

Foreign Direct Investment, Natural Resources and Institutions



In brief

- Foreign direct investment is a good source of finance for long-term economic growth. FDI can be important for knowledge and technology transfer, boosting productivity and improving the competitiveness of the host country.
- This study analyzes two determinants of foreign direct investment: natural resources and the quality of institutions in host countries.
- There are three main findings of this study:
 - Natural resources negatively effect foreign direct investment
 - Good institutions can facilitate FDI flows
 - Institutions can mitigate the adverse effect of natural resources on FDI, but cannot completely the natural resource curse.
- The relevance of foreign direct investment has significant contemporary implications. Ghana may be soon clasified as an oil exporting country, thus, how can Ghana avoid the FDI-natural resource curse?
- Ghana has weak institutions which have deteriorated over time. This includes measurements on corruption and law and order, reflecting the impartiality of the legal system.
- The adverse effect of natural resources on FDI can be mitigated by improving the quality of institutions in Ghana, particularly by implementing policies that curb corruption and improve the reliability of the legal system.

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:

1. Do natural resources crowd out FDI – ie, is there an FDI-natural resource curse?
2. Do institutions mitigate the adverse effect of natural-resources curse on FDI?
3. Can institutions completely neutralize the FDI-natural resource curse?

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

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?

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,

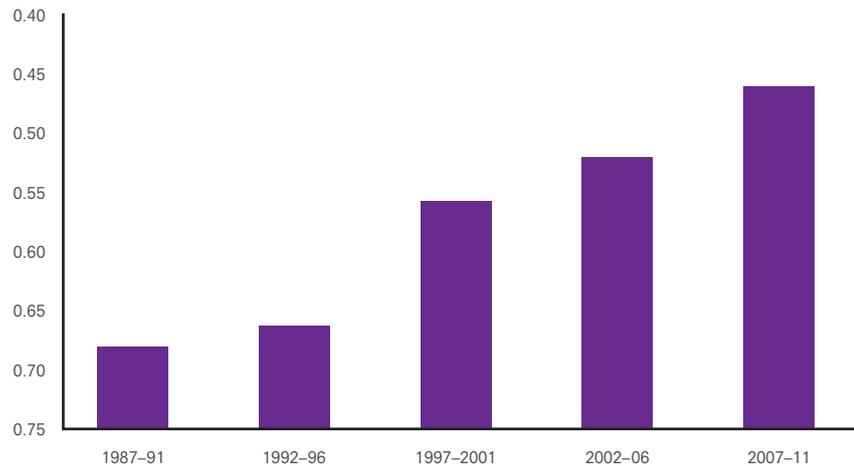
1. Data on the measures of institutional quality are from the International Country Risk Guide. For more information, see www.prsgroup.com/icrg.aspx

“Natural resources have a negative effect on FDI”

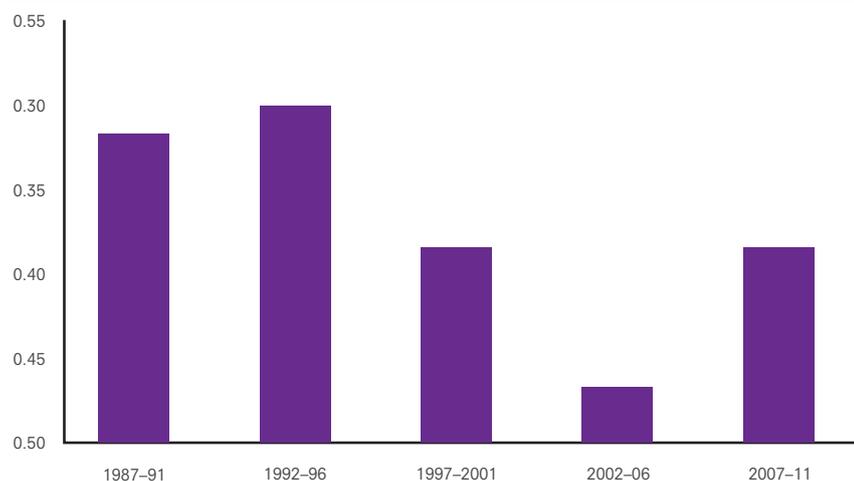
the corruption index increased from 0.48 in 1987-91 to about 0.7 in 2007-11, and the rule of law index declined from 0.49 to 0.39 over the same period.

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, policies that curb corruption and improve the reliability of the legal system.

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 implies a more reliable legal system



About the authors

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