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International Finance

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FDI and Growth in Post 20th-Century Colonial States

**Intro:**

This paper will assess the impact of foreign direct investment (FDI) on economic growth in countries that were European colonies after 1900. It was assumed that as the world grew wealthier in the mid-20th century the wealth gap between developed and undeveloped nations would shrink. This proved untrue; inequality has grown even in a globalized economy. Keely found that average disposable income in the wealthiest 10% of countries increased from 7 to 9.5 times larger than in the bottom 10% between 1990 and 2015[[1]](#footnote-0). Moreover, a study from FRED showed that the GDP in rich countries was around 2.5 times larger than that of poor countries in 1770[[2]](#footnote-1). This gap has ballooned in recent decades, leaving poor countries with a GDP roughly 35 times smaller than those of rich countries[[3]](#footnote-2). In light of this discrepancy: what growth policies should underdeveloped nations implement? One of the major policies enacted by undeveloped countries in order to grow private industry in their economy has been the acceptance of foreign direct investment. In theory, this policy of attracting multinational entities (MNEs) should lead to several positive impacts, such as the spillover of technology and business practices in the local economy and increased job opportunities. The theory shows that there are many benefits for the MNEs, which will profit from cheaper labor, a reduction in material and shipping costs, and better overall efficiency. However, there are also potential negative impacts of FDI on growth in undeveloped countries. For example, attracting multinational entities could crowd out local businesses that cannot compete with large corporations, transfer of natural resources could hinder long-term domestic growth, and MNEs only hold interest in developing their business, not in the growth of their host country. Overall, leaders of the international community (mostly developed Western nations) have concluded that the benefits of FDI outweigh the costs, leading to a steep 532% increase in FDI over the past 35 years (UNCTAD, 2023)[[4]](#footnote-3). It is hypothesized in this paper that FDI and growth are positively correlated in post-20th-century colonial states due to spillover effects, increased wages, and the creation of jobs. Additionally, most of the previous literature finds a strong and positive relationship between FDI and economic growth in various countries.

**Literature Review:**

Many studies have evaluated the impact of FDI on economic growth. One of the most prominent was Borensztein et al., which found that FDI is important for driving technological growth and progressing human capital in developing countries[[5]](#footnote-4). This supports the idea of technological spillovers. While Borensztein et al. also found a small crowding-out effect on domestic investment, the overall relationship between FDI and growth was strong and positive[[6]](#footnote-5). Similarly, a study conducted by Alfaro et al. found that all else equal, the impact of FDI on growth was significantly positive[[7]](#footnote-6). In addition, this study found that the strength of the financial sector in a country, measured by stock value traded relative to the broad money in the economy, significantly impacted the effect of FDI on growth. Countries with stronger financial institutions already in place reaped stronger benefits from FDI[[8]](#footnote-7). Furthermore, the positive effect of FDI on growth was significantly lower in African countries than non-African countries[[9]](#footnote-8). These two findings regarding financial sector strength and location could be relevant to the findings of this paper. Many former colony states post-1900s are in Africa and have underdeveloped financial sectors, potentially mitigating the impact of FDI on growth.

Mehic et al. used a case study of Southeastern European countries to assess the impact of FDI on growth and again found a strong positive relationship[[10]](#footnote-9). They also used a Granger Causality Test and found that FDI impacted GDP more than GDP impacted FDI[[11]](#footnote-10). In contrast, Türkcan et al. ran a Granger Causality Test on a more comprehensive sample and found that GDP impacted FDI more than the other way around[[12]](#footnote-11). These contrasting findings could be due to the different samples. In theory, if FDI was driving growth, it would be beneficial for developing countries to open up their economies to FDI. If growth was causing an increase in FDI, however, that would imply that strong economies attract more FDI due to pre-existing conditions such as the strength and stability of their institutions. In this case, it would be better for developing nations to focus on other drivers of growth before accepting FDI.

Similar tests were run on case studies in Morocco and China. In both of these studies, a positive trend between FDI and GDP growth was found[[13]](#footnote-12),[[14]](#footnote-13). In addition, when a Granger Causality Test was run, it was determined that FDI was driving an increase in GDP, corroborating the results from Mehic et al[[15]](#footnote-14),[[16]](#footnote-15). It is important to note that in the case study of China, no significant spillover effects were seen in the Chinese economy as a result of FDI, and it was concluded that increasing FDI in developing countries was unlikely to stimulate growth[[17]](#footnote-16). This contrasts the findings of Borenstein et al., which found positive spillover effects in technological and human capital.

Lastly, Carkovic & Levine found no significant relationship between FDI and GDP growth after accounting for control variables such as trade openness[[18]](#footnote-17). This contradicts all findings from the previous studies, as the other studies implied a strong positive relationship between FDI and growth. Overall, there are some inconsistent findings when studying the relationship between FDI and GDP growth, but most studies find that increasing FDI drives GDP growth.

**Economic Theory:**

Convergence theory states that low-income countries will eventually catch up with rich countries[[19]](#footnote-18). There are a few theoretical reasons behind this. Firstly, developing nations will have higher returns to labor and capital compared to developed nations. This is because developed nations experience diminishing returns to these inputs, with most of their resources already in use. Developing nations, on the other hand, have many underutilized resources that they can take advantage of to help increase productivity and growth. One problem with this theory is that it does not account for technological growth. Investment in new technology has been the main driver of growth in developed nations, mitigating the impact of diminishing returns to capital and labor[[20]](#footnote-19). Developing nations do not have the money nor resources to catch up with developed nations technologically. Another theoretical advantage developing nations have is that they know how other countries grew economically and can implement similar strategies[[21]](#footnote-20). One problem with this is that every country is unique in its political and economic makeup. What works for one country is not ensured to work for another.

Regarding the flow of capital, it is theorized that developed nations should invest in developing nations which have more resources that could be put to use. However, this isn’t usually the case.A study by Lucas found that the risk associated with these investments, including the lack of stable institutions, can scare investors away from investing in developing nations[[22]](#footnote-21). Because of this, capital tends to flow from poorer countries to richer countries, which is counterintuitive and counterproductive to the advancement of developing nations. Because convergence theory has not held true, developing nations have had to search for sustainable growth strategies, including opening their economy up to FDI.

As previously mentioned, there are many theoretical advantages of FDI from the perspective of MNEs. Firstly, internalizing transaction costs lowers total costs. This occurs when companies can horizontally integrate instead of outsourcing. Instead of paying a premium for the production of goods to a foreign company, the MNE would be able to produce everything themselves. In addition, expanding the size of the company will reduce costs through economies of scale. Also, finding alternative labor sources reduces diminishing returns to labor. Figure 1 shows that, as more labor inputs are used, the returns to labor reduce. Because labor in underdeveloped nations is not fully exhausted, though, using this labor will result in higher returns to output, avoiding diminishing returns. Expanding sources of labor across international sectors can also benefit through diversity within the company. This can lead to the development of new workplace practices or business strategies. MNEs can also benefit from avoiding trade barriers with the expansion of multiple international locations, as well as reducing tax, labor, and emissions costs. This is because developing nations that attempt to attract FDI typically reduce or abolish minimum wage, emissions standards, and corporate taxes.

Increasing returns

Diminishing returns

Negative returns

QL

Output

Figure 1

There are also theoretical benefits to accepting FDI in developing countries. The most prominent positive impacts involve spillover effects. When MNEs bring over technology from their parent countries, the implementation of this technology can lead to a better understanding of how to use, develop, and improve it in host countries. While there is evidence that there is a positive relationship between FDI and technological productivity, several studies including Liu have found that this relationship is not statistically significant[[23]](#footnote-22). The non-conclusive nature of these studies imply that more research should be done on this topic. Additionally, good business practice spillovers can occur with the introduction of MNEs in developing countries. Implementing good business practices provides domestic laborers and investors an opportunity to see how a profitable and functioning corporation works. It can also create more opportunities for these workers to apply and execute successful strategies in domestic industries.

MNEs also create stable jobs and training for workers in developing countries. In addition, because these companies operate on a wider scale, they make larger profits, potentially leading to higher wages for workers in comparison to local options. This theory was supported by Arnal & Hijzen, which found that MNEs paid significantly higher wages than local businesses in similar industries[[24]](#footnote-23).

While FDI can lead to positive outcomes in developing countries, there are also some potential negative effects. MNEs can stunt the growth of local businesses that cannot compete with the resources and scale benefits of large corporations. This would imply that, despite the initial benefits associated with FDI in developing nations, MNEs would result in dependency on foreign corporations that could choose to leave at any time. There is also the problem regarding the distribution of profits regarding MNEs. Profits generated by local businesses will almost always stay within the country, while profits from MNEs tend to flow back to the corporation’s domestic country. Bankman et al. looked at this phenomenon and found that most of the profits generated by US-based MNEs returned to the US[[25]](#footnote-24). As a result, there are limited benefits to helping these businesses attain higher profits.

Furthermore, MNEs have no reason to care about the negative externalities they cause in their host nations. This is particularly prevalent regarding the environment, where low emissions standards are one of the many policy tools used to attract FDI. By moving to countries with lower emissions standards, MNEs are essentially exporting their environmental costs, leading to higher pollution in the host country. This applies to the host country’s business sector as a whole. MNEs have no reason to care about the overall impact they have on the local economy. Because of these effects, it could be argued that isolationist policies, such as subsidizing local businesses and reducing FDI, could be more beneficial to developing countries in the long run.

Overall, the theory regarding FDI shows that there could be mixed effects on local economies when accepting FDI. Whether or not FDI will lead to economic growth in a country is dependent on whether the positive spillover effects outweigh the negative externalities. Key variables such as available human capital, technology, and economic stability play a large role in the effectiveness of FDI, as shown in the previous literature.

**Data:**

Data was collected from 116 randomly selected countries (57 post-1900 colonies and 59 non-colonies) from 2001 to 2016. Economic growth was measured using percent change in PPP GDP per capita[[26]](#footnote-25). This method was employed by several other papers, including Alfaro et al., and Mehic et al[[27]](#footnote-26),[[28]](#footnote-27). The FDI data was measured in FDI as a percentage of GDP[[29]](#footnote-28). In previous literature, such as Mehic et al. and Carkovic & Levine, this was the most common method of measuring FDI[[30]](#footnote-29),[[31]](#footnote-30). Initially, FDI was to be measured using FDI as a percentage of total financial account inflows, but an abundance of missing data made this method ineffective. Again, all missing data was removed from the dataset.

Several control variables were also implemented to improve the accuracy of the results. In papers such as Borensztein et al., Türkcan et al., and Alfaro et al., similar controls were included when running regression models[[32]](#footnote-31),[[33]](#footnote-32),[[34]](#footnote-33). Inflation was the first control variable chosen. This was applied as a proxy for economic instability within a country, as lower values of inflation tend to indicate higher instability. Change in annual consumer price index was used to measure inflation[[35]](#footnote-34). Alfaro et al. found that countries with more financial sector stability received greater economic benefits from FDI[[36]](#footnote-35). Exports plus imports divided by GDP was another control variable that was included in the study[[37]](#footnote-36). This served as a proxy for trade openness, which, when included in the Alfaro et al. study, significantly reduced the positive effect of FDI on economic growth[[38]](#footnote-37). A control variable showing average school life expectancy for primary and secondary education for all sexes in a country was used to measure education[[39]](#footnote-38). Education levels are commonly used as a proxy variable for existing human capital in a country. In Borensztein et al., it was found that having high levels of human capital was a prerequisite for achieving positive economic impacts from FDI[[40]](#footnote-39). Lastly, a variable that measures control of corruption in a country was used as a proxy for institutional strength. In this data, lower values represent a country that has little to no control over corruption. It is theorized that countries with stronger institutions will receive more benefits from FDI because more MNEs will be willing to expand their production in a safe business setting, eventually leading to stronger spillover effects. All of these variables were obtained from the World Bank Data Center, and all missing values were removed.

Table 1 shows the summary statistics of the variables listed above.

**Table 1:**

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The total number of observations in the set was 1123, 588 of which were from non-post-20th-century colony states, and 535 of which were from post-1900 former colony states. While there is some imbalance in the data, it is not significant enough to be concerning. In addition, the data contained FDI and inflation as whole percentage values (i.e. an input value of 1 represented 1%). This is important to remember when looking at the results of the study.

**Methodology and Results:**

Four regression equations with percent change in PPP GDP per capita as the dependent variable were chosen to evaluate the impact of FDI on post-20th century colonial states and non-former colonial states. The initial two regressions run only included FDI as an independent variable. The first equation was run using data from the former colony states while the second was run with the non-former colony states. Both of the remaining regressions were run with FDI as a percentage of GDP, inflation, trade openness, education, and corruption as independent variables. In addition, the interaction between the FDI term and all the control variables was assessed. This was done to understand the setting in which FDI can drive GDP growth in both types of nations. The econometric specifications for the equations are shown below.

1:For Colony Data: yt,i = 𝛃0 + 𝛃1\*FDIt,i

2:For Non-Colony Data: yt,i = 𝛃0 + 𝛃1\*FDIt,i

3: For Colony Data: yt,i = 𝛃0 + 𝛃1\*FDIt,i + 𝛃2\*Inflationt,i + 𝛃3\*Tradet,i + 𝛃4\*Educationt,i + 𝛃5\*Corruptiont,i + 𝛃6\*FDIt,i\*Inflationt,i +  𝛃7\*FDIt,i\*Tradet,i + 𝛃8\*FDIt,i\*Educationt,i + 𝛃9\*FDIt,i\*Corruptiont,i

4: For Non-Colony Data: yt,i = 𝛃0 + 𝛃1\*FDIt,i + 𝛃2\*Inflationt,i + 𝛃3\*Tradet,i + 𝛃4\*Educationt,i + 𝛃5\*Corruptiont,i + 𝛃6\*FDIt,i\*Inflationt,i +  𝛃7\*FDIt,i\*Tradet,i + 𝛃8\*FDIt,i\*Educationt,i + 𝛃9\*FDIt,i\*Corruptiont,i

Where yi,t represents percent change in GDP for country i in time t.

The results of the first two regression equations are shown in Table 2, while the results of the third and fourth regression are shown in table 3.

**Table 2**

|  |  |  |
| --- | --- | --- |
| Variable Name | Colony Data | Non-Colony Data |
| Intercept | 0.0407\*\*\*  (p = 2 \* 10^-16) | 0.0420\*\*\*  (p = 2 \* 10^-16) |
| FDI | 0.0004  (p = 0.44) | 0.0014\*\*\*  (p = 0.00007) |

**Table 3**

|  |  |  |
| --- | --- | --- |
| Variable Name | Colony Data | Non-Colony Data |
| Intercept | 0.0899\*\*\*  (p = 0.0001) | 0.0078  (p = 0.69) |
| FDI | -0.0035  (p = 0.44) | 0.0111\*\*\*  (p = 0.00005) |
| Inflation | -0.0017\*\*  (p=0.005) | -0.0009 .  (p = 0.1) |
| Trade Openness | 0.00004  (p = 0.64) | 0.0002\*\*  (p = 0.005) |
| Education | -0.0055\*  (p = 0.02) | 0.0025  (p = 0.21) |
| Corruption | -0.0095  (p = 0.18) | -0.0071\*\*  (0.006) |
| FDI:Inflation | 0.0002 .  (p = 0.06) | 0.0003\*\*  (p = 0.005) |
| FDI:Trade Openness | 0.000001  (p = 0.90) | -0.0002\*  (p = 0.02) |
| FDI:Education | 0.0003  (0.48) | -0.0009\*\*\*  (0.0001) |
| FDI:Corruption | 0.0004  (p = 0.75) | -0.0002  (p = 0.5) |

The results of Table 2 show that, while there is a positive effect of FDI on GDP growth in both groups, the coefficient in the colony dataset is not statistically significant at a 95% confidence level. This, along with the coefficient value, implies that increasing FDI leads to stronger GDP growth in non-colonial states than in colonial states. The intercept of these two regressions also shows that all else equal, the average change in PPP GDP per capita is slightly larger in non-colony states than in former colony states. The coefficient for the FDI term in the former colony dataset can be read as follows: when FDI as a percentage of GDP increases by 1 percentage point, change in PPP GDP per capita will increase by 0.04 percentage points. This is a relatively small change, especially when compared to the non-colony dataset, where a 1 percentage point increase in FDI as a percentage of GDP leads to a 0.11 percentage point increase in change in PPP GDP per capita.

Table 3 shows how the relationship between FDI and economic growth changes after considering exogenous factors such as economic stability, trade openness, human capital, and institutional strength. After accounting for these control variables, the relationship between FDI and GDP growth in former colony countries flipped from positive to negative. It is important to note that neither of these findings are significant, but the change in sign is still interesting. It was also found that there was no significant interaction between FDI and the control variables, meaning that in any economic background, the effects of FDI are the same for former colony states. This was not the case for non-colonies, though, which maintained a strong positive relationship between FDI and GDP growth. Additionally, many of the interaction terms were significant. Countries with higher inflation, lower trade openness, and lower human capital experienced significantly higher economic returns from the same level of FDI.

**Discussion:**

Using the results of the above models, it can be concluded that FDI does not have a significant impact on economic growth in post-20th-century colonial states. This was true when solely evaluating the relationship between FDI and economic growth as well as when adding control variables. The fact that FDI and economic growth are positively correlated in non-former colonies matches the findings of several previous papers, such as Türkcan et al., Borensztein et al., Alfaro et al., Mehic et al., Al Nasser, and Baliamoune-Lutz[[41]](#footnote-40),[[42]](#footnote-41),[[43]](#footnote-42),[[44]](#footnote-43),[[45]](#footnote-44),[[46]](#footnote-45). Much of the previous literature also found that the relationship between FDI and economic growth was not statistically significant after accounting for control variables in developing countries, including Al Nasser, Alfaro et al., and Gunby et al[[47]](#footnote-46),[[48]](#footnote-47),[[49]](#footnote-48). However, including these control variables did not significantly change the relationship between FDI and GDP growth in former non-colony countries. An interesting finding was that the interaction terms were not significant for former colonies, meaning that the effect of FDI was the same regardless of economic background. In addition, the interaction terms for the non-colony countries implied that having higher inflation, lower trade openness, and lower human capital resulted in more economic benefit from FDI. Both of these results counter the findings of Borensztein et al. which found that countries with less human capital received less benefit from FDI[[50]](#footnote-49). Furthermore, the findings of Alfaro et al. show that countries with stronger financial sectors received a stronger economic boost from FDI, which is the opposite of what was found in the non-colony dataset[[51]](#footnote-50).

Based on these findings, former colony countries do not receive significant economic benefits from FDI regardless of economic background. In addition, all non-former colonies see a strong positive relationship between FDI and GDP growth but countries with weaker financial sectors, less human capital, and less trade openness experienced more benefits from FDI. In all, weaker economies that were not colonized after the 20th century see the strongest relationship between FDI and GDP growth. This reflects the theory that capital should flow downhill, resulting in higher profits for MNEs and long-run growth in developing countries. This is not the case for former colony states, though, where the effects of systematic exploitation still linger. One potential reason that former colony states see significantly less impact from FDI on growth could be the types of FDI that are implemented in these countries. A study by Willems te Velde found that the type of FDI received by a country was a stronger predictor of economic growth than the quantity received[[52]](#footnote-51). High value added manufacturing in Asia was the most prominent example of how FDI could lead to growth in developing economies. In related research, Glaister et al. found that there was evidence that former colonial countries received significantly more inward FDI from their former colonizers than non-colonial states[[53]](#footnote-52). Because of this, the type of FDI implemented in former colonies could still contain colonial aspects that fail to address the interests of host nations. Based on this conclusion, it seems that there is no explicit benefit for these countries to open up their economy to FDI, especially to former colonizer states. More research should be done on the types of FDI received from former colonial states to reinforce the findings of this paper.

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