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Economic freedom and foreign direct investment in South Asian countries

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Abstract. *The risk related to any overseas investment is polygonal which reflects numerous features that are appropriate for investor, such as rule of law, transparency, governance, level of international trade, business and financial conditions etc. All such components combine to form domestic investment climate of an economy, which influence the inflows of foreign capital in a country. This study analyzed the role of domestic investment climate (measured by Heritage Foundation economic freedom index) along with other macroeconomic variables in attracting FDI in South Asia covering 20 years from 1995 to 2014 by applying panel data techniques. Results revealed that overall economic freedom is an important determinant of FDI. Disaggregated analysis of economic freedom suggests that only fiscal and trade freedom has statistically significant influence on FDI. Therefore, Study recommends south Asian Nations to improve domestic investment environment to attract more foreign capital.*

Keywords: economic freedom, foreign direct investment.

JEL Classification: O170, F210.

1. Introduction

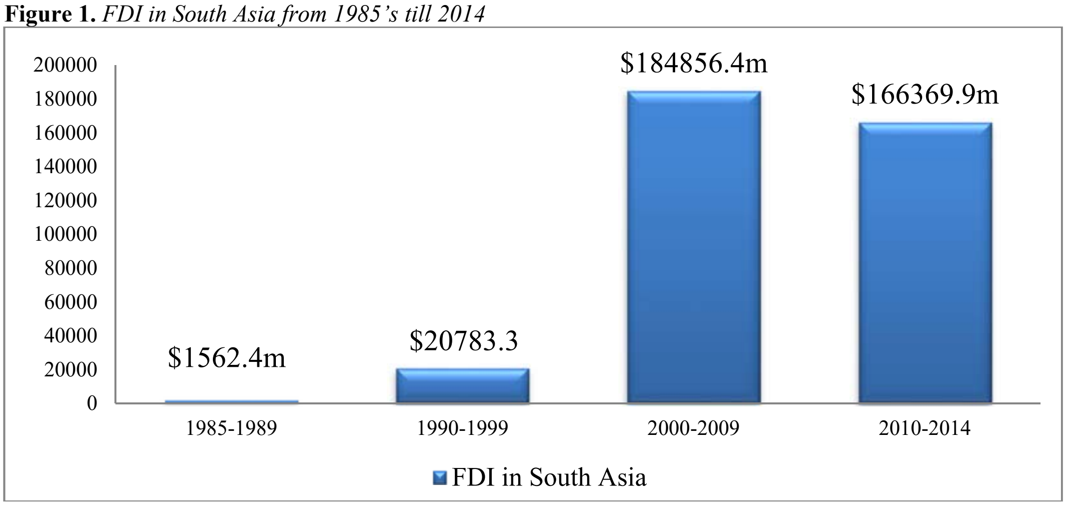
Foreign direct investment has been recognized as one of the key source of financing long term sustainable economic progression in developing countries. FDI plays a critical role in the development of recipient countries by helping nations to improve their economic performance, through Technological development, capital accumulation, improving resource allocation and strengthening financial capital. Considering the benefits derived from FDI, firms usually have different motives behind attaining FDI which are described by Dunning (1997) OLI Model (ownership-specific factors, location-specific factors and internalization advantages). It is also observed that along with macroeconomic determinants other factors like institutions of the host country also play important role in attracting foreign direct investment. A well-developed institutional framework also comprising better investment climate, allows firms greater discretion in the choice of their strategies. Market-supporting and investment friendly institutional environment facilitates foreign investors by reducing unnecessary hurdles in business operations and maintaining such activities in host countries. Macro-level institutions in a nation influence transactions costs within that economy. Empirical findings suggested that strong institutions of a country will make it an attractive destination for FDI for three reasons. First, it decreases transaction costs (Bevan and Estrin, 2004) secondly, a well-developed institutional framework allows firms greater discretion in the choice of their strategies (Delios and Beamish, 1999). Finally, it will reduce risks related with transactions by decreasing information asymmetries (Tong et al., 2008).

Domestic investment environment of a country can be captured by “Economic Freedom” prevailing in a nation. Freedom implies no restriction, pressure or obligation in choice or exchange or transfer of personal assets which have achieved legally. Gwartney (2009) proposed that main constituents to Economic Freedom comprise protection of individual as well as property, freedom to compete, and voluntary exchange. In an economically free society, individuals are free to work, produce, consume and invest in any way they please and government permits free movement of labor, capital and goods. Economic Freedom is a composite measure of different aspect of domestic investment climate including freedom in selection and supplying resources, competition in business activities and freely trade with others. According to Heritage Foundation Index, economic freedom is the amalgamation of ten subcomponents namely property right freedom, freedom from corruption, labor freedom, fiscal freedom, business freedom, monetary freedom, trade freedom, government spending, investment freedom and financial freedom. Hence, Economic freedom provides better investment climate which is very important for the foreign firms. MNCs while allocating resources mainly consider the environment provided by host country for investment because it will affects the decision of allocation. Nations having improved environment for investment are able to attract more MNCs as it is easy for them to work in investment friendly climate. The importance of domestic environment in attracting foreign capital motivates us to analyze this relationship along with other influential aspects of FDI in five South Asian economies, Pakistan, Bangladesh, India, Nepal and Sri Lanka, over a 20-year time frame from 1995 to 2014.

2. Trend analysis of FDI in South Asian economies from 1985-2014

Flow of foreign investment to the developing economies of South Asia is raised substantially since 1980's with some fluctuations. Data highlighted that in 1985's foreign investment to South Asian nations was low while 1990s there is a gradual rise due to liberalized policies adopted by the nations. Figure 1 reveals that FDI has increased substantially in 2000s and extended up to $184856.4 million. According to UNCTAD (2011) huge decline has been noticed after 2008 global financial crisis.

Figure 1. *FDI in South Asia from 1985's till 2014*



Source: Index Mundi (2016).

The bifurcation of FDI in the region is shown in Table 1. It is noted that India has kept up higher FDI in the region throughout the period trailed by Pakistan. Similarly Indian economy was able to attain highest inflows of FDI till 2014. India is one among the emerging economies of the world which is also providing better investment climate to foreign firms. In South Asia, India is the dominant recipient of inflows in automotive industry and during 2013-2014; Indian was able to get 12 projects larger than $100 million. According to the World Investment Report (2015) India has jumped to the ninth rank in 2014 with a 22% rise in the FDI inflows where it was in the fifteenth position in the previous two years. For Nepal, volume of FDI remains negligible over three decades. During 1985-1989, flows on foreign capital were minimal or even negative in Nepal, with an average of $4.31 million. However, there was a distinct acceleration during the 1990s, although total amount of flows remained insignificant during 1990-2000. Nepal does not work well in attracting foreign investment as compared with the rest of developing economies of South Asia. Increase in FDI may be attributed by the experts as a result of investment boom. Moreover, FDI incorporates the economic strategies which interns enhance efficiency of capital and labor.

Table 1. *Bifurcation of FDI in South Asia*

Country	1985-1989 (million dollars)	1990-1999 (million dollars)	2000-2009 (million dollars)	2010-2014 (million dollars)
Bangladesh	7.727	558.073m	5226.208m	8484.125m
India	779.49	15060.64m	156290.2m	149915.7m
Nepal	4.31	79.352m	83.087m	353.835m
Pakistan	763.588	5008.599m	23006m	7318m
Sri Lanka	7.373	76.639m	250.951m	298.322m

India was able to acquire 30% share of FDI inflows in 2000-2013 in south Asian Countries. According to a survey report of UNCTAD, during 2010-2012 it has been noticed that the second most important FDI destination after China was India for MNCs. There has been a tremendous up surge in the economic development of the country. However, the sectors in which inflows of foreign investment were increased included: services, construction activities, telecommunication, computer software and hardware industry while the UK, US, Singapore and Mauritius were among the leading sources of foreign investment flows. Moreover, Pakistan captured 27% of the total foreign capital followed by Sri Lanka (24%) and Bangladesh (15%) during 2000-2013. In South Asian economies Nepal, being a least developed nation, has equipped for drawing the least amount of inflows (4%). In the underlying years of its liberalization, Nepal's share was very insignificant and minute.

3. Literature review

Existing Foreign direct literature is fundamentally aimed to explore different determinants of FDI and their impact on the economy. Economic environment of a nation is an important factor in stimulating FDI. It is the product of interaction among a number of normative, regulative and cultural cognitive institutional components. North (1991) defines institutions as "perceived confinements that structure financial and socio political cooperation". They include both informal aspects (culture and traditions) and formal aspects (laws and regulations). On the bases of North's work institutional economists argue that "the policy and institutional environment is an essential factor of economic growth because sound institutions inspire productive actions and depress predatory behavior" (Gwartney, 2009). As indicated by this perspective, availability as well as productivity of resources is influenced by the quality of an economy's institutions. There has been a significant surge in empirical and theoretical work in the recent years, using the institutional approach in international business research. Khanna and Palepu (2000) have claimed that the absence of developed institutions make unrelated diversification an attractive strategy in developing economies. It has also been noted that in institutionally distant nations, subsidiaries have enhanced survival chances but there should be more ownership of foreign firms (Gaur and Lu, 2007). In this regard, transparency in financial approaches is a fundamental issue for foreign investors. If financial environment is not in favor of foreign investors, it can impose additional expenses on firms which give negative impression about nations.

Many researchers used Economic freedom to capture the institutional environment prevailing in the nation. Gwartney et al. (1996) stated that: “individuals have economic freedom when (a) the property attain is without the use of theft, fraud or force and protected from physical invasions by others and (b) they are free to exchange, use or give away their property as long as their activities do not violate the identical rights of others.” It is described by Heritage Foundation Index as “the absence of government constraint or coercion on the production, distribution, consumption of goods and services beyond the extent necessary for citizens to protect liberty”. So, economic freedom reflects investment climate prevailing in domestic economy which helpful in efficient allocation of resources.

Economic freedom is taken as an indicator of the domestic investment climate in the literature. For instance, Quazi (2007) revealed that lucrative investment climate prevailed in East Asian countries attracted significant foreign investment. Furthermore, large market size, higher return on capital and greater information about the location where investment will be allocated will improve the flow of foreign capital. Similarly, Zghidi et al. (2016) empirical analysis found economic freedom is an important element for economic progression. In this regard market-supporting and investment friendly institutional environment also facilitates foreign investors by reducing unnecessary hurdles in business operations and maintaining such activities in host countries (Wei, 2000). Foreign entrants are likely to maximize profits and eliminate transaction costs in the presence of well-functioning regulatory frameworks and market supporting policies (Hoskisson et al., 2000). However, an efficient and favorable market-supporting institutional regime lessens investment related costs of foreign investors in uncertain business environments and does not hinder access to essential organizational capabilities.

Foreman (2007) illustrated that changing certain components of economic freedom like reducing government intervention, increasing property rights protections and lowering barriers to capital flows are likely to raise FDI. Similarly, Bengoa and Robles (2003) illustrated that economic freedom in the host nation has a positive impact on FDI while Nasir and Hassan (2011) explored the association among economic freedom, market size and FDI in South Asian countries from 1995-2008 and found that the association between market size and FDI is significant which is quite reasonable because markets which are large have more potential for attracting foreign direct investment.

Aggregate impact of economic freedom can be different from its subcomponents effect. The property rights protection in terms of reducing government intervention and efficient enforcement of contracts is considered to be an essential institutional determinant of FDI (Cotton and Ramachandran, 2001; Fabro and Aixala, 2012). Foreign investors are keen in the appropriate enforcement of lawful contracts to guarantee continuous business transactions. Secondly, corruption can drastically influence the effectiveness of FDI. It arises from the misuse of discretionary authority, endorsed or unchecked by weak legal frameworks in host nations. The presence of corruption is widely believed to influence business activities through raising the operating charges of foreign investors (Jain, 2001; Mudambi et al., 2013; Ajide and Eregha, 2014). Dima (2008) showed that overall a higher level of the components of economic freedoms (mainly security of property rights) tends to be associated with a better capacity of the host countries to attract FDI.

Similarly, Beheshtitabar and Irgaliyev (2008) explored that only investment freedom and trade freedom have significantly positive impact in receiving FDI. Which indicates that reducing trade barriers (both tariff and non-tariff barriers) and improving environment for investment are positive indicators for FDI. While, Hassan (2015) found that the countries with lower tax burden, corruption-free operating environment and business friendly regulation impose a positive influence on international relocation decision of the investors. Similarly government size being one of the subcomponents of economic freedom is negatively associated with FDI. Bellos and Subasat, (2012) implies that FDI is encouraged by a decline in government size. However business regulations that ease operations can be significant influencing aspect of FDI. Another aspect of economic freedom is effective liberalization in the services sector. The impact of openness to trade was examined by Kandiero and Chitiga (2014). Increasing openness in the whole economy while reducing tariff and nontariff barriers such as licensing will enhance FDI inflows in a country. The greater imposition of direct as well as indirect taxes raises the transaction costs of establishing and maintaining businesses in foreign nations (De Mooij and Ederveen, 2003). Similarly, on the effects of corporate income taxation, most EU based studies find a negative association of higher tax rates on FDI. Like, Bellak and Leibrecht (2009) revealed negative relationship with corporate taxation on FDI.

Where, Sambharya and Rasheed (2015) indicated that better economic management (monetary policy, fiscal burden and banking and finance), less government participation in the economy in terms of government size and absence of wage and price control leads to higher FDI. Julio et al. (2013) found that reducing corruption, lessening restrictions on investment, higher protection of private property, the independence of the financial system and labor freedom will enhance FDI streams. So, better level of economic freedom not only attains greater amount of foreign capital but also permits host nations to take full advantage from foreign investments. The literature highlights the fact that with regard to the role of economic freedom in determining FDI, previously few studies were conducted on South Asia. However, along with other determinants of foreign direct investment, this study will going to investigate the role of economic freedom and it’s subcomponents in determining FDI in the South Asian region.

4. Data and methodology

By implying panel regression method this study empirically explores the role of economic freedom in attracting FDI in selected South Asian countries during 1995-2014.To analyzed the heterogeneity among the panel data researcher can either apply fixed or random effect model. Fixed effect determine whether intercept varies across time or across group while random effect check differences in error variance over period of time or across group. Hausman specification test (Hausman, 1978) equates whether a random effect model is applicable or fixed effect. Its null hypothesis is that the individual effects are not correlated with the other regressors, when this null it is rejected; a fixed effect model is favored over its random effect model. This study assumes a positive association between Economic Freedom and FDI stocks.

The econometric model specification is as follows:

$$(FDI)_{it} = \beta_{0i} + \beta_1 (EF)_{it} + \beta_2 (MS)_{it} + \beta_3 (HC)_{it} + \beta_4 (TRA)_{it} + \\ + \beta_5 (QOI)_{it} + \beta_6 (NR)_{it} + \varepsilon_{it}$$

In above model, FDI stock is dependent variable of country i at time t , while independent variables are Economic freedom (EF), Market size (MS), Human capital(HC), Trade (TRA), Quality of infrastructure (QOI) and Natural resource (NR).Current study used Heritage Foundation Economic freedom Index which ranges from 0-100, where 0 is minimum and 100 implies maximum economic freedom. Data of FDI Stock & Natural resources (ores and metals export as percentage of merchandise export) is extracted from ESCAP online Statistical database 2016 while market size (measured by GDP per capita), Human Capita(Gross secondary school enrolment ratio) and total trade as percent of GDP is taken from World Development Indicator 2016.

5. Results discussion

Correlation analysis is conducted before applying panel regression in order to detect strength of linear association among the variables. Result in Table 2 revealed that economic freedom has a strong positive association with FDI in south Asian countries. Correlation of all independent variable is less than 0.80 which indicate that there is no multicollinearity among the independent variables. In our study, the VIF values for independent and control variables used in regression analysis also less than 10. So any potential collinearity is not expected to influence the results of panel regression analysis.

Table 2. *Correlation analysis*

	FDI	EF	HC	MS	NR	QOI	TRA
FDI	1.000						
EF	0.686***	1.000					
HC	0.413***	0.519***	1.000				
MS	0.783***	0.618***	0.784***	1.000			
NR	-0.218**	-0.434***	-0.194*	-0.222**	1.000		
QOI	0.125	-0.156	0.028	0.120	0.736***	1.000	
TRA	0.299***	0.697***	0.676***	0.414***	-0.338***	-0.202**	1.000

Table 3 displays the panel regression analysis for role of economic freedom in FDI. Hausman test is performed to choose between fixed and random effect model. This test looks at whether the individual impacts are uncorrelated with different regresses in the model. If the null hypothesis is rejected, a fixed effect model is applied. However, after applying Hausman test it is revealed that fixed effect is appropriate for this model.

Table 3. *Impact of economic freedom on foreign direct investment*

Independent Variables	MODEL 1	MODEL 2	MODEL 3
Economic Freedom	0.161* (0.068)	0.137** (0.035)	0.117* (0.044)
Market Size	0.005*** (0.001)	0.006*** (0.001)	0.004*** (0.001)
Human Capital	0.054** (0.013)	0.046** (0.014)	0.031** (0.007)
Trade	0.083*** (0.017)	0.079*** (0.016)	0.045* (0.017)
Natural Resources		0.138 (0.138)	0.051 (0.284)
Quality of Infrastructure			3.96E-05** (1.3E-06)
Constant	-12.15** (4.151)	-11.39*** (4.012)	-6.859* (2.855)
Diagnostic Tests			
observations	99	95	95
R^2	0.641	0.665	0.692
Adj. R^2	0.625	0.629	0.670
F-Stats.	24.79	33.72	31.42
F (p-value)	0.000	0.000	0.000
Hausman (p-value)	0.000	0.000	0.000

Standard error in parenthesis, ***, ** and * represent the level of significance at 0.01, 0.05 and 0.10 percent, respectively.

Table 3 represents estimation results of three models in which FDI stock is dependent variable. The coefficient of Economic Freedom is positive and statistically significant in all models at varying level of significance. It shows that increase in Economic Freedom leads to increase FDI in South Asia. The rationale for this positive relationship is that higher economic freedom implies improved domestic investment environment prevailing in the country. This will provide better rule of law, regulatory efficiency with open market economy, which encourages foreign investors to bring more investment. This positive relationship between Economic freedom and FDI is supported backed by Pourshahabi et al. (2011), Ajide and Eregha (2014), Sambharya and Rasheed (2015).

Market size which is measured by GDP per capita demonstrates a positive and statistically significant relationship with FDI in all models. As large market size would seems as an attractive factor for investors who are seeking higher demand for their products. Investors can get benefit from efficient allocation of resources and economies of scale. This implies that investors are appealed to host economies having sizeable markets. Our results are in line with Laabas and Abdmoulah (2009), Mohamed and

Sidiropoulos (2010), Pourshahabi et al. (2011), Amendolagine et al. (2013), Bannaga et al. (2013) and Ajide and Eregha (2014).

Study also included human capital, which has positive and significant relationship with FDI. It is a worthy signal indicating that availability of a skilled workforce is a significant factor and plays important part in attracting FDI stock. While Jimenez (2011) recommended that higher rates of enrolment in education is an indicator for an accessible more productive and qualified workforce trained to adapt more swiftly to advance technologies and knowledge. Hakro and Omezzine (2011) found the similar results. Trade is also included as an independent variable and its coefficient value is positive and statistically significant. However, markets that are more open are having better chances to have significant economic welfare gains with the help of more efficient allocation of resources as compared to the markets that are less open. Thus, foreign investors prefer investing in nations with substantial volume of trade. Our trade results are consistent with Elfakhani and Matar (2007) and Abderrezak (2008).

Model 2 includes natural resources, which are measured by ores and metal export in South Asia. Literature highlights the fact that natural resource is one of the important variables for gaining FDI. Whereas, our study results indicate statistically insignificant relationship of natural resources and FDI. While quality of infrastructure, which is measured by mobile subscription (per 1000 people), is incorporated in model 3 along with natural resources as independent variable. Estimation results reveal that it has positive and significant impact on FDI; a good infrastructure attracts more FDI. However, this value is very small but it is statistically significant. Availability of better infrastructure reduces transaction costs by permitting entrepreneurs to easily connect with their customers and suppliers. Infrastructure provision, like highways, roads, ports, electricity, communication networks would generally increase productivity and thereby attract higher levels of FDI. The positive association between FDI and quality of infrastructure is consistent with Asiedu (2002), Khadaroo and Seetanah (2007) and Benacek et al. (2014).

Results depict that economic freedom, market size, human capital, trade and quality of infrastructure have positive and statistically significant influence on FDI, while natural resources have positive and statistically insignificant impact in current study. The explanatory power of all the statistical models of the study is good because R^2 is (64.1, 66.5 and 69.2) percent respectively. Probability of F-statistics is below 0.01 percent in all models which represent the correctness of model. It is also important to mention that along with doing the regression analysis for the aggregate economic score, we have also divided the economic freedom index into sub-components in order to perform detailed analysis as well as observe difference/similarities between these sub-categories of economic freedom in attracting FDI.

Economic Freedom has ten subcomponents described by *Heritage Foundation Index*[(1)]. In current study we only display fixed effect results of those subcomponents whose coefficient is statistically significant in different models. It is shown that fiscal freedom is positive and significant in all the three models. Fiscal freedom measures the burden of direct as well as indirect taxes on conducting businesses in the host countries. However, in model 3 by including quality of infrastructure as independent variable fiscal freedom coefficient value is increased to 0.62 units. Reducing tax burden will cause in reduction of cost associated with business. So it has substantial impact on the location choices by foreign investors in the South Asia. This result is consistent with Hassan (2015).

Second component is trade freedom as it measures the absence of obstacles known as tariff plus non-tariff barriers that affect export and import of goods and services. Trade freedom is significantly positive only in model 1 and 2. This positive association is consistent with Beheshtitabar and Irgaliyev (2008). While remaining subcomponents of economic freedom including property right freedom, freedom of corruption, government spending, business freedom, labor freedom, monetary freedom, investment freedom and financial freedom are insignificant indicating that, they are not playing important role in attracting FDI in the South Asian region.

Table 4. *Impact of subcomponents of economic freedom on FDI*

Models	Model 1		Model 2		Model 3
Independent variable	Fiscal freedom	Trade freedom	Fiscal freedom	Trade freedom	Fiscal freedom
Sub component of Economic Freedom	0.057*** (0.011)	0.022* (0.009)	0.057*** (0.011)	0.023* (0.009)	0.062*** (0.011)
Market Size	0.004** (0.001)	0.004*** (0.000)	0.005** (0.00132)	0.005*** (0.0008)	0.003** (0.001)
Human Capital	0.047*** (0.009)	0.041** (0.013)	0.042** (0.011)	0.036*** (0.007)	0.024** (0.005)
Trade	0.109** (0.025)	0.098*** (0.019)	0.099** (0.023)	0.088*** (0.017)	0.056* (0.022)
Natural Resources			0.049 (0.275)	0.082 (0.298)	-0.033 (0.286)
Quality of Infrastructure					4.0E-05** (1.3E-06)
Constant	-8.389*** (1.329)	-4.297* (1.662)	-8.561*** (1.326)	-4.519** (1.317)	-4.849** (1.499)
Diagnostic tests					
observations	99	99	95	95	95
R^2	0.642	0.63	0.673	0.662	0.708
Adj. R^2	0.609	0.597	0.626	0.626	0.688
F Stats.	40.29	38.35	34.99	33.31	33.97
F (p-value)	0.000	0.000	0.000	0.000	0.000
Hausman (p-value)	0.000	0.000	0.000	0.000	0.000

Standard error in parenthesis, ***, ** and * represent the level of significance at 1, 5 and 10 percent levels, respectively.

6. Conclusion

This study empirically explore the role of domestic business environment measured by Heritage foundation economic freedom index in attracting FDI in selected South Asian countries (Pakistan, Bangladesh, India, Nepal and Sri Lanka) covering the time frame of 20 years from 1995 to 2014. The Panel Fixed Effect estimation results revealed that economic freedom has positive relationship with FDI in Selected south Asian

Countries. Results demonstrate that the institutional climate of a country, matters in encouraging or inhibiting the flow of foreign capital into a country. Economic freedom plays vital role in attracting FDI. Host economy's domestic market is also important aspect for drawing market seeking FDI. Large sized market represents greater domestic demand so it is an attractive factor for investors seeking higher demand for their products. However large market size will help in economies of scale, efficient allocation of resources, cost reduction and maximize profit. There occur a significant investment by MNEs in the field of research and development like for the development of advance technologies. So, there must be a certain degree of human capital availability in the host economy that is able to work and understand with advance technology brought by MNEs. Consequently, skilled, well-educated and trained labor force can be a key feature in acquiring foreign capital flows.

It has been noticed that improving economic openness by relaxing barriers and obstacles to trade would attract better volume of foreign investment in the region. Relaxing barriers would encourage foreign investors as highlighted by literature. Empirical results indicate that infrastructure availability will promote FDI by reducing operational cost which will decrease the cost of doing business for foreign enterprises which will ultimately leads them towards profit maximization. This will also increase access to local and global markets which encourage FDI. Considering the empirical evidence, a higher degree of overall fiscal freedom in a host country is expected to decrease the cost associated to business by reducing taxes imposed by the government and there occur upsurge in profit, ultimately higher will be the likelihood of FDI being located there.

Based on empirical analysis this study recommendations are:

- Economic Freedom measuring domestic investment climate matters in terms of attraction of foreign direct investment. Policy makers should focus on betterment of investment climate by raising its level through transparent policies, eliminating corruption, reducing tax burden and stable economy.
- By reducing tax burden through effective policies can result in a higher degree of fiscal freedom in a host country by reducing the cost associated to business. Furthermore, it will result in raising the profit, ultimately increasing the likelihood of FDI being located there.

Note

(1) For details, see Heritage Foundation Economic Freedom Index.

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