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# Foreign Direct Investment and Tourism Development: A Theoretical and Empirical Review

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## INTRODUCTION

Tourism is one of the most significant export sectors for several countries across the world. The United Nations World Tourism Organization (UNWTO) and World Travel and Tourism Council (WTTC) statistics indicate that tourism accounts for around 10 percent of the world's gross domestic product (7.2 trillion USD) and supports more than 284 million jobs. It is predicted that tourism will grow at an annual rate of 4 percent over the next 10 years (UNWTO, 2016; WTTC, 2016). In view of the economic implications of tourism, many countries desire its expansion. Tourism has therefore become such a sector that few government can afford to neglect. Tourism is a major contributor to economic development, generates income and foreign exchange, creates new employment opportunities for local people, and helps diversify the local economy. The tourism sector has also been considered as a vehicle for preserving the environment, culture, and heritage of the host destination (see Bilen et al., 2017; Latkova and Vogt, 2012; Nunkoo and Gursoy, 2012; Nunkoo and Ramkissoon, 2010a, 2010b, 2010c, 2011a, 2011b, 2012; Nunkoo and So, 2016; Nunkoo and Smith, 2013; Paramati et al., 2017; Ramkissoon and Nunkoo, 2011; Seetanah, 2011; Sinclair, 1998; Sinclair and Stabler, 2002, Yu, Chancellor, and Cole, 2011; Zuo and Huang, 2017). Rural communities experiencing economic decline and hardships have also adopted tourism as a new economic development strategy (Hashemi and Ghaffary, 2017; Látková and Vogt, 2012; Park et al., 2015; Wang and Pfister, 2008; Tirado Ballesteros and Hernández Hernández, 2017). In view of the economic, environmental, and sociocultural implications of tourism development, residents often consider the sector as a way of strengthening the local economy and improving their quality of life (Andriotis and Vaughan, 2003; Hao et al., 2011). The tourism industry therefore is an economic priority for several governments who attempt to have the right policy prescriptions to promote growth in a sustainable manner.

Tourism development involves a series of cross-cutting activities including the provision of goods and services such as accommodation, transport, entertainment, construction, and agricultural and fisheries production. The tourism industry structure also encompasses a wide diversity of players ranging from global transnational corporations (TNCs) to small and medium-sized enterprises (Martínez-Román et al., 2015; Nunkoo and Ramkissoon, 2016; Saarianen, 2016, 2017). Tourism remains an activity where capital, infrastructure, knowledge, and access to global marketing and distribution chains play an essential role (Banerjee et al., 2015; Hof and Blázquez-Salom, 2015; Stauvermann and Kumar, 2017). The capital-intensive nature of tourism, where the industry's development requires the provision of transport infrastructure and the construction of hotels and airports, mean that several countries, especially developing ones, rely on foreign direct investment (FDI) (Endo, 2006; Khoshnevis et al., 2017a, 2017b). FDI plays an important role in the tourism economy and is often considered one of the most effective engines for supporting the critical elements the industry requires (Tang et al., 2007). According to the United Nations Conference on Trade and Development (UNCTAD, 2007) and several empirical studies on this topic (e.g. Davidson and Sahli, 2015; Khoshnevis Yazdi et al., 2017a, 2017b; Jalil et al., 2013; Li et al., 2017), the inflow of FDI is likely to boost the tourism industry by upgrading the facilities and services such as hotels, restaurants, historical sites, and recreation centers and by supporting other physical infrastructure and services such as transportation, tour operators, travel agent and car rental services that may be lacking in the destination.

Despite the accepted role of FDI in boosting tourism development, studies on the causal relationship between FDI and tourism development are scarce in the existing literature. As Tomohara (2016) recently argued 'the existing research in this field is inadequate, because tourism–FDI interactions are not in reality restricted to typical tourism-related FDI such as in hotels, airlines, and restaurants. Tourism development may induce FDI in other sectors as well' (p. 435). This chapter reviews the theoretical underpinning of the FDI-tourism nexus and the empirical work on the topic. It also identifies literature gaps and makes a number of recommendations for future research.

## FDI AND TOURISM DEVELOPMENT: THEORETICAL UNDERPINNINGS

The tourism sector requires capital, infrastructure, knowledge and access to global marketing and distribution chains to develop and sustain (Banerjee et al., 2015; Hof and Blázquez-Salom, 2015; Stauvermann and Kumar, 2017). The availability of financial sources is therefore essential for furthering tourism development and economic growth, especially in the case of capital-intensive tourism projects that are often tied up with huge set-up costs. Thus, FDI which is mainly generated by transnational corporations (TNCs), is expected to play a significant role in developing the tourism industry, especially in developing countries, by providing the required capital and knowledge necessary for land improvements and development of infrastructure and buildings. These include international airports, highways, hotels, tour operators, travel agencies, car rental, restaurants and tourist attractions, which are critical tothe success of tourism.

Foreign direct investment not only plays a significant role in developing the tourism industry by providing the required capital (Endo, 2000; Selvanathan et al., 2012; UNCTAD 2007), but it also facilitates the transfer of skills, knowledge and production techniques to the host destinations (Blomström et al., 1999; Jacob and Groizard, 2007; Khoshnevis Yazdi et al., 2017a, 2017b; Markusen, 1995; Marrocu and Paci, 2011; Williams and Deslandes, 2008). TNCs are expected to make a significant contribution to the development of human capital which remains critical for tourism development (Salifou and Haq, 2017). Sinclair (1998) posited that the overall outcome of FDI depends largely on the extent to which foreign enterprises are able to transfer their specialist knowledge to domestic firms. There is indeed a large body of literature that describes the potential for transfer of technology from TNCs to local firms (e.g. Blomström et al., 1999; Khoshnevis Yazdi et al., 2017a, 2017b; Markusen, 1995).

Transnational corporations are expected to make a significant contribution to human capital development as they benefit from economies of scale and scope and have the experience in running systematic training programs directed at the international markets. On-the-job training, formal face-to-face, distance or online lectures, case study films, courses at headquarters, and instruction manuals remain their main channels for training and knowledge transfer. It is noteworthy that an overwhelming majority of TNC hotels have designed training programs for their staffs, including formal modular education packages. Such programs are offered at all levels of the tourism and hospitality industry, from housekeeping to top level management. Transnational hotel chains usually hold seminars in different parts of the world. They help keep hospitality and tourism employees at all levels of the industry up-to-date on new techniques, methods and procedures utilized in marketing and sales. Tecle and Schroenn (2006) argued that the overall outcome of FDI depends in part on the degree to which specialist knowledge is transferred to domestic firms as well.

Although it has been argued that the problem of technology transfer is usually constrained by the gap between developed and developing countries, Caves (1996) posited that this is less likely to occur in tourism as compared to other more capital-intensive sectors. Personal skills are central at all levels of the tourism chain and this explains the value of such knowledge and skills transfer for the tourism industry. Tourism is a service sector where consumers are closely linked to the service providers at all stages of the process of production and consumption. Therefore, knowledge and skills transfer from TNCs to local tourism and hospitality enterprises also contributes to enhancing the tourism experience. Indeed, the United Nations Centre on Transnational Corporations (UNCTC, 1982) and UNCTAD (2007) reported that the transfer of knowledge and skills was considered as the most important contribution of FDI in the hotel sector by developing and industrialized countries.

In the tourism literature, technology encompasses not only the 'hardware' of building and design of hotels and restaurants, but also the 'software' which relates to the skills related to the hospitality industry. While much have been discussed about skills, UNCTAD (2007) stresses emphasis on the marketing power of international brands, noting that destination marketing organisations can benefit from the loyalty schemes, corporate network, and the large customer base of TNCs. UNCTAD (2007) further reported that tourism-related TNCs have the ability to improve on the international recognition of destinations and enhance the image of host countries. Similarly, TNCs also contribute to raising standards through more advanced systems and quality control that in turn enhance the quality of the destination products, thereby promoting tourism development. Furthermore, travellers who originate from developed countries mostly, are accustomed to modern infrastructure and high quality hospitality services in their home environment. They therefore prefer to have essentially the same comforts and standards as at home while traveling (Cohen, 1984). The presence of TNCs and international hotel and restaurant chains in a destination contribute to the provision of high level of service quality and a good image of the destination. Therefore, FDI is expected to foster the quantum as well as quality of service which are then linked to increased international tourist arrivals (Zhang and Chong, 1999; Endo, 2000; Selvanathan et al., 2012).

Another argument in favor of FDI in tourism development relates to the increase in business travel it generates (Tang et al., 2007). The presence of TNCs requires that foreign investors, their associates, and staffs travel regularly to the source country for business purposes such as to obtain more detailed and complex information which are not readily available through the government or the private sector institutions (Haley and Haley, 1997). Such travel becomes important so as to understand the different cultures and the economic and political structures to ensure business success. Moreover, FDI in the form of foreign real estate investment, especially in Integrated Resort Schemes and Residential Estate Schemes, has also been found to generate further tourism development and increase tourist arrivals. Owners of real estates in the host countries often travel to the destinations with their families and friends, which in turn generates additional travel and revenues for the destinations (Fereidouni et al., 2014). Export-oriented FDI which is closely linked to trade expansion is also likely to create a growing awareness of goods and services that business and holiday travelers require. By engaging in heavy advertising campaign for their products and services abroad, such firms help in promoting the image of the host country as a tourist destination. As such, as the tourism industry is relatively volatile, TNCs can be more robust and stable than local firms, and thus help ensure the stability of and maintain confidence in an economy (UNCTAD, 2007).

## *Empirical Evidences*

The above discussion has reviewed the theoretical underpinnings of the relationship between FDI and tourism development. Table 33.1 presents the key empirical work on FDI and tourism development. Among the pioneering work on this topic feature Haley and Haley's (1997) study. The researchers demonstrated empirically that FDI led to the development of new tourist attractions and accommodation facilities which in turn boosted tourist arrivals in Vietnam. Interestingly, the authors also found that the causality between FDI and tourism can also run from FDI to tourism. In a subsequent study, Sanford and Dong (2000) also found a positive relationship between FDI and tourism in the United States. They however assumed that there exists a one-way causality running from tourism to FDI and, therefore, did not investigate the possible role that FDI flows can have on stimulating the tourism industry.

In a study based on small island developing states, Craigwell and Moore (2007) applied panel causality methods and found a bidirectional relationship between FDI and tourism development. Their findings revealed that FDI provides additional capacity for the small island states, allowing them to expand their tourism activities. The researchers also found that tourism development was associated with a higher level of FDI, but, however, the bidirectional relationship between FDI and tourism was confirmed only for a smaller set of countries. Similar results were found by Sadi and Henderson (2001) for the case of Vietnam. Likewise, Tang et al. (2007) investigated the relationship between FDI and tourism in China for the period 1978 to 2005 using a time series econometric approach.. The authors found a one-way causality link from FDI to tourism, implying that FDI was a significant contributor to tourism development in China. They further found that a rise in tourist arrivals led to an increased demand for hotels rooms which was in turn met by increased FDI in the destination as the large international hotel chains invested more to meet the growing tourism demand.

**Table 33.1 Key empirical literature on foreign direct investment and tourism**

| *Author* | *Context* | *Methodology used* | *Brief view of findings* |
|---|---|---|---|
| | | FDI ➔ TOURISM | |
| Haley and Haley (1997) | Vietnam | Time series econometric analysis (causality analysis) | FDI generates the development of new tourist attractions and accommodations, which in turn leads to an increased tourism. |
| Broadman and Sun (1997) | China | Ordinary least squares regression | FDI has been a significant contributor to expanding tourism in China. |
| Sanford and Dong (2000) | United States | Tobit analysis | Found a positive relationship between FDI and tourism. |
| Sadi and Henderson (2001) | Vietnam | Time series econometrics and causality analysis | FDI provides additional capacity for the SIDS, thus allowing them to expand their tourism activities. Results also provided support for a bidirectional relationship. |
| Craigwell and Moore (2007) | Sample of small island developing states (SIDS) | Panel causality methods | FDI provides additional capacity for the SIDS, thus allowing them to expand their tourism activities. Results also indicated a bidirectional relationship |
| Tang et al. (2007) | China | Time series | One-way causality link from FDI to tourism. FDI has been a significant contributor to expanding tourism in China. |
| Garcia-Flores et al. (2008) | Mexico | Time series regression analysis | The existence of a positive relationship between FDI and tourism development. |
| Fereidouni and Al-mulali (2012) | Selected OECD countries | Panel co-integration and panel Granger causality regression techniques | Found a long-run relationship from FDI in real estate sector to tourism flows. The researchers also noted a bidirectional causal relationship. |
| Selvanathan et al. (2012) | India | Time series econometrics (vector autoregressive framework) | Presence of only a one-way causal relationship from FDI to tourism. |
| Othman et al. (2012) | 18 major tourism destinations | Time series econometrics –ARDL approach | Findings confirmed the existence of a strong positive relationship between FDI and tourism. |
| Samimi et al. (2013) | Developing economies | Dynamic panel data techniques | Confirmed the existence of a long-term relationship between FDI and tourism. In addition the authors reported existence of reverse causality. |
| Jayaraman et al. (2014) | Fiji | Dynamic time series econometrics – ARDL approach | Identified positive long-run associations between FDI and tourism earnings; an increase in the ratio of FDI to GDP by 10% would results in an increase in tourism earnings by around 0.49% |
| Tomohara (2015) | Japan | Dynamic panel models | A favorable interaction between inward FDI and foreign tourists visiting Japan; tourism enhancement has positive spillover effects on inward FDI beyond tourism-related industries |
| Li et al. (2017) | China (outward FDI to 21 host countries) | Panel data analysis | China's outbound tourism scale to the host country, and host country's tourism economy scale were significantly associated with Chinese outward FDI in tourism. |
| Khoshnevis Yazdi et al. (2017a) | Iran | Granger causality | No relationship between FDI and tourism but tourism development was found to influence FDI. |

*(Continued)*

**Table 33.1 (Continued)**

| *Author* | *Context* | *Methodology used* | *Brief view of findings* |
|---|---|---|---|
| | | TOURISM ➔ FDI | |
| Haley and Haley (1997) | Vietnam | Time series econometric analysis (causality analysis) | Found that the causality between FDI and tourism can also run from tourism to FDI.. |
| te Velde and Nair (2006) | 9 Caribbean countries | Panel regression analysis | No significant relation between tourist arrivals and FDI flows. |
| Katircioglu (2011) | Turkey | Dynamic time series econometrics | Unidirectional causation from international tourism growth to net FDI inflows. |
| Tiwari (2011) | India, China, Pakistan and Russia | Panel ordinary least squares estimation technique | Found that tourism played important role in increasing FDI. |
| Salleh et al. (2011) | East Asian context: Malaysia, Thailand and Hong Kong | Time series econometrics | Tourist arrivals influenced FDI in Malaysia, Thailand and Hong Kong.<br>Evidence of bidirectional relationship for both variables for Hong Kong only. |
| Alam et al. (2015) | Malaysia | Simple bivariate regression analysis | Found a positive direct relationship and the authors posited that when the number of tourists increased, it created more revenue for the country and effected FDI. |

Their results confirm the earlier work of Broadman and Sun (1997) who studied the influence of FDI on tourist arrivals in China.

Garcia-Flores et al. (2008) evaluated the relationship between FDI, tourism development, and the environment in Mexico for the period 1982 to 2007. Using a time series regression analysis, they demonstrated a positive relationship between FDI and tourism development. However, they also found that increased tourism development led to severe environmental damage in the destination. Selvanathan et al.'s (2012) study revealed similar findings in their study on FDI and tourism development in India for the period 1995 to 2007. Among the rare studies investigating the relationship between FDI in tourism in African countries is that of Othman et al. (2012). Their findings confirmed the existence of a strong positive relationship between FDI and tourism. The researchers demonstrated empirically that inward FDI in Africa led to a substantial growth in tourism. Subsequent work on developing economies from Samimi et al. (2013) who adopted dynamic panel data techniques to investigate the FDI-tourism link from 1995 to 2008 confirmed the existence of a long-term relationship between the variables. More recently, Fereidouni and Al-mulali (2014) studied the long and short run empirical link between FDI in real estate sector and international tourism flows for selected Organisation for Economic Co-operation and Development (OECD) countries. Using panel co-integration and panel Granger causality regression techniques, they not only found the existence of a long-run relationship from FDI to tourism flows, but also a bidirectional causal relationship. Using a similar co-integration technique, Jayaraman et al.'s (2014) study on Fiji identified positive long-run associations between FDI and tourism earnings. Specifically, the authors reported that an increase in the ratio of FDI to GDP by 10 percent would results in an increase in tourism earnings by around 0.49 percent.

### *Tourism Development and FDI*

Interestingly, as illustrated in Table 33.1 and in the above discussion, there also exists a reverse causal relationship which may run from tourism to FDI. Tourists demand goods and services such as accommodation, food, transportation services, and entertainment in the host country. In most developing countries, provision of goods and services that the tourism industry requires put pressure on the current level of production due to the limited capital, infrastructure, production techniques, and manpower. Tang et al., Selvanathan and Selvanathan (2007) argued that investment, particularly FDI, plays an important role in such economies which are usually constraint by domestic resources. The authors further argued that FDI is likely to be enhanced as international hotel chains are attracted by the prospects of growing tourism demand and their ability to capitalize on their brands to meet the rising demand. Additionally, Sanford and Dong (2000) argued that international tourism gives potential investors the opportunity to obtain 'first-hand knowledge' and 'ground information' of the economic and business environment of the host country and as a result, investment possibilities could be identified and made in more confidence.

A number of empirical studies on the topic confirm the influence of tourism development on the level of FDI. Haley and Haley (1997) were among the first research to highlight this fact in their pioneering work. They argued that a rising demand for international business travel is created as foreign investors in the presence of asymmetric information might want to reduce the challenges of different cultures, economic and political structures. Using dynamic time series analysis, Katircioglu (2011) investigated the causal relationship between international tourism and FDI inflows for the case of Turkey. Their findings pointed to unidirectional causation from international tourism growth to net FDI inflows growth in the country. Subsequent work by Tiwari (2011) also found that tourism played important role in increasing FDI for Asian countries, namely India, China, Pakistan, and Russia.

Another study by Salleh et al. (2011) in the East Asian context reported that tourist arrivals influenced FDI in Malaysia, Thailand, and Hong Kong. The authors found that while for the case of Malaysia and Thailand, it was the number of tourist arrivals that significantly influenced FDI, for Hong Kong, there was evidence of a bidirectional relationship for both variables. Salleh et al. (2011) concluded that 'in order to stimulate sustainable economic growth, tourism development that brings in arrivals must be carried out as it has the potential in generating economy as well attracting investments from overseas' (Salleh et al., 2011: 255). Recently, Alam et al. (2015) investigated the role of tourism in attracting FDI for the case of Malaysia over the period 1995 to 2011 using simple bivariate regression analysis. The study found a positive direct relationship, and the authors posited that when the number of tourists increased, it created more revenues for the country and generated more FDI. It is noteworthy, however, that a study from te Velde and Nair (2006), who investigated the link between tourism development and FDI for the case of nine Caribbean countries over a seven year period from 1997 to 2003 using panel regression analysis, could not find any significant relation between tourist arrivals and FDI flows. Therefore, the empirical findings on the relationship between tourism development and FDI are not conclusive, requiring further research on the topic.

## AGENDA FOR FUTURE RESEARCH

Overall, the empirical findings suggest that FDI has positive consequences on destinations in the forms of better quality tourism products and services, increased tourism arrivals, development of human resources, and skills and technology transfer. However, despite the wide belief in tourism-related FDI development, existing empirical studies remain relatively scarce and a number of gaps in the literature exist. As presented in Table 33.1, we note that very few studies have focused on small island states, which rely heavily on tourism for economic development (Nunkoo and Gursoy, 2012; Nunkoo et al., 2010; Nunkoo and Ramkissoon, 2010a; Ramkissoon and Nunkoo, 2011). Small island states display unique characteristics of smallness, insularity, vulnerability, and fragility in environment (Briguglio, 1995; Douglas, 2006) which pose major challenges for tourism development, providing a unique case for researchers to study the tourism-FDI nexus in such economies. Small size is economically disadvantageous for a number of reasons (Briguglio, 1995). For small island economies, their small size inhibits efficient domestic production, resulting in higher costs and prices, and a lack of international competitiveness (Knox, 1967; Thomas, 1982). These lead to lower income and thus, to poorer economic growth performance than larger states (Armstrong and Read, 2002).

Small size also implies limited natural resource endowment and low industry linkages, resulting in high import content in relation to GDP, thus, making the economy highly dependent on foreign exchange earnings (Briguglio, 1993, 1995). Small size is also associated with limitations on import substitution possibilities for small islands (Armstrong and Reed, 2002; Briguglio, 1995; Worrel, 1992). Disadvantages of small size are also associated with a small domestic market and a high dependence on the export market, making the economy reliant on the economic conditions of the rest of the world (Briguglio, 1995). For instance, reliance on only a few domestic markets can expose small island states to exogenous shocks from instability in export prices and revenues in the economy of their main trading partners (Armstrong and Reed, 2002).

Vulnerabilities of small island economies are also often linked to the idea that small states are unable to influence their terms of trade due to their lack of international power (Liou and Ding, 2004). It is argued that due to their small size, small island developing states are unable to diversity their export, thus, leading to an overdependence on a narrow range of goods and services (Armstrong and Reed, 2002; Briguglio, 1995). Briguglio (1995) noted the limited ability of small islands in influencing the domestic price level. He argued that while most developing countries are price takers to some extent, small islands are price takers to a much higher degree as a result of the small volume of external trade in goods and services they trade in. The unique characteristics of small island states therefore provide a special case for studying the tourism-FDI relationship.

From a statistical standpoint, existing research has not given enough attention in separating long-run causality from short-run ones and has largely ignored dynamic and endogeneity issues in their modeling. Analysis of the FDI-tourism nexus in a dynamic setting is crucial since tourism is a dynamic phenomenon given the presence of repeat tourism. Moreover, appropriate dynamic regression techniques (for instance Vector Autoregression Models) are also required to analyze the link given also that there is the possibility of reverse causality and also of the presence of indirect effects (for instance FDI is likely to influence the growth of the destination country or FDI could enhance the tourism infrastructure base of the recipient country, both of which can in turn ultimately boost tourism). In addition, existing research have overwhelmingly been based on econometric approaches, with hardly any study, to our knowledge, employing survey or alternative analysis that can bring deeper theoretical insight to the debate.

While econometric approaches have no doubt advanced our understanding of the relationship between FDI and tourism development considerably, there are opportunities of using other methodological approaches to understand the topic, especially on how FDI impacts on local communities and their responses to tourism-induced FDI. Surveys for example, can provide valuable insights on residents' attitudes toward tourism-related FDI in the destination by providing valuable information on the roles of TNCs in poverty reduction, improving residents' quality of life, enhancing employment opportunities for local people and influencing other components that form an important part of the local communities' livelihoods. Surveys may also help gain a better understanding on the potential adverse consequences of FDI on the destination. Research suggests that foreign domination in a destination disempowers local people, destroys local businesses, and perpetuates social inequalities (Nunkoo and Ramkissoon, 2016). Surveys therefore have the ability to provide a 'people perspective' on the tourism-FDI relationship which econometric approaches fail to capture. There is also potential of using subjective approaches to understand the role of tourism-related FDI in community development. Subjective methodological approaches are able to capture the attitudinal and perceptual dimensions and real-life events that are not readily convertible into numbers through statistical and economic procedures (Nunkoo and Ramkissoon, 2009; Nunkoo et al., 2013). Qualitative approaches have the advantage of providing naturally occurring information that allows the researchers to understand tourism-related FDI as a social process from a community perspective.

## CONCLUSION

This chapter provides a discussion on the theoretical underpinnings of the FDI-tourism nexus, a link which remains relatively under-researched in the tourism literature. It reviews the related empirical work that has been published on this topic, identifies literature gaps, and sets the agenda for future research on tourism and FDI. Overall, the empirical findings suggest that FDI positively impacts on destinations and that the relationship between FDI and tourism is also of a bidirectional nature. Despite the theoretical advancements made to date, a number of literature gaps still remain. Existing empirical studies remain relatively still scarce, particularly with respect to small island states and developing countries that rely heavily on FDI for tourism and destination development. Research works in these contexts will supplement the literature and bring more insights into the FDI-tourism nexus. Furthermore, existing research seems to rely heavily on econometric approaches based on secondary data to empirically test the relationship between tourism development and FDI. While existing studies have considerably advanced our theoretical and empirical understanding between tourism and FDI, the debate misses a 'people perspective' on the role of tourism related FDI in community development. This requires that researchers are opened to a more diverse set of methodological approaches to understanding the topic.

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