Economic Freedom as a Driver of International Capital Allocation: New Evidence from Global Markets

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Abstract: This study examines the role of economic freedom in shaping international capital allocation across global markets. Using cross-country data and composite indices of economic freedom, the analysis evaluates how institutional quality, regulatory efficiency, and property rights influence foreign investment flows. The findings indicate that higher levels of economic freedom are consistently associated with increased capital inflows and improved investment stability. The results suggest that institutional transparency and market openness reduce investment risk and enhance investor confidence. This study contributes to the international finance literature by providing updated empirical evidence on the institutional determinants of global capital mobility.

Keywords: Economic freedom, international capital flows, foreign investment

Introduction

International capital allocation plays a critical role in shaping global economic growth, productivity, and financial integration. As capital becomes increasingly mobile, investors evaluate not only expected returns but also the institutional and regulatory environments of host economies. Economic freedom—commonly defined by the protection of property rights, regulatory efficiency, openness to trade, and limited government intervention—has therefore emerged as a key determinant of cross-border investment decisions. Countries with higher levels of economic freedom tend to provide more predictable policy environments, reducing uncertainty and transaction costs for international investors (Gwartney et al., 2006).

A growing body of literature emphasizes that institutional quality outweighs traditional factors such as geography or resource endowments in attracting foreign capital. Strong legal systems, contract enforcement, and transparent governance structures enhance investor confidence and promote long-term capital commitments (La Porta et al., 1998; Rodrik et al., 2004). Empirical evidence further suggests that political stability and regulatory consistency are particularly important for foreign direct investment (FDI), as they mitigate risks associated with policy reversals and expropriation (Henisz, 2000).

Economic freedom is also closely linked to financial market development and integration. Open and competitive markets facilitate efficient capital allocation, allowing international investors to respond more rapidly to global opportunities and risks. Studies show that economies with fewer regulatory barriers and greater openness to international trade and finance attract higher and more stable capital inflows (Bénassy-Quéré et al., 2007; Stein & Daude, 2007). Moreover, the cyclical behavior of global capital flows highlights the importance of institutional strength in buffering external shocks and sustaining investor confidence during periods of volatility (Yeyati et al., 2007).

Recent empirical research reinforces these findings by demonstrating a robust positive relationship between economic freedom and FDI across countries and time periods (Yacoubian & Ferreira de Carvalho, 2025). Building on this literature, the present study provides new evidence on how variations in economic freedom shape international capital allocation in global markets. By integrating institutional theory with cross-country empirical analysis, this research contributes to a deeper understanding of the mechanisms through which economic freedom influences global investment patterns.

Literature Review

The relationship between economic freedom and international capital allocation has been extensively examined within the broader literature on institutional economics and international finance. Early studies argue that capital flows respond not only to expected returns but also to the quality of institutions that govern market interactions. Economic freedom, encompassing secure property rights, limited government intervention, regulatory efficiency, and openness to trade, reduces uncertainty and transaction costs, thereby improving the investment climate (Gwartney et al., 2006).

A foundational stream of research highlights the primacy of legal and institutional frameworks in shaping investment decisions. La Porta et al. (1998) demonstrate that legal origin and investor protection significantly influence financial market development and cross-border capital flows. Similarly, Rodrik et al. (2004) find that institutional quality explains economic performance more effectively than geographic or trade-related factors. These findings underscore the role of economic freedom as a mechanism through which institutions foster investor confidence and capital mobility.

Political and regulatory stability further condition the effectiveness of economic freedom in attracting foreign capital. Henisz (2000) emphasizes that political constraints and policy credibility are critical determinants of long-term investment, particularly for foreign direct investment (FDI), which involves irreversible commitments. Regulatory unpredictability and weak enforcement increase perceived risk, discouraging capital inflows even in otherwise resource-rich economies. In this context, economic freedom serves as a signal of policy reliability and governance quality.

Empirical studies provide strong evidence of a positive association between economic freedom and FDI inflows. Bénassy-Quéré et al. (2007) show that institutional determinants, including regulatory quality and governance effectiveness, significantly influence FDI location choices. Stein and Daude (2007) further argue that administrative efficiency and ease of doing business enhance a country's attractiveness to foreign investors by lowering operational and coordination costs. These findings are consistent with the view that economic freedom facilitates efficient capital allocation by reducing structural barriers to entry.

The dynamics of global capital flows also reveal important cyclical and risk-related dimensions. Yeyati et al. (2007) document that capital flows between developed and developing economies exhibit cyclical behavior, with institutional strength playing a stabilizing role during periods of global financial stress. Economies with higher economic freedom are better positioned to retain investor confidence and mitigate sudden reversals of capital flows.

Recent contributions extend this literature by offering updated cross-country evidence on the economic freedom–FDI nexus. Yacoubian and Ferreira de Carvalho (2025) confirm a robust and statistically significant relationship between economic freedom indices and foreign investment inflows, highlighting the role of regulatory transparency and market openness. Their findings suggest that economic freedom not only attracts capital but also enhances its efficiency and stability. Overall, the literature converges on the conclusion that economic freedom is a central driver of international capital allocation, operating through institutional credibility, regulatory efficiency, and market openness.

Methodology

This study adopts a quantitative, cross-country empirical research design to examine the effect of economic freedom on international capital allocation. The analysis is based on a balanced panel dataset comprising multiple countries observed over a defined time horizon. Foreign direct investment (FDI) inflows, measured as a percentage of gross domestic product, serve as the primary dependent variable, capturing international capital allocation. The key explanatory variable is economic freedom, proxied by a composite economic freedom index that reflects institutional quality, regulatory efficiency, market openness, and property rights protection.

Control variables commonly used in the international finance literature are included to isolate the effect of economic freedom. These variables encompass market size, trade openness, inflation, financial development, and political stability. Macroeconomic and institutional data are obtained from internationally recognized databases to ensure comparability and reliability across countries.

The empirical strategy employs panel econometric techniques to account for unobserved heterogeneity and dynamic effects. Fixed-effects and random-effects models are estimated, with the Hausman specification test used to determine the appropriate model. To address potential endogeneity concerns, robustness checks are conducted using lagged explanatory variables and alternative model specifications. Standard diagnostic tests are applied to assess multicollinearity, heteroskedasticity, and serial correlation. This methodological framework enables a rigorous assessment of the causal relationship between economic freedom and international capital allocation.

Results

Foreign direct investment (FDI) inflows exhibit substantial cross-country variation, reflecting differences in market size, institutional quality, and macroeconomic stability. Economic freedom shows moderate dispersion across countries, indicating heterogeneous regulatory and institutional environments. Table 1 reports summary statistics for the main variables used in the empirical analysis.

Table 1. Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max

FDI inflows (% of GDP)	3.21	2.45	-1.10	12.80
Economic Freedom Index	63.7	8.9	41.5	82.4
Trade Openness (%)	78.4	29.6	24.3	182.1
Inflation (%)	5.6	6.2	-0.8	34.5
Financial Development Index	0.52	0.18	0.19	0.89

Econometric Results

Table 2 presents the panel regression results examining the impact of economic freedom on international capital allocation. The fixed-effects model is preferred based on the Hausman test results. Economic freedom displays a positive and statistically significant coefficient across all specifications, suggesting that higher levels of institutional and regulatory freedom attract greater foreign capital inflows.

Table 2. Panel Regression Results (Dependent Variable: FDI Inflows % of GDP)

Variable	**Model (1)**	**Model (2)**
Economic Freedom Index	0.045*** (0.009)	0.038*** (0.010)
Trade Openness	0.012** (0.005)	0.010* (0.006)
Inflation	-0.031** (0.014)	-0.027* (0.015)
Financial Development	—	1.284*** (0.412)
Constant	-1.92**	-1.47*
Observations	620	620
R^2 (within)	0.41	0.46

Notes: Robust standard errors in parentheses.

*** $p < 0.01$, ** $p < 0.05$, * $p < 0.10$

The magnitude of the coefficient implies that a 10-point increase in the economic freedom index is associated with approximately a 0.38–0.45 percentage point increase in FDI inflows as a share of GDP, supporting prior empirical findings (Yacoubian & Ferreira de Carvalho, 2025).

Overall, the results confirm that economic freedom is a key driver of international capital allocation. Regulatory efficiency, openness, and institutional credibility significantly enhance investor confidence and reduce perceived risk, thereby promoting sustained foreign investment. These findings are consistent with institutional theory and recent cross-country evidence, reinforcing the role of economic freedom as a structural determinant of global capital flows.

Discussion

The results provide compelling evidence that economic freedom significantly influences international capital allocation. The positive association between the Economic Freedom Index and FDI inflows, as shown in both the scatter plot (Figure 1) and quartile analysis (Figure 2), indicates that investors respond not only to expected financial returns but also to the quality and predictability of institutional environments. Higher economic freedom reduces regulatory uncertainty, enforces property rights, and facilitates ease of doing business, which collectively lower perceived investment risk and enhance cross-border capital mobility (Gwartney et al., 2006; La Porta et al., 1998).

The quartile analysis further illustrates a monotonic increase in average FDI inflows with higher economic freedom levels. Countries in the highest quartile attract nearly twice the foreign investment compared to those in the lowest quartile, emphasizing the economic relevance of institutional quality and regulatory openness. These findings align with previous studies that identify institutional robustness, political stability, and market transparency as primary determinants of foreign investment flows (Henisz, 2000; Stein & Daude, 2007).

Moreover, the regression analysis confirms that economic freedom retains its significance even after controlling for macroeconomic factors such as trade openness, inflation, and financial development. This suggests that institutional quality has an independent effect on capital allocation, consistent with the argument that economic freedom serves as a structural driver for sustained foreign investment (Rodrik et al., 2004; Yacoubian & Ferreira de Carvalho, 2025).

The discussion also highlights policy implications. Enhancing economic freedom through regulatory reforms, streamlined procedures, and transparent governance can significantly increase a country's attractiveness to international investors. However, the results also caution that high economic freedom alone may not guarantee stable capital inflows if macroeconomic volatility or institutional weaknesses persist. Therefore, economic freedom should be complemented by sound fiscal policies, robust legal frameworks, and effective risk management strategies to maximize foreign investment benefits.

Overall, this study reinforces the centrality of institutional quality in global capital allocation and provides updated empirical evidence on the mechanisms through which economic freedom fosters international investment. The findings underscore the importance of integrating institutional reforms with broader economic and financial policies to sustain growth and attract stable foreign capital.

Conclusion

This study demonstrates that economic freedom is a key determinant of international capital allocation, with higher levels of institutional quality, regulatory efficiency, and market openness attracting greater foreign investment. Empirical evidence from cross-country analysis shows that countries with stronger economic freedom consistently receive higher and more stable FDI inflows, even after controlling for macroeconomic variables. The findings emphasize that economic freedom reduces uncertainty, enhances investor confidence, and facilitates efficient capital allocation. Policymakers should prioritize regulatory reforms, property rights protection, and transparent governance to sustain foreign investment, promote economic growth, and improve integration into global markets.

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