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Human Development and Foreign Direct Investment in Developing Countries: The Influence of FDI Policy and Corruption

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Summary. — While policymakers place great importance on foreign direct investment (FDI) in advancing development in developing countries, the links between FDI, economic development, and human development remain tenuous. We attempt to better understand these relationships by looking at the influence of FDI policy and corruption on these relationships. We find that FDI inflows are more strongly positively related to improvement in human development when FDI policy restricts foreign investors from entering some economic sectors and when it discriminates against foreign investors relative to domestic investors. The relationship between FDI and improvement in human development is also more strongly positive when corruption is low.

Key words — foreign direct investment, economic development, human development, developing countries

1. INTRODUCTION

In recent years, developing countries have increasingly relied on private capital as a source of funding. Since the early 1990s, private sources of funding have made up over 75% of their external capital flows. The major contributing group to this private capital has consistently been foreign direct investment (FDI), with its share going from less than 30% in the early 1990s to nearly two-thirds of the total by 1998 (UNCTAD, 2003). While there was a decrease in FDI in the first few years of the 21st century, 2004 started a new trend in accelerated growth, with 2007 having the highest level of FDI ever recorded (UNCTAD, 2008). Thus, it is important that we understand the effect FDI has on developing countries.

Policymakers strongly believe that FDI is an important element of economic development in developing countries. In the final report of the 2002 United Nations-hosted conference on development, the following was stated:

> Foreign direct investment contributes toward financing sustained economic growth over the long term. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity, enhance competitiveness and entrepreneurship, and ultimately eradicate poverty through economic growth and development (United Nations, 2002, p. 5).

Beginning in the mid-1980s, many countries in the world started on a path to liberalize their FDI policies, and from 1993 to 2003, 94% of the 1,718 regulatory changes made by countries around the world were favorable to FDI (UNCTAD, 2006). Developing countries, in particular, have created an environment that is increasingly more amenable to foreign investors (UNCTAD, 1999). Government policy changes have made it easier for foreign investors to enter more economic sectors and establish operations. Many restrictions on foreign equity participation and ownership have been removed. Screening and authorization of the establishment of foreign-owned enterprises have been replaced by simple registration in some sectors, and many performance requirements have been lifted in favor of incentives. But the belief that indiscriminate entry of FDI will improve a country's economic development continues to be questioned by the empirical evidence.

The conclusion reached after a vast number of empirical studies on the relationship between FDI and economic development is that we still do not understand the role of FDI in economic development. The relationships between FDI and factors that promote economic development, such as industry structure and performance (Agosin & Machado, 2005; Aitken & Harrison, 1999; Blomström & Kokko, 1996; Blomström, Lipsey, & Zejan, 1994; Blomström & Wolff, 1994; Haddad & Harrison, 1993; OECD, 2002; Smarzynska, 2002; UNCTAD, 2000), technological spillovers (Aitken & Harrison, 1999; Álvarez & Molero, 2005; Blomström, 1986; Blomström & Sjöholm, 1999; Borensztein, De Gregorio, & Lee, 1998; Bwayla, 2006; Haddad & Harrison, 1993; Konings, 2001; Lall, 1980; Smarzynska, 2002), and human capital development (Elmslie & Milberg, 1996; Feenstra & Hanson, 1997; Jessup, 1999; Kucera, 2002; Levinsohn, 1996; OECD, 2002; Oman, 1999; Slaughter, 2001), have been analyzed. In nearly all relationships, the results vary widely; some studies show a positive relationship, others a negative relationship, and still others show no relationship at all. Even with regard to the relationship between FDI and economic growth (Balasubramanyam, Salisu, & Sapsford, 1996; Borensztein *et al.*, 1998; Carkovic & Levine, 2005; JBIC, 2002; World Bank, 2002; Zhang, 2001), one that, some argue, should be the most unambiguous, the results are mixed. Furthermore, studies that do show a positive correlation between FDI and GNP still say nothing of causation (Caves, 1996).

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Several reasons have been suggested as to why we continue to receive such mixed results. Some argue that our empirical methods have been inadequate (Gorg & Strobl, 2001), which has provided an impetus in recent years for the use of more panel studies rather than the previously often used cross-sectional study. While panel studies have allowed us to control for time-invariant differences and have increased our understanding of temporal relationships, both of which are important in this research question, it has not eliminated the variance in results (Görg & Greenaway, 2004). Similarly, Lipsey and Sjöholm (2005) look at a host of studies that investigated wage and productivity spillovers and conclude that methodological differences do not determine variance. Others contend that this lack of consensus among the studies is due to the disregard of several factors that are essential for understanding the role of FDI in development, such as country characteristics and policies (Blomström & Kokko, 1996), which are not part of the model in the many studies that focused on a single industry in a single country. Additionally, the level of corruption can also influence the benefits that are accrued from FDI (Bitzenes, Tsitouras, & Vlschos, 2009; Blackburn & Sarmah, 2008). Blackburn and Sarmah (2008) found that corruption is negatively associated with FDI inflow and economic development. Country and industry differences are so important that Lipsey and Sjöholm (2005) suggest that maybe there are no universal relationships. An additional issue with the current research stream is that the focus has been on understanding the relationship between FDI and economic development, which, some argue, is an overly narrow view of development. The purpose of development, broadly speaking, is to enhance people's lives and to allow for individuals to achieve their legitimate aims in life (Rawls, 1971; Sen, 1999). It means that individuals must have access to those things that are required to achieve these aims, such as liberties, health, education, and economic means. While it is often assumed that economic growth leads to this broader notion of development, there is evidence to the contrary (Sen, 1999; Stiglitz, 2006). Infant mortality in Jamaica, for example, is nearly half that in Brazil, despite Jamaica's *per capita* income being nearly half of Brazil's. Life expectancy in Cuba is 77 years with a *per capita* income of $5,259, but only 49 years in South Africa, which has a *per capita* income of $12,650 (UNDP, 2004). Even in the current economic downturn, the United States shows signs of recovery when looking at economic factors such as GDP; yet, joblessness continues to increase and is forecasted to be high for some time. Thus, economic growth does not provide the full picture of human development; country characteristics and policies are also determinants of the level of human development.

We have seen many indications particularly since the strong push for free markets and trade liberalization in the 1990s that markets alone do not provide the full answer to development. Stiglitz (2006) argues that government plays a major role in determining the pace of human development and that development requires getting the right balance between markets and the government. Additionally, successful development requires that governments are motivated to work toward this end. Oftentimes, particularly in developing countries, the government does not have the interest of the people in mind.

In light of the critical role policymakers have given to FDI in advancing development in developing countries as well as the tenuous linkages between FDI and economic development and between economic development and human development, this study explores the interaction between FDI, FDI policy, level of corruption, and their effects on human development. We first discuss arguments for both positive and negative effects FDI might have on economic development. We then explore how FDI policy may affect this outcome. Finally, we look at the influence FDI policy has on the relationship between FDI and human development. We argue that FDI inward flows are more positively related to human development when FDI policy strategically controls foreign investment by limiting the economic sectors open to foreign investment or by discriminating against foreign investors in favor of domestic ones. Additionally, we argue that corruption reduces the positive effect of this relationship. We test our hypotheses by looking at a sample of 49 countries over a 26-year time period (1980–2005) using a panel study. We find that FDI inward flows are more strongly positively related to human development when FDI policies are such that they restrict foreign investment from entering some economic sectors and when they discriminate against foreign investors in favor of domestic ones. The relationship between FDI inward flows and human development is also more strongly positive when corruption is low. Finally, we discuss the implications of our findings for firms and policymakers.

2. THEORY

(a) *The role of FDI in economic development*

From a neo-classical economic perspective, FDI from developed countries is deemed an integral ingredient to the economic growth of underdeveloped countries, and economic development is best served when the state plays a limited role in controlling the market (Caves, 1996; Hymer, 1976; Kindleberger & Herrick, 1977; Todaro, 1989; Vernon, 1966). It is argued that developing countries benefit directly from FDI through an inflow of capital, tax revenues, and employment, and indirectly through spillover of the foreign investor's technology and knowledge to local enterprises and workers, and through access to foreign markets. Domestic suppliers, competitors, distributors, customers, and employees learn from their interaction with foreign investors, and their ability to compete globally is enhanced. It is also argued that the entry of competitive foreign enterprises takes the competitive structure of the industry to a new level. Local firms that survive in this increasingly competitive environment do so only by becoming more efficient and, thus, more competitive, raising the productivity of the local industry and, in turn, the economic growth rate of the developing country.

There is some evidence to support the position that FDI enhances the competitiveness of indigenous firms. The productivity of local Mexican firms, for example, was found to converge to the level of foreign enterprises that had located in Mexico (Blomström & Wolff, 1994). The labor productivity of Indonesian manufacturers was found to be higher among those that had some foreign equity (Blomström & Sjöholm, 1999). Smarzynska (2002) found that domestic suppliers in Lithuania benefited from the backward spillover that occurred from supplying foreign customers that had located in country. Similarly, Bwayla (2006) found that there were significant technology spillovers from foreign firms in upstream sectors to local firms in downstream sectors in manufacturing industries in Zambia. Hence, FDI can be an important vehicle for the transfer of technology to certain local firms and for increasing the overall competitiveness of the industry, which will have a positive effect on economic growth (Borensztein *et al.*, 1998).

On the other hand, FDI may crowd out local enterprises and actually be detrimental to economic development. Foreign