COMPARING BUSINESS REGULATIONS AND FOREIGN DIRECT INVESTMENT ON ECONOMIC GROWTH OF G77 AND OECD COUNTRIES

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Abstract

One of the prerequisites for economic growth is capital. One way of financing is absorbing Foreign Direct Investment. Attracting foreign direct investment needs safe business environment, because it makes possible the return on investment and investment performance. For establishing a safe environment, we require proper Laws for business. In this study, the relationship between foreign direct investment, regulation of business and economic growth are examined in the years 2004 to 2010.This study is done using panel data model. Statistical sample used in this study, including 19 selected countries among G77 countries and 15 selected countries from OECD countries. The results show that the amount of foreign direct investment in the G77 countries with two-lag period has positive and significant impact on economic growth. In addition, the rule of law, with one period of delay has a positive and significant impact on economic growth. In OECD countries, the results indicate that foreign direct investment without delay has a positive and significant impact on economic growth, and the rule of law without delay has a positive and significant impact on economic growth.

Keywords

Foreign Direct Investments; Rule of law; Business environment; Economic growth; Panel Data.

INTRODUCTION

In the late 90s, the importance of "business environment" as the link between micro- and macro-economic sectors was introduced in the economics literature. Obviously, reforming the business regulations and improving these indicators in the global arena, not just is a positive step to strengthen the participation of the private sector in the economy, but also promote and facilitate Technology Entrance into the country. While the business environment does not improve, firm performance and the overall growth of the private sector are not possible. Some consequences of inappropriate business environment are Reduction of enterprise's competitiveness and the expansion of the unofficial sector. Expansion of the unofficial sector of the economy for the government means the decline in tax revenues, for the unofficial economic actors mean being deprived of official financing, for official firms mean being in an unhealthy competition to unofficial actors. Simplification of business regulations, especially for small and medium enterprises (SMEs) is to the extent important that countries like South Korea, China, Malaysia, and Russia for improving their economic conditions, have put reforming of these rules in their plans.

The main objective of this paper is to investigate the effect of business regulations on economic growth and the effects of foreign direct investment (FDI) on economic growth in 19 selected G77countries including Algeria, Argentina, Bangladesh, Colombia, Dominican, Egypt, India, Indonesia, Iran, Morocco, Pakistan, Peru, Saudi Arabia, Thailand, Tunisia, Uruguay, Venezuela, Vietnam, Singapore, also 15 selected OECD countries include Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Japan, Norway, Spain, Sweden, Switzerland, United Kingdom, America. In this regard, a comparison between the impact of FDI on economic growth and business regulations in the two countries will be executed. The reason for choosing these two kind countries is comparing the impact of FDI on economic growth and business regulations in developed and developing countries. Another factor in this group of countries is the homogeneity in the rankings on the business environment and having the same extent of rule of law. So that, according to leading economists Association in 2010, the G77 countries' rank in the business environment is between 3.96 and 5.42, and OECD countries' rank in the business environments 7.5 to 8.55.

Therefore, in this article we will try to answer this question. How do the rule of law and FDI will affect economic growth? Accordingly, the following hypotheses are considered for this article:

- Does the rule of law in selected countries of G77 have a positive and significant effect on economic growth?

- Does the amount of foreign direct investment and strict regulation of business in the selected G77 countries have a profound effect on economic growth?

- Does the rule of law in selected OECD countries have a significant positive impact on economic growth?

- Does the FDI and the amount of strict business regulation have a positive and significant effect on economic growth in selected OECD countries?

A comparison between the effect of foreign direct investment and strict regulation of business in the OECD and G77 countries. To this end, we have tried to explore the question and hypothesis of the research with Panel Data Method.

THEORETICAL FOUNDATIONS

In classical economics and simple interpretations, economic growth is the increase in the production of a country in a particular year compared to its level in the base year. Michael Todaro knows economic growth a sustained process that the production capacity of the economy grows over time and increases the level of national income. However, there is a more precise concept of Kuznets economic growth: a long-term increase in production capacity in order to offer more diverse economic goods to the people (Branson, 1982).

To increase economic growth and development, requirements should be prepared. We can define the required circumstances for increasing production and expand the business. In other words, business environment is one of effective variables on firms that are out of the firm's control and power, but it is very effective on the result of their efforts.

Capital accumulation is also one of the basic needs of the growth process, which can be financed from internal or external sources. Foreign funding is a supplementary for the domestic savings. One of the best ways for foreign financing is Foreign Direct Investment (FDI).The benefits of FDI are attracting investment, new technology, new knowledge, improve management capacity, increasing employment, improving the balance of payments and increasing the competitive strength. According to studies, foreign investment is the function of many factors such as the rate of return on capital, openness of the economy, infrastructure, economic growth, domestic investment, natural resources, human capital, inflation, exchange rates, external debt, financial situation of the government and the market size.

One of the most important issues on foreign direct investments regulation and the rule of law in countries, which are being invested. Regulations can relatively be a barrier to entry for investors in the production sector, which could be an obstacle in the way of domestic investors and foreign investors (the most severe). For example, if foreign ownership of domestic assets is prohibited, there will not be an incentive to invest left any more.

Making consistent rules and reducing cumber some rules for entering and exiting into the business will increase the number of foreign investors into the host economy and make positive effects on economic growth. Basically, foreign firms that will start up under foreign direct investment in the host economy, benefit relatively from more advanced technology and modern management methods and so on in comparison with domestic firms in production process andbyincreasingtheshareofforeignfirmsinthehosteconomyandtheinteractionbetween domestic and foreign firms have positive effects on labour skills, market structure, and wage levels which ultimately leads to improved productivity in the host country and its economic growth (Valinia, 2011, 44-45).

The costs of rules are in two shapes of money and time. Financial expenses, which are expenses of the investment process or the operation of the investment, should be paid to factors other than production such as expenses that must be paid for the registration of such company or expenses that the law compel you pay more than production direct factors' costs, such costs shall be paid in accordance with the law, the right to work and housing.... Time costs, the costs that investor due to loss of time as dictated.

Some of the negative effects of high levels of these rules can be outlined in a business environment:

- Informal sector of the economy is going to be larger and the black market will grow because of the escape of law costs or escape from the tortuous provisions' steps; and

- Reduction of investment in the economy and consequently high unemployment rate and economic growth.

REVIEW THE TREND OF RESEARCH VARIABLES

To better illustrate the effects of variables of the rule of law and foreign direct investment on economic growth, we Review the trend of ruling of the G77 countries during the years 2000 to 2010.

Considering Figure 1 it can be seen that the trend of rule of law in G77 and OECD countries is a very softly trend. Because it requires time to change the rule of law. Another striking point in this diagram can be the kind of rule of law in these countries. In OECD countries, the rule of law is a positive one, So that these countries have a high ranking in the business environment, while the rule of law in G77 countries is negative. In other words, the type of governance and required institutions for these countries is negative.
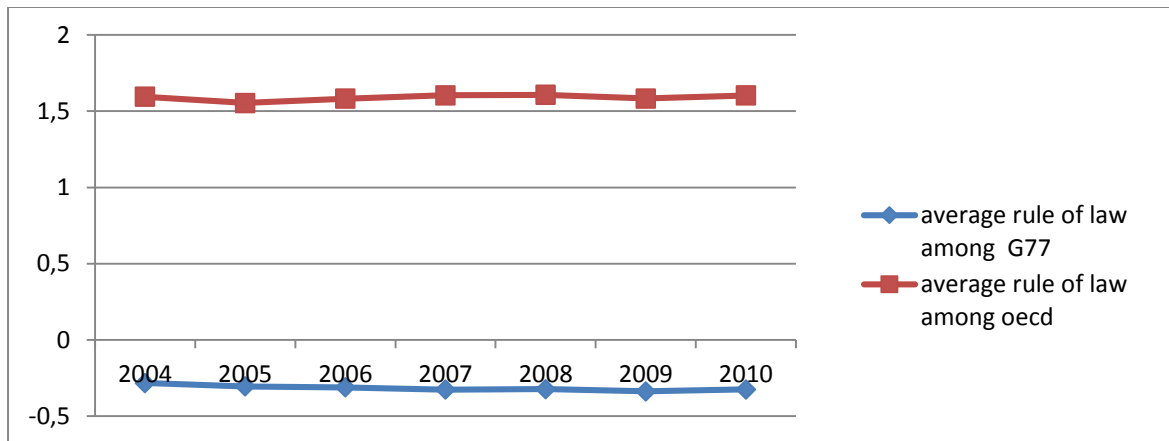
FIG. 1 COMPARISON OF RULE OF LAW AMONG G77 AND OECD COUNTRIES

As can be seen in Figure 2 the trend of amount of foreign direct investment in the G77 countries is rising with a soft slope and in OECD countries has SIN state. That is, it has declining steep during the years 2000 to 2003, during the years 2003 to 2007 is quite ascending with a steep, during the years 2007 to 2009 is quite steep descending and in the years 2009 to 2010 is approximately constant. However, about the causes of sinusoidal of foreign direct investment in OECD countries we can refer events occurred in the world economy. As follows, those in 2001 due to the collapse of the twin towers in America and the world economy have been influenced by this incident; levels of foreign direct investment took declining trend. During the years 2007 and 2009, a crisis swept the global economic and this time, banks were on the brink of financial ruin; but in the years 2009 with injecting money into the banks has been prevented the economic crisis to some extent and foreign direct investment took a mild trend.
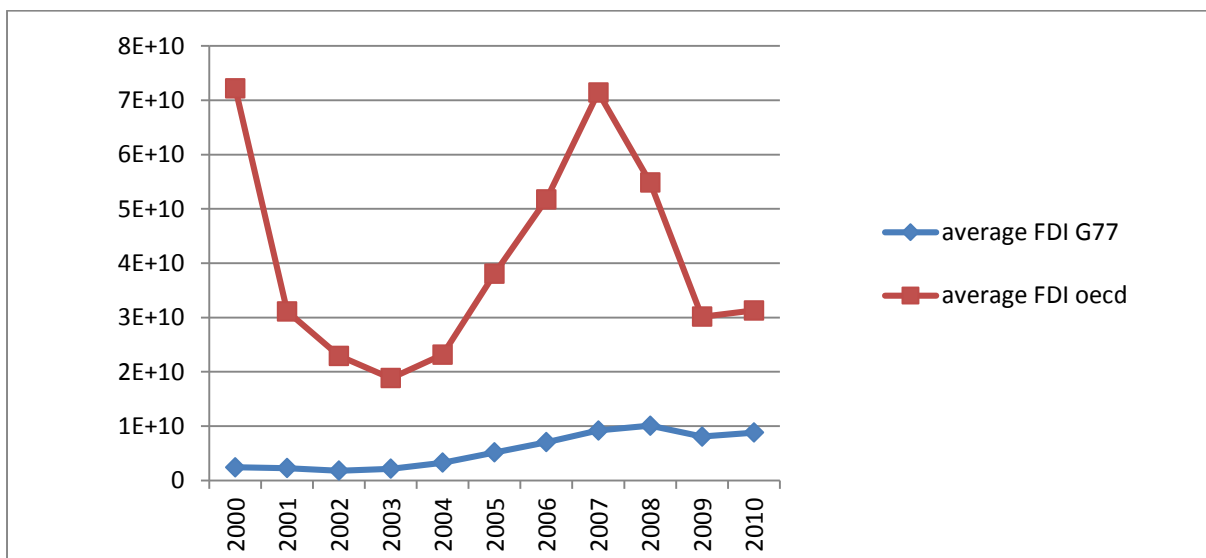

FIG. 2 COMPARISON OF FDI TREND IN OECD AND G77 COUNTRIES

Another interesting aspect of this chart can be the very low levels of foreign direct investment in the economy of the G77 countries. One of the reasons could be lack of

the necessary economic stability and uncertainty or In other words the lack of necessary institutions for investment and return on investment.

As can be seen in Figure 3, the rate of economic growth in G77 countries is higher than the rate of economic growth in OECD countries. One of the main reasons for this difference is the available empty production capacity in G77 countries due to their incomplete development. Of other points can be seen in the diagram, they are fluctuations. Most of changes are within 2007-2009. Its major reason is the global economic crisis as well as currency fluctuations in Europe (EURO) during these years. GDP growth rate in G77 countries over the years 2002-2005 have also been reduced. One of the main causes is the fall of the twin towers in America and followed by an economic crisis caused by falling stock worth and reduced investments in Europe because of the economic crisis.
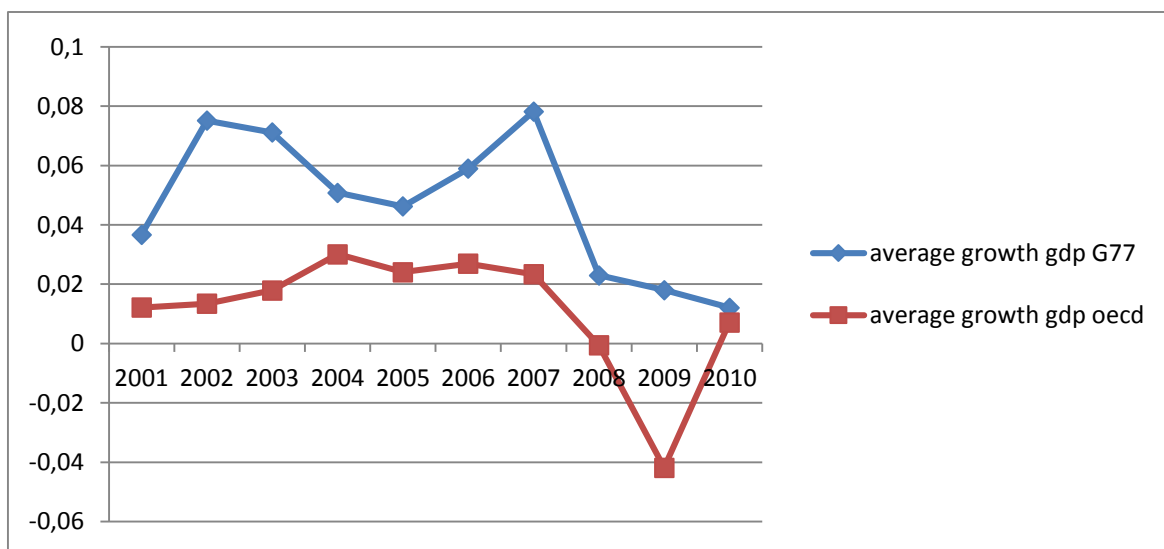

FIG.3 COMPARISON OF GDP GROWTH TREND

Research history

Valinia (2011) has studied the effects of ease of entry and exit to the business on the totalᵒ factors productivity, case studies of selected developing countries. In this study using a panel data model, he has reached this result that there is a significant relationship among the starting a business stages index, start time of a business, the cost of starting a business, minimum capital required to start a business, the rate of business closures taking index, closing time business index, business closure costs, the degree of openness and the business and totalᵒ factors productivity. The article also stated that the ease of entry and exit to business through foreign investment is an effective factor on productivity.

In an article, Bengoa and Sanchez Robles (2002) studied the interaction between economic freedom, FDI and economic growth for a sample of 18 Latin American

countries over years 1970-1999. The results obtained in this paper is that economic freedom in the host country has a positive impact in attracting foreign direct investment and foreign investment has a positive impact on economic growth. However, adequate human capital, economic stability and open market effectively benefit more in the long-term interests of foreign direct investment.

An article by Loayza et al, (2005) can be pointed. The study entitled "The effect of regulation on economic growth and the informal sector", finally come to the conclusion that excessive regulation of the labour market and production will reduce economic growth and stimulate Informal sector. Busse and Groizard in their studies done in two times (2005, 2008) come to this result that too much regulations in countries with strict laws, will limit the economic growth due foreign direct investment. This study showed that the results using different econometric models are varied. The model on this study was taken from their selected model.

SPECIFICATION OF THE MODEL OF ECONOMIC GROWTH FUNCTION

Economic growth conditions in selected countries suggest that many factors are effective in economic growth. Some of these items are foreign direct investment, physical capital, employment, rule of law and the amount of regulations in business environment. Thus, it was necessary to carry out an empirical study about effective factors in economic growth in G77 and OECD countries. At this paper we used the Busse and Groizard's model for estimating economic growth function in selected countries.

$$\log GDP_{it} = c + \beta_1 DB_{it} + \beta_2 \log EMP_{it} + \beta_3 \log CAP_{it} + \beta_4 RUL_{it} + \beta_5 \log FDI_{it} + U_{it} \ (1\text{-}1)$$

Which:

$GDP_{it} =$ Economic growth in country i and time of t

Whereas: C is intercept; DB_{it} is the i country's business environment rank in time of t; β_1 is GDP changes per changes in country's business environment rank; EMP_{it} employment in country i in time t; β_2 is employment elasticity; CAP_{it} is physical capital; β_3 is physical capital elasticity; RUL_{it} is the rule of law index in country i and time of t; β_4 is changes of GDP per changes in rule of law index; FDI_{it} is foreign direct investment in country i in time of t, β_5 is elasticity of FDI; U_{it} is disturbance sentence in country i in time of t. According past researches and carried out studies, these are expected that $\beta_1 < 0$, $\beta_2 > 0$, $\beta_3 > 0$, $\beta_4 > 0$, $\beta_5 > 0$

First test (The width origin test)

$$H_0 : \alpha_1 = \alpha_2 = \alpha_3 = ... = \alpha_i$$
$$H_1 : \alpha_i \neq \alpha_j$$

One may note that in this study, we use panel data or combinational data and for

this F test is used. Zero hypothesis states there is no difference between estimated coefficients for every panel and for accumulation estimated coefficient; that is there is not needed to use panel data model. In other words pool model is preferred to fixed effects model. After F test, calculated F statistic is compared with critical statistic F. If calculated statistic F is more than critical number, zero hypotheses will not be accepted and it is necessary that the model estimated using panel data methods. Thus, pool model is preferred to fixed effects model.

The critical statistic F for the countries of G77 at the 95% level is 1.87 and it is above critical value, thus the null hypothesis based on having equal width from the countries of the G77 will not be accepted and it is necessary to estimate the model with panel data method; also for OECD countries.

TABLE1. RESULT OF F TEST FOR DETERMINING PANEL OR COMBINATIONAL DATA

Model	Degree of freedom-Numerator	Degree of freedom-denominator	F-Statistic (prob)	critical statistic F 90%
Economic growth in OECD countries	14	25	25/14 0.000	3/79
Economic growth in G77 countries	18	71	33/93 0.000	1.87

Second test, choosing from RE and FE

After be assure of using panel data method, the main question is that the model should be estimated with fixed effects or accidental effects? For this we use Hausman Test which is presented in 1980. This statistic has a Chi-square Distribution with degree of freedoms equals to independent variables. Zero hypothesis of Hausman Test is the equality of coefficients of explaining variables in fixed and accidental state. We have:

$H_0 : \hat{\beta} = \beta$

$H_1 : \hat{\beta} \neq \beta$

Zero hypothesis of Hausman Test says model has an accidental effects. Statistic of this test is Chi-square Distribution. If calculated χ^2 statistic is more that critical amount, zero hypotheses base on estimating the model with accidental effects will not be accepted.

TABLE2. RESULT OF F TESTS FOR DETERMINING FIXED OR ACCIDENTAL EFFECTS

Model	Degree of freedom-Numerator	Degree of freedom-denominator	F-Statistic (prob)	critical statistic F 95%
Economic growth in OECD countries	14	71	33/93 0/000	1/87
Economic growth in G77 countries	18	25	25/14 0/000	3/79

The critical statistic F for OECD countries at the level of 95% is 3.79 and calculated statistic F is above critical value, so the null hypothesis based on having equal width from the countries of the OECD will not be accepted and it is necessary to estimate the model with panel data method; also for G77 countries.

Estimating economic growth model for G77 countries

Finally, it is the estimated model in the period 2004-2010 for G77 countries:

$$\log GDP_{it} = 9/4 - 0/00014 DB_{it} + 1/01 \log EMP_{it} + 0/21 \log CAP_{it} + 0/0024 RUL_{it-1} + 0/0076 \log FDI_{it-2}$$

(9/7)　　(-1/69)　　(16)　　(6/6)　　(4/65)　　(3/89)

$$R^2 = 0/99$$
$$\overline{R}^2 = 0/99 \quad F = 3411 \quad D-W = 1/17$$

Interpretation of data

The Sign of all estimated coefficients are consistent with the theory. The Adjusted coefficient of determination ($\overline{R}^2$) is also 0.99 that is showing that explanatory power of the model is appropriate. The amount of $\overline{R}^2$ suggests that independent variables those are the rank of every country in business environment, employment, physical capital, rule of law and foreign direct investment totally explain 0.99% of changes of dependent variable, means economic growth rate.

T-Statistic shows that coefficient of every selected variable including the rank of every country in business environment, employment, physical capital, rule of law and foreign direct investment is acceptable. The Probability of t-statistic in above equation suggests that all coefficients are meaningful at the 0.95% level.

F-Statistic is saying that the coefficients of all selected independent variables are either effective in dependent variable or not. As it is can be seen the estimated statistic is F=3411. Thus, it can be said that all estimated coefficients of independent variables generally are effective in economic growth. The coefficient of variable C (intercept) is showing the effective factors which are not considered as independent

variables but there are in error term with the form of fixed effects. Its estimated number is totally 9.4 (its effect on every country is below the Fixed Effects), it means that the amount of other factors which are not been considered and their effects are in fixed effects is 9.4.

Interpretation of Coefficients

If the model is Log-Log, coefficients are elasticity (sensitivity). In other words, coefficients are showing the percentage changes of dependent variables per one percent change in independent variable. But if the model is simple and without Log, coefficients are shown as unit, it means for every one unit change in independent variable, dependent variable also change one unit and if the model is half-Log, changes only is shown as effect.

Every country's rank in business environment (DB)

Given that our function on this paper for independent variable of the rank of every country in business environment is without Log, and in other hands the dependent variable is with Log, so we can just see its effects on economic growth variable. Since the estimated variable is -0.00014 and it is a negative number, it suggests that the rank of every country in business environment has an adverse effect. In other words the higher the rank, economic growth is lower.

Employment (EMP)

As our function in this study for independent variable of employment is with Log and also the dependent variable of the model is with Log, so the coefficient of this independent variable suggests Elasticity (Sensitivity), in other words if employment increases one percent, economic growth intensifies 1.01%, that it is in accordance with the theory.

Physical capital (CAP)

Because our function in this research for independent variable of physical capital is with Log, and the dependent variable of the model is with Log, so the coefficient of this independent variable shows the elasticity (sensitivity), in other words if physical capital increases one percent, economic growth will increase 0.21% that it is consistent with the theory.

Rule of law (RUL)

Given that our function in this study for independent variable of rule of law is without Log, and in other hands dependent variable is with Log, so we can just say that how the effect of this variable in economic growth is. As regards, the estimated coefficient is 0.0024 and this is a positive number, so the rule of law has a positive

effect in economic growth. Estimated coefficient is in accordance with the theory. The reason for one period lag of calculating this variable and it is positive, is known in kind of rule of institutions in these countries, because for accepting rules in these countries, they need time. In other words for executing any rule in these countries, the required time is one year. Because the governing institutions are so weak both in terms of law enforcement and in terms of governing corruption led to circumvent the law of these countries.

Foreign Direct Investment (FDI)

Because our function in this research for independent variable of foreign direct investment is with Log, and also the dependent variable of the model is with Log, so the coefficient of this independent variable shows the elasticity (sensitivity), in other words if foreign direct investment increases one percent in year of t, economic growth will increase 0.0073% with a two-year lag. Its reason can be the lack of appropriate labour in these countries after entering foreign direct investment. In other words for affecting foreign direct investment in economic growth it needs time, that is two years until labour can be trained and according to capital gain skill. The effect of this variable is in accordance with past studies.

In comparison of the effects of independent variables in economic growth, is shown rule of law, employment, physical capital and foreign direct investment have a positive and meaningful effect in economic growth, but the rank of every country in business environment has a reverse and meaningful effect in economic growth. Also in comparison between coefficient of employment and foreign direct investment, employment has much more effect in economic growth than foreign direct investment. It emphasizes on the level of employment in these countries. The reason is that if foreign direct investment enters into a country but does not make an effect in employment, that foreign direct investment is not useful for that country, or has a little effect. Thus, when the foreign direct investment can be useful, that firstly can create jobs and secondly create skill and proficiency. In addition, the people of these countries should have required knowledge and skills, otherwise it cannot affect in economic growth.

However, in comparison between elasticity of physical capital and employment, employment has 4.8 times more effects in economic growth than physical capital. It itself shows that the problem of lack of economic growth is not capital, rather is the lack of skilful people in these kind countries. In comparison between coefficients of physical capital and foreign direct investment, first of all physical capital is more than foreign direct investment, it can be because of shortage of required backgrounds for foreign direct investment in these kind of countries. Secondly, physical capital affects in the same year but foreign direct investment affects with a two-year delay. In addition, whatever rules of the business market grows, the

difficulty of entering a business gets more, so fewer people enter the space and GDP gets low.

In general, we may say that the poor rule of law in G77 countries caused that firstly the amount physical capital in these countries was low. Secondly caused the foreign direct investment due to the existing uncertainty was low and it answers after two years. Thirdly, caused employment in these countries was very low, and also caused the rank of these countries in business environment was so bad. Thus, promotion of economic growth in G77 countries is very low.

Estimating economic growth model for OECD countries

Finally, it is the estimated model in the period 2004-2010 for OECD countries:

$$\log GDP_{it} = 20/29 - 0/00028 DB_{it} + 0/00086 \log EMP_{it} + 0/24 \log CAP_{it} + 0/0019 RUL_{it} + 0/0004@\, pch(FDI_{it})$$

$$(34) \quad (-0/76) \quad\quad (-8/6) \quad\quad\quad (11/51) \quad\quad\quad (26/19) \quad\quad (1/9)$$

$$R^2 = 0/99$$
$$\overline{R}^2 = 0/99 \quad F = 105716 \quad D - W = 2/9$$

Interpretation of data

The Sign of all estimated coefficients are consistent with the theory. The Adjusted coefficient of determination ($\overline{R}^2$) is also 0.99 that is showing that explanatory power of the model is appropriate.

The amount of $\overline{R}^2$ suggests that independent variables those are the rank of every country in business environment, employment, physical capital, rule of law and foreign direct investment totally explain 0.99 percentage of changes of dependent variable, means economic growth rate.

T-Statistic shows that all coefficients except the rank of business environment are meaningful at the 0.95% level. As it is can be seen the estimated statistic is F=105704. Thus, it can be said that all estimated coefficients of independent variables generally are effective in economic growth.

The coefficient of variable C (intercept) is showing the effective factors which are not considered as independent variables but there are in error term with the form of fixed effects. Its estimated number is totally 20.29 (its effect on every country is below the Fixed Effects), it means that the amount of other factors which are not been considered and their effects are in fixed effects is 20.29.

Interpretation of Coefficients

Every country's rank in business environment (DB)

Given that, our function on this paper for independent variable of the rank of every country in business environment is without Log, and in other hands, the dependent variable is with Log, so we can just see its effects on economic growth variable. Since the estimated variable is -0.00028 and it is a negative number, it suggests that the rank of every country in business environment of OECD countries has an adverse effect in economic growth. However, because t-statistic is more than 0.1, it shows the rank in business environment in OECD countries is ineffective. The reason can be said in this way that because of right rule of law are those countries relatively in ranks among 1 to 10 and relocation in these ten ranks is not affective in their economic growth. The sign of estimated coefficient is in accordance with the theory. In addition, the first hypotheses is ejected in these countries.

Employment (EMP)

As our function in this study for independent variable of employment is with Log and also the dependent variable of the model is with Log, so the coefficient of this independent variable suggests Elasticity (Sensitivity), in other words if employment increases one percent, economic growth increases 0.00086%, that it is in accordance with the theory.

Physical capital (CAP)

Because our function in this research for independent variable of physical capital is with Log, and the dependent variable of the model is with Log, so the coefficient of this independent variable shows the elasticity (sensitivity), in other words if physical capital increases one percent, economic growth will increase 0.24% that it is consistent with the theory.

Rule of law (RUL)

Given that our function in this study for independent variable of rule of law is without Log, and in other hands dependent variable is with Log, so we can just say that how the effect of this variable in economic growth is. As regards, the estimated coefficient is 0.0019 and this is a positive number, so the rule of law has a positive effect in economic growth.

Foreign Direct Investment (FDI)

Because our function in this research for independent variable of foreign direct investment is as @pch that is a kind of Log, and the dependent variable of the model is with Log, so the coefficient of this independent variable shows the elasticity (sensitivity), in other words if foreign direct investment increases one percent, economic growth will increase 0.0004%. In comparison of the effects of independent

variables in economic growth, is shown rule of law, employment, physical capital and foreign direct investment have a positive and meaningful effect in economic growth, but the rank of every country in business environment has a reverse and meaningless effect in economic growth. Also in comparison between elasticity of physical capital and employment in OECD countries, elasticity of physical capital has 279 times more effects in economic growth than employment. It itself shows that employment capacity is full and the sensitivity is for physical capital.

RESULTS

Given the estimated models the results are:

- The effect of increasing the rule of law in economic growth in G77 countries is 1.26 times more than OECD countries; and

- The effect of increasing foreign direct investment in economic growth in G77 countries is 18.25 times more than OECD countries.

The effect of rule of law in OECD countries caused firstly promotion of physical capital in these countries was high, secondly by reducing misalignments, assurance will intense and assurance of return of investment gets high and return of foreign direct investment increases in these countries. Also right rule of law caused entering people to business environment was simple and employment was high. Thus, promotion of economic growth in OECD countries is high; however in G77 countries because of bad rule of law with decrease ensure of return on foreign direct investment, decreasing domestic physical capital and decreasing growth of employment. So economic growth in these countries is very low and vacant capacity for production is more, and changes in regulations better response.

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