bearings on FDI inflows, while the number of political upheavals has a negative bearing [6, 13]. On the determinants of FDI in developing countries, most studies argue that FDI inflow is attracted largely by natural resource endowments [6, 13]. Morisset (2000) pointed that there is a high correlation between FDI inflows and total value of natural resources in each country. Asiedu (2002) indicated that governments can play an important role in directing FDI through trade reform, macroeconomic, efficient institutions and improvement in infrastructure. Several other studies find that countries that have a higher degree of openness attract more FDI [10, 15, 17]. Luo (2002) conclude that political instability significantly reduces the inflow of foreign direct investment. Lemi and Asefa (2001) also arrive at similar conclusions. Moreover economic factors such as labour, trade connection, size of the export sector and external debt of the host countries are found to be significant determinants of FDI flows to emerging countries [5, 8, 13]. Lee (2003) draws particular attention to the effectiveness of government policies towards foreign direct investment activity. Corruption is also another key concern of foreign investors on top of political and policy instability. The World investment Report (1999) reports that factors most frequently mentioned by foreign investors as having a negative influence on investment are bribery, high administrative cost of doing business, and access to capital. In general, greater red tape, more restrictive performance requirements, an unstable political situation, or economic instability would make the host country less attractive for FDI [5].

Human capital, both in terms of quantity and quality, is another important factor in promoting labour intensive and export oriented FDI in particular. Recent literature puts forward agglomeration effects as a significant factor of attracting FDI [14]. Venables, (1996) argues that agglomeration economies arise from the presence of other firms, other industries, as well as from the availability of skilled labour force. Empirical evidence evaluating agglomeration effects is limited though, partly because of data limitations and difficulties in obtaining definite statistical specifications. On the other hand Neumayer and Spess (2005) suggest that bilateral investment treaties (BITS) can serve as a substitute for low quality domestic institutions and poor law enforcement for foreign investors operating in developing countries. This could implicitly suggest that political risk matters to FDI inflows only when one reaches a certain level of development, before that lack of stability can be mediated by BITS. Thus, bilateral investment treaties to large extent influence firm decision to go abroad. After a brief review of literature on FDI determinants, we generate a set of hypotheses, in section four, to test the fundamental location variables affecting foreign investors to construct their hotels in Zanzibar.

4. Hypothesis Development

To explore research objective the study relied on a set of hypotheses that would provide the framework for the statistical analysis. These hypotheses are outlined below:

4.1. Market Size

The market size theory has long established that the size of the host country market is an important determinant of FDI [12]. The theory argues that FDI is attracted to a large market in order to exploit economies of scale and to earn higher returns on investment [18]. Thus, small countries like Zanzibar are severely disadvantaged because the smallness of their markets constitutes a major disincentive to FDI. The corollary of the size hypothesis is that larger countries with larger markets are able to attract more FDI because larger markets make it possible to exploit economies of scale and earn higher returns [12]

- Hypothesis I: All others factors remain constant the inflow of hotel FDI in Zanzibar is influenced by regional tourism market.

4.2. Economic Growth

Hunya (2004) argued that changes in the relationship between growth rates in different countries impact on the pattern of international capital movement. In other words, capitals move from countries experiencing a downturn in their economic growth towards countries with higher economic growth rate [2, 9]]. Lipsey (2000) confirmed the positive relationship economic growth in the host country and annual inward FDI. Generally, there is substantial support, in the literature for the FDI and economic growth causal relationship as well as, the economic growth and FDI causality [3, 4, 9]. The large economies with rapid economic growth provide multination companies with opportunities to generate greater profits and therefore become an inducement to FDI inflow [7, 12]. In the same vein, it could be suggested that small economies with weak growth rates are unable to attract significant amounts of FDI and vice versa is true [4].

- Hypothesis II: All other factors remain constant; the economic growth is not directly related to the inflows of hotel FDI in Zanzibar.

4.3. Infrastructure

Physical infrastructure is not only an important pillar of economic development but, also, impacts on the ability of businesses to operate successfully [18]. A well developed infrastructure in a host countries is expected to improve the production possibilities of the domestic industries, develop greater inter sectoral linkages within the economy and provide a platform for the efficient distribution of goods and services [5]. Thus, this aspect of national development is critical to the efforts of small countries to attract FDI [17]. It is found that higher the availability of infrastructure lower is the infrastructure costs and higher is the ability of the host country to attract FDI [13]. The term infrastructure in the host country refers to the quality of roads, railroad, dependable energy and telecommunication availability, credit and banking facilities and other financial, legal and transport systems. Cheng & Kwan (2000) also found that cost and quality of infrastructure as a very important factor influencing FDI in China.

- Hypothesis III: All others factors remain constant the flow of hotel FDI in Zanzibar is positively associated with availability quality of infrastructural

4.4. Openness

Empirical studies also reported mixed evidence on the effect of openness in determining FDI [18, 20]. For example Dees (1998) found that openness to the rest of the world a significantly positive impact for China's inward FDI. Janicki and Wunnava (2004) study revealed that openness to trade is a key determinant of FDI inflows in CEECs. Some studies have found less significant links between domestic openness and inward FDI. For example Gong, H. M, 1995 obtained a weak positive link between openness and FDI.

- Hypothesis IV: All other factors remain constant openness of Zanzibar would promote greater FDI inflows

4.5. Tourism Demand

The economic literature has long recognized that the production opportunities available to small countries are relatively limited because of major economic disadvantage [6, 8]. Because of these limitations, the production base of most small countries has remained relatively undiversified in their export activities [6]. As a consequence, most small states were forced to pursue policies that would promote economic diversification [7]. Due to the perceived economic benefits and the possibility of stimulating economic growth tourism is mostly seen as a diversification strategy and therefore serves as a major source of FDI inflows to the small countries [18]. Dunning (1993) has suggested that tourism FDI looks for foreign locations that possess natural and cultural resources and related facilities. Natural resources include national parks, game reserve, marine and forest species. MoFEA (2003) argued that foreign tourism investments into Tanzania have been undertaken to take advantage of the abundance of mineral and cultural resources in the country regardless of infrastructure availability. In this hypothesis, we attempt to test whether Zanzibar's natural and cultural resources are positively correlated with hotel FDI flow.

- Hypothesis V: All others factors remain constant the hotel FDI into Zanzibar is influenced by availability if diverse tourism assets.

4.6. Cost of Labour

Results of past empirical studies on wage costs and FDI's location determinants have varied. Some have found that higher labor costs deterred FDI flow [1, 2, 4]; while others have found a statistically insignificant correlation between the inflow of FDI and labor cost [13, 36]. Cassidy (2002), Wei et al (1999) and Fu (2000) found a negative correlation between effective wage and FDI flow; while Cheng (2006) found a positive correlation between the effective wage and FDI flow in China. It is argued that country with lower labor costs plus higher productivity will attract FDI while country with lower labor cost as well as lower productivity will not [7, 12]. Dunning (1993) suggested that MNEs that are motivated by efficiency seeking of products require an experienced labor force, which tend to be associated with higher wage levels. By contrast, MNEs that are motivated by efficiency seeking of processes tend to require lower cost labor.

- Hypothesis VI: All other factors remain constant the wage rate in Zanzibar is directly related to the inflows of hotel FDI inflows.

4.7. Exchange Rate

Exchange rate is another common variable involved in the analysis of the determinants of FDI. According to Hunya (2004) both the level and the variability of exchange rate count. The way the level of exchange impacts on FDI flows depends on the type of investment in consideration [9]. A depreciation of the host country's exchange rate will have a positive influence on the flows of horizontal FDI it receives through reduced cost of capital [7]. On the other hands, an appreciation of the local currency increases the flows of horizontal FDI because the local consumers are having a higher purchasing power [9]. Thus, the appreciation of a local currency has a negative effect on vertical FDI inflows because items produced locally are becoming expensive abroad.

- Hypothesis VII: all other factors remain constant the exchange rate influences the hotel FDI inflows in Zanzibar.

4.8. Investment Cost

The effect of investment cost in the host country on FDI is less controversial. Studies that included investment cost as one of the determinants have mostly found that it has a negative impact on attracting FDI [10]. Waldkirch (2004) investigated the determinants of Mexican inward FDI, and found that the influence of investment climate is not statistically significant.

- Hypothesis VIII: all other factors remain constant the investment cost in Zanzibar affect the inflows of hotel FDI.

4.9. Political Stability

Empirical evidence on political factors has also given mixed results. For example, Luo (2002) found that political instability has a negative impact on FDI inflow. On the other hands, Cheng, S, 2006 found political instability has no significant effect on FDI. Bandelj (2002) studied FDI determinants in Central and East European countries (CEEC) and concluded that the effect of political volatility in post-socialist nations is not uniformly negative. Bevan and Saul (2004) studied the flow of FDI from the EU to Central and Eastern European nations, and found host country risk not a significant determinant.

- Hypothesis IX: All other factors remain constant the political instability of Zanzibar is directly related to the inflows of FDI inflows.

5. Methodology

The data for this research gathered using a questionnaire, from hotel FDI operating in Zanzibar. A detailed questionnaire, drafted using relevant literature, was mailed out to approximately 44 respondents in Zanzibar. Before the actual questionnaire was mailed out, a pilot study was conducted to gauge content validity and based on the feedback final changes were made in the questionnaire. Respondents were asked to describe why they made FDI decisions to invest in Zanzibar. The variables used are regional tourism market size, economic growth, political stability, tourism demand, investment cost, exchange rate, low labour cost in Zanzibar, infrastructure development and Zanzibar's trade openness. The descriptive analysis was firstly carried out to summaries the frequency percentages for each variable considered by foreign hotel firms with respect to their FDI decision to Zanzibar. Thereafter simple logistic regression used to investigate whether there are any significant relationships between the importance of determinant factors and inflow of hotel FDI.

6. Result and Discussion

The result of descriptive analysis are depicted in figure 1 indicated that 98 percent of respondents described that regional tourism market (RM) was the determinant of their firms FDI decision in Zanzibar hotel industry. Over two thirds believed that tourism demand in Zanzibar (TD) was one among the factors in their hotel FDI decisions. The influence of Zanzibar openness (OP) to the external world was rank in the third position, and about one third considered that political stability (PS) in Zanzibar also played an important role. Slightly less than a quarter of companies regarded the availability of infrastructure (IS) and economic growth (EG) as an important factor. Only 7 percent of the responses considered low labour cost (LC) as important factors on their decision for hotel FDI in Zanzibar. Less than 5 percent of the hotel firms took the factors of investment cost, and exchange rate into account when these firms were making their FDI decision into Zanzibar hotel industry.

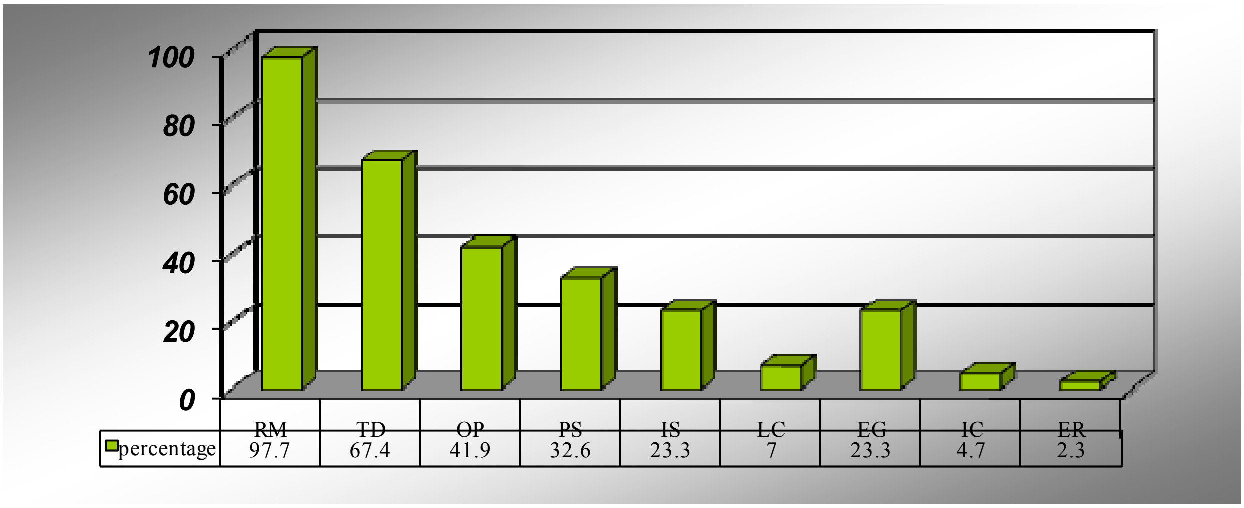

Figure 1: Descriptive Analysis

Beginning with regional tourism market, high statistical significance with a positive sign is observed, but only for Tanzania mainland ($\beta = 2.18$, $p < 0.05$). Bases on the way in which the variable was shaped, this result would be interpreted as follows: being a party of the United Republic of Tanzania is positively associated with hotel FDI inflow in Zanzibar. In other words, the Zanzibar enjoys large tourism market available in the Tanzania mainland. In principle, this result confirms our Hypothesis I, in the sense that the larger tourism market existing in East Africa countries and Tanzania mainland in particular increases the likelihood of hotel FDI in Zanzibar. As for, economic growth a negative-sign influence was identified, which is in keeping with the formulation of our hypothesis II. This influence is not statistically significant though. Therefore, perhaps the role of this variable is not so critical in the choice of FDI for Zanzibar. We found a negative sign for infrastructure, but without statistical significance. In this regard, and although, as we pointed out when that hypothesis III was formulated, the positive influence on the availability of infrastructure had been the most frequent result in many previous research works, there is also empirical evidence in the hotel industry in which that relationship is not totally confirmed either [22, 23]. According to these authors, that result reinforces the belief that many multinational hotel firms and Italians in particular like to invest their hotel projects in emerging countries where there is potential tourism market and very limited infrastructures. In fact the vast majority of hotels in Zanzibar are owned by Italian companies; they are risk takers.

The study revealed that the openness has a positive and statistically significant influence on the decision of firm to established hotel FDI in Zanzibar ($\beta=0.35$, $p<0.05$). Because of its narrow production base Zanzibar relies on foreign trade to stimulate economic activities and growth. The openness policy becomes a strong signal to the outside world, which indicated Zanzibar intention to become aggressively involved in the world tourism business. The openness brought new opportunities for foreign investors who tended to have a presence in Zanzibar seeking future long term tourism business development. Although, the study evidence the positive relationship between a country's openness to hotel FDI inflow (Hypothesis IV), yet the inflow is not as it was expected. Thus, higher openness ratio is required. The results obtained also support our hypothesis V, as the logistic regression analysis shows a strong relationship between the factor of availability of diverse tourism products/assets and inflow of hotel FDI in Zanzibar ($\beta=0.77$, $p<0.05$). Therefore, we can deduce that a greater availability of diverse natural and cultural resources have motivated foreign tourism investors into Zanzibar. Cost of labour (hypothesis VI) and cost of investment (Hypothesis VIII) did not prove significant and have consequently not determined the decision of hotel investors. The exchange rate turned out to be moderately significant (β= - 0.51, $p<0.1$). The negative sign for the exchange variable suggests that hotel FDI inflow do depend on the exchange rate.

Table 1 Result of Regression analysis

Variables	β coefficient
Regional tourism market-Tanzania mainland	2.18**
Regional tourism market – other East African Countries	-0.65
Economic growth	-0.11
Tourism demand	0.77**
Political stability	0.330**
Exchange rate	-0.51*
Investment cost	-0.00
Labour cost	0.08
Infrastructure	-0.11
Openness	0.35**
***p<0.01; **p<0.05; *p<0.1.	

Relatively stable political conditions in Zanzibar received significant attention from the foreign hotel investors (β=0.33, $p<0.05$). In other words, there are is statistically relationship between political stability and inflow of hotel FDI. A dramatic change that has occurred in Zanzibar's political and economic environment has motivated multinational tourism firm to operation in Zanzibar through FDI entry mode. The social and political environment for foreign investors has been improved significantly accompanied with outstanding economic performance, which has provided a more stable investment environment and a more promising future tourism market for foreign investors in Zanzibar for their long term business development. Furthermore, the studies revealed that there was a significant negative relationship between the variable of political stability and firm's country of origin. This can be interpreted as western firm viewed Zanzibar political condition as more important than hotel firms from developing countries.

7. Concluding Remarks

This paper has been motivated by the low FDI flows to the Zanzibar despite its interest to diversify income sources and the potential benefits of FDI. Building on the location advantage hypothesis of the OLI paradigm and others FDI theories, the paper examines location determinants of FDI in Zanzibar hotel industry. The paper revealed that the size of tourism's market in the neighboring countries is a major factor in attracting FDI in Zanzibar hotel industry. The problem of market size was also complimented by availability of diverse tourism assets. The study revealed several traditional location variables such as infrastructure, political stability, economic growth and openness to trade, do promote the flow of FDI to Zanzibar hotel industry. It was also found that hotel investors from developing countries relatively tend to perform activities with low-cost structures thereby minimizing the relevance of the perceived risk associated with the host country and operate in countries with dissimilar business practices in relation to the home country. As with all empirical research there are important limitations to this study. Due to relatively small sample size, a caution has to be exercised when interpreting the results. However, the results, at least, can be used to establish the fact that these factors might influence foreign investors' decisions in choosing a location. As much of the discussion on FDI in Zanzibar, it is expected that the findings of this study will provide a basis for future studies.

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