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Governance, Private Investment and Foreign Direct Investment in Developing Countries

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Summary. — This paper uses annual aggregate data for 46 developing countries covering the period 1996–2009 to investigate if FDI crowds out domestic private investment and if alternative elements of governance have differing effects on the relationship between FDI and private investment. Results suggest that total investment (FDI and private) is greater in countries with good governance, there is evidence of crowding out (FDI displaces domestic private investment), and the extent of crowding out is related to governance. Corruption and political instability are the governance indicators that appear to have the greatest impact on investment. Political stability is found to be the most important aspect of governance in terms of the relationship between FDI and domestic private investment: an increase in FDI has the greatest effect on reducing private investment (but increasing total investment) in politically stable regimes.
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Key words — FDI, private investment, sources of investment, governance

1. INTRODUCTION

It is generally recognized that investment is important for growth and that governance affects investment; good governance is associated with higher investment (both FDI and private domestic). Less attention has been paid to whether particular aspects of governance have different effects on specific types of investment, and on the relationship between sources of investment. This paper investigates the relationship between foreign direct investment (FDI) and private investment in a sample of 46 developing countries for 1996–2009, and in particular how this relationship may be affected by governance (distinguishing alternative measures of governance). Alternative sources of investment finance can have different effects on total investment depending on how they relate to each other and how each responds to country characteristics, governance in our case. Using the Kaufmann, Kraay, and Mastruzzi (2010) data allows us to distinguish different elements or indicators of governance, but restricts the coverage to the period since 1996. The recent period is appropriate as there was a global increase in FDI from the mid-1990s and many countries implemented economic liberalization in the early 1990s that attracted FDI; Agosin and Machado (2007) report that the major increase in their "openness to FDI" index was during 1990–96, with only small changes after 1996. These global and policy influences on FDI are unlikely to confound inferences from a sample for the period 1996–2009.

A specific concern is whether FDI crowds in (adds to) or displaces (crowds out) domestic private investment. Although this is an important issue, there are surprisingly few empirical studies of the impact of FDI on domestic investment in developing countries (Nunnenkamp, 2004). If FDI crowds out domestic investment, total private investment rises by less than the FDI and the benefits for the country are reduced; Mišun and Tomšík (2002) find evidence for crowding-out in Poland in the 1990s. If FDI crowds in (stimulates) private investment, total investment increases by more than the FDI and the benefits are enhanced; Mišun and Tomšík (2002) for Hungary and the Czech Republic in the 1990s, and Kim and Seo (2003) for South Korea in 1985–99 find evidence of crowding in. Agosin and Machado (2005) find that FDI has no significant effect on domestic private investment for countries in Africa, Asia, and Latin America over 1971–2000, although there seems to be crowding out in Latin America in some sub-periods. The evidence on the relationship between FDI and domestic investment is mixed. However, none of these studies consider if governance is relevant to the relationship.

There is a large literature on determinants of FDI that does include governance indicators but their significance is contested. Blonigen and Piger (2011) conduct a meta analysis of studies of determinants of FDI and find that a number of variables commonly included in the literature are not robust, including host country institutions. However, for particular (groups of) countries host factors may be important (Gastanaga, Nugent, & Pashamova, 1998). Lipsey and Sjöholm (2010) argue that the weak business environment and inefficient institutions relative to other destinations in East Asia account in part for low inflows of FDI to Indonesia. It may also be the case that host country factors matter more for certain types of FDI; Lederman, Mengistae, and Xu (2010) find that foreign manufacturing firms are more likely to locate in better governed Southern African countries. Asiedu and Lien (2011), for 112 developing countries over 1982–2007, find that in countries

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with a relatively low share of minerals and oil in total exports democracy enhances FDI whereas democracy reduces FDI in countries with high natural resource shares in exports. Specific aspects of the political regime may be important. Busse and Hefeker (2007) find that government stability attracts FDI while Guerin and Manzocchi (2009) find that parliamentary democracies are more likely to attract FDI than presidential ones. However, this literature does not address the link between FDI and domestic investment, hence the impact on total investment.

We consider a specific hypothesis that the relative importance of alternative sources of financing for private investment, and how they interact, may be influenced by the quality of governance as an indicator of how capital (investment) friendly the political regime is (the notion is clarified further in the next section, but our primary concern is with the stability of the regime). Existing studies of FDI and private investment interactions either do not include governance variables or do not consider that governance may affect the relationship. Political uncertainty and poor governance (such as weak property rights, high corruption, or excessive regulation) have been found to discourage domestic private investment and FDI (Campos, Lien, & Pradhan, 1999; Mauro, 1995). This paper considers whether, in addition, the relationship between FDI and private investment is affected by the nature of the political regime. We characterize regimes with high (good) values of governance indicators as capital-friendly or favorable to investment, while regimes with low values of governance are capital-unfriendly or unfavorable to investment.

The paper is structured as follows. Section 2 outlines a theoretical link between political regime and the source of private investment that motivates our empirical analysis. Section 3 sets out our empirical specification and choice of variables. Section 4 presents the results of the analysis of the relationship between private investment and FDI under different governance indicators using dynamic panel methods with annual data for 46 low or middle income countries over 1996–2009. Section 5 provides conclusions and discusses implications for financing private investment.

2. POLITICAL REGIMES AND SOURCES OF INVESTMENT FINANCE

A private agent in a developing country who is considering undertaking an investment has open to them three principal means of financing. First, they can consider domestic financing, either borrowing on domestic markets or accessing funds from family or other informal sources. Second, they can seek a foreign partner and attract foreign direct investment (FDI); even if not a joint venture, much FDI is linked to domestic investors. Finally, they can seek to borrow abroad for foreign debt financing. Although we do not observe the individual decisions of investors, we can observe aggregate values of types of investment funding at a country level, and assess how they relate to total investment.

The nature of the political regime may influence the investor's choice of source of financing. Regimes that are stable, more market-oriented, and supportive of the private sector are likely to be more attractive to private investors; these will be termed "capital-friendly" regimes. A "capital-unfriendly" (or labor-friendly) regime is therefore one that is unstable and oriented against market liberalization; more strictly, unstable regimes have a distinct possibility that a government that is not capital-friendly may come to power (and forward-looking investors will consider this). The empirical analysis of how features of the political regime influence agent's preferences over the source of financing is motivated by the model of Dalmazzo and Marini (2000). Their aim is to provide a theoretical explanation for why, given the relatively high political risk and weak property rights that discourage investment, developing countries accumulate foreign debt to finance investment. To this end they develop a model that generates predictions on the relative importance of three different sources of investment financing – domestic capital self-financing (DSF), FDI financing, and foreign debt financing (FDF) – under political uncertainty. They derive results under a politically unstable regime, represented as a country where there is a positive probability of a populist (labor-friendly) government being in power after investment decisions are made. As we wish to suggest hypotheses regarding the importance of each source of financing under favorable and unfavorable regimes for investment, we also solve the model for politically stable regimes (i.e., where there is a "zero probability" of a populist government).

Dalmazzo and Marini (2000) consider a country with a representative worker (w) and capitalist (c) who produce an export good (y) and consume an imported good with a utility function $U(C_i) = C_i$, where consumption of the imported good (C) is distributed as the Nash-solution to a bargaining game with at least two players to determine each agent's share S_i (for $i = w, c$). A unit of y is traded for P units of the import so that aggregate consumption is $C = Py$. The capitalist can make an investment at cost $K > 0$, but requires the labor services of the worker (who retains some bargaining power over the surplus that the project generates) to generate y. As K could have been spent on consumption of imports the opportunity cost is C; a "social efficiency of capitalist technology" assumption implies that $C - K \geqslant 0$.

The domestic investor (capitalist) faces an exogenous probability $(1 - \rho)$ that a populist government (that favors labor, a type w government) comes into office when the investment has been made. This implies lower returns to the investor because, once in office, the populist government will increase worker's share of the surplus, C_w, to the maximum level. [1] This is a specific formulation to make a more general point that capital-unfriendly regimes will discourage investment because expected (share of) returns are lower. Entering into an agreement with a foreign investor or lender can provide some protection to domestic capitalists should a populist regime gain power if the foreign partner can impose sanctions when the government violates an international agreement. Although investors may not have the ability to impose sanctions, this is a way of representing their ability to exert pressure (such as the threat of withdrawal or the ability to elicit threats from their home government). [2]

The basic idea is that if the regime is capital-unfriendly or there is an expectation of such a regime in the future, domestic investment is discouraged unless investors can acquire a foreign partner. In our context, the interpretation is that FDI will be a relatively more important source of investment finance in regimes with poor governance, especially if this is in the form of political instability. First, at time $t = 0$, the decision of whether or not to invest the sunk cost K is taken. Then at time $t = 1$ political uncertainty is resolved with either a type c government (that favors the domestic capitalist) in office with probability ρ or a type w government that will exclude the capitalist from the division of the surplus with probability $(1 - \rho)$. Finally at $t = 2$ production takes place; trade occurs under a type c government or under a type w government that has not implemented actions to encourage sanctions.

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