

THE RELATIONSHIP BETWEEN POLITICAL AND ECONOMIC OPENNESS AND FOREIGN DIRECT INVESTMENT

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ABSTRACT

In this paper, we discuss a model that shows the relationship between foreign direct investment and political and economic freedom. Empirical research shows the strong and positive relationship between economic liberalization and economic growth and development. Since foreign direct investment is necessary in most developing countries in order to create adequate levels of investment, an environment that promotes foreign direct investment is necessary. We show that the level of foreign direct investment is positively related to the degree of political and economic openness. That is, foreign direct investment is highest in countries with the most economic and political freedom.

INTRODUCTION

Empirical research indicates that there is a positive relationship between foreign direct investment and economic growth and development. Further, countries that have more open and transparent political and economic systems attract the most foreign direct investment. We test this hypothesis in this study by analyzing the relationship between foreign direct investment and the Index of Economic Freedom. *World Development Indicators 2001* defines foreign direct investment as the sum of “net investment to acquire a lasting management interest...in an enterprise operating in an economy other than that of the investor.” The Index of Economic Freedom is an index published by the Heritage Foundation that measures the degree of economic freedom in countries. Beach and O’Driscoll (2003) define economic freedom as “the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself.” Political openness (democracy) and economic openness (capitalism) lead to higher levels of foreign direct investment which in turn are related to higher levels of economic growth and development.

Foreign direct investment has become increasingly important for multinational corporations. The level of foreign direct investment by US multinational corporations outside of the United States and by non-US multinational corporations into the United States has increased. The need for political and financial/economic risk analysis has increased as well. Although some regions of the world have reduced barriers to foreign direct investment, other regions of the world have become increasingly hostile to foreign direct investment. Although country risk assessment services are available, these services provide general ratings rather than ratings specific to the actual project being considered by the multinational corporation.

Stoever (2002b) provides a model that is useful discussing the relationship between foreign direct investment and economic liberalization. Government attitudes toward liberalization may differ with respect to economic sectors, such as extractive industries, local consumption manufacturing, and export related manufacturing. The Stoever (2002b) model is developed in the context of developing or transition economies, nonetheless, developed economies may suffer from bad industrial policy deteriorate economically, too. Stage four of Porter's (1990) model of economic development is one of economic stagnation implying that economic development is not a monotonic process. Rostow (1971) argues that Argentina entered the take-off stage in the 1930's then regressed into economic chaos and decay. The Japanese economy has been stagnant since 1989. Although most foreign direct investment, in terms of total value, is into and between developed countries, developed countries need viable development models to promote foreign direct investment and economic growth.

Stoever (2002a) states that the stimulus for economic liberalization may result from any number of crises and may be a sudden shock to a gradual deterioration of the economic environment. Economic policy changes in reaction to a crisis may take the form of changes in the domestic environment or changes in the foreign direct investment environment. Reforms of the domestic competitive environment would include changing the level of competition, regulation, or government involvement in the economy. Reforms of the foreign direct investment environment would include changing the approval process, opening sectors of the economy to foreign direct investment, and relaxing the rules for foreign acquisitions. The impact of changes in economic policy on the foreign direct investment environment would affect different sectors of the economy such as the manufacturing, financial services, retailing, or the government sector. Economic policy changes may be economy wide or may only affect specific industries or sectors of the economy.

Multinational firms would be willing to make foreign direct investment in countries with a favorable economic policy environment, i.e., an open or transparent environment. Otherwise, multinational firms would restrict foreign direct investment to countries where the multinational firm could negotiate and enforce favorable contract terms for the specific project. A multinational firm would make foreign direct investments in a country that provides broad protections for all firms or protections for specific firms, specific sectors of the economy, or specific investments. Alternatively, if the overall economic environment is not favorable, the multinational corporation needs to negotiate a favorable one-time contract.

Stoever (2002a) discusses the mechanism by which specific economic liberalizations lead to foreign direct investment and economic development. As the host country government liberalizes the environment, multinational firms will be permitted increased latitude of activity. Economic liberalization leads to reduced restrictions on activities of the multinational corporation. These reduced restrictions lower the costs and risks to multinational corporations making foreign direct investment in the country. With lower costs and risk, the multinational corporation demands a lower rate of return that increases the benefits to the host country. A country developing economic policies for foreign direct investment needs to avoid inconsistency, to develop clear priorities, to evolve policies over time, to match the speed of deregulation with the rate of economic growth, to keep actions and statements consistent, to make reforms genuine, and to avoid excess political influence in the liberalization process.

Literature Review

Roll and Talbott (2001) evaluate the macroeconomic, structural, political, and institutional variables that affect real economic growth, as measured by GNI per capita using fourteen variables on have and impact on real economic growth. The authors find that property rights, black market activity, and government regulation have the highest level of statistical significance, the first with a positive sign and the other two with a negative sign. Other statistically significant variables with positive coefficients are civil liberties, political rights, press freedom, government expenditures and statistically significant variables with negative coefficients are regulation, inflation, and trade barriers. Roll and Talbott evaluate the impact of both positive and negative political liberalization and find that the former are followed by increases in real economic growth and the latter are followed by decreases in real economic growth. Roll and Talbott conclude that “countries can develop faster by enforcing strong property rights, fostering an independent judiciary, attacking corruption, dismantling burdensome regulation, allowing press freedom, and protecting political rights and civil liberties.”

Roll and Talbott use the Index of Economic Freedom and nine sub-indices published by the Heritage Foundation. The gross national income data are taken from *World Development Indicators* that is published by the World Bank and from Maddison (2001). Political events are determined from the *CIA Factbook*. The authors argue that differences in GNI per capita are not the result of exogenous historical or geographic variables, which cannot be effected, anyway. They seek explanatory variables that can be manipulated by governments. They use fourteen variables of which ten are sub-indices of the Index of Economic Freedom, income per capita, and political events in their analysis.

Roll and Talbott (2001) find that nine of the explanatory variables are statistically significant and explain 80-85 percent of the variance in each of the five years studied. The authors categorize the variable into three groups. The three variables that have the highest level of statistical significance are measures of economic freedom: property rights, black market activity, and government regulation. The second group of variables consists of measures of political freedom: political rights, civil liberties, and freedom of the press. The variables in the third group are: monetary policy or inflation, trade barriers and government expenditures as a percent of GDP.

Bekaert, Harvey, and Lundblad (2001) analyze the relationship between real economic growth and financial liberalization for twenty emerging markets over the period from 1980 to 1997. The authors find that liberalization of an emerging market leads to an increase of real economic growth of from one to two percent annually, with the increase in real economic growth being higher in countries with a more educated populace. They control for the effects of macro-economic influences, of banking system development, and of equity market development. The macro-economic variables used are government consumption as a percent of GDP, the trade divided by GDP, the annual rate of inflation, and a measure of human capital – secondary school enrollment. As proxies for equity market development, they use the size of the equity market, the number of domestic firms listed on the stock market, and market turnover.

Bekaert, Harvey, and Lumsdaine (2002) estimate actual liberalization dates for twenty countries using economic metric analysis rather than announced

liberalization dates. The authors find that emerging equity market liberalization leads to larger and more liquid markets and that stock returns become more volatile but more correlated with world markets. This increase in market integration leads to a lower cost of capital, an improved credit rating, real exchange rate appreciation, and an increase in real economic growth. Similar effects are not found in developed markets. The authors find empirical breaks that do not correspond with actual liberalization dates, which could reflect the announced date of liberalization, the announcement of the first ADR, or the date the first country fund is issued. Empirical liberalization effect dates generally occur after the official dates. "Allowing foreign investment does not appear to be sufficient to bring about market integration. Foreigners still have to be willing to invest."

Bekaert, Harvey, and Lumsdaine (2002) find three patterns of market liberalization. One pattern reflects a gradual liberalization over a long period of time. This pattern reflects a number of mini-liberalizations that lead to a steady and growing liberalization effect. A second pattern reflects a single large liberalization effect. This pattern results from a single, liberalization event. A third pattern, reflected in the majority of countries, show two liberalization effects. This first effect reflects the announcement of liberalization and the second effect reflects the onset of actual liberalization. Thus, it appears that the process of financial system liberalization is complex.

Although the general finding of reported research finds a positive effect between financial system development and economic growth, not all of the research is consistent. Demetriades and Hussein (1996) find that relationship between financial system development and real GDP to be complex. For some countries, there is a bi-directional relationship between financial system development and economic growth, and for some countries there is a reverse causality between financial system development and economic growth. A number of studies find a positive relationship between deregulation and real income per capita and output growth, such as Jayaratne and Strahan (1996). Demirgud-Kunt and Maksimovic (1998) find that an active stock market and a well developed legal system lead to externally financed firm growth. Ryoo and Smith (2002) report that as the Korean stock market was liberalized from 1988 to 1998 by reducing daily price limits that proportion of stocks following a random walk increased and Barry and Peavy (1997) find that the group of investable stock indices listed in the IFC Emerging Markets database outperformed the group of restricted stocks indices. Savvides (1995) finds that growth in GDP is affected by the initial conditions in the country, investment, population growth, trade orientation, inflation, financial system development, growth of the political sector, and the degree of economic freedom.

Beck, Levine, and Loayza (2000) find that financial intermediaries positively affect total factor productivity growth, economic growth, and capital growth. Wurgler (2000) finds that a developed financial sector improves capital allocation by moving capital to high growth industries and away from low growth industries. The effect is positively correlated to the amount of available firm-specific information and the legal protection of minority investors and negatively related to government ownership within the economy. Nourzad (2002) finds that financial system development leads to increased productive efficiency. Fischer and Sahay (2000) find that the best performing of the former Communist bloc countries were those most committed to reform. Henry (2000a) and Henry (2000b) report that stock market

liberalizations lead to stock market increases that reduce the cost of capital within the liberalizing country.

The relationship between political and economic freedom is supported by most published literature even if there is less consensus on the exact mechanism by which growth is related to political and economic freedom. Choice allows capital to flow within the system to the firms and industries with the highest expected rates of return that leads to the highest growth rate. This process leads to higher growth in income and wealth.

Economic Growth, Savings, Investment, and Foreign Direct Investment

Growth in real GNI per capita requires that the total available capital in the economy grow to accommodate both the increase in population and the increase in output needed to increase real GNI for the new population. In low-income economies, even with high rates of savings, the total amount of funds available for investment is inadequate. Therefore, external sources of investment funds must be found. Public sources of investment funds are too small to meet the requirements of all developing countries, so, private sources of investment funds are needed, that is, foreign direct investment by multinational corporations.

Todaro and Smith (2003) show that, in order to meet the total investment needs of the economy, total savings must equal total investment. Total savings, **S**, is equal to the savings rate, **s**, times GNI, **Y**, that is **S=sY**. Net investment, **I**, is equal to the change in the total capital stock, **ΔK**, after accounting for increases in the total population and increases in the capital requirement per worker. The capital to output ratio, **k**, is the total capital stock, **K**, divided by GNI, that is, **I=ΔK=kΔY**. The change in the capital stock divided by the change in GNI equal the capital to output ratio. Alternatively, the change in total capital equals the capital to output ratio times the change in GNI. Total savings must equal total investment. In summary, since total investment must equal total savings,

$$\mathbf{S = sY = k\Delta Y = \Delta K = I} \tag{1}$$

Since,

$$\mathbf{sY=k\Delta Y} \tag{2}$$

then,

$$\mathbf{\Delta Y/Y=s/k} \tag{3}$$

and,

$$\mathbf{(S/Y)/(K/Y)=(\Delta S/\Delta Y)/(\Delta K/\Delta Y)=(\Delta S)/(\Delta K)} \tag{4}$$

The ratio of total savings to GNI divided by the total capital stock equals the ratio of the change in savings divided by the change in GNI divided by the change in total capital divided by the change in GNI. The change in savings divided by the change in investment implies that increases in GNI require increases in investment and the increase in investment must be equal to the increases in savings, assuming that the capital to output ratio is constant.

To generate a ten percent increase in GNI with an existing capital stock of \$1000, the savings increase must be \$100.

$$\mathbf{\Delta Y/Y=(\Delta S)/(\Delta K)=(100/1000)} \tag{5}$$

If \$50 is available from domestic savings, the remaining \$50 must be derived from foreign direct investment.

The Independent Variables

An overall measure can be used to measure the overall level of openness and transparency. The Index of Economic Freedom is one such measure, but others exist – such as the index published by Transparency International. The advantage of the Index of Economic Freedom is that the data are available through the internet. The ten components of the Index of Economic Freedom are trade policy, fiscal burden of the government, government intervention in the economy, monetary policy, capital flows and foreign investment, banking and finance, wages and prices, property rights, regulation, and black market activity. Countries are graded on each of the ten components from free (1) to repressed (5). The overall index is an equally weighted average of the ten components

The Index of Economic Freedom is a broad based measure of economic openness published by the Heritage Foundation. Economic freedom is defined as “the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for the citizens to protect and maintain liberty itself.” The index of economic freedom is an equally weighted index of the ten factors evaluated. Countries are rated on each of the ten factors from one to five with one being most free and five being most restrictive. The overall score is an equally weighted average of the ten factors. Countries with scores from one to two are free. Countries with scores from four to five are economically restrictive.

Factor one relates to trade policy. Three variables are used to compute the trade policy factor: the average tariff rate, non-tariff barriers, and corruption in the customs service. Factor two is the Fiscal Burden of the Government. Four variables are used to compute the fiscal burden of the government factor: the top income tax rate, the average tax rate, the top corporate tax rate, and government expenditures. The third factor measures government economic intervention. Four variables are used to compute the government intervention factor: government consumption as a percent of the economy, government ownership of business and industries, share of government revenues from state-owned enterprises and government ownership of property, and economic output produced by the government. Factor four measures monetary policy and is measured by the ten year average inflation rate. Factor five measures capital flows and foreign investment. Seven variables are used to measure restrictions on capital flows and foreign direct investment: foreign direct investment code, restrictions on foreign ownership of business, restrictions on the industries and companies open to foreign investors, restrictions and performance requirements on foreign companies, foreign ownership of land, equal treatment under the law for both foreign and domestic companies, restrictions on the repatriation of earnings, and availability of local financing for foreign companies.

Factor six measures the openness of the banking and finance sector. Five variables are used to measure banking and finance sector openness: government ownership of banks, restrictions on the ability of foreign banks to open branches and subsidiaries, government influence over the allocation of credit, government regulations, and freedom to offer all types of financial services, securities, and insurance policies. Factor seven measures wages and prices using five variables: minimum wage laws, freedom to set prices privately without government influence, government price controls, the extent to which the government uses price controls, and government subsidies to businesses that affect prices. Factor eight relates to

property rights and is measured with seven variables: freedom from government influence over the judicial system, the commercial coded defining contracts, sanctioning of foreign arbitration of contract disputes, government expropriation of property, corruption within the judiciary, delays in receiving judicial decisions, and legally granted and protected private property. Factor nine relates to government regulation and is measured by six variables: the licensing requirements to operate a business, the ease of obtaining a business license, corruption within the bureaucracy, labor regulations, environmental regulations, consumer safety, and worker health regulations, and other regulations that impose a burden on business. Factor ten is based on the black market and is measured by seven variables: smuggling, piracy of intellectual property in the black market, agricultural production supplied on the black market, manufacturing production supplied on the black market, services supplied on the black market, transportation supplied on the black market, and labor supplied on the black market.

Countries are rated on each of the ten factors from one to five with one being most free and five being most restrictive. Countries with ratings below 1.95 are considered to be free. Countries with ratings from 2.00 to 2.95 are considered mostly free. Countries with ratings from 3.00 to 3.95 are considered to be mostly unfree. Countries with ratings of 4.00 or higher are considered to be repressed. The overall score is an equally weighted average of the ten factors. The overall score is used as one of the discriminant variables in our study.

We collect data for the five-year period from 1997 to 2001 for foreign direct investment and the index of economic freedom. The foreign direct investment data are from *World Development Indicators 2001*, published by the World Bank and the index of economic freedom is from the Heritage Foundation. Both data sets can be down loaded from the appropriate web sites.

Empirical Results

Table 1 shows the summary statistics for the data. For foreign direct investment, the sample size ranges from 142 to 150 countries. For the index of economic, the sample size ranges from 142 to 155 countries. The average of the natural logarithm of foreign direct investment ranges from a low of 5.80 in 1997 to a high of 5.97 in 2001 with a standard deviation that ranges from 2.39 to 2.62. The maximum is 12.61 and the minimum is 0.00. The average index of economic freedom ranges from 3.06 to 3.13, which is not surprising, given the method of computing the index. The standard deviation ranges from 0.75 to 0.78.

Table 2 shows the correlation coefficients for the data. Both the index of economic freedom and the foreign direct investment year to year numbers are very highly correlated and mostly in the range of 0.90 to 0.95. The index of economic freedom correlation with foreign direct investment ranges from -0.50 to -0.60. Note that the index of economic freedom is higher for countries with less freedom and lower for countries with more freedom. Thus, the negative correlation between the foreign direct investment and the index of economic freedom indicates that more foreign direct investment is associated with a lower value for the Index of Economic Freedom. For the Index of Economic Freedom, a country with a low value, one, has a higher degree of economic freedom than a country with a high index value such as five.

Table 3 shows the results of the regressions for each year between the natural logarithm of foreign direct investment and the index of economic freedom

which is used as the independent value. For each of the five years, the regression coefficient is of the correct sign and statistically significant at the 0.00 percent level. The smallest t-statistic is -7.09 . The average, adjusted R^2 is 0.32, indicating that about one third of the variation in foreign direct investment is explained by the index of economic freedom.

Table 1
Summary Statistics
Index of Economic Freedom and Natural Logarithm of Foreign Direct Investment

FDI Inflows	FDI 97	FDI 98	FDI 99	FDI 00	FDI 01
Average	5.80	5.88	6.04	6.14	5.97
Standard Deviation	2.41	2.32	2.41	2.43	2.37
Maximum	11.55	12.07	12.55	12.61	11.73
Minimum	0.00	1.10	0.00	1.10	0.00
Range	11.55	10.97	12.55	11.52	11.73
Count	145	150	143	142	146

IEF	IEF 97	IEF 98	IEF 99	IEF 00	IEF 01
Average	3.06	3.10	3.13	3.12	3.11
Standard Deviation	0.77	0.75	0.78	0.78	0.78
Maximum	5.00	5.00	5.00	5.00	5.00
Minimum	1.30	1.40	1.30	1.30	1.30
Range	3.70	3.60	3.70	3.70	3.70
Count	151	142	150	155	155

FDI – foreign direct investment

IEF – Index of Economic Freedom

The reported numbers for FDI are natural logarithms.

The reported numbers for the IEF are the index values. A value of five indicates a total lack of economic freedom while a value of one indicates the country with the maximum of economic

Table 2
Correlation Matrix
Index of Economic Freedom and Natural Logarithm of Foreign Direct Investment

	FDI97	FDI98	FDI99	FDI00	FDI01
FDI97	1.000				
FDI98	0.938	1.000			
FDI99	0.936	0.946	1.000		
FDI00	0.905	0.928	0.959	1.000	
FDI01	0.887	0.901	0.929	0.945	1.000

	IEF97	IEF98	IEF99	IEF00	IEF01
IEF97	1.000				
IEF98	0.984	1.000			
IEF99	0.976	0.989	1.000		
IEF00	0.966	0.976	0.987	1.000	
IEF01	0.942	0.948	0.965	0.965	1.000

	FDI97	FDI98	FDI99	FDI00	FDI01
IEF97	-0.527	-0.539	-0.546	-0.581	-0.572
IEF98	-0.559	-0.557	-0.556	-0.596	-0.573
IEF99	-0.563	-0.562	-0.564	-0.605	-0.580
IEF00	-0.546	-0.558	-0.560	-0.596	-0.582
IEF01	-0.514	-0.542	-0.552	-0.580	-0.578

All of the correlation coefficients (Pearson) are statistically significant at the 1% level (two-tailed test).

*FDI – natural logarithm of foreign direct investment

IEF – Index of Economic Freedom

Table 3
Regression Results
Index of Economic Freedom and Natural Logarithm of Foreign Direct Investment

Year	1997	1998	1999	2000	2001	
Constant		11.15	11.15	11.67	12.07	11.67
T-statistic	14.81	16.78	16.36	17.40	16.70	
Regression						
Coefficient (IEF)	-1.70	-1.67	-1.84	-1.95	-1.89	
T-statistic	-7.09	-8.02	-8.12	-8.79	-8.37	
Adjusted R2	0.27	0.31	0.31	0.35	0.33	
F-ratio		50.26	64.36	65.92	77.33	70.12
Significance	0.00	0.00	0.00	0.00	0.00	

FDI – foreign direct investment

IEF – Index of Economic Freedom

The reported numbers for FDI are natural logarithms.

The reported numbers for the IEF are the index values.

SUMMARY AND CONCLUSIONS

Using linear regression, we show that there is a statistically significant relationship between the level of foreign direct investment for countries and the Index of Economic Freedom. These regression results are consistent with previous literature that finds a relationship between various types of political and economic liberalization and numerous measures of economic growth and development. We show the link between economic openness and foreign direct investment. Countries that have higher levels of political and economic openness attract higher levels of foreign direct investment. For most developing economies, foreign direct investment is necessary to fill the gap between domestic savings and the level of investment needed to foster economic growth in real GNI per capita.

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