IGC International Growth Centre

Policy Note
13/0311
April 2012

International Growth Centre
London School of Economics
and Political Science
4th Floor,
32 Lincoln's Inn Fields
Houghton Street
London WC2A 2AE
United Kingdom

Foreign Direct Investment, Natural Resources and Institutions

Elizabeth Asiedu[a]

Motivation of study

Foreign direct investment (FDI) is a good source of finance for long-term economic growth. It is especially important for its potential to transfer knowledge and technology, create jobs, boost overall productivity and enhance competitiveness in host countries. Many international development agencies, such as the World Bank, consider FDI as one of the most effective tools in the global fight against poverty, and therefore actively encourage poor countries to pursue policies that will encourage FDI flows. It is therefore important to determine the factors that affect FDI flows to developing countries. This paper focuses on two determinants of FDI, namely, natural resources and the quality of institutions in host countries. Specifically it answers three questions: (i) Do natural resources crowd out FDI – ie, is there an *FDI-natural resource curse*?; (ii) Do institutions mitigate the adverse effect of natural-resources curse on FDI? (iii) Can institutions completely neutralize the FDI-natural resource curse? There are three main findings:

- Natural resources have a negative effect on FDI.
- Good institutions facilitate FDI flows.
- Institutions can mitigate the adverse effect of natural resources on FDI, but cannot completely eliminate the natural resource curse.

Relevance to Ghana

Very soon, Ghana may be classified as an oil exporting country. Furthermore, the country's institutions are not well developed and FDI to Ghana has been uneven and quite small. The relevant question is this: how can Ghana avoid the *FDI-natural resource curse?*

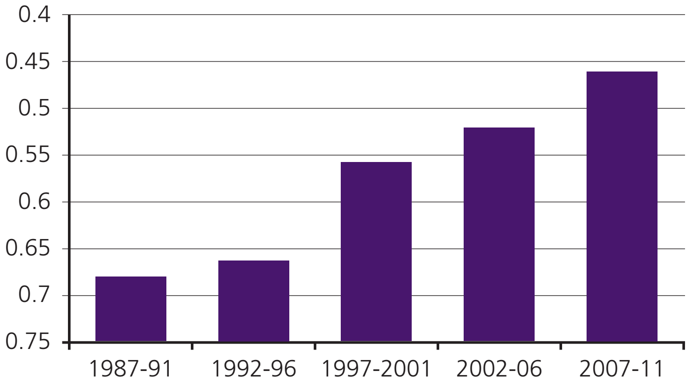
[a]Professor Department of Economics
University of Kansas
Asiedu@ku.edu

Many international development agencies, such as the World Bank, consider FDI as one of the most effective tools in the global fight against poverty.

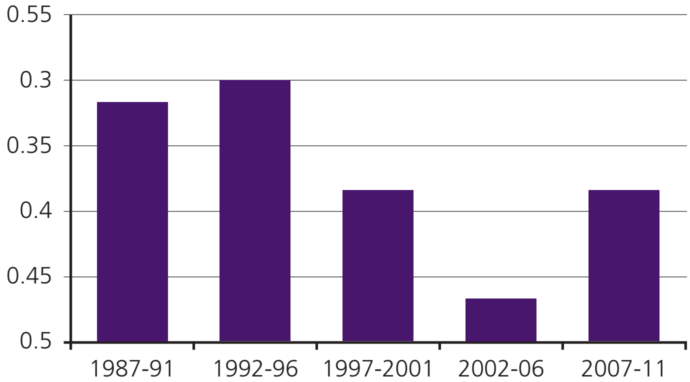
Analysis and Policy Recommendations: The Quality of Institutions in Ghana

The paper employed several measures of institutional quality, including corruption and law and order. The corruption indicator assesses corruption in Government and it ranges from zero to one, where a higher number implies more corruption.[1] The measure of rule of law reflects the impartiality of the legal system and popular observance of the law. It ranges from zero to one and a higher number implies a more effective legal system. Graph 1 shows the trend for corruption and Graph 2 shows the trend for law and order for Ghana, over the period 1987-2011.

There are two noticeable points from the graphs. First, Ghana has weak institutions. Furthermore, the quality of institutions has gotten worse over time. For example, the corruption index increased from 0.48 in 1987-91 to about 0.7 in 2007-11, and the rule of law index declined from 0.49 to 0.39 over the same period.



Graph 1: Corruption Index for Ghana. Ranges from 0 to 1, a higher number implies more corruption



Graph 2: Law and Order Index for Ghana. Ranges from 0 to 1, a higher number a reliable legal system

The findings of the research suggest that the adverse effect of natural resources on FDI can be mitigated by improving the quality of institutions in Ghana, in particular, polices that curb corruption and improve the reliability of the legal system.

[1] Data on the measures of institutional quality are from the International Country Risk Guide. For more information, see www.prsgroup.com/icrg.aspx