Journal of International Economics 84 (2011) 99–111

Contents lists available at ScienceDirect

Journal of International Economics

journal homepage: www.elsevier.com/locate/jie

Democracy, foreign direct investment and natural resources☆

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ARTICLE INFO

Article history:
Received 31 March 2010
Received in revised form 7 December 2010
Accepted 8 December 2010
Available online 17 December 2010

JEL classification:
F23
D72

Keywords:
Democracy
Foreign direct investment
Natural resources

ABSTRACT

Empirical studies that examine the impact of democracy on foreign direct investment (FDI) assume that the relationship between democracy and FDI is the same for resource exporting and non-resource exporting countries. This paper examines whether natural resources in host countries alter this relationship. We estimate a linear dynamic panel-data model using data from 112 developing countries over the period 1982–2007. We find that democracy promotes FDI if and only if the value of the share of minerals and oil in total exports is less than some critical value. We identify 90 countries where an expansion of democracy may enhance FDI and 22 countries where an increase in democratization may reduce FDI. We also find that the effect of democracy on FDI depends on the size and not the type of natural resources.

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1. Introduction

In the past two decades, there has been a significant shift in the attitude towards foreign direct investment (FDI) to developing countries. Specifically, the discussion among academics and policy-makers has shifted from *whether* FDI should be encouraged to *how* developing countries can attract FDI. Indeed many international development agencies, such as the World Bank, consider FDI as one of the most effective tools in the global fight against poverty, and therefore actively encourage poor countries to pursue policies that will enhance FDI flows.[2] However, many of the countries that want to attract FDI also have weak democracies or nondemocratic governments. It is therefore important to understand the effect of democratization on FDI. For example, if democracy deters FDI, then countries face a trade off — between increased democratization and attracting more FDI.

This paper answers three questions: (i) Does democracy facilitate FDI?; (ii) Do natural resources alter the relationship between FDI and democracy?; and (iii) Do foreign direct investors prefer less democracy when they operate in natural resource exporting countries? Answers to these questions cannot be discerned from theory because the theoretical impact of democracy on FDI is unclear.[3] On the one hand, democratic institutions may have a positive effect on FDI because democracy provides checks and balances on elected officials, and this in turn reduces arbitrary government intervention, lowers the risk of policy reversal and strengthens property right protection (North and Weingast, 1989; Li, 2009).[4] On the other hand, multinational corporations (MNCs) may prefer to invest in autocratic countries. One reason is that unlike a democracy, autocratic governments are not accountable to their electorates. As a consequence, autocratic governments may be in a better position to provide more generous incentive packages and also offer protection from labor unions (Li and Resnick, 2003). In addition, it is easier for MNCs to exploit their oligopolistic or monopolistic positions when they operate in autocratic countries (Li and Resnick, 2003). Thus, the overall effect of democracy on FDI has to be determined empirically.

☆ We thank the editor Bruce Blonigen and three anonymous referees for detailed and valuable suggestions. We also thank Christobel Asiedu, Luisa Blanco, Francis Owusu and Yi Jin for helpful comments, and Peng Chen, Komla Dzigbede, and Kwasi Nti-Addae for excellent research assistance.

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[2] For example, the key function of the World Bank's Multilateral Investment Guarantees Agency (MIGA) is to facilitate FDI to poor countries. Also, the United Nations millennium declaration stipulates that an increase in FDI to developing countries will result in a significant reduction in global poverty rates.

[3] See Li and Resnick (2003) and Jensen (2003) for a detailed discussion about the theoretical impact of democracy on FDI.

[4] Due to the irreversible nature of FDI, the risk of policy reversal (e.g., changes in tax laws, royalty fees, etc.), which may be considered as partial expropriation has a profound adverse impact on FDI (Asiedu et al., 2009). Li (2009) argues that democratic regimes are less likely to expropriate FDI than autocratic governments. He documents that between 1960 and 1990 there were 520 incidents of expropriation, and autocratic governments were responsible for about 80% of these incidents.

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doi:10.1016/j.jinteco.2010.12.001

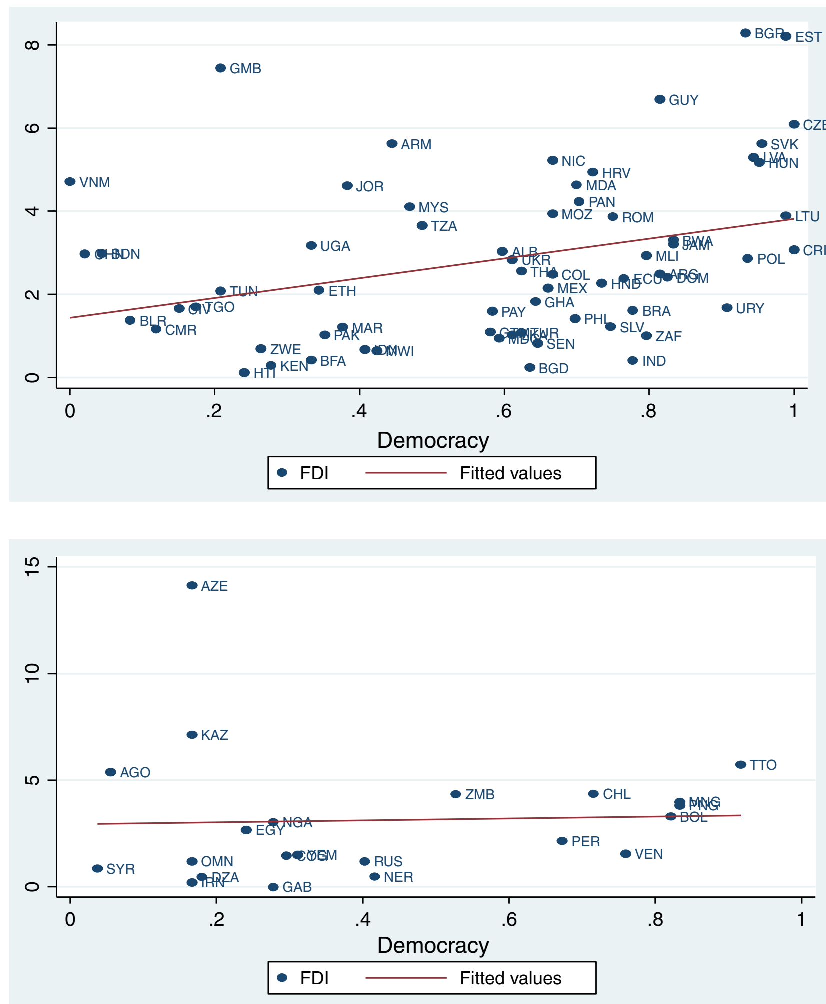

Fig. 1. FDI and freedom house measure of democracy (*free*). a: Non-natural resource exporting countries (Group 1). b: Natural resource exporting countries (Group 2). The data on FDI/GDP and democracy are averaged from 1982 to 2007. The democracy variable ranges from zero to 1, a higher number implies more democratic rights. Non-resource exporting countries (i.e. Group 1) consists of countries where the sum of minerals and oil in total merchandise exports, $\overline{nat}$, is less than 50%, and resource exporting countries (i.e., Group 2) consists of countries where $\overline{nat} \geq 50\%$. There are 65 countries in Group 1 and 22 countries in Group 2. Democracy seems to be positively correlated with FDI/GDP for non-resource exporting countries (a), but uncorrelated for natural resource exporting countries (b). The OLS regression of democracy on FDI for Group 1 countries yields, $\hat{y} = 1.43 + 2.38 \times dem$, with robust p-value = 0.021 and; and for Group 2 countries, $\hat{y} = 2.93 + 0.46 \times dem$, robust p-value = 0.842 and $R^2 = 0.002$. See Table A1 in the appendix for the list of countries.

Natural resources in host countries may affect the FDI-democracy relationship. We provide two plausible explanations. First, note that FDI in natural resource exporting countries tends to be concentrated in extractive industries. Furthermore, a stable policy environment is important to MNCs in general, but more so for MNCs in extractive industries because the exploration and extraction of minerals involve an initial large-scale capital intensive investment (i.e., sunk cost), a high degree of uncertainty and long gestation periods.[5] Thus, to the extent that longevity of government implies a more stable and predictable business environment, democratic regimes are less preferable because democracies are typically associated with a frequent change of government officials.[6] The second explanation is that FDI in extractive industries is mainly driven by access to natural resources in host countries, and natural resources are strategically, politically and financially important to host countries. As a consequence, FDI in natural resources is tightly controlled by the government.[7] Thus, here, having close ties with the government may imply gaining access to an invaluable production input. Clearly, such relationships are easier to foster under autocratic regimes.

[5] The relative importance of a stable policy environment for MNCs in the primary sector is noted in a survey conducted by the Economist Intelligence Unit (EIU) in 2007 (EIU, 2008). In the survey, MNCs in the primary sector indicated that "a stable and business-friendly environment" is the second (out of twelve) most important location criterion (the most important factor is access to natural resources). In contrast a stable policy environment ranked nine out of twelve for MNCs in manufacturing, and seven out of twelve for MNCs in the services sector. The two most important location factors for MNCs in services and manufacturing are the size of local markets and the growth of markets.

[6] The view that autocratic regimes provide a more stable business environment is consistent with the EIU survey results where about 62% of the respondents agreed with the statement that authoritarian regimes provide a more stable and predictable business environment.

[7] For example in Nigeria, the only sector that has restrictions on foreign equity ownership is the oil industry: 100% foreign ownership is allowed in all other sectors except for petroleum where foreign equity share is limited to 50%. See Asiedu and Esfahani (2001) for a discussion about the reasons why governments impose equity restrictions.

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