Autocracy, Democracy and FDI inflows in Asian Developing Countries

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June 2017

AUTOCRACY, DEMOCRACY AND FDI INFLOWS IN ASIAN DEVELOPING COUNTRIES

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Abstract

The study examines the effect of autocracy and democracy on FDI inflows in Asian developing countries from 1990-2010. Using multiple regression analysis the study found the positive and significant effect of autocracy on FDI inflows in the selected range of countries while democracy statistically shows negative and significant effect on FDI inflows. Among controlling variables market capitalization, population, literacy rate, sea access and trade shows significant and positive effect on FDI inflows in both models while imports and exports shows insignificant results with autocracy.

Key Words: *Autocracy, Democracy, Panel Data, FDI, Multinational Corporations.*
JEL Classification Codes: *C230, F130, F140, F210 and K380*

1. Introduction

Foreign Direct Investment (FDI) is expected to favourably affect an economy by bringing job opportunities, managerial skills, technology, as well as increased competition in the market and provide access to foreign markets (Shah, 2009). FDI fills the gap in various aspects in developing countries like investment, tax revenue and foreign exchange (Smith, 1997). Due to this, most of the developing country's top priority is to attract FDI. Post 1980 and 1990 globalization a significant increase in FDI to the developing world is observed (Shah, 2013b). Multinational corporations (MNCs) look for many aspects primarily to maximise their returns on investment (Shah, 2016a).

Earlier literature has found a number of variables as key determinants of FDI inflows such as market size, labour cost, inflation, literacy rate, quality of infrastructure, trade, civil liberties, political instability etc (Shah, 2012b). Wheeler and Mody (1992) found negative effect of labour cost on FDI. Scaperlanda and Mauer (1969) say that at threshold level when firms have economies of scale and efficient resources then FDI inflows have significant and positive effect on market size. Political instability negatively affects FDI and discourages overseas investors (Schneider & Frey, 1985). Literature has identified GDP and population etc. as proxy variables for market size (Shah, 2011a). There are a few variables that play a very important role in attracting FDI e-g corruption, efficient and easily accessible markets, property rights and liberal political structures (Leavell, Wainwright, & Maniam, 2004; Shah, 2013a). Corbo and Schmidt-Hebbel (1991) and Shah (2017d) found that uncertain political and economic environment negatively affect economic growth and investment opportunities.

Democracy is a type of government where the people of the country plays a key role and have the power of electing their representative directly through fair and free elections

(Nwogu, 2015). Similarly autocracy is a type of government where one person autocratically assumes unlimited power (Shah, 2017b). Earlier literature argues that autocracy is a political regime where the public don't elect their representative and power is constrained in a few hands (Linz, 2000). Their policies favour the ruling leaders. Whilst literature claims that democracy strongly and positively affect FDI inflows because of better proprietorship rights and public ownership (Li & Resnick, 2003).

This study focuses on the effect of political regime type on FDI inflows. In this research, the relationship between autocracy, democracy and foreign direct investment will be examined by using panel data of fifteen Asian developing countries from 1990 - 2010. The study contributes to literature by focusing on a set of factors that may affect these flows, and helps in providing a conclusive relationship among the variables identified such as FDI, autocracy, democracy, market capitalization, imports, exports, population and literacy rate.

1.1 Objectives of the Study

The main objective of this research is as follows:

- To determine the effect of autocracy and democracy on FDI in Asian developing countries.

1.2 Need for Study

The inconclusive literature on FDI and its determinants justify the need for continuous research in this area in order to find conclusive evidence apropos possible effect of autocracy and democracy on FDI inflows in Asian developing countries.

1.3 Paper Structure

The paper comprises of five parts. Part one provides the background and objectives of the study. Part two analyse the existing literature on FDI and its determinants and the possible role of political regime in effecting inward FDI. Part three explains methodology of the study, including discussion on data collection methods and of the variables used in the study. Part four consists of the discussion apropos the results derived from the model. The last part five presents the conclusion.

2. Literature Review

2.1 Foreign Direct Investment

The decision where to locate FDI is greatly affected by economic and non-economic factors of the host country (Shah & Khan, 2016). These factors include labour availability, political conditions, economic development etc.

There is an enormous increase in FDI or multinational enterprises (MNEs) activities across countries due to increase in globalisation of the world economy (Shah, 2014b).

However, most international investments are undertaken in developed countries, such as Canada, the European Union, Japan and the United States. Although, absolute FDI flows to developing countries are relatively weak, still they have increased over the past couple three decades (Shah, 2012c; Shah, 2012d). Moreover, FDI to developing countries surpassed official development flows by a considerable amount. In 2011, FDI to developing countries totalled US 684.4 billion (UNCTAD, 2012).

FDI benefit developing economies as MNCs introduce new technologies, expand capital stock, increase competition within key industries of the economy, and benefit local workers by providing more and better-paid jobs (Shah & Qayyum, 2015). Proponents of FDI argue that it increase GDP growth rates and decrease poverty thus benefiting the local population (Shah 2011b). While their critics argue that MNCs aren't beneficial for developing countries because they deprive them of their economic sovereignty and support repressive regimes (Meyer, 1998). They argue that multinationals subdue the local wages and work environment through their market power due to weak labour laws in developing countries.

2.1.1 Foreign Direct Investment and its Determinants

There are a number of variables identified as the determinants of FDI e.g. labour cost, political instability, literacy rate, market capitalization etc. Blonigen and Wang (2005) observed that factors determining FDI inflows vary from country to country. Factors in developing countries are different as compared to developed world. Culture and geography plays a key role in FDI inflows from Hong Kong and Taiwan to China (Hong & Chen, 2001). They found economic freedom to be a key determinant of FDI. Scaperlanda and Mauer (1969), Wheeler and Mody (1992), Schneider and Frey (1985) and Shah (2012a) used different proxies for market size and found it to be a significant determinant of FDI.

2.2 Democracy and Autocracy

Empirical literature on FDI determinants show that multinational companies respond to numerous factors, in varying intensities. According to Kaufmann, Kraay, & Mastruzzi, (2011) governance is the institutional authority exercised in an economy. Shah and Afridi (2015) say that good governance implies an independent, fair and transparent legal system, public favouring legislature and high public trust in governing institutions. Pinto and Zhu (2016) worked on democracy, corruption and FDI inflows. They established FDI - democracy relation indirectly through corruption. They reveal that in democracies higher FDI lessen corruption, whilst in non-democratic countries increase in FDI lead to more corruption.

Dunning (2013) suggested OLI model which considers only economic variables. But MNCs consider both economic and non-economic factors such as political stability and political regime in deciding where to invest. Literature suggests indefinite results on FDI-political regime nexus. Few studies found democracy to be enhancing FDI inflows by providing better property rights. Others favour autocracy on the basis that it supress labour rights and can offer exclusive tax incentives to MNCs.

2.2.1 Democracy, Autocracy and FDI

O'Donnell (1978) argues that autocratic regimes are reliable in the development of global capitalism as compared to democratic regimes. He suggests that autocratic regimes support FDI and multinational firms. Olson (1993) argues that democratic countries have independent judicial system and respect for individual rights. Therefore, overseas investors readily invest in democratic regimes. Oneal (1994) suggests that there is no relation between autocracy / democracy and US outward FDI. Rodrik (1996) was the first one who worked on democracy and major UN affiliates FDI abroad. He found democracy to be a significant indicator of FDI inflows. Harms and Ursprung (2002) revealed a positive democracy-FDI relationship by working on 62 developing and emerging markets.

2.3 Review of Current Studies

The determinants of FDI are of two types. One, pull factors, such as market size and second, push factors, such as source country's economic conditions. There are certain factors that influence the decision of multinational corporations (MNCs) about where to invest (Shah, 2011e). These are market size, taxes, trade policies, exchange rate, interest rate, production costs, infrastructure etcetera (Shah, 2015). They influence the location choice decision of multinational enterprises in global market (Shah, 2016c). Recently, FDI of developed countries played a vital role in the developing countries' economies by bringing in financial capital, technology and advancement (Shah, 2010). They argued that determinants of FDI like governance and legal structure are more important in comparison to wages and infrastructure (Shah & Faiz, 2015).

The existing FDI literature suggests an inconclusive autocracy, democracy and FDI relationship. Therefore, continuous research on the subject is required to see the latest trends in this area. This is an open research topic. Results can vary with variable change, time frame consideration, regions and countries included in the sample.

Jensen (2003) mentions two reasons for which 'democratic accountability' may attract FDI. First, democratic governments create credible and consistent policies, which reduce the risk of fundamental policy reversals such as nationalization, expropriation and renegotiation of tax rates. Second, in democratic regimes political leaders are accountable for their actions. If governments fall back on their contracts post investment, MNCs can react by refusing to invest in future. Therefore, the fear of loss of reputation can lead to more consistent policies towards MNCs. Li and Resnick (2003) found that democracy has a significant effect on FDI encourages overseas investors. Bates (2006) argued that democratic institutions by giving possessions rights and security attract MNCs. In the same way, Henisz (2000) states that a democratic regime is not controlled by a single autocrat; there are a number of veto players that set constraints on policy changes.

Busse and Hefeker (2007) found that more FDI is done in democratic countries. This result is not valid for the 1970s when FDI flowed to countries with suppressive regimes. Yang (2007) working on a sample of 134 developing countries investigated the relationship between autocracy/democracy and FDI inflows to the developing countries over the 1983-2002 period. He found that political regime don't effect FDI and suggested that democracy doesn't attract FDI. Du, Lu and Tao (2008) observed in US, Taiwan, EU, Hong Kong, Japan and South Korea that FDI location choice is greatly affected by regional economic institutions and traditional factors like market size.

Guerin and Manzocchi (2009) analysed autocracy/democracy and bilateral FDI association from advanced and emerging countries. Their findings suggest significant positive effect of democracy on FDI. Patti and Navarra (2009) analysed democratic regime and FDI inflows to see to what extent they affect economic growth. Youngs (2010) analysing the relationship between western MNCs, commercial interests and democracy in developing markets reveals that autocracy attracts investors to invest capital and low-intensity democracy benefits investors. Subasat and Bellos (2011) investigated the link between governance and foreign direct investment for 14 transition countries. By applying a panel gravity model, they suggest that lack of good governance does not deter foreign direct investors.

Libman (2015) considers former Soviet Russian states as a sample and establishs the impact of sub-national political systems on economic growth. He found the influence of democracy on economic performance and size of the bureaucracy on economic outcomes. Furthermore, regions with low level of democracy and strong autocracies perform better than hybrid regimes. Okafor, Piesse and Webster (2015) investigated the influence of democracy on FDI. Their findings in the selected sample of Sub-Saharan countries suggest that advancement towards a stronger and more efficient democracy declines FDI inflow. Moreover, the profit margin of MNCs shrinks as harmonized host country interest has now taken the place of MNCs profit maximization interest. Shah and Afridi (2015) and Shah (2017b; 2017d) suggests that improved health of the political and economic institutions in South Asia positively influence overseas investors.

3. Methodology

3.1 Data Collection Methods

The current research is about the effect of autocracy and democracy on FDI inflows in fifteen Asian developing countries over the period of 1990-2010.

3.1.1 Sampling

The sample of fifteen countries was selected from Asian countries for analysing the impact of autocracy and democracy on FDI in developing countries in Asia.

3.1.2 Types of Data Collection

A secondary method of data collection was used where the information required was obtained from the websites of World Bank, World Development Indicators (WB, WDI), POLITY IV and Transparency International.

3.2 Estimation Models

The following equations will be used as the estimation equations to analyse the relationship of dependent variable with independent and control variables including: FDI, autocracy, democracy, trade, imports, exports, sea access, market capitalization, population and literacy rate.

3.2.1 Model 1:

$$\textbf{Log FDI}_{jt} = \alpha_0 + \beta_1 \textbf{log Trade}_{jt} + \beta_2 \textbf{log Exports}_{jt} + \beta_3 \textbf{log Imports}_{jt} + \beta_4 \textbf{ Sea Access}_{j} + \beta_5 \textbf{log Market Capitalisation}_{jt} + \beta_6 \textbf{log Population}_{jt} + \beta_7 \textbf{Literacy Rate}_{jt} + \beta_8 \textbf{ Autocracy}_{jt} + E_{jt} \quad \textbf{(Equation 1)}$$

3.2.2 Model 2:

$$\textbf{Log FDI}_{jt} = \alpha_0 + \beta_1 \textbf{log Trade}_{jt} + \beta_2 \textbf{log Exports}_{jt} + \beta_3 \textbf{log Imports}_{jt} + \beta_4 \textbf{ Sea Access}_{j} + \beta_5 \textbf{log Market Capitalisation}_{jt} + \beta_6 \textbf{log Population}_{jt} + \beta_7 \textbf{ Literacy Rate}_{jt} + \beta_8 \textbf{ Democracy}_{jt} + E_{jt} \quad \textbf{(Equation 2)}$$

Among the variables given in the above equations FDI (foreign direct investment) is the study's dependent variable. Democracy and Autocracy are the two main explanatory variables. The set of control variables include market capitalization, trade, imports, exports, population, literacy rate and sea access. All of them are discussed in the following section

3.3 Dependent Variable Foreign Direct Investment (FDI)

FDI inflows represent the amount of capital being invested in the country by foreigners less amount of capital taken out (with drawn) from the country by foreigners.

3.4 Control Variables: Democracy and Autocracy

To evaluate the effect of democracy and autocracy on FDI, the democracy or autocracy indicator from POLITY IV are used. A country is said to be autocratic if it lies between the range (-1) to (-10). Between the range of (-6) to (-10) countries are more autocratic and at -10 the country is said to be extremely autocratic. The country is said to be democratic if it lies between the ranges of 1 to 10. Between the ranges 6 to 10 a country is said to be more democratic and at 10 countries are said to be immensely democratic.

3.5 Explanatory Variables

3.5.1 Imports

Import means goods and services produced abroad and bought by locals through legal process (Shah & Samdani, 2015). Imported products are normally subject to quotas, trade and tariff agreements (Shah, 2017a). Custom authorities play a critical role in imports movement from producer to consumer nation. An import shows the local demand for foreign products. Log of import is used as an independent variable in this research.

3.5.2 Exports

Exports means goods & services produced domestically and sold to overseas consumers through legal process. Custom authorities play the same role as in imports. Increasing exports showing higher foreign demand for local products encourage more production and thus enhances GDP (Shah & Jamil, 2016). Export is measured in terms of US $ and is expected to have a positive effect on FDI. Log of export is used an independent variable in this research.

3.5.3 Sea Access

A country's infrastructure plays a very important role in attracting FDI (Shah, 2011f). Infrastructure includes roads, railways, sea ports, communication, electricity, etc. and is a significant determinant of FDI (Shah, 2011c). Following published literature this research uses a dummy variable for sea access and is expected to have a positive rapport with FDI. The variable is coded one if a country has a sea port and zero otherwise.

3.5.4 Trade

Trade includes both imports and exports. Log of trade is used as an independent variable in the study as a measure of openness of a country. Every country has some comparative advantage in certain products. So a country that is best in producing a specific product shall specialise in the particular category and export it (Shah, 2011d). Trade is also a significant determinant of FDI inflows because MNCs investment decision is based on the host economy's degree of openness (Shah, 2017c).

3.5.5 Population

Population is the measure of a country's annual population. In assessing the demand for MNCs products or services, MNCs consider the country population as well. We propose a positive relationship between FDI and population.

3.5.6 Literacy Rate

Literacy rate is the education received by people. It is becoming increasingly important in today's global economy. Education increases workers efficiency. MNCs often invest in developing nations due to low labour costs. However, low labour skills will lessen this advantage. A higher level of human capital is a good indicator of the availability of skilled workers, which can significantly boost the location advantage of a country (Shah, 2014a). Following Feenstra and Hanson (1997) this study uses adult literacy rate as a proxy for the level of human capital.

3.5.7 Gross Domestic Product (GDP)

GDP measures the economic size of the host market. Domestic demand in the host country plays a crucial role in attracting 'market seeking' FDI, where the primary objective of MNCs is to serve the domestic market (Shah & Ali, 2016). Following the literature, this study uses per capita real GDP as a proxy for the domestic market size.

3.5.8 Market Capitalization

Market capitalization is the stock price times the number of outstanding shares of all the firms listed on a stock exchange (Shah, 2016b). As outstanding stock is bought and sold in public markets, capitalization could be used as a proxy for the MNCs possibility of raising future capital. We expect a positive relationship between the variable and FDI.

4. Results, Discussion and Empirical Concerns

This is the result and discussion part and it includes the statistical methods applied to the sample of fifteen Asian developing countries. This section explains the results obtained through multiple regression analyses about the liaison of autocracy and democracy with FDI in detail. The descriptive statistics for all the variables included in the paper is given below.

4.1 Descriptive Statistics

The descriptive statistics are given for analysing the basic features of variables selected in the data set (Shah & Khan, 2017). The values of mean, minimum, maximum, variance and standard deviation for each variable are presented in table one.

Table 1: Descriptive Statistics

Variables	Minimum	Maximum	Mean		Std. Deviation	Variance
	Statistic	Statistic	Statistic	Std. Error	Statistic	Statistic
FDI	-4.550E9	1.851E11	6.824E9	1.263E9	2.206E10	4.867E20
GDP	240.409	5.930E12	2.228E11	3.565E10	6.287E11	3.953E23
Imports	0.000	1.520E12	6.401E10	9.223E9	1.636E11	2.680E22
Exports	0.000	1.750E12	6.991E10	1.099E10	1.951E11	3.807E22
Trade	0.0000	3.270E12	1.339E11	2.020E10	3.586E11	1.286E23
Market Capitalization	2.E7	6.E12	1.73E11	4.024E10	6.439E11	4.146E23
Democracy	0	10	4.65	0.204	3.607	13.009
Autocracy	-88	10	1.77	0.529	9.366	87.722
Sea access	0.000	1	0.87	0.019	0.340	0.116
Population	492891	1.E9	2.07E8	2.136E7	3.790E8	1.437E17
Literacy Rate	34.000	99.400	7.858E1	1.053E0	18.689	349.303

4.2 Regression Analysis

4.2.1 Regression Analysis with Autocracy

Multiple regressions is performed by taking autocracy as main independent variable and log of trade, log of import, log of export, sea access, log of market capitalization, log of population and literacy rate as control variables with FDI as dependent variable. Table two presents the regression results of the model with the autocracy performed with SPSS.

Table 2 Regression Analysis with Autocracy

Variables	Coefficients	T-Statistic	P-Value
Constant	4.296	2.379	0.018
Ln Exports	-1.178	-0.950	0.343
Ln Imports	1.240	0.998	0.319
Sea Access	3.728	4.531	0.000
Ln Market Capitalization	0.099	3.004	0.003
Ln Population	0.617	3.865	0.000
Literacy Rate	0.097	5.917	0.000
Autocracy	0.132	4.674	0.000
R-Squared	0.338		
Adjusted R-Squared	0.320		
F-Statistic	22.345		

The results presented in the table 2 shows that R^2 is 33.8%. It means that 33.8% of the variation in the dependent variable (FDI) is explained by the independent variable: autocracy and control variables: log of exports, log of imports, sea access, log of market capitalization, log of population, literacy rate. The F-statistic of 22.345, displays that the overall model is statistically significant, stable and reliable.

The coefficient of 0.132 for autocracy with a probability of 0.000 demonstrates that autocracy has a significant and positive effect on FDI in Asian developing countries. This value is significant at 1%. The values of the Log of imports and Log of exports show an insignificant rapport with FDI. However, the values of log of market capitalization, sea access, log of population and literacy rate indicate positive and significant influence on FDI.

Sea access is used as a dummy variable in the research. Countries having seaports are coded as one and those that don't have seaports have a value of zero. The value of coefficient of sea access is 3.728 and it is significant at 1%. This result confirms that countries having seaports attracts more FDI and land locked countries receive less FDI.

The coefficient of market capitalization is 0.099 and is significant at 1%, showing that it has a positive significant effect on FDI. Population also has a positive connexion with FDI in Asian developing countries with a coefficient of 0.617 being significant at 1%. It means greater the population more FDI is attracted. Literacy rate of the Asian developing nations also has a positive liaison with FDI. The coefficient value is 0.097 and is significant at 1%. These results are also supported by O'Donnell, (1978) and Olson, (1993, 2000).

4.2.2 Regression Analysis with Democracy

Regression analysis is subsequently performed by taking democracy as the main explanatory variable with FDI. Table three presents the regression results of the model with the democracy performed with SPSS.

Table 3: Regression Analysis with Democracy

Variables	Coefficients	T-Statistic	P-Value
Constant	-3.324	-1.263	0.207
Ln Trade	12.993	4.112	0.000
Ln Exports	-7.361	-4.111	0.000
Ln Imports	-5.570	-2.402	0.017
Sea Access	3.853	4.587	0.000
Ln Market Capitalization	0.117	3.427	0.001
Ln Population	0.602	3.580	0.000
Literacy Rate	0.092	5.531	0.000
Democracy	-0.234	-2.767	0.006
R-Squared	0.352		
Adjusted R-Squared	0.335		
F-Statistic	20.45		

The results presented in table three shows that R^2 is 35.2%. It illustrates that 35.2% of the variation in the dependent variable (FDI) is explained by the independent variable democracy and the control variables log of trade, log of exports, log of imports, sea access, log of market capitalization, log of population and literacy rate. The F-statistic is 20.45 exhibiting that the model is significant, stable and reliable.

Democracy has a coefficient of -0.234 with probability value of 0.006 displaying a significantly negative effect on FDI in Asian developing countries. The values of the Log of imports and Log of exports reveal a significant negative influence on FDI. However, the overall value of trade is found to exert a positive significant effect on FDI.

Among the control variables log of market capitalization, sea access, log of population and literacy rate shows a positive and significant impact on FDI. Sea access is used as a dummy variable in the research. Countries having sea ports are coded as one and those without ports have a value of zero.

5. Conclusion

The research aims to find the effect of autocracy and democracy on FDI inflows in Asian developing countries over the period of 1990-2010. Panel data has been used to examine the effect of autocracy and democracy on FDI inflows using multiple regressions analysis. Countries for the selected sample are based on GNI per capita that ranges from $996 to $12,195 (WB, WDI 2011).

The primary finding of this research are: Autocracy, log of market capitalization, literacy rate, log of population and sea access shows positive significant effect on FDI inflows. While log of imports and exports reveal their insignificant influence on FDI. Autocracy in the selected sample shows positive and significant relations because probably in Asian countries, the autocrats' supress labour rights, thus ensuring provision of cheap skilled labour and offers tax incentives to MNCs to lure them to invest. Democracy shows significant negative effect on FDI inflows. The negative and significant effect of democracy in Asian countries may be because of the reason that the democrats being answerable to the public in general won't let the multinationals flourish at the expense of locals.

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