<u>Referee report on “Are the GCC FDI Location Determinants Favorable?” for E-conomics</u>

This paper examines which characteristics of the Gulf Cooperation Council (GCC) countries are correlated with inflows of foreign direct investment (FDI). The author first provides an extensive description of factors deemed relevant in the literature on FDI determinants, such as education or institutional quality, for the GCC countries. Then, he runs a fixed effects regression for the 1980-2002 period and as a robustness check one omitting the first three years. He finds that per capita GDP, trade openness and (in the second regression only) the rule of law are positively correlated with FDI whereas education, measured as secondary school enrollment, is significantly negative in both regressions. From this result, he questions the wisdom of policy makers’ and international development organizations’ current education and labor policies.

The paper addresses a question that many developing countries are interested in. Which characteristics of an economy help attract FDI, which is by now regarded as largely beneficial by most countries? Rather than appealing to results from the wider literature that often examines a large cross-section of diverse countries, this paper examines the specific determinants for the GCC countries. This is useful as it might explain why FDI in the region has declined in recent years, although it would not necessarily predict what will be needed to successfully attract diverse FDI in the future. Of course, the result that larger markets help attract FDI is of little policy relevance. The result that FDI and trade openness, as measured by exports and imports as a share of GDP, are positively correlated is probably a reflection of the simultaneity of the two rather than evidence of causality running from trade to FDI. The author should either address the endogeneity issue or find a different measure of trade openness, such as an index of trade barriers.

Most importantly, the finding that education and FDI are negatively correlated is at odds with most of the existing literature and to draw the policy conclusion that support of education should be reconsidered is ill-advised, if not dangerous, for a number of reasons. First, secondary school enrollment, as the author himself acknowledges, is a poor measure of human capital. At the very least, he should use other available measures to conduct robustness checks of the result. One does not want to draw such important conclusions from just two regressions. I also wonder how robust the result is in the first place. The sample consists of six countries over a 23 year period, which implies a maximum of 138 observations. Yet, Table 12 indicates only 68 observations were used in the regression. This suggests that several year-country combinations were missing. Are there particular countries that have very few observations? When the first three years (1980-82) are excluded to run the regression shown in Table 13, the sample size only drops by 2. However, the rule of law then becomes significant, suggesting that the results are sensitive to outliers. I am also puzzled by the fact that the OLS and random effects coefficients in Table 12 are exactly identical, which they should not be (and in Table 13, they are indeed not). This also leads me to be suspicious of the results.

The author discusses omitted variable bias at length. The most obvious omission, however, is an indicator for oil production and reserves, since most FDI over the last 25 years would clearly have been resource-seeking. In a closely related study (Mina 2007, not cited in the paper), the author does include several such measures, including the world oil price. Once a measure of oil wealth is included, however, I am not sure how the current paper would really be different from Mina (2007).

In summary, this paper addresses a very relevant question and provides a nice overview of important characteristics of GCC countries and appeals to the literature for which variables to include in the empirical model. However, much more sensitivity analysis is needed before policy conclusions should be drawn based on its results. The author should also double-check the coefficients to ensure that they are reported correctly. Finally, the paper is a bit rough at times and could use some judicious editing.

Additional Reference:

Mina, Wasseem. The location determinants of FDI in the GCC countries. Journal of Multinational Financial Management 17 (2007), pp. 336-48.