UNIVERSITY of LIMERICK
OLLSCOIL LUIMNIGH

KBS RESEARCH BULLETIN

OCTOBER 2018

ISSUE 66

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Local conditions and economic growth from South–South FDI

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Synopsis

This paper examines growth in Southern economies arising from FDI from both Southern and Northern economies. We explore local conditions that are necessary for growth. A system GMM estimator is used to distinguish between South–South and North–South FDI flows. The highly skilled labour and strong property rights protection required to achieve growth from Northern FDI are not necessary local conditions for achieving growth from Southern FDI. It is strong law and order that emerges as a critical necessary condition associated with positive growth following Southern FDI. The results indicate a distinctive impact of local conditions in activating growth from FDI.

Introduction and Background

Over the past 20 years, there has been a clear shift in the pattern of global foreign direct investment (FDI) flows. An increasing share of outward FDI has been attributed to investors from developing and transition countries and a higher proportion of these investments have flowed to other developing and transition economies in the form of South–South FDI. This change signifies an increased importance in understanding how Southern countries can achieve growth through inward Southern investments. While FDI can be an important catalyst for growth in recipient countries, an absolute growth effect from FDI is not consistently evidenced in the empirical literature (see, for example, Alfaro et al. 2004; Carkovic and Levine 2005). Rather, the positive impact of FDI on growth is shown to be dependent of a country's absorptive capacity. A prominent finding in this regard is that host-country conditions matter to absorb spillovers from FDI (see, for example, Borensztein, De Gregorio, and Lee 1998), while a low technology gap between foreign and domestic firms is also shown to increase a country's capacity to absorb FDI technologies (see, for example, Kokko, Tansini, and Zejan1996). Moreover, there is evidence that spillovers from high- and low-technology FDI are sensitive to different local conditions (Amendolagine et al. 2013; Branstetter et al. 2011). Existing macro-empirical studies of the FDI–growth nexus have focused mainly on Northern FDI (see, for example, Alfaro et al. 2010; Balasubramanyam, Salisu, and Sapsford 1996; Borensztein, De Gregorio, and Lee 1998; Saini, Baharumshah, and Law 2010) and have not explored the link between Southern FDI and growth in recipient Southern countries. There is a good a priori case to presume that Southern FDI can generate growth in these economies, though in a different way than Northern FDI.

Issues and Questions Considered

This paper examines growth arising from Northern and Southern FDI in recipient Southern economies. In particular, we examine those local conditions that may be relevant only for the growth effect from Northern or Southern FDI. Previous studies show that highly skilled labour (Borensztein, De Gregorio, and Lee 1998) and strong property rights protection (Branstetter et al. 2011) are critical for capturing spillovers from high-technology investments; and thus may matter in particular for the growth outcomes from Northern FDI. In contrast, high-quality legal systems are found to facilitate linkages and thus produce spillovers from MNCs with a technological content close to that of domestic firms (Amendolagine et al. 2013); consequently,

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this condition may promote growth only from Southern FDI. Covering the period 1980–2007, our analysis applies a system-generalized method-of-moments (GMM) estimator to a novel dataset in order to examine the contribution of these local conditions to growth arising from Northern and Southern FDI, respectively. By distinguishing between FDI originating in Northern and Southern countries, our findings build on the results from a number of recent macro-level studies showing differences in the growth effects from FDI by source country (Ford, Rork, and Elmslie 2008; Fortanier 2007). We provide a timely perspective on the local conditions necessary to realize growth from Southern FDI, as distinct from Northern FDI growth effects which have been mapped in previous studies (Alfaro et al. 2010; Balasubramanyam, Salisu, and Sapsford 1996; Borensztein, De Gregorio, and Lee 1998; Saini, Baharumshah, and Law 2010). One of the key policy implications relates to the effective allocation of costs in attracting FDI. As noted by Rolfe et al. (1993) and Harding and Javorcik (2007), Southern countries frequently incur significant costs in attracting FDI, for example, through the provision of incentives to MNCs. The desire to activate economic growth from the resultant investment is identified as a key motivation for these incentives (Blomstrom, 382 G. SIRR ET AL. Kokko, and Mucchiello 2003). The results from this paper provide some direction to policy-makers as well as investment promotion agencies (IPAs) tasked with identifying those MNCs with the greatest expected growth impact. Indeed, with Southern nations expected to account for up to 60% of global gross domestic product (GDP) by 2030,3 there may also be increased opportunities for Southern countries to consider FDI opportunities from other Southern venues.

Methodology

A dynamic panel data is used to investigate the growth effects from Southern FDI and Northern FDI in recipient Southern countries. Our sample consists of 46 Southern host economies and spans the period 1980–2007.4 We average the annual data over six nonoverlapping five-year periods (1980–1984, 1985–1989, 1990–1994, 1995–1999, 2000– 2004, 2005–2007) in order to mitigate potential business cycle effects and thus focus on the long-run impact of Southern and Northern FDI on host-country growth.5 Real per capita GDP is from the World Bank's World Development Indicators. FDI inflows consist of equity capital, reinvested earnings and other capital (mainly intra-company loans), and are measured as a percentage of GDP. The data is from UNCTAD's Data Extract Service, which also provides a classification of Northern (developed) economies and Southern (developing and transition) economies. The baseline FDI-growth model is given as

$$Growth_{i,t} = \alpha InitialGDP_{i,t-1} + \beta_1 NFDI_{i,t} + \beta_2 SFDI_{i,t} + \gamma X_{i,t} + a_i + u_{i,t}$$

where Growth is the real per capita GDP growth; InitialGDP is the real GDP per capita in the first year of each 5-year period and α is the convergence coefficient related to the initial GDP; NFDI is the Northern FDI inflows as a share of GDP; SFDI is the Southern FDI inflows as a share of GDP; X is a standard vector of explanatory variables that affect growth; the composite error term is decomposed into the unobserved country-specific effect, a, and the idiosyncratic error term, u; the subscripts i and t represent each country and time period, respectively.

Outcomes and Findings

We find that neither Northern FDI nor Southern FDI directly impact growth (Model 1). The finding in the case of Southern FDI is novel and creates the imperative for exploring whether local conditions matter for the growth outcomes from these investments. The distinguishing feature of the empirical analysis resides in the outcome of those local conditions that facilitate growth from either Northern or Southern FDI. In relation to human capital, higher educated workers contribute to growth from Northern FDI. An improvement of 1% in the quality of human capital enables Northern FDI inflows (as a share of GDP) to produce, on average, a 1.681% higher impact on the growth rate of GDP per capita. Northern FDI is also found to raise growth in countries above the median human capital level.

The highly skilled labour and strong property rights protection that are critical for growth from Northern FDI are not necessarily the local conditions for achieving growth from Southern FDI. Rather, Southern economies must have effective legal systems if they are to meet their growth objectives through inward Southern investments. In seeking FDI, host-country governments offer a range of incentives to attract MNC investment, such as subsidies, grants and tax concessions (Rolfe et al. 1993). These incentives are a cost which is often justified by expected growth arising from increased FDI (Blomstrom, Kokko, and Mucchiello 2003). Thus, in directing efforts and costs towards attracting FDI, host countries must consider those local conditions that matter for the growth effect from FDI. This paper provides further support for the traditional literature on Northern FDI, acknowledging that growth effects are dependent on a highly skilled local population and the strong protection of property rights (Branstetter et al. 2011). From a policy perspective, governments in Southern countries should first ensure the existence of a strong local legal system before directing substantial efforts and costs towards attracting Southern MNCs. One of the key policy implications of the findings relates to the effective allocation of costs in attracting FDI. The empirical results provide some direction to policy-makers as well as IPAs tasked with identifying those MNCs with the greatest expected growth impact.

The underlying study was published in The Journal of International Trade & Economic Development, 27:4, 380-388,:
DOI:
10.1080/09638199.2017.1385645

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Forthcoming Research Bulletin
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Authors: Lale Yaldiz, Donald Truxillo, Todd Bodner, Leslie Hammer

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