



Foreign direct investment, economic freedom and economic growth: International evidence

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ABSTRACT

In this paper, we investigate the systemic link between economic freedom, foreign direct investment (FDI) and economic growth in a panel of 85 countries. Our empirical results, based on the generalized method-of-moment system estimator, reveal that FDI by itself has no direct (positive) effect on output growth. Instead, the effect of FDI is contingent on the level of economic freedom in the host countries. This means the countries promote greater freedom of economic activities gain significantly from the presence of multinational corporations (MNCs).

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1. Introduction

The effect of foreign direct investment (FDI) on growth has been debated extensively in the economic literature. The rising interest in this area of research also coincides with the shift in emphasis among policymakers towards attracting more FDI inflows in recent years. Since the early 1980s, many countries (including the developing ones) have lifted many of the restrictions imposed on foreign capital flows.¹ As a result, global FDI inflows rose sharply from \$57 billion in 1982 to \$1271 billion in 2000. In fact, over the past few decades the growth rate of world FDIs has exceeded the growth rates of both world trade and GDP (UNCTAD, 2001). The reason for the increased effort to attract more FDIs stems from the widespread belief that FDI has several positive effects, including productivity gains, transfers of new technology, the introduction of new processes, management techniques, and technical know-how in the local market, employee training, and international production networks.² Additionally, FDI is

not as volatile as other forms of capital (e.g., short-terms capital), and hence, is less destructive (World Bank, 1999).

Although the theoretical literature predicts that FDI inflows bring enormous benefits to the host country, empirical studies on the FDI–growth relationship have reported conflicting results (see Herzer et al., 2008). Some studies in this literature have found that FDI exerts a positive growth effect on the recipient countries (De Mello, 1999; Chong et al., 2010), while others have found no such evidence (Ericsson and Irandoust, 2001) or even a negative effect (Moran, 1998) on growth [see also the survey by Gorg and Greenaway (2004)]. In recent literature, the absorptive capacity of the host country appears to be the key explanatory variable for the weak (or conflicting) FDI–growth relationship.³ Specifically, the growth effect of FDI may not be strong in countries with low (or poor) absorptive capacity. In other words, host countries must have certain qualities that allow them to absorb the benefits linked to FDI flows. Apart from this important finding, several intervening factors that are important for FDI spillovers have also been identified in earlier literature, such as

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¹ According to UNCTAD (2002), 208 changes in FDI laws were made by 71 countries in 2001. Of these changes, 194 (93%) created a more favorable climate in an effort to attract more FDI. It is worth noting that FDI accounts for 60% of private capital flows (Alfaro et al., 2004).

² Domestic firms may benefit from MNCs presence via technology imitation (Wang and Blomstrom, 1992) or transfer of new knowledge through labor mobility (Fosfuri et al., 2001). MNCs may also benefit host countries by creating backward and forward linkages with domestic suppliers and customers of intermediate inputs produced by MNCs (Rodriguez-Clare, 1996).

³ Cohen and Levinthal (1990) defined absorptive capacity as a firm's "ability to recognize the value of new information, assimilate it, and apply it to commercial ends." This concept differs from learning-by-doing, which is the automatic process by which firms become more experienced, and hence, more efficient at current practices. In contrast, absorptive capacity firms may acquire new knowledge developed by others that will enable them to do something in different ways.

the quality of human capital, the development of financial markets, and trade policy.⁴

In an effort to further understand the nature of the FDI–growth nexus, this paper draws from recent literature that highlighted the importance of institutions in the growth process. In particular, our research emphasizes the importance of freedom of economic activities in mediating FDI spillovers to help answer these questions. Our argument is simply based on the fact that the lack of economic freedom can limit a firm's (or nation's) ability to absorb and internalize new technology from multinational corporations (MNCs) (i.e., foreign presence) and contribute to host country's economic growth. To date, the literature has emphasized the quality of institutions and economic freedom, but the focus has been primarily on the direct effect on economic growth. Hence, this is not the first article that examines the role of economic freedom in wealth creation.⁵

In this paper, we utilize the index of economic freedom (EF, hereafter) provided by the Fraser Institute to establish the potential link between EF and growth. The index is a measure of institutional quality that provides insight into the characteristics of an environment conducive to prosperity. A glance at the index components reveals several reasons to expect that countries with higher levels of EF will have greater absorptive capacity, and thus allow them to reap more benefits from FDI spillovers. First, there is broad agreement within the profession that, in general, less regulation would be good for economic progress. It is well known that a free and competitive market provides greater opportunities for entrepreneurs to try out new ideas. It also encourages firms to engage in risky ventures such as FDI-related activities, in search of higher returns for their investment. On the other hand, if the market is extensively regulated, it will not function well, and hence the allocation of resources would be adversely affected in such an environment. For example, if financial markets are extensively regulated, FDI-related activities will be affected as firms need external funds to finance the adoption of new technology (Alfaro et al., 2004).

Second, labor laws for hiring and firing of employees may also have implications for FDI spillovers. If the laws are very restrictive, managers and workers who were trained by MNCs with new technology or management techniques may find it difficult to join local firms. This may limit spillover effects through labor mobility as emphasized in Fosfuri et al. (2001). Third, the protection of property rights is another integral element of EF. Countries providing better property rights protection are expected to benefit more from MNCs presence because they can attract FDI of a higher technological content (Javorcik, 2004), and they also more likely to encourage MNCs to expand their research and development (R&D) activities locally (Nunnenkamp and Spatz, 2004). Finally, freedom of exchange across borders may help domestic firms to penetrate international markets for exporting purposes (Aitken et al., 1997). In short, there are strong reasons to believe that countries with higher levels of freedom have greater absorptive capacity and are therefore more likely to benefit from the MNCs' presence.⁶

⁴ Crespo and Fontoura (2007) provide an excellent survey of absorptive capacity literature.

⁵ Through investigation of the FDI flows in Asia, Quazi (2007) considers economic freedom (a proxy of domestic investment climate) apart from the traditional variables. The author highlights the importance of economic freedom in terms of attracting FDI. The author concludes that strategies should be formulated to promote long-term economic freedom in the developing countries. Such efforts will likely foster a healthy environment to court FDI, and also nurture the ingredients necessary for economic growth.

⁶ In related study, Adkins et al. (2002) find that the level of EF does not matter much in the early stage of economic development. In other words, EF at the beginning of the growth period does not sufficiently explain growth, but the positive change in EF. The experience of the Asian countries suggests that the cost of capital controls and restrictive trade policies that deter FDI can be high. As pointed out by Baharumshah and Thanoon (2006), the last type of capital control a country should adopt is the control of FDI flows.

In addition to examining a new aspect of absorptive capacity, this paper contributes to the present literature by applying panel estimation procedures. It departs from the existing studies by using the dynamic panel data technique. To the best of the authors' knowledge, all of the existing studies on absorptive capacity have relied mainly on the cross-sectional estimation technique.⁷ In this paper, we employ a more advanced dynamic panel econometric technique that formally addresses country-specific effects and simultaneity bias. The method relies on the generalized method-of-moment (GMM) estimator, which has a number of advantages over the cross-section estimator.

The remainder of the paper is structured as follows. Section 2 provides a brief review of the literature while Section 3 outlines the model specification. Section 4 explains the methodology. Section 5 highlights the data and empirical strategy. Section 6 reports the empirical results and their interpretation. Conclusions and summary are presented in Section 7.

2. Brief review of the literature

The provision of incentives (i.e., tax incentives and/or subsidies) and the adoption of FDI-stimulating policies stem from the expectation that FDI will bring tremendous benefits to the recipient countries. MNCs have been linked to superior technologies, patents, trade secrets, brand names, management techniques, and marketing strategies (Dunning, 1993). Besides that, MNCs are known to be among the most technologically advanced firms, as they are responsible for a large part of the world's R&D expenditures (Borensztein et al., 1998). They also hire a large number of technical and professional workers (Markusen, 1995). Through FDIs, the recipient countries are granted instant access to new technology that may benefit those receiving the foreign capital, and also other firms in the host country. To the extent that FDIs add to the existing capital stock, they may have growth effects similar to domestic investments, in addition to alleviating the balance-of-payment deficits. Besides labor augmentation, MNCs train managers and workers who may then later join local firms. FDIs (especially export-oriented FDIs) may promote export by setting up assembling plants and helping local firms to access international markets for exports (Aitken et al., 1997). Foreign capital may also create backward and forward linkages, and provide technical assistance to their local suppliers and customers (Rodriguez-Clare, 1996). The competitive pressure exerted by MNCs may also force local firms to operate efficiently and adopt new technologies earlier than what would otherwise have been the case (Blomstrom et al., 1994a).

A few scholars, however, cast doubt on the special merits of FDI inflows. They have highlighted the adverse socioeconomic impacts of economic freedom (i.e., investment freedom) that include linkages, asset bubbles, foreign dominance, economic instability, and massive inflows of foreign labors, among others. For instance, Krugman (2000) argues that foreign investors can take advantage of liquidity constrained domestic investors' fire sales of assets during financial crises. In this situation, foreign investors acquire local firms because of their superior cash position, and not because of technology advantage. Likewise, Hausmann and Fernández-Arias (2001) are doubtful about the benefits associated with FDI. They argue that a recent rise of FDI in Latin American countries is not a sign of good health, but instead a sign that local markets are not working properly. Domestic residents are selling their companies to foreigners because they do not have the markets and institutions that allow them to grow. Razin et al. (1999) in their article argue that foreign investors' asymmetric information

⁷ Existing cross-sectional studies are plagued by incorrect instruments of country-specific effects. The cross-specific effect representing technology and taste gives rise to omitted variable bias. Another econometric issue that is equally important is the existence of subset of regressors that are expected to be exogenous.

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