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ECONOMIC FREEDOM AND FOREIGN DIRECT INVESTMENT: NEW GLOBAL OVERVIEW

Abstract

This paper investigates the connection and impact of economic freedom, measured by the index of economic freedom, on the inflow of foreign direct investments in developing countries. The research problem is sublimated by the question of whether variations in economic freedom affect the inflow of foreign direct investments. The panel analysis was conducted on a sample of 40 developing countries in the period 2005-2023. The research results showed that 8 components of the Economic Freedom Index have a statistically significant impact on foreign direct investment inflows, while the impact of the 2 components is irrelevant. In this way, the research hypothesis was confirmed that the higher degree of economic freedom has a significant and positive impact on the inflow of foreign direct investments ceteris paribus. The contribution of the research is reflected in the wide geographical and temporal scope, as well as the choice of analytical tool, in order to obtain conclusions with a higher degree of accuracy and reliability.

Keywords: Index of Economic Freedom, Foreign Direct Investments, Developing Countries, Panel Analysis

JEL classification: F21, K20, O50.

ЕКОНОМСКЕ СЛОБОДЕ И СТРАНЕ ДИРЕКТНЕ ИНВЕСТИЦИЈЕ: НОВИ ГЛОБАЛНИ ПРЕГЛЕД

Апстракт

У овом раду истражује се веза и утицај економских слобода, мјерених индексом економских слобода, на прилив страних директних инвестиција у земље у развоју. Проблем истраживања сублимиран је питањем да ли варијације економских слобода утичу на прилив страних директних инвестиција. Панел анализа спроведена је на узорку од 40 земља у развоју у периоду 2005-2023. године. Резултати истраживања показали су да 8

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компоненти индекса економских слобода имају статистички значајан утицај на прилив страних директних инвестиција, док је утицај 2 компоненте ирелевантан. На тај начин потврђена је истраживачка хипотеза, да виши степен економских слобода има значајан и позитиван утицај на прилив страних директних инвестиција ceteris paribus. Допринос истраживања огледа се у ширем географском и временском обухвату, као и избором аналитичког алата, како би се добили закључци са већим степеном тачности у поузданости.

Кључне ријечи: *индекс економских слобода, стране директне инвестиције, земље у развоју, панел анализа*

Introduction

Economic freedom represents the freedom of individuals and companies to act freely on the market. That is, freedom of choice in all aspects of business activities, without large and unnecessary government interference in their activities. Key aspects of the economic and entrepreneurial environment are subject to political control, and they relate to aspects of the legislative, institutional and regulatory environment. The rule of law, the size of government and administrative capacities, regulatory efficiency and market openness are significant predictors of an effective and efficient economic environment, which have a stimulating effect on the entrepreneurial spirit and the movement of capital.

This paper examines the connection between the aforementioned assumptions of a successful economic environment and international capital flows, in the form of foreign direct investments. By examining the mentioned connection, the research will provide an answer to the problem question, do the variations of economic freedom have an impact on the inflow of foreign direct investments? The subject of the analysis refers to 40 developing countries in a 2005-2023 period. The index of economic freedom was taken as a representative indicator of the independent variable. By analyzing ten components of the index of economic freedom, the aim will be to obtain results with a higher degree of accuracy, reliability and relevance regarding the relationship and impact of the dependent variable on the independent variable.

In this way, the research hypothesis will be tested, that the higher degree of economic freedom has a significant and positive impact on the inflow of foreign direct investments *ceteris paribus*. After the introductory considerations, the first part gives an overview of the research, that is, a theoretical and cross-sectional section of relevant studies. The second part of the paper refers to the determination of research methods and data used in the analysis. In the third part, the results of the analysis are presented and the results of the research are compared with similar and/or comparable studies. In the fourth part, concluding considerations are given.

Review of relevant studies

The two most important indicators used to measure the degree of economic freedom are the Economic Freedom of the World (EFW), published by the Fraser Institute, and The Index of Economic Freedom (hereinafter IEF), published by the Heritage Foundation. This paper will analyze the role and importance of IEF in the inflow of foreign direct investments (hereinafter FDI). Quazi (2007), analyzing the role of economic freedom in the inflow of international capital, based on a sample of East Asian countries, determined that increased economic freedom, measured by IEF, represents a significant and strong determinant of FDI inflow. The results of the analysis of Caetano & Caleiro (2007) show the existence of a positive relationship between economic freedom (measured by IEF) and FDI inflows in MENA countries, and that the relationship is stronger with the growth of economic freedom.

Haydaroğlu (2016), as well, established the existence of a positive and significant relationship between economic freedom and FDI inflows to BRICS countries. By analyzing the five components that make up IEF, it was determined that four components (except government size) have a positive effect on the inflow of FDI and economic growth. A panel analysis of 79 developing countries by Hossain (2016) showed that economic freedom (measured by IEF) is a positive determinant of FDI inflows. Another panel analysis by Imtiaz & Bashir (2017), on a sample of five South Asian countries, came to the conclusion that economic freedom is an important factor influencing the inflow of FDI. Also, the analysis found that fiscal and trade freedom (in IEF structure) have the statistically most significant influence on the inflow of FDI.

A panel analysis by Bengoa & Sanchez-Robles (2003), on a sample of 18 Latin American countries, showed the existence of a significant and positive relationship between economic freedom and FDI, and that economic freedom represents a positive determinant of FDI inflows. The analysis of Azman-Saini, Baharumshah & Law (2010) also confirmed the existence of a positive relationship between economic freedom and FDI inflows, and that countries with a greater degree of economic freedom generate greater benefits from the presence of multinational companies. Sulliman & Mollick (2009) emphasize, among other factors, the significance of economic freedom as an important factor in the inflow of FDI in the countries of Sub-Saharan Africa. The positive and significant influence of economic freedom, in addition to institutional development and trade liberalization, on the inflow of FDI in the countries of Central and Eastern Europe was also confirmed in the analysis of Tintin (2013).

Research by Iamsiraroj (2016) showed that economic freedom, trade openness and labor availability are key determinants of FDI inflows in analyzed 123 countries. Also, other studies (Zghidi, Mohamed Sghaier & Abida 2016; Badri & Sheshgelandib, 2017; Dkhili & Dhiab, 2018; Sofuoglu, Kizilkaya & Uyusal, 2019; Štilić, A., Mastilo, Vuković & Mastilo D., 2023; Shikur, 2024) confirmed the existence of a statistically significant and positive relationship between economic freedom and FDI inflows, and that economic freedom is a significant predictor of FDI inflows. The research of Subasat & Bellos (2011), based on the analysis of 7 factors of IEF, showed that only the trade freedom indicator has a significant and positive impact on the inflow of FDI, two indicators (government spending and fiscal freedom) have a negative impact and 4 indicators have an insignificant impact. Mehrara & Zirak (2013), analyzing 123 developing countries,

concluded that the impact of economic freedom (based on 10 indicators of IEF) is different. Only 23 countries, thanks to an adequate and efficient economic policy, were successful in attracting FDI. The panel analysis conducted by Moussa, Çaha & Karagöz (2016) of 156 countries showed that the impact of economic freedom (measured by IEF) positively affects FDI inflows, but there is a degree of heterogeneity in different regions. The effect and impact is most pronounced in European countries and the least pronounced in the countries of Oceania and fragile-conflict affected countries.

The analysis of Taran, Mironiuc & Huian (2016) came to the conclusion that economic freedom, measured by IEF, is a significant factor in the inflow of FDI. However, only the indicators of fiscal, financial, monetary and trade freedom and government consumption have a statistically significant influence, and the influence of other indicators on the inflow of FDI is irrelevant. Also, the analysis of Sooreea-Bheemul, Rasool & Sooreea (2020) show that higher economic freedom is a key determinant of FDI inward in Sub-Saharan Africa. The analysis of the IEF component has shown that business, labor, monetary and fiscal freedom, market and trade openness and market size are key determinants in attracting FDI while fiscal and investment freedom are less important. Research by Ullah & Khann (2017) analyzed the determinants of FDI inflows in SAARC and ASEAN countries, as well as Central Asian countries. The heterogeneity of the obtained results implies the existence of the influence of various factors that make up IEF. The Index of economic freedom has a positive and significant impact on FDI inflows to SAARC countries. In the countries of Central Asia the effect of IEF on the inflow of FDI is negative and not statistically significant. Unlike the two regions mentioned, institutional factors play a positive role in attracting FDI to ASEAN countries.

A study by Singh & Gal (2020) investigated the determinants of FDI inflows in nine regions, at the global level. The results of the study showed that economic freedom, measured by the IEF, has a significant and positive influence on the inflow of FDI in the countries of South and East Asia, Northern and Western Europe and Latin America, and an insignificant influence in the countries of the Middle East, North Africa, and Southern Europe. A study by Lim (2001) identified key determinants that significantly affect FDI inflows, and are related to economic and political stability, trade openness, fiscal incentives and a stimulating business and investment climate.

Other studies (Harms & Ursprung, 2002; Hailu, 2010) emphasized the importance of the openness of the national economy and the existence of political stability as factors that statistically significantly and positively influence the inflow of FDI. The analysis of Demekas, Horváth, Ribakova & Wu (2005) showed that the liberalization of trade, the development of the institutional and infrastructural framework and an adequate tax policy significantly influence the inflow of FDI. Also, other relevant studies (Globerman & Shapiro, 2003; Onyeiwu & Shrestha, 2004; Bénassy-Quéré, Coupet & Mayer, 2005; Kim, 2010; Adams & Opoku, 2015; Malikane & Chitambara, 2017; Aziz, 2020; Tag & Degirmen, 2022; Kwablah & Amoah, 2022) reached similar conclusions, that is, that the openness of the national economy, well-developed financial markets, monetary stability, the development of the institutional and regulatory framework, the quality of institutions, an adequate tax system, the conditions for starting a business, rule of law and reduced corruption represent fundamental factors that statistically significantly and positively affect the inflow of FDI.

Methodology and data

The subject of the research is the analysis of the connection and impact of economic freedom on the inflow of FDI. The aim of the research is to test the existence of a connection and determinism between economic freedom and FDI. The dependent variable in the research is foreign direct investments, and the quantitative indicator of the variable is the value of FDI inflows in analyzed countries. The independent variable in the research is economic freedom and the quantitative indicator is the index of economic freedom. The index of economic freedom is focused on quantifying key aspects of the economic and business environment over which governments have control: *Rule of law*, *Government size*, *Regulatory efficiency*, and *Market openness*. The index of economic freedom measures 12 components from the aforementioned four categories, ranked on a scale of 0-100.

The index of economic freedom, which measures the degree of economic freedom since 1995, classifies 184 countries into 5 categories, from repressive to free (Heritage Foundation, 2024). The first four places in the ranking for 2023. are occupied by Singapore, Switzerland, Ireland and Taiwan, and these countries are in the category *free* (score of 80 or more), 22 countries are in the category *mostly free* (70-79.9), 55 countries are in the category *moderately free* (60-69.9), 62 countries are in the category *mostly unfree* (50- 59.9) and 33 countries are in the category *repressed* (0-49.9) (Heritage Foundation, 2024). The paper analyzed 10 components of IEF, that were shown in Table 1 (*Government Integrity*, *Government Spending*, *Tax Burden*, *Property Rights*, *Monetary Freedom*, *Business Freedom*, *Investment Freedom*, *Labor Freedom*, *Financial Freedom* and *Trade Freedom*). Two components (*Judicial Effectiveness* and *Fiscal Health*) were omitted from the analysis due to the lack of data for the targeted time period.

The research was conducted on a sample of 40 developing countries from Asia (China, Cambodia, Lao People's Democratic Republic, Malaysia, Philippines, Viet Nam, Bangladesh, India, Pakistan, Sri Lanka), Africa (Egypt, Morocco, Tunisia, Cameroon, Ethiopia, Kenya, South Africa, Côte d'Ivoire, Ghana, Nigeria), Middle East (Iran, Bahrain, Jordan, Kuwait, Lebanon, Oman, Qatar, Saudi Arabia, Turkey, United Arab Emirates), and Latin America (Argentina, Brazil, Columbia, Ecuador, Paraguay, Uruguay, Costa Rica, Honduras, Mexico and Dominican Republic), according to the M49 classification of the United Nations (United Nations, 2022).

Table 1: The value of 10 components of the index of economic freedom

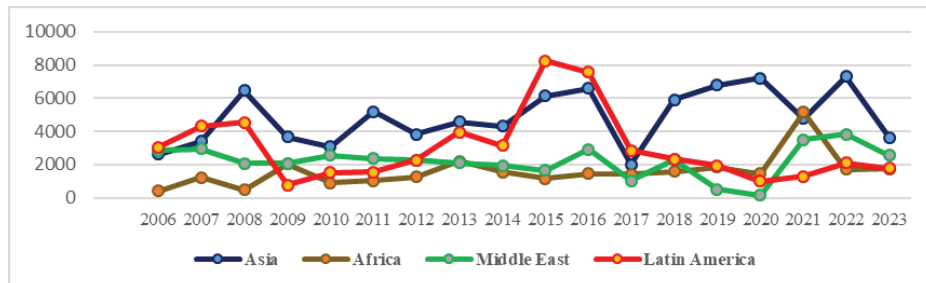
	Property Rights	Government Integrity	Tax Burden	Government Spending	Business Freedom	Labor Freedom	Monetary Freedom	Trade Freedom	Investment Freedom	Financial Freedom
2005	39.5	34.0	80.1	75.8	61.0	59.9	75.4	62.4	44.0	41.8
2006	39.5	33.7	80.1	76.3	58.7	59.4	75.9	63.5	43.5	46.0
2007	38.3	35.3	81.1	78.1	59.6	59.3	74.3	58.1	43.3	45.5
2008	38.8	34.9	81.7	79.1	61.2	59.3	73.1	69.0	43.0	44.5
2009	37.5	34.5	81.3	78.5	63.7	59.6	72.5	71.5	43.3	46.0
2010	38.8	35.5	82.3	78.4	63.1	60.3	69.3	73.1	45.0	46.0
2011	38.9	35.2	82.3	78.1	63.3	59.3	72.1	73.6	47.9	46.0
2012	38.1	35.5	82.4	74.0	64.1	60.1	73.1	72.7	47.6	46.0

2013	38.0	35.3	82.7	74.9	63.1	58.6	72.5	72.3	48.6	46.5
2014	37.9	34.7	82.9	75.2	62.9	59.0	72.4	72.2	50.6	47.0
2015	37.5	38.0	82.7	74.5	61.5	59.1	72.9	72.6	50.2	47.2
2016	37.0	38.8	82.7	74.3	62.9	57.8	72.8	73.5	52.3	47.5
2017	51.1	37.6	82.6	73.7	62.5	56.9	74.4	74.6	53.2	47.8
2018	49.5	37.9	82.4	73.6	62.6	55.8	74.5	74.8	54.6	48.2
2019	50.7	38.0	82.4	73.8	61.8	57.0	73.9	73.7	54.5	48.3
2020	55.5	39.9	82.2	74.9	62.4	56.6	72.9	73.2	54.6	48.5
2021	53.7	41.9	81.9	75.5	63.7	56.9	73.2	70.1	54.9	48.5
2022	48.1	38.8	82.4	74.2	60.3	56.6	71.8	69.4	54.9	48.8
2023	47.6	38.4	81.1	74.9	60.8	53.3	70.5	69.6	54.0	48.0

Source: Author's calculation based on Heritage Foundation (2024)

The time period of observation is 2005-2023 for the value of IEF and 2006-2023 for the inflow of FDI (Graph 1). A time lag of one year represents the construction, the impact of the independent on the dependent variable would be tested only when it starts to generate effects. Although the value of IEF has been calculated since 1995, there are no values for all components for the analyzed developing countries in the period 1995-2023, so 2005 was chosen as the base year, from which there is comprehensive data on the value of the components.

Graph 1: FDI Inflow in analyzed countries, in four geographic region, in millions USD



Source: Author's calculation based on UNCTAD (2024)

Statistical data for the value of the dependent variable were taken from the databases of the United Nations Conference on Trade and Development (UNCTAD), and for the value of the independent variable from the databases of The Heritage Foundation.

Research results and discussion

The analysis of the collected data was performed using the Panel data model in the statistical tool SPSS. Data processing was performed on the basis of statistical software for social sciences – SPSS, v. 23. Three models were constructed: A model without predictors, The fixed effects model, and The random effects model. Based on

the calculated Intraclass Correlation Coefficient for all models, the fixed effects model was chosen, where the ICC value implies that 99.9% of the total variability represents the variability 8 from 10 indicators of IEF as an independent variable, that is, that 99.9% of the variability can be explained by the presence of 8 analyzed indicators as an independent variable. Based on the formula for calculating the Intraclass Correlation Coefficient, the value in the model with fixed predictors was calculated.

$$ICC = \frac{\text{Variability Between Groups}}{\text{Variability Between Groups} + \text{Variability Within Groups}} \cdot 100 \quad (1)$$

$$ICC = \frac{1.21 \cdot 10^{19}}{1.21 \cdot 10^{19} + 1.72 \cdot 10^{18}} \cdot 100 = 99.9\% \quad (2)$$

The fixed effects model shows the maximum amount of clustering. The calculated values, which were shown in Table 2, imply that the specified weighting values of IEF have an impact on the inflow of FDI in the analyzed developing countries, that is:

$$\begin{aligned} FDI_{(n)} = & \text{Property Rights } (n-1) + \text{Government Integrity } (n-1) + \\ & \text{Tax Burden } (n-1) + \text{Government Spending } (n-1) + \text{Business Freedom } (n-1) \\ & + \text{Labor Freedom } (n-1) + \text{Monetary Freedom } (n-1) + \text{Trade Freedom } (n-1) \\ & + \text{Investment Freedom } (n-1) + \text{Financial Freedom } (n-1) \end{aligned} \quad (3)$$

Table 2: Estimates of Fixed Effects

Parameter	Estimate	Std. Error	df	t	Sig.	95% Confidence Interval	
						Lower Bound	Upper Bound
Intercept	3,115743E-11	.	.	.	.	.	.
Property Rights	425781,10	303022,62	9,915	1,405	,191	-250177,28	1101739,48
Government Integrity	45571,35	417289,16	10,980	,109	,915	-873076,28	964218,98
Tax Burden	117628,67	126075,34	10,507	,933	,372	-161458,71	396716,06
Government Spending	-263228,53	156238,31	10,477	-1,685	,122	-609212,68	82755,63
Business Freedom	266407,43	184765,48	10,702	1,442	,178	-141645,19	674460,06
Labor Freedom	209037,27	316079,61	10,942	,661	,522	-487102,08	905176,61
Monetary Freedom	9252,77	135118,79	10,226	,068	,947	-290910,94	309416,48
Trade freedom	-63435,60	136030,57	10,040	-,466	,651	-366367,31	239496,11
Investment Freedom	-2,135780E-7	.	.	.	.	.	.
Financial Freedom	-5,110449E-9	.	.	.	.	.	.

Source: Author's calculation in SPSS

After including the covariance parameters, the following model was defined:

$$\begin{aligned} FDI = & 425781,1005 * \text{Property Rights } (\pm 303022,6179) + \\ & 45571,34812 * \text{Government Integrity } (\pm 417289,1655) + \\ & 117628,6704 * \text{Tax burden } (\pm 126075,3452) - 263228,528 * \text{Government Spending} \\ & (\pm 156238,3128) + 266407,434 * \text{Business Freedom } (\pm 184765,4805) \\ & + 209037,2656 * \text{Labor Freedom } (\pm 316079,6107) + 9252,768505 * \text{Monetary} \\ & \text{Freedom } (\pm 316079,6107) - 63435,604 * \text{Trade Freedom} \end{aligned}$$

$$\begin{aligned} (\pm 135118,7852) - 0,000000213578 * \textit{Investment Freedom} \\ (\pm 136030,5696) - 0,000000005110449 * \textit{Financial Freedom} \end{aligned} \quad (4)$$

In the fixed effects model, the obtained value implies that 99.9% of the variability of FDI is explained by the variations of the *Property Rights, Government Integrity, Tax Burden, Government Spending, Business Freedom, Labor Freedom, Monetary Freedom* and *Trade Freedom* indicators. The stated values imply that an increase in economic freedom, in terms of the development and improvement of the legislative, institutional, and regulatory framework, has a significant impact on FDI inflows in the analyzed countries. In other words, ensuring property rights protection, improving government integrity, increasing tax burden and government spending, and enhancing business, labor, monetary, and trade freedom are predictors that positively stimulate FDI inflows in the analyzed countries. The impact of indicators *Investment Freedom* and *Financial Freedom* is not statistically significant and does not significantly affect the variations of the dependent variable due to the obtained values of the coefficients in the model.

The results obtained in the analysis confirmed the existence of a connection and impact between economic freedom and the inflow of FDI in the developing countries that are the subject of the analysis. The analysis targeted eight indicators of the independent variable that have a statistically significant impact on the indicator of the dependent variable. Decomposing IEF into 10 components identified 8 components, i.e. indicators that have a statistically significant impact on the inflow of FDI into the analyzed developing countries. Other two components of IEF also have an impact on the dependent variable, but this impact is not at a statistically significant level. The above implies the existence of heterogeneity of the impact of the 10 components of IEF on the inflow of FDI. A positive sign in the model implies the existence of a positive relationship between the value of the IEF and the inflow of FDI. The cumulative value 8 of 10 components sublimated in IEF has an impact on the inflow of FDI, which means that an increase in the degree of economic freedom has a statistically significant and positive effect on the inflow of FDI in the analyzed developing countries.

The results of similar and comparable research also show a significant degree of heterogeneity and differentiation in terms of the impact of the analyzed components of IEF and the cumulative value of IEF on the inflow of FDI. The results of the panel analysis of Bengoa & Sanchez-Robles (2003) show the existence of a statistically significant and positive impact of IEF on the inflow of FDI. Also, research by Quazi (2007), Caetano & Caleiro (2007), and Hossain (2016) proved that the increase in the value of IEF is a significant predictor of the inflows of FDI. Other studies prove the existence of a certain degree of differentiation of the impact of the components of IEF on FDI flows. Analyzes by Subsat & Bellos (2011), Mehrara & Zirak (2013), Moussa, Çaha, & Karagöz (2016), Taran, Mironiuc & Huian (2016), Haydaroğlu (2016), Imaztiaz & Bashir (2017), Ullah & Khann (2017), Singh & Gall (2020), Aziz (2020), Sooreea-Bheemul et al. (2020), Tag & Digirmen (2022), Štilić et al. (2023) came to the conclusion that certain components have a statistically significant impact on the inflow of FDI, and the degree of heterogeneity is present in all the mentioned studies.

There are no uniform impacts of certain components of IEF, but the differentiation depends on the degree of development of the analyzed developing countries, the geographical scope of the research and the time period of observation. The results

obtained in the research are compatible with the majority of comparable studies, in the aspect of analyzing the cumulative value of IEF, while the values of the analyzed 10 components of IEF, collectively or individually, are to a certain extent similar to the mentioned studies.

Conclusion

This paper investigates the impact and role of economic freedom in international capital flows at the global level. The research aimed to provide an answer with the highest possible degree of accuracy, objectivity and representativeness to the research problem, which is covered by the question of whether variations in economic freedom have an impact on the inflow of foreign direct investments. As a representative indicator of the degree of economic freedom, IEF was taken, which sublimates 12 integrative components that tend to include factors that have an impact on international trade and financial flows. The limitation in the research refers to the impossibility of incorporating all 12 components of the Index into the model due to the lack of data for the analyzed countries in the period since the beginning of index measurement (1995). In other words, the Heritage Foundation databases do not contain complete indicators of the IEF components for the analyzed countries concerning the time frame of the analysis.

The analysis tested the impact of IEF on the inflow of FDI. The time period of observation included 18 years for IEF and 17 years for FDI. The time lag of one year for the value of FDI refers to the logical assumption that the impact of the independent variable on the dependent variable shows its effects only after a minimum of one year has passed. The geographical coverage of the research represents the analysis of 40 developing countries, according to the M49 United Nations classification. A panel data model was used as an analytical tool. Three models were constructed and based on the obtained parameters, the fixed effects model was selected. The direct implication of the analysis is the identification of eight indicators that have a statistically significant impact on the variations of the dependent variable.

The first approximation of the analysis is that IEF has a statistically significant and positive impact on the inflow of FDI in the analyzed developing countries. This means that positive variations in IEF, i.e. an increase in economic freedom, have a stimulating impact on the inflow of FDI. The second approximation of the analysis represents the targeting eight of ten components of IEF that have a statistically significant impact on the inflow of FDI. In this way, the research hypothesis was proven, which represents the construction that the higher degree of economic freedom has a significant and positive impact on the inflow of foreign direct investments *ceteris paribus*.

This research represents a good starting point for future studies of the aforementioned relationships. The conclusions reached in the analysis are temporary and fragile and are based on imperfect research that will be expanded and supplemented in the future. New insights can be obtained by using a larger temporal and geographical coverage, in accordance with the available statistical data, in order to obtain results with a greater degree of accuracy and objectivity, *ceteris paribus*. In terms of the geographical criterion, the aforementioned implies the inclusion of a larger number of developing countries in the analysis, while the extension of the research timeframe depends on the

updating of databases for the values of the dependent and independent variables, which were not fully available at the time of the analysis in this paper.

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