CHAPTER 1

INTRODUCTION

1.1 Background

Nowadays, many countries are becoming more integrated with the global economy because of the open market policies promoted by the IMF and the World Bank. It also affects the increasing FDI inflows in each country. FDI plays an important role in improving welfare in the host country because of the benefits or effects of FDI, such as the introduction of innovations and technologies, new managerial techniques, and the development of additional skills.

Markusen & Venables (1999) argue that FDI has an essential role in the economy of a country. According to them, FDI can increase capital, create jobs and improve the conditions, and develop the industrial sector in the country. So, it is clear why so many countries compete in increasing FDI.

The importance of FDI for the economy in a country makes understanding the determinants of FDI very important. Existing theories focus mainly on economic factors, such as human capital, market size, and trade policy, as well as institutional factors such as democratic institutions, political stability, and also the rule of law.

Human Capital has long been considered an essential factor in FDI. Lucas (1990) argues that human capital must include as input into the production process like other factors of production. He said that the accumulation of human capital implies a deepening of capital, leading to a period of accelerated growth. In other words, Lucas's conclusion on this topic is that with a higher level of labor (Human Capital), the FDI received by developing countries will be much higher too.

Also, Alexander, J. S. (2014) argues that the rule of law can reduce uncertainty, protecting investment, so making it easier for investors to engage in long-term planning and help countries attract FDI. He also believes that under the weak rule of law, a state is still able to attract FDI because Investors can use personal relationships with business partners and government connections to reduce the uncertainty created by the weak rule of law. In particular, personal relationships provide investors with information about the market of the host country and provide guaranteed protection in investment. It reduces investor uncertainty and makes it easier for investors to make plans, so it makes it easier for them to invest.

UNCTAD World Investment Report (2014) states that net FDI inflows worldwide increased from USD 2380 million in 1990-2000 to USD 5874 million in 2001-2011. Both developed and developing countries experienced a sharp increase in FDI flow. Likewise, with Muslim countries (OIC), which has increased about 6.3 times, that is from USD 75 million to USD 478 million. OIC countries have more significant FDI inflows compared to other countries.

Since the 1990s, many OIC countries have been innovating to attract FDI, such as building human capital through improving education and health, improving infrastructure and transportation, and reducing trade barriers. The results show a positive effect in terms of attracting FDI inflows and accommodating many foreign investors in various sectors.

However, in 2013, the average inflow of OIC FDI decreased. In the UNCTAD World Investment Report (2014), the average FDI inflows in OIC countries in 2012 were USD 695 million and fell in 2013 to 654 million. It is thought to be due to problems in the Middle East and Africa, such as the problem of regime change, street protests, a war between nations, and other issues. It affects the level of uncertainty for foreign investors wishing to invest in the region, reflected in the reduction in net FDI inflows from the OIC group.

The performance of each OIC country individually in increasing FDI inflows not evenly distributed. It raises the question, whether the innovations that have been made by Muslim countries have been irrelevant in attracting FDI inflows? Why increased FDI inflows are uneven or concentrated in only a few countries? Is it possible to identify a set of government policies that can increase the country's attractiveness OIC as an FDI location?

Therefore, this paper investigates the relevance of human capital and the rule of law as a resource that can attract FDI to OIC countries. Chapter two presents the theories and determinants of FDI as well as previous literature studies. Chapter three presents the research methodology. Chapter four investigates empirical evidence and discusses how the relevance of human capital in attracting FDI to OIC countries. What is the role of the level of labor & the labor costs in attracting FDI to OIC countries, and the rule of law has a statistically significant effect on FDI inflows in OIC countries? Chapter five present the general overview of human capital and rule of law. The last chapter presents conclusions and suggestions from the results of this study.

1.2 Research Problems

Based on available data that innovations made by countries in the world, including Muslim countries since the 1990s through building human capital, reducing trade barriers, increasing the rule of law, and other policies, show a positive effect in attracting FDI. However, this did not last long for Muslim countries, which experienced a decline in FDI after ten years. It raises the question of whether the innovations carried out by Muslim countries since the 1990s, especially in building human capital, are no longer relevant in attracting FDI? Many studies have stated that the role of institutions, such as the rule of law, has an essential role in attracting FDI. However, some researchers claim that countries with weak legal regulations can still attract FDI, and this requires empirical evidence.

Based on these conditions, the problem that will review in this study is how the relevance of human capital while looking at the role of the level of labor & the cost of labor in attracting FDI in OIC countries. Second, to identify government policies related to the rule of law that can increase attractiveness OIC countries as an FDI.

1.3 Research Objectives

According to the research problem, the objectives of this study are to analyze the relevance of human capital while looking at the role of the level of labor & the cost of labor in attracting FDI in OIC countries. Second, to identify government policies related to the rule of law that can increase attractiveness OIC countries as an FDI.