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Foreign Investment, Growth, and Economic Freedom: What Is OPIC's Role?

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The particular question facing the Subcommittee today is whether or not to reauthorize the Overseas Private Investment Corporation (OPIC), presumably for another four years. OPIC's mission is "to mobilize and facilitate the participation of United States private capital and skills in the economic and social development of less developed countries and areas, and countries in transition from nonmarket to market economies."[1] The justification for the OPIC mission is that in executing this investment mission, it increases U.S. exports and therefore increases the number of U.S. jobs.

While I find myself deeply supportive of the goals of OPIC, I am not confident that the organization is actually able to achieve them. Ironically, OPIC was created in the late 1960s because the traditional model of government-to-government funding of less developed economies was so clearly failing. In the decades since, we continue to learn what strategies fail to promote development, and there is a very dark cloud of failure over the entire enterprise of pushing investment of any kind into economies, rather than having economies compete to pull in investment dollars. Likewise, the goals of job creation and export promotion seem to be minor aspects of OPIC's mission, and there is no clear case that the exports and jobs associated with OPIC are not at the expense of efficiencies elsewhere.

Approaches to Economic Development

I should probably confess that while preparing for this testimony, it dawned on me that OPIC is in a sense a competitor of mine. Our project, the annual *Index of*

Talking Points

- Efforts to promote economic development via investment are out of date. Empirical studies show that growth comes first, and investment follows, which implies that building the institutions for growth is the optimal development strategy.
- The Overseas Private Investment Corporation (OPIC) is designed to push investments into risky places by having the taxpayer offer risk insurance.
- Congress should explore a phase-out of OPIC. Its operations are duplicative of the private sector, generally, and the funding of activities of high value for U.S. foreign policy are clearly not a priority in light of low levels of OPIC funding in Iraq and Afghanistan.
- Likewise, the goals of job creation and export promotion seem to be minor aspects OPIC's mission, and there is no clear case that the exports and jobs associated with OPIC are not at the expense of efficiencies elsewhere.

This paper, in its entirety, can be found at:
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Economic Freedom, has the same goal that OPIC does, which is economic development.[2] But our approaches are quite different. OPIC wants to push investments into risky places by having the taxpayer offer risk insurance, whereas I want governments aboard to first make their economies competitive as a means to attract investment without any need for U.S. taxpayer assistance.

In a time of massive budget deficits and unabated federal spending, this would seem to be the perfect time to scrutinize the necessity of OPIC. Any time Congress considers spending the money of the American citizen, it should set a very, very high bar.

This is the standard which I use to evaluate congressional spending and authorizations. Indeed, my colleague at the Heritage Foundation, Dr. Edwin Feulner, provides clear guidelines in the form of six questions that every government action or policy should answer:

1. Is it the government's business?
2. Does it promote self-reliance?
3. Is it responsible? Specifically, who pays for it?
4. Does it make America more prosperous?
5. Does it make us safer?
6. Does it unify us?[3]

In order to justify continued funding, OPIC should be able to make an airtight case in answering these questions.

How American Jobs Are Created

The notion that any government organization can "create" jobs is not based on credible economic foundations. The private sector creates jobs that last, whereas governments use taxed dollars to pay for temporary work. Sometimes that work, such as construction jobs that exist for a summer while a new road is laid, add value in the form of a public good. That is, the externality of the production of the job outweighs the cost of the worker's salary. But it is not the inherent employment of the individual that is of value. So the question is whether OPIC creates public value for the U.S. taxpayer? Is it investing abroad in some fashion that outweighs the fees that it charges to the U.S. government?

Investment Is a Consequence, Not a Cause of Growth

The instinctive understanding of economic growth leads us to believe that investment is a vital input because societies without investment are obviously stagnant. We tend to see a link between heavy levels of investment and economic growth. The appearance of cranes and tractors in a bustling city is evidence. And yet, this instinct is misguided. The question to ask is: Why are the cranes and tractors here? Why in this city, not that city? Why this country, not that country?

Rather than ask this question, our humanitarian urge is to create new incentives to push investment into poor areas. But pushing inputs is almost always ineffective, which reminds us of the famous maxim "You cannot push a rope."

Growth economists have confirmed a strong correlation between investment and economic growth. However, the use of sophisticated time series econometrics has confirmed the causality of the relationship. We know now that investment does not cause growth, but vice versa. Countries that grow tend to attract investment. This was a view first proposed, one might say, by Adam Smith in the 18th century. It was articulated clearly in the modern era by Albert Hirschman (a professor at Yale, Columbia, Harvard, and the Institute for Advanced Study) in 1958.[4] But current data have been able to confirm Hirschman's point that growth causes investment, and the consensus of professional economists is now resolved.

1. Overseas Private Investment Corporation, "Doing Business With Us," at *www.opic.gov* (June 13, 2007).
2. See Tim Kane, Kim R. Holmes, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007).
3. Edwin J. Feulner and Doug Wilson, *Getting America Right: The True Conservative Values Our Nation Needs Today* (New York: Crown Forum, 2006).
4. A. O. Hirschman, *The Strategy of Economic Development* (New Haven, Conn.: Yale University Press, 1958).

From an influential 1996 paper in the *Quarterly Journal of Economics*, we learn:

- "[O]bserved long-term relationships were due more to the effect of growth on capital formation than to the effect of capital formation on growth";
- "The main result persists when inter-country differences are eliminated: growth seems to precede capital formation"; and
- "[I]informal and formal tests using only fixed investment ratios as independent variables give evidence that economic growth precedes capital formation, *but no evidence that capital formation precedes growth*. Thus, the causality seems to run in only one direction, from economic growth to capital formation."[5]

These authors used a technique known as Granger causality, named after Nobel Prize recipient Clive Granger, who was also a professor of mine at the University of California at San Diego in the late 1990s. I urge the Congress to consider the serious implications of this research.

If we wish to combat poverty around the world, our efforts must be geared toward promoting the institutions of growth first, not by pushing investments—and certainly not by reducing the costs of bad risks.

This leads one to inquire about the nature of the "institutions of growth"—those policies and cultures that create the incentives for markets to form, for specialization to occur, and for development to accelerate. Needless to say, the fruits of economic development are born from private markets. Local and national governments cannot plant the seeds of prosperity, but they can create the climate for entrepreneurial seeds to prosper.

In my next section, I will describe further the "institutions of growth," which we have long attempted to understand and even measure with our annual publication of the *Index of Economic Freedom*.

Economic Freedom and the Institutions of Growth

With the publication of the 2007 edition, The Heritage Foundation/Wall Street Journal *Index of Economic Freedom* marked its 13th anniversary. It was also my first year as director and chief editor of the project. The idea of producing a user-friendly "index of economic freedom" as a tool for policymakers and investors was first discussed at The Heritage Foundation in the late 1980s. The goal then, as it is today, was to develop a systematic, empirical measurement of economic freedom in countries throughout the world. I should mention that we make all the material, country scores, and even raw data available for free on the Internet at *www.heritage.org/Index*.

Economic theory dating back to the publication of Adam Smith's *The Wealth of Nations* in 1776 emphasizes the lesson that basic institutions that protect the liberty of individuals to pursue their own economic interests result in greater prosperity for the larger society. Modern scholars of political economy are rediscovering the centrality of "free institutions" as fundamental ingredients for rapid long-term growth. In other words, the techniques may be new, but they reaffirm classic truths. The objective of the *Index* is to catalogue those economic institutions in a quantitative and rigorous manner.

Results from the *Index of Economic Freedom*

The *2007 Index of Economic Freedom* measures 157 countries across 10 specific factors of economic freedom, which are:

- Business Freedom
- Trade Freedom
- Fiscal Freedom
- Freedom from Government
- Monetary Freedom
- Investment Freedom
- Financial Freedom
- Property Rights

5. Magnus Blomstrom, Robert E. Lipsey, and Mario Zejan, "Is Fixed Investment the Key to Economic Growth?," *The Quarterly Journal of Economics*, Vol. 111, No. 1 (Feb. 1996), pp. 269–276 (emphasis added).

- Freedom from Corruption
- Labor Freedom

High scores approaching 100 represent higher levels of freedom. The higher the score on a factor, the lower the level of government interference in the economy.

The methodology for measuring economic freedom is significantly upgraded. The new methodology uses a scale of 0–100 rather than the 1–5 brackets of previous years when assessing the 10 component economic freedoms, which means that the new overall scores are more refined and therefore more accurate. Second, a new labor freedom factor has been added, and entrepreneurship is being emphasized in the business freedom factor. Both of these new categories are based on data that became available from the World Bank only after 2004.

The methodology has been vetted and endorsed by a new academic advisory board and should better reflect the details of each country's economic policies. In order to compare country performances from past years accurately, scores and rankings for all previous years dating back to 1995 have been adjusted to reflect the new methodology.

Economic freedom is strongly related to good economic performance. The world's freest countries have twice the average income of the second quintile of countries and over five times the average income of the fifth quintile of countries. The freest economies also have lower rates of unemployment and lower inflation. These relationships hold across each quintile, meaning that every quintile of less free economies has worse average rates of inflation and unemployment than the preceding quintile has.

Progress is universal across all continents. Across the five regions, Europe is clearly the most free using an unweighted average (67.5 percent), followed at some distance by the Americas (62.3 percent). The other three regions fall below the world average: Asia–Pacific (59.1 percent), North Africa/Middle East (57.2 percent), and sub-Saharan Africa (54.7 percent). However, trends in freedom are mirrored closely across all regions. The main distinguishing feature of the regions is that Asia–Pacific countries have the highest variance, which means that there is a much wider gap between the heights of freedom in some economies and the lows in others that is nearly twice as variable as the norm.

Of the 157 countries graded numerically in the 2007 *Index*, only seven have very high freedom scores of 80 percent or more, making them what we categorize as "free" economies. Another 23 are in the 70 percent range, placing them in the "mostly free" category. This means that less than one-fifth of all countries have economic freedom scores higher than 70 percent. The bulk of countries—107 economies—have freedom scores of 50–70 percent. Half are "somewhat free" (scores of 60–70 percent), and half are "mostly unfree" (scores of 50–60 percent). Only 20 countries have "repressed economies" with scores below 50 percent.

The typical country has an economy that is 60.6 percent free, down slightly from 60.9 percent in 2006. These are the highest scores ever recorded in the *Index*, so the overall trend continues to be positive. Among specific economies during the past year, the scores of 65 countries are now higher, and the scores of 92 countries are worse.

The variation in freedom among all of these countries declined again for the sixth year in a row, and the standard deviation among scores now stands at 11.4, down one-tenth of a percentage point from last year and down two full points since 1996.

There is a clear relationship between economic freedom and numerous other cross-country variables, the most prominent being the strong relationship between the level of freedom and the level of prosperity in a given country. Previous editions of the *Index* have confirmed the tangible benefits of living in freer societies. Not only is a higher level of economic freedom clearly associated with a higher level of per capita gross domestic product (GDP), but those higher GDP growth rates seem to create a virtuous cycle, triggering further improvements in economic freedom. This can most clearly be understood with the observation that a ten point increase in economic freedom corresponds to a doubling of income per capita.

The reason that I am devoting so much of my testimony to the topic of economic freedom is because I hope to impress on you the centrality of internally generated policy change as the key to development.

To be blunt, countries control their own fate, and it is almost always impossible for external forces to "jump start economic growth.

Is OPIC Necessary?

I do not believe there is justification to reauthorize OPIC. It pains me to say that, because I share the objectives of the good people who work at OPIC. But as designed, I think it is clear that the organization is based on an outdated economic philosophical foundation. I would like to make a number of minor points.

First, is OPIC really costless to the taxpayer? It claims to be a net economic gain for the U.S., in the sense that it is generating revenue. But how does it generate income? Having scrutinized some of the balance sheets for OPIC, my eyes are drawn to Statement of Income on page 41 of its annual report. Of $403 million in 2006 revenues, nearly half come from fees.[6] But who is paying those fees? I may be wrong, but I assume those fees are paid by the U.S. government for services rendered. Perhaps this would be a fruitful line of inquiry for the Subcommittee to pursue.

Second, if OPIC is a profitable enterprise, then why does it need re-authorization from Congress? In that case, I would recommend that Congress sell it off and take the proceeds of that "IPO" to pay down the deficit, while letting OPIC continue its mission as a private entity. If instead, the accounting numbers show that on net OPIC is not truly profitable, but that its costs are creating some public good that is worth it, then we can at least have an honest discussion.

Third, the only merit I can see for the existence of OPIC would be if its investments were geared toward promotion of economic freedom, particularly in places of strategic interest for U.S. foreign policy. What I would hope is that OPIC would not be reinforcing nations that are economically unfree.

Again turning to OPIC's annual report, I was surprised to see how little OPIC money has been geared towards the economic development of Iraq. Compare the $200 million being spent on Russia by OPIC to the $6 million spent on Iraq. Barely $1 million was spent on Afghanistan. The mismatch of funds to national priorities is astounding. In contrast, $19 million was spent on projects in Vietnam. But why Vietnam? Yes, they are a vital partner for the U.S., but they are also one of the hottest economies in all of Asia, and a hotbed for private market investments.

Let's face it: If your global mutual fund isn't allocating some dollars into Vietnam, you should be upset. Why then, does the U.S. taxpayer need to spend its precious strategic dollars in Vietnam instead of Afghanistan? Is economic development in Afghanistan only 6 percent as important as it is in Vietnam? Is economic progress in Iraq only one-third as important as as it is in Vietnam?

To be fair, and in order to provide some intellectual rigor to this inquiry, let's consider a broader view. In preparation for today's hearing, I assembled the data on OPIC's recent investments into various countries and compared it to the economic freedom scores those countries received in our *2007 Index of Economic Freedom*.

There are 39 countries that received OPIC finance or insurance that also received a score in our *Index*. Keep in mind that a score below 50 percent is considered a repressed economy. The average score worldwide in 2007 was 60.6 percent. What I found was that the average freedom score of countries receiving OPIC funds was 58 percent. Further, I calculate a weighted average so that countries with higher funding levels are counted proportionally more; the weighted average freedom score of countries receiving OPIC funds was 59 percent. Frankly, this is an encouraging finding, as it shows that very few OPIC dollars are supporting investments in unfree economies. In fact, more than half of OPIC dollars are spent in support of investments in what The Heritage Foundation categorizes as free economies.

As my earlier points must reveal, this finding does not lead me to conclude that OPIC should be reauthorized, but it is somewhat heartening.

Conclusion

Realistically, I have come to accept the maxim of Ronald Reagan that once a government program is created, it is practically immortal. But I do feel

6. Overseas Private Investment Corporation, "2006 Annual Report," at *www.opic.gov/pdf/OPIC_AR.pdf* (June 19, 2007).

strongly that OPIC should be revised, with a cap on the fees that it can charge to the U.S. taxpayer—and I would suggest cutting these in half.

In light of all the evidence, however, my recommendation would be that Congress explore a phase-out of OPIC. Its operations are duplicative of the private sector, generally, and the funding of activities of high value for U.S. foreign policy are clearly not a priority in light of the levels of funding towards Iraq and Afghanistan. It is difficult for me to understand why, then, the organization exists, which is what the great Milton Friedman cautioned years ago when he said, "I cannot see any redeeming aspect in the existence of OPIC."

—Tim Kane, Ph.D., is Director of the Center for International Trade and Economics at The Heritage Foundation. These remarks were delivered May 24, 2007, before the U.S. House Committee on Foreign Affairs, Subcommittee on Terrorism, Nonproliferation, and Trade.