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Impact of Economic Freedom and Foreign Direct Investment on Economic Development: A Study of G-5 Economies

Ankita Dhyani[1] and Dr. Aneesh K. A[2]

ABSTRACT
A desire for upliftment, well-being, freedom, and prosperity is an innate human tendency. More often than not, humans tend to equate this freedom with their entire identities. Freedom is defined as either having the capacity to act or change without restriction or having the strength and resources to pursue one's goals without interference. But at times, interference in question is the requirement of the situation, making freedom biased and subjective. People have been relegated to poverty and degradation for a large portion of human history because they lacked economic freedom, i.e., the right to be in charge of their labour and property and, in turn, opportunities. Economic freedom is one of the variables that have an association with the development of the economy. With newfound ideologies like "minimum government, maximum governance" in India or global waves of start-ups, the rise of the gig economy, an engineer turned stand-up comedian movements; we are expanding the freedom boundaries further & further. This puts the government in a difficult position and makes it crucial for us to study the impacts of the same on different facets. This study also uses Foreign direct investment as another critical variable, which helps in knowing the international situation of the G-5 economies. Using panel data analysis and regression models such as pooled OLS, fixed effect model, and random effect model, this paper investigates the impact of these variables on the economic development indicator Human Development Index. An attempt was made to determine if both variables positively affect economic development indicators. As emerging and rapidly developing economies, more macroeconomic variables influence these countries' economic development.
Keywords: Economic freedom; Foreign direct investment; G-5 Economies; Economic development; Human development index; Panel data analysis; Pooled OLS; Fixed effect model; Random effect model.
JEL Classification: O11, O43, F21

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I. INTRODUCTION

Economics has been in existence since time immemorial. People, kings, and presidents concerned themselves with the economic matter long before it came to be recognised as a separate discipline. The awareness grew, and so did the subfields that range from the economics of crime to the economics of sexes. It is said that good economics and good politics don't go hand in hand. But it isn't true anymore. Nowadays, political decisions often require economic backing to improve economic growth and development, demonstrating the importance of economics as a discipline.

Economic freedom is a crucial aspect of economics. The four pillars of economic freedom are a personal choice, voluntary exchange facilitated by markets, freedom to participate in and compete in markets, and protection of people and their property from outside violence Gwartney & Lawsonb (2002). We have an Economic freedom index that assesses how well a country's institutions and policies support this protective role and people's freedom to make economic decisions (Economic Freedom Basics, n.d.). Governments should only restrict freedom to the amount necessary to safeguard that liberty. Economic freedom, prosperity, and resilience are inextricably linked.

According to Fraser Institute, the economic freedom index measures degree of freedom as per their presence in five major areas: the size of government, sound money, freedom to trade internationally, regulations, legal system, and security of property rights. The index contains forty-four variables in totality. All variables are derived from third-party sources, such as International Country Risk Guide, the Global Competitiveness Report,

[1] *Student, M.Sc. Economics & Analytics, CHRIST (Deemed to be University), Delhi NCR Campus. (adhyani2012@gmail.com)*
[2] *Assistant Professor, Department of Economics, CHRIST (Deemed to be University), Delhi NCR Campus. (aneesh.ka@christuniversity.in)*

and the World Bank's Doing Business project, to maintain the reliability and to eliminate bias Hence, the authors' subjective opinions have no bearing on the index.

Upon reviewing the literature, it has been observed that economic growth and development are separate and distinct concepts with a discernible delineation between them. Economic growth is a conservative concept. It denotes the rise in a nation's actual output level because of the increased quality of resources. In contrast, economic development is comparatively a normative concept. It represents the enhancement in the standard of living of an individual and self-esteem needs, Srivastav(n.d.). For instance, improvements in productivity, health, literacy rates, and public education affect a nation's economic development.

Theories and literature suggest that the market works best when left on its own and free. Debroy (n.d.), mentioned that Adam Smith, Milton Friedman, and Friedrich Hayek have stressed that freedom of exchange and market coordination fuel economic progress. Without exchange and entrepreneurial activity coordinated through markets, modern living standards would be impossible. This is why it is suggested that economic freedom influences incentives, productive effort, and resource utilisation effectiveness, and contributes significantly to economic progress.

According to the literature, it is considered that more economic freedom will increase the capacity to absorb Foreign direct investment and use it appropriately for economic development. Theoretically, there is a widespread belief that foreign direct investment generates positive externalities for host countries. Dkhili & Dhiab (2018), stated a positive and significant relationship between economic freedom and foreign direct investment and between economic freedoms and economic growth. Effect of foreign direct investment is contingent on the level of economic freedom in the host countries. This means the countries that promote greater freedom of economic activities gain significantly from the presence of multinational corporations (Haydaroğlu, 2016).

One such factor that showcases a country's position and extent of economic development is the Human development index, more commonly known as the HDI. The HDI is an effective tool for measuring an economy's real growth. It includes overall development in terms of GDP per capita, living conditions, government facilities, employment opportunities, people's self-esteem, and many other reforms/changes at the grassroots of an economy. As per UNDP, The HDI was created to emphasize that people and their capabilities should be the ultimate criteria for assessing the development of a country, not economic growth alone.

However, such stability and prosperity cannot thrive in the absence of the rule of law and economic freedom. People will only have a higher quality of life as their economic freedom increases if they have better access to health, education, and resources, and there is less disparity between the rich and the poor, i.e., as their socioeconomic development level rises. This paper is an attempt to bring all this together and test the same for G5 countries.

II. REVIEW OF LITERATURE

Economic development is a concept that has been changing or emerging with time. It is a broad concept, and that's why different thinkers have different perspective for the same. According to Seers (1979), development involves reducing poverty, inequality and unemployment, and broadening choice, while Sen (1999), views it as reducing deprivation. Sen's economic goals include freedom of exchange, labour contracts, social opportunities, protective security, and overcoming deprivations. His welfare theory relies on individuals' capabilities and focuses on many essential functions central to well-being (Nafziger & Wayne, 2006). The most popular approach for economic development is Amartya Sen's Capability Approach which promotes enhancement of capabilities and expansion of freedom.

Gwartney, Lawson, & Randall (n.d), said that it is undeniably valuable to know how various inputs affect output; it also has become clear that simply expanding the availability of input does not always lead to economic growth, as creating an environment conducive to economic growth is a complex process involving several interrelated factors. The Economic freedom index captures some of those factors, but other factors also play a role. Doucouliagos & Ulubasoglu (2006), noted the same and said that there is strong evidence of a direct positive relationship between economic freedom and economic growth. This association is statistically significant as well as economically significant. Economic freedom may be an explanatory factor for growth and income distribution. However, Berggren (2016) mentioned that economic freedom is distinct from political freedom and from civil freedom.

According to Jagdish Bhagwati (n.d.) it is not difficult to assert that economic freedom is likely to have a favourable effect on economic prosperity. Those countries that turned inward and had extensive regulations of all kinds on domestic economic decision-making in production, investment and innovation, are the countries that have really not done too well. If nations create an environment conducive to economic growth, they will attract investors and give people the incentive to enhance their human capital. On a similar note, de Haan & Sturm (2000), stated that the debate over the role of economic freedom in determining economic development is bedeviled by a lack of clear definition of what is meant by economic freedom, and by a lack of data that applies this definition across a wide range of countries.

"Economic freedom" boosts growth by increasing total factor productivity as well as capital accumulation. Ayal & Karras (1998), identified six elements of economic freedom that are shown to be significantly correlated statistically with multifactor productivity and capital accumulation.

Kaur (n.d.) highlighted that if economic freedom promotes growth and trickles down, it promotes larger margins (e.g., a healthy and productive life, free from want and deprivation). Higher Economic Freedom, conversely, implies lower government interventions in sectors such as health and education, thereby limiting some aspects of larger freedoms. According to the econometric analysis in the paper "Economic Freedom, Larger Freedoms and State Intervention", higher levels of Economic Freedom promote higher levels of GDP per capita and positively impact larger freedoms. However, the findings confirm that higher levels of economic freedom associated with a few of its subcomponents, specifically lower government consumption expenditures and lower transfers and subsidies, harm larger freedoms, additionally. Haana & Sturmc (2003), discovered that in their sample of developing countries, increases in economic freedom were caused to some extent by the level of political freedom.

Bac´ovic´ & Vukotic´ (2006), founded that the level of economic freedom is significantly correlated with all macroeconomic indicators of development. If countries need more foreign investment, it is necessary to increase the level of economic freedom and to encourage the development of the market economy and its institutions. Similarly, Baharumshah, Azman-Saini, & Law (2010) found that the countries under review (including the developing countries) that promote freedom of economic activities gain significantly from the MNCs' presence. In these countries, firms can more easily absorb and adopt new technology and other benefits associated with foreign direct investment inflows.

Adegbite & Ayadi (2011), studied relationship between foreign direct investment flows and economic growth in Nigeria. And it confirmed the positive influence of foreign direct investment over growth of economy. According to Haydaroğlu (2016), economic freedom and foreign direct investment have a positive and significant impact on economic growth. He discovered that the size of the government is another key component of economic freedom that is negatively correlated with growth while developing the index.

Lehnert, Benmamoun, & Zhao (2013) emphasised the importance of infrastructure and nation-building investments for companies looking to invest in other countries. It demonstrates a strong link between foreign direct investment and social welfare and the possibility of a robust multiple variable forms. Lall & Narula (2007) suggested, we need a new agenda if foreign direct investment is to be leveraged efficiently to promote development.

Economic freedom and development of the economy are the concepts that sound so close that at the onset we imagine them having a direct relationship. But economic freedom is a sensitive indicator. Although the overall index of economic freedom shows a positive relationship with growth, this does not necessarily imply that greater economic freedom, as defined generally, has a simple positive trend for economic growth and development because some of the categories in the index are insignificant while some of the significant variables have negative effects. Some of the studies used the selected area of this index for research but this might not give complete understanding of relationship we are trying to study. Most of the literature reviewed was studying and investigating the relationship between economic freedom and economic growth. And knowing that there is a difference between economic growth and economic development, there is a possibility that results might differ when we analyse the relationship between economic freedom and economic development.

Economic development is the broader concept and this will give us better insights for this relationship. Other than that, Foreign direct investment is a crucial variable as it reflects the absorptivity of economy and ease of doing international trade. Most of the previous studies were either for individual countries or some alliances neglecting the G-5 countries.

III. AREA OF STUDY

This paper studies the impact of Economic freedom and Foreign direct investment on Economic development of G-5 countries. Since the middle of the 2000s, Brazil, China, India, Mexico, and South Africa have been members of the Group of Five (G-5). A rapidly expanding and crucial geopolitical and economic region of the world is represented by these emerging market economies.

China is said to be in a sceptic stance. With its extraordinary growth being accompanied by a weak legal and financial system, a lack of economic freedom, and a high level of corruption. Its economic freedom rating has consistently been lower than the global average and has shown little improvement over time (Wu, 2011). And India, despite evidence of high economic growth and rising living standards following the 1991 reforms, never fully committed to the pursuit of economic freedom following the initial set of reforms in the 1990s and early 2000s (Rajagopalan, 2021).

Mexico's governmental system is much more centralized, with a significantly greater role for the federal government. Despite the inefficiencies, the Mexican government has continued to promote privatization and protect private property rights for both foreign and domestic investors (Kapoor, n.d). For decades, overly centralized Brazilian federal government has crushed economic freedom. Many economic sectors are dominated by the state, and too many large private or public-private partnerships are shielded from competition. Brazilians face a difficult regulatory regime as well as a tax burden that is significantly higher than in many other emerging economies. Growth in South Africa, technological innovation, and private-sector participation in public-sector services offer credible opportunities for accelerated development, but only if policymakers are aware of the political realities. Well-targeted policy interventions can have dramatic and long-term effects.

These five economies have enough variations to support this study, with their dissimilarities weighing the similarities on more than one occasion. Thus, the group of five has been considered to answer the question as to whether the economic development of a country is affected by economic freedom and Foreign direct investment. Or in other words, the effect of economic freedom on economic development through the stimulation of foreign direct investment is to be seen in these G5 economies taking the human development index (HDI) as a proxy for the country's standard of living.

OBJECTIVES

It will be intriguing to examine the G-5 economies in order to have a clearer understanding of the connection between economic freedom and foreign direct investment and economic development.

This paper is an attempt:

1. To study the impact of economic freedom on economic development of G-5 economies.
2. To study the impact of economic freedom, foreign direct investment on economic development of G-5 economies.

This paper attempts to bring the element of economic development by taking the Human development index as the measure for living standards of people to check the relationship between economic freedom and economic development in G-5 economies. Additionally, it attempts to look at the improvement in economic development with the improvement of economic freedom and foreign direct investment.

IV. DATA AND METHODOLOGY

In this paper panel data of G-5 economies (India, China, Brazil, Mexico and South Africa) is used to see the impact of Economic freedom, Foreign Direct Investment on Economic development of a country.

Secondary data is used for the time period 2000-2020. HDI and foreign direct investment datasets were collected from world bank dataset and UNDP data centres. And the economic freedom index was available on Fraser institute website.

The first step is to examine the association between the EFI and HDI variables. This will give a general idea of how the two variables relate to one another. Panel data regression will be used to examine the influence of EFI and FDI further. The time series and cross-sectional nature of the panel data will be considered as this regression is carried out using the R software.

V. DISCUSSION AND ANALYSIS

In accordance with the initial objective of this paper, the correlation between EF and HDI is calculated using MS Excel, to see the impact of economic freedom on the economic development of a country.

The correlation analysis of these two variables for all the countries that we are considering is indicating a moderately positive relationship between the two variables. The correlation coefficient as 0.4 demonstrates that societies tend to have higher levels of human development in countries with greater economic freedom (Estimates using MS Excel). However, the link is moderate, suggesting that factors other than HDI might also affect EFI. Because that correlation does not always imply causality, panel data regression is used to continue the research further and for more clarity.

In order to examine the impact of economic freedom (EF), foreign direct investment (FDI) on economic development (HDI), a panel data analysis is conducted. The following equation represents the regression model for the panel data analysis.

$$Y = \beta_0 + \beta_1 EFI + \beta_2 ln\ (FDI) + \varepsilon$$

Where ,

Y = HDI, a measure of economic development and dependent variable of this study.

ln(FDI) = Natural logarithm of foreign direct investment, a measure of the amount of investment flowing into a country.

β_0 = Intercept term, which represents the expected value of HDI when both Economic Freedom and ln(FDI) are equal to zero.

β_1 = Coefficient of Economic Freedom, which represents the expected change in HDI associated with a one-unit increase in Economic Freedom, holding ln(FDI) constant.

β_2 = Coefficient of ln(FDI), which represents the expected change in HDI associated with a one-unit increase in the natural logarithm of FDI, holding Economic Freedom constant.
ε = Error term, which represents the variability in HDI that is not explained by the model.
According to Gujarati, (1978) there are four possible techniques for the panel data model. However, in this paper, only three of these techniques are employed to achieve the best estimation fit. To determine the more appropriate model, the Hausman specification test is used.

Pooled OLS model
The first technique used is pooled OLS estimator to examine the relationship between Economic freedom index, FDI and HDI (Economic development*). Results as depicted in the table* show that both EFI and FDI have a statistically significant positive impact on HDI.
According to results When both independent variables are 0, the predicted value of Y will be negative since the intercept (constant term) is significant and negative. The R-squared value is 0.4471, meaning that 44.71% of the variance in Y can be explained by the model. The p value of F statistics tells the overall statistical significance of the model.

Fixed effects or within estimator
This part shows results for fixed effects that allows control for all time invariant omitted variables. *Results for this method are attached in the table below:*
The results for this technique suggest that both EFI & FDI have positive impact on HDI with coefficients 0.061 and 0.069 respectively and their p value indicates that significant effect was observed. The positive relationship means that economic development increases for all G-5 countries when there is an increase in inflow of FDI and Economic freedom of country. R value of the model indicates that it explains significant portion of the model and it is a good fit.

Random effects estimator
It established that some explanatory variables are linked with the unobserved individual specific effect. In this result the p-value for intercept, EFI, and FDI shows that the relationship between the predictor and response variable is statistically significant.
The intercept term is statistically significant with a negative sign, meaning that the predicted value of HDI will be negative when EFI, and FDI are 0. Adjusted R square and R squared depict that most of the model is significant and chi square test statistics verifies models' overall significance. Overall random effect estimator is providing a good fit of the estimation.

Table 1: Panel data regression results

Pooled OLS model				
	Estimate	Std. Error	t-value	Pr(>|t|)
β0	-0.8044185	0.1640316	-4.9040	3.557e-06
β1EFI	0.1143800	0.0144607	7.9097	3.203e-12
β2ln (FDI)	0.0710162	0.0094903	7.4830	2.644e-11
Fixed effects or within estimator				
	Estimate	Std. Error	t-value	Pr(>|t|)
β1EFI	0.061675	0.016573	3.7214	0.0003306
β2ln (FDI)	0.069882	0.011060	6.3182	7.812e-09
Random effects estimator				
	Estimate	Std. Error	t-value	Pr(>|t|)

(Intercept)	-0.451983	0.109480	-4.1285	3.652e-05
β1EFI	0.064799	0.015825	4.0948	4.225e-05
β2ln (FDI)	0.068285	0.010554	6.4698	9.813e-11

Source: Estimates from R Studio

Table 2: Regression result summary

	Pooled OLS Model	Fixed effects or within estimator	Random effects estimator
Total Sum of Squares:	0.54579	0.18379	0.1873
Residual Sum of Squares:	0.30177	0.08509	0.087613
R-Squared	0.4471	0.53704	0.53224
Adj. R-Squared	0.43626	0.50869	0.52307
	F-statistic: 41.2416 on 2 and 102 DF, p-value: 7.4958e-14	F-statistic: 56.8397 on 2 and 98 DF, p-value: < 2.22e-16	Chisq: 116.061 on 2 DF, p-value: < 2.22e-16

Source: Estimate from R Studio

According to Gujarati, (1978) the null hypothesis underlying the Hausman test is that the fixed effect model and random effect model do not differ substantially. So, for this study as well Hausman test was used to know the preferred model between the two. And findings indicate that since p value is greater than 0.05 i.e., 0.7878, we fail to reject the null hypothesis that there is no difference between the fixed effects and random effects models. Therefore, we can choose either model, but the random effects model may be preferred since it allows for unobserved heterogeneity that may affect the outcome variable.

VI. CONCLUSION

In this paper, the impact of economic freedom, foreign direct investment on economic development of G-5 economies for the period of 2000-2020 is examined, where HDI was indicator of economic development and economic freedom index and foreign direct investment were explanatory variables, and G-5 countries are selected for the analysis.

It is impossible to undervalue the significance of a nation's economic independence because it affects societal advancement and living standards. This theory is supported by a lot of literature, and it is becoming more widely known over time. FDI is crucial to this liberalisation and globalisation because it allows countries to share resources that would otherwise be inaccessible, facilitating their expansion, development, and growth. Economic freedom and foreign direct investment have a favourable impact on economic development for the G-5 countries, according to all of the findings in this study following the panel data analysis. It indicates that these nations will advance as economic freedom and FDI expand. It demonstrates that, in contrast to growth, development is not only a quantitative process. The circumstances of the nation and its methods for carrying out policies have an impact on its development.

While this study offers insightful information there are some limitations that need to be acknowledged. To start with, economic development may be influenced by some other variables as well that are not included in this analysis. Furthermore, this study is focused on G-5 countries, emerging economies, so the findings may not be generalized for all the countries because of different circumstances and political situations.

This study helps us understand the core idea that freer markets and higher FDI absorption have a favourable impact on economic development. It is crucial to accept these constraints and proceed with caution when interpreting the results since, as we showed in the case of the G-5 nations, they may differ for other nations.

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