

MODELING THE IMPACT OF CORRUPTION, DEGREE OF FREEDOM TO INVEST AND DEMOCRACY ON DOMESTIC INVESTMENT: EVIDENCE FROM MENA COUNTRIES

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Abstract

This study examines the impact of corruption, investment freedom, and democracy on domestic investment in countries in the Middle East and North Africa. In order to achieve this, the GMM model was used to test the annual data from 2011 to 2017. The empirical results show that corruption has a negative impact on domestic investment, but the degree of investment freedom and democracy have a positive impact on domestic investment. One of the major contributions of this work is to assert the requirement to wheel more awareness to the direct link between corruption, governance, investment freedom, and domestic investment.

Keywords

corruption; investments; governance; investment freedom

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Introduction

Today's investment is one of the most important financial resources on which the different countries of the developed and underdeveloped world rely, because the most attractive countries for investment are those that are most successful in their growth. Investment has become the economic phenomenon that characterizes the end of the 20th century and the beginning of the 21st century. It is one of the main pillars of economic development.

The success of investment law is also linked to its adequacy to international law and the caution of investment principles, i.e. granting investors the freedom to transfer their money, the inadmissibility of their nationalization and the recourse to international arbitration for the settlement of investment disputes. As a macroeconomic variable, it plays an important role in the economic system because it is directly related to other variables such as savings, income, employment, and growth rates.

This is the theoretical aspect of the issue that is of concern to all countries, as evidenced by the growing awareness of the need to strengthen their capacity to attract foreign direct investment through financial, technical, administrative and human resource development mechanisms. Thus, the increase in the volume of investments requires the creation of adequate economic conditions.

Domestic investment is defined as gross fixed capital formation in a country. It is therefore the sum of local investment and foreign investment. Domestic investment in MENA countries is divided mostly between the extractive and public sectors (services), followed by the agricultural and manufacturing sectors.

Studies on the effects of democracy, corruption and degree of freedom to invest on domestic investment in MENA countries are extremely rare. However, MENA countries have particular characteristics both in terms of their business climates (informal sector, institutional weaknesses, embryonic industry...) and in terms of political changes. These characteristics make the analysis of the relationship between the above-mentioned variables and domestic investment in this region a major theoretical and empirical challenge.

This work differs from other studies in two respects: (i) its focus on MENA countries; (ii) the study of the role of democracy, corruption and the degree of freedom to invest in changing the sector distribution of domestic value added.

In order to respond to this double problematic, this work is composed of five sections. Section 2 develops a review of the literature. It is followed by the presentation of the data from our study and the empirical model in section 3. Section 4 is empirical. It consists of the interpretation of the estimation results of the econometric model in the context of a dynamic panel. Finally, the conclusion and the policy implications will be the subject of the fifth section.

Review of the literature

In what follows, we cite some empirical works that have focused on studying the impact of political variables (democracy, corruption and economic freedom) on domestic investment.

Democracy and domestic investment

Democracy is a political system characterized by political and civil liberty (Gastil, 1989). According to proponents of democracy, citizens' incentives to work, invest and allocate resources efficiently can all be maintained in a climate characterized by political and economic freedom, free flow of information and protection of property (North, 1990).

Democracy can have negative effects on the economy if political and social demands turn into strikes and demonstrations that disrupt business activity and force entrepreneurs to stop their activities and leave the country. Continued protests and strikes can even discourage foreign direct investment inflows. Therefore, the impact of democracy on growth can only be negative or negligible. The type of the connection between political regime and growth can also be affected by political instability. The results of the theoretical work suggest that the link between democracy and growth can be influenced by political instability. Alesina and Tabellini (1989), Özler and Tabellini (1991), Cukierman et al. (1992) argue that political instability considerably reduces the time horizon, not only of the investor, but also of the political decision-maker. In a democratic regime, the latter is then satisfied with a wait-and-see management of power, particularly in the economic field. The big changes needed are then dodged. This type of effect is particularly noticeable in weak democracies, where the partisan system is very fragmented. A government with a short time horizon may also choose to run away from power and pursue a worst-case economic policy that it hopes to reap the benefits in the medium term (failure of its successor). Similarly, a government with a short time horizon has no incentive to respect either its commitments or the rules and principles that should, in principle, regulate economic activity (property law, contract law, taxation, etc.), Clague et al. (1996).

Furthermore, Fosu (1992) points out that the probability of capital loss rises in the presence of political uncertainty, which decreases the amount of investment actually undertaken. The unstable country then sees national and foreign investors turning away from the opportunities offered by the national economy. The consequences for growth can be serious: a decline in investment, deterioration in export performance, and

difficulties in financing private and public projects. Moreover, Alesina and Perotti (1996) found that the connection among political instability and economic growth tend to a rise at risk and a decline in investment due to the volatility of the political climate. The experiences of several countries, especially the Arab Spring countries (Tunisia, Libya and Egypt), which have undergone a change of political regime reveal that the transition to a more democratic political regime can be followed by political instability affecting development. Evidence from these three countries indicates that a phase of transition to democracy can be accompanied by political instability that may adversely affect growth. This implies that the impact of democracy on investment depends on political stability.

For example Kurzman et al. (2002) argue that democracy reduces investment because the unpopular policies that allow investment are not enforced by democratic regimes. Acemoglu et al. (2008) claim that, due to their redistributive tendencies, political institutions generate distortions.

In the period 1960-2004, Aisen and Veiga (2013) studied a sample of 169 countries and found that authoritarian regimes limit development by reducing the accumulation of physical and human resources.

However, the empirical results of Zouheir and Karim (2012) analysis, using a dynamic panel data model, to define the connection between democracy, investment and economic growth for a sample of 11 countries from the MENA region during the period 2000-2009, show that there is a significant correlation between democracy and investment on the one side and on the other side between civil liberties and economic growth. The findings also highlight a positive connection between investment and political rights.

Also, for a sample of 79 countries over the period 1984-2008, Makrem and Faycel (2018) tried to test this relationship and to incorporate the notion of political stability as a complementary variable for democracy. The key findings indicate that democracy impacted significantly growth in a politically stable climate. The findings of the work are heterogeneous, implying that the influence of democracy on domestic investment is far from obvious.

Corruption and domestic investment

Corruption is an international scourge. While its existence, degree and scale vary from a country to another, it is a phenomenon that affects all nations: it affects the most advanced, the least developed, the wealthiest and the poorest nations.

Corruption has several forms, such as bribery, embezzlement, influence peddling, abuse of office, illicit enrichment, fencing, money laundering, tax evasion, nepotism, revolving doors between the government and the private sector, conflict of interest, and so on.

Numerous studies have established that corruption disheartens investment and is an additional cost to businesses, reducing the profitability of investment projects.

First, empirical evidence proposes that corruption reduces the investment/GDP ratio, lowers the level of investment and significantly retards economic growth (Mauro, 1995).

Corruption also distorts the dynamic cycle related with public investment and influences the distribution of public spending. Corruption can induce public officials to distribute public funds, but in compliance with the corrupt opportunities they provide, such as major infrastructure or defense projects.

Mauro (1998) argues that public spending on education as a proportion of GDP is negatively correlated with the level of corruption in most countries. Same, four mechanisms by which corruption impacts economic development have been established by Tanzi and Davoodi (1997): 1. higher public expenses; 2. lower public

funds; 3. decreased public spending on some turfs, such as health or education; and 4. poorer quality public infrastructures.

In addition, some researchers have empirically shown that corruption decreases the output of capital and constitutes an important factor in the decision-making of investors. According to the findings of Lambsdorff (2003), an increase in corruption by one point on a scale of 0 (highly corrupt) to 10 (highly clean) decreases an output by 4 percent of GDP and 0.5 percent of GDP by net capital inflows.

Campos et al. (1999) suggest that investment is not only influenced by the degree of corruption, but also by the essence of corruption. Corruption systems that are more stable than those that demand government favors have less harmful investment consequences than those that are less predictable.

Asiedu and Freeman (2009) examine the effect of corruption on investment by using aggregate (country-level) investment data, country-level measurement of corruption, and pooling data for countries from multiple regions. They employ firm-level investment data and corporate and country-level corruption measures, and permit the impact of corruption to vary by region. Their endogen variable is the growth of investment by firms and they use six corruption measures from four different sources: two corporate and four country-level measures. They notice that the corruption impacts investment differently across regions.

Everhat et al. (2009) employ an International Finance Corporation data set of 50 developing and transitional countries covering the period 1984-1999 that bypasses these issues. They notice that the effect of corruption appears to be more ambiguous on the level of public investment than has been found in previous literature. They do, nevertheless, notice that the impact of corruption on private capital accumulation is significantly more detrimental than what was previously discovered. They also notice that corruption's impact on governance is unambiguously negative, further deterring economic growth.

For the period 2004 to 2013, Zakharov (2019) studied the causal correlation between corruption and fixed capital investments in the Russian regions. By adding novel instrumental variables for corruption, they fix the issue of endogeneity: the existence of the free press and abuses of the freedom of journalists. The key finding is that corruption affects significantly and negatively aggregate investment in fixed capital. He found that, by disaggregating investment by ownership, corruption reduces private investment, and not the investment that is made by state-owned firms. For businesses with international investment, the influence is greater. A strong negative association between regional imports of capital goods and corruption has also been observed. To conclude, the domestic investment effect of corruption is negative.

Degree of freedom to invest and domestic investment

The principle of the freedom to invest, seen from the point of view of the right of establishment, is recognized in post-1945¹ commercial treaties, but is not nowadays the subject of a precise definition. This seems normal so far as the notion of investment itself is not defined. Several projects have been launched on the subject of freedom of investment². These projects have opened a debate on the subject. They have confirmed the need to recognize certain fundamental principles in favor of foreign investors, namely transparency, liberalization and non-discrimination. Nevertheless, they did not succeed in finding a common definition of the term. Consequently, it is up to each state

¹Jean-Pierre Lavieć, *Protection et promotion des investissements*, Paris, Presses universitaires de France, 1985 aux pp 53-77 [Lavieć].

²See in particular OECD, Investment Committee, « La liberté d'investissement, la sécurité nationale et les secteurs stratégiques », on line : OCDE
<www.oecd.org/fr/investissement/politiques-investissement/40473834.pdf>.

to set its own conditions governing the admission and treatment of investment on its territory.

Despite the scarcity of a dense literature on studies of the effect of economic freedom on domestic investment, studies on the effect of economic freedom on FDI are extremely frequent.

In a sample that includes 18 Latin American countries, Bengoa and Sanchez-Robles (2003) analyzed the link between economic freedom, FDI and economic growth using panel data. Their findings suggest that economic freedom leads to FDI inflows in a favorable way.

In his research, Quazi (2007) explored the correlation between economic freedom and FDI in seven countries in East Asia (China, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand). The results showed that a significant determinant of FDI investments is economic freedom.

The link between economic freedom and FDI has been explored by Heriot and Theis (2008). The outcome found that in drawing FDI, nations with more economic independence were more competitive.

In a report for Middle East countries and European countries in Africa, Caetano and Calerio (2009) studied the association between economic freedom and FDI. As a result of the research, it was determined that the association between economic freedom and FDI was favorable.

In a panel of 85 countries, Azman-Saini et al. (2010) explored the relation between economic freedom, foreign direct investment and economic growth. The outcomes reveal that the influence of FDI in the host country is contingent on the degree of economic freedom.

Pourshahabi et al. (2011) analyzed the OECD countries' relationship between FDI, economic freedom and growth. The first model indicated that FDI was positively influenced by human resources, business size, political stability and inflation and had an important influence on FDI in countries. It was inferred, however, that while the association between economic freedom and FDI in OECD countries was favorable, it was of no major significance. The second model indicated that growth was driven by FDI, economic freedom, spending on public consumption, public investment and human resources.

In a US report, Pearson et al. (2012) explored the relation between economic freedom, economic growth and FDI. The research covering the time between 1984 and 2007 indicated that both economic freedom and the rate of growth in each state were major variables that had a positive effect on FDI flows.

Using panel data analysis for a survey of 79 developed countries from 1998 to 2014, Hossain (2016) examined the interplay between economic freedom, foreign direct investment and economic development by considering the degree of economic freedom as given by the "Heritage Foundation". The outcome reveals that economic freedom in the developed country is a strong determinant of FDI inflows.

In a panel of four North African countries (Tunisia, Morocco, Algeria and Egypt), Zghidi et al. (2016) explored the causal interactions between foreign direct investment (FDI), economic freedom and economic growth over a five-year period from 1980 to 2013. They discovered clear evidence of a positive correlation between FDI and economic growth using the Framework Generalized Process of Moments (GMM) in a panel data study. They also observed that economic freedom tends to act as a supplement to FDI and that in the presence of the economic freedom component, the influence of FDI is more pronounced. This suggests that multinational corporations (MNCs) benefit most from the involvement of countries that encourage greater freedom of commercial activity.

Intiaz and Bashir (2017) examined, by employing panel data approach, the role of the domestic investment environment (measured by the Heritage Foundation economic freedom index) along with other macroeconomic variables in attracting FDI in South Asia for 20 years from 1995 to 2014. Results have shown that economic freedom as a whole is a significant determinant of FDI. Disaggregated economic freedom research shows that FDI is statistically strongly affected only by fiscal and trade freedom. As a result, the report urges south Asian countries to boost their domestic investment climate in order to draw more foreign capital.

The role of economic freedom of the host country in bilateral direct investment was examined by Xu (2019). With a selection of 155 countries, he has researched this topic in a gravity model. He has also used some efficient gravity model estimation techniques to combine the zero observations and the quantile regression approach adopted. The results show that both home-country and host-country economic freedom are positively associated with bilateral direct investment and that home-country economic freedom has much greater explanatory capacity for foreign direct investment. Therefore, the promotion of economic freedom could attract more foreign direct investment from outside than direct investment from within.

Motivated by this background, we note that FDI is positively affected by the degree of freedom to invest. In our study, we try to understand the nature of the relationship between the degree of freedom to invest and domestic investment in a better way.

Data, methodology and model specification

Data description

The selected countries respect the ranking and analysis of the World Bank. The sample includes the MENA Countries depending on the availability of data. In total, our sample comprises 9 countries (Algeria, Egypt, Iran, Lebanon, Morocco, Oman, Saudi Arab, Tunisia and Yemen), and the estimation period is from 2011 to 2017.

Variables and sources of data

To study the impact of Democracy, Degree of freedom to invest and corruption on domestic investment, we will apply a linear estimation of panel data that has 8 variables whose reason to clarify this effect. The following table defines the variables and the data source of each variable.

Table 1. Descriptions of Variables

N	Variable	Description	Source
1	DI	Gross fixed capital formation (% of GDP)	Perspective Monde/World Bank
2	CORR	Corruption Perceptions Index	Transparency International
3	DEMO	Democracy Index	Economist Intelligence
4	DFI	Degree of freedom to invest	Perspective Monde
5	IDH	Human Development Index	Perspective Monde
6	FDI	Foreign direct investment, net inflows (% of GDP)	Perspective Monde/World Bank
7	FC	Final consumption expenditure (% of GDP)	Perspective Monde/World Bank

8	Y	GDP growth (annual %)	Perspective Monde/World Bank
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Source: Collected and calculated by authors from Perspective Monde and World Bank

Definitions of variables

Our empirical methodology is based around the estimation of 8 variables. In this paragraph, we will present the definitions and tools for the use of its variables.

- ✓ **Gross fixed capital formation (% of GDP):** Gross fixed capital formation (formerly gross domestic fixed investment) includes land improvements (fences, ditches, drains, and so on); plant, machinery, and equipment purchases; and the construction of roads, railways, and the like, including schools, offices, hospitals, private residential dwellings, and commercial and industrial buildings. According to the 1993 SNA, net acquisitions of valuables are also considered capital formation.
- ✓ **Corruption Perceptions Index:** The Corruption Perceptions Index (CPI) scores countries on how corrupt their governments are believed to be. It is published by Transparency International, an organization that seeks to stop bribery and other forms of public corruption. A country's score can range from zero to 100, with zero indicating high levels of corruption and 100 indicating low levels. Transparency International launched the index in 1995, and today it scores 180 countries and territories.
- ✓ **Democracy Index:** Synthetic index of democracy, according to the analyses made by The Economist. This measure takes into account the democratic culture, the government's ability to implement its program, respect for civil liberties, citizen participation and the quality of the electoral process.
- ✓ **Degree of freedom to invest:** Degree of freedom to invest. A degree close to 100 means that investments can be made with few limits. Some countries have great freedom in this respect: Luxembourg, Denmark and the United Kingdom. Conversely, North Korea, but also Zimbabwe, Iran, and Cuba have virtually nonexistent freedom. The constraints are then multiple: they can hit the foreign or domestic investments. Limitations can be financial, bureaucratic or property-related. To determine this degree, several sources are used, including Economist Intelligence Unit. This indicator was developed by the Heritage Foundation, in partnership with the Wall Street Journal. The Heritage Foundation is a research and educational institute founded in 1973 whose mission is to formulate and promote conservative policies based on the principles of free enterprise.
- ✓ **Human Development Index:** Human Development Index (HDI). It is a composite index that measures the average quality of life of a country's population. Theoretically, the index ranges from 0 to 1. It takes into account three dimensions of human development. First, the possibility of having a long and healthy life based on life expectancy at birth. Then, the level of schooling, estimated from the rate of illiteracy and attendance at different levels of the school system. Finally, the standard of living, calculated from gross domestic product (GDP) per capita, taking into account purchasing power parity (PPP).
- ✓ **Foreign direct investment, net inflows (% of GDP):** Foreign direct investment are the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. This series shows net inflows (new investment inflows less

disinvestment) in the reporting economy from foreign investors, and is divided by GDP.

- ✓ ***Final consumption expenditure (% of GDP)***: Final consumption expenditure (formerly total consumption) is the sum of household final consumption expenditure (private consumption) and general government final consumption expenditure (general government consumption). This estimate includes any statistical discrepancy in the use of resources relative to the supply of resources.
- ✓ ***GDP growth (annual %)***: Annual percentage growth rate of GDP at market prices based on constant local currency. Aggregates are based on constant 2010 U.S. dollars. GDP is the sum of gross value added by all resident producers in the economy plus any product taxes and minus any subsidies not included in the value of the products. It is calculated without making deductions for depreciation of fabricated assets or for depletion and degradation of natural resources.

Model specification and empirical methodology

In this paper, we create a model dealing with domestic investment as a dependent variable. In this model we apply as independent variables: Corruption Perceptions Index, Democracy Index, Degree of freedom to invest, Human Development Index, Foreign direct investment net inflows (% of GDP), Final consumption expenditure (% of GDP) and GDP growth (annual %).

The basic model is written as follows:

$$DI = F(CORR, DEMO, DFI, IDH, FDI, FC, Y) \quad (1)$$

The empirical format of this model is written as follows:

$$DI = C(1) + C(2) * CORR_{it} + C(3) * DEMO_{it} + C(4) * LIB_{it} + C(5) * IDH_{it} + C(6) * CF_{it} + C(7) * FDI_{it} + C(8) * Y_{it} + \epsilon_{it} \quad (2)$$

To determinate the direct effect of Democracy, Degree of freedom to invest and corruption on domestic investment, we will apply an empirical analysis based on estimation of Panel Generalized Method of Moments (GMM).

Empirical Analysis

The estimation of the equation (2) gives the substituted coefficients which are written as follow in the equation (3):

$$DI = 14.1875002171 - 0.175426593265 * CORR + 1.95562727381 * DEMO + 0.0972111079188 * LIB + 27.8249459548 * IDH - 0.289140869408 * CF + 0.562416798505 * FDI + 0.0816927210284 * Y \quad (3)$$

According to the equation (3), we can note that Corruption Perceptions Index and Final consumption expenditure have negative effect on domestic investment. However, Democracy Index, Degree of freedom to invest, Human Development Index, Foreign direct investment (net inflows) and GDP growth have a positive effect on domestic investment.

The objective of the following table is to specify the significance of each variable to determine the robustness of the impact of the independent variables on the domestic investment.

Table 2: Estimation of Panel Generalized Method of Moments (GMM)

Dependent Variable: DI				
Method: Panel Generalized Method of Moments				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	14.18750	12.51381	1.133747	0.2618
CORR	-0.175427	0.095520	-1.836540	0.0717

DEMO	1.955627	0.789288	2.477711	0.0163
LIB	0.097211	0.042691	2.277079	0.0267
IDH	27.82495	12.48273	2.229075	0.0299
CF	-0.289141	0.078928	-3.663341	0.0006
FDI	0.562417	0.555862	1.011793	0.3161
Y	0.081693	0.125800	0.649387	0.5188

Source: Calculations done by the authors based on the EViews 10 software.

The econometric rule states that the relationship between the X and Y variables in a regression model is statistically significant when the probability of the coefficient (Prob) is less than 10%.

With:

- ✓ Prob < 1% means a strong significance.
- ✓ Prob < 5% means a normal significance.
- ✓ Prob < 10% means a low significance.

According to the estimation of Panel GMM, that Corruption Perceptions Index, Final consumption expenditure, Democracy Index, Degree of freedom to invest and Human Development Index are significances. These mean that Corruption Perceptions Index and Final consumption expenditure have negative effect on domestic investment. However, only Democracy Index, Degree of freedom to invest and Human Development Index have a positive effect on domestic investment. Table 3 includes a set of diagnostic tests to verify the quality of our model and the robustness of our estimate.

Table 3: Diagnostic Tests

Diagnostic Tests	
R²	0.663558
Adjusted R²	0.620738
Jarque-Bera	4,370767
Probability of Jarque-Bera	0,112435

Source: Calculations done by the authors based on the EViews 10 software.

All residual diagnostic tests are satisfactory and assert that our model is acceptable and well treated (R² is greater than 60% and the probability of Jarque-Bera is greater than 5%).

Conclusion

This research examines the impact of corruption, degree of freedom to invest and democracy on domestic investment in MENA Countries. In order to achieve this purpose, annual data for the periods between 2011 and 2017 were tested using GMM model. Empirical results show that corruption has a negative effect on domestic investment, however, the degree of freedom to invest and democracy have a positive effect on domestic investment.

Indeed, corruption is a global scourge. Although its nature, degree and extent differ from one country to another, it is a phenomenon of concern to all countries: it affects the most developed countries, the least developed, the richest and the poorest. Likewise, corruption erodes community and investor confidence in the country. In general, corruption discourages investment, which hinders economic growth. In fact, empirical evidence indicates that corruption reduces investment. One of the main reasons corruption discourages investment is that it increases the cost of doing business, which

reduces the profitability of the investments. In this context, and according to the OECD (2016), bribes and difficult and drawn-out negotiations increase transaction costs, thus increasing the costs of economic activity in general. Bribes and other illegal fees act as a "hidden tax", which increases the cost of the investment. Likewise, corruption often involves heavy bureaucracy with many steps, including unnecessary delays and procedures that increase the chances of collecting bribes.

Corruption affects all countries and undermines sustainable development. As indicated in the report, corruption can negatively affect the productivity of the private sector because it discourages investment. It also harms competition and entrepreneurship. Then, corruption can have negative effects on states' public revenues. Indeed, corruption undermines the ability of states to collect taxes. Finally, corruption can disrupt the decision-making process leading to public investment and thus can have negative effects on the state's public spending, particularly by limiting its efficiency. It should be borne in mind that corruption also affects other determinants of economic and social well-being, such as sustainable development, health, education and access to water.

The overall policy message in this article is very straightforward: reducing the level of corruption in a country will help domestic investment and ultimately help increase economic growth. There is still much work to be done in terms of the interaction between corruption and the accumulation of domestic investment and its impact on economic growth. One of the main contributions of this article is to emphasize the importance of paying more careful attention to the direct link between corruptions rather than the direct link between corruption, governance, investment freedom and domestic investment.

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