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Institutional Governance and Foreign Direct Investments: Evidence from South Asian Emerging Markets

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ABSTRACT

The current study investigated the effect of institutional governance on foreign direct investment inflows in five South Asian emerging countries for the period of 1996–2017. The results of the Housman's specification test support the fixed effects model could better fit the data. The estimated results showed that a governance variable such as control of corruption has positive and significant whereas, political stability, regulatory quality, and voice and accountability have a negative and significant impact on foreign direct investments. Moreover, the results of the market size have significant negative, whereas, level of development and trade openness is found to have a significant and positive effect on foreign direct investments. These results have important policy implications for South Asian emerging countries. The results suggest that countries should improve the quality of their business and institutional environment that would create an attraction for foreign investors.

Introduction

The investment of multinationals in foreign markets either by broadening the existing business activities or acquiring a firm in the host country is called as a foreign direct investment (FDI)(M. H. Shah & Afridi, 2015). FDI as a flow of private capital is one of the most important components of globalization in the 1990s(Villaverde & Maza, 2015). FDI provides new investment opportunities, better technology, expertise in management, and export markets to host countries(Sahoo, 2006), and hence, it accelerates economic growth in developing economies (Kemel, 2000). Moreover, it also increases the welfare of a country by improving competitiveness, the flow of technology, human capital accumulations, and faster

spillover effects (Asiedu, 2006; Borensztein, De Gregorio, & Lee, 1995; Chakrabarti, 2001; Durham, 2004).

In developing countries, FDI inflows are influenced by physical resources, macroeconomic factors, and institutional quality of the host country (Campos & Kinoshita, 2003). Among all the developing countries, South Asia received the lowest portion of inward FDI due to weak investment policies and reluctance to embrace free trade (M. Shah, 2011). In South Asia, only India receives the bulk of FDI, while other countries such as Afghanistan, Bhutan, Maldives, and Nepal receive relatively less FDI (Ekanayake & Perera, 2015). Therefore, the current study is focused to find out the main factors which are helping in increasing FDI in South Asia. There are two mechanisms through which FDI contributing economic growth to developing countries; first, it increases the total investment in the host country, and second, it also increases the productivity of the host country by effective management and technology (Mellow, 1999).

The rest of the paper is arranged as follows; section-2 describes the detailed literature about institutional governance and FDI, in the section-3 methodology of the study is given. Section-4 highlights detailed analysis and results. Section-5 describes the conclusions and future recommendations.

Government Effectiveness and FDI

Numerous studies show a positive association between government effectiveness and FDI. Such as Steven and Daniel (2002) found that good governance has a positive impact on FDI in developing and transition economies as compared to developed economies. Similarly, Hyun (2006) also suggested that FDI is positively affected by the strong government stability of the host country both in the short and long-run. Moreover, Pajunen (2008) highlighted that the FDI's decisions are mostly based on the government attractiveness and economic growth of the host country. Similarly, Newton (1982)and Garcia-Sanchez, Cuadrado-Ballesteros and Frias-Aceituno (2013) also supported that effectiveness of the government can be reflected by the size of government and providing several socially desirable services. More recently, Hossain and Rahman (2017) found a positive association between government effectiveness and FDI.

Hypothesis 1: Government effectiveness has a positive impact on inward FDI.

Rule of law and FDI

Rule of law is also one of the most important determinants of FDI (Mengistu and Adhikary, 2011), and most of the studies show a positive association between rule of law and FDI. Such as, Samimi and Ariani (2010) reviewed the 16 countries of MENA and found a positive association between inward FDI and rule of law. Moreover, Asiedu (2006) observed that inward FDI show increasing patterns to those countries where the rule of law is higher. Biglaiser and Staats 2009b) examined

the joint ventures of Latin America and found that the countries where rule of law and legal courts are strong having high inward FDI. Furthermore, Gangi and Abdulrazak (2012),concluded that rule of law has a positive effect on FDI. Likewise, Kar et al., (2015)examined the 22 emerging and 14 European countries and concluded a positive and significant association between rule of law and FDI. Furthermore, Azam, Khan, Hunjra, Ahmad and Chani (2011), analyzed seven south Asian countries and found that rule of law has a positive effect on inward FDI.

Hypothesis 2: There is a positive relationship between the Rule of Law and FDI.

Voice and accountability and FDI

Various studies show a positive relationship between voice and accountability and FDI inflows. Such as, Gangi and Abdulrazak (2012) showed a positive relationship between voice and accountability and inward FDI. Similarly, Kurul and Yalta (2017) used the dynamic panel approach on 113 developing countries and concluded that voice and accountability has a positive and significant impact on FDI inflows. Moreover, Aidt, Dutta and Sena (2008) argue that if there is proper accountability of the politicians in a country, it reduced corruption, and thus FDI is increased.

Hypothesis 3: Voice and Accountability have a positive and significant effect on FDI.

Control of Corruption and FDI

Transparency International (2017), reports that every country is facing the problem of corruption and no county is free from corruption in the world. Several studies show a positive association between the control of corruption and FDI. Egger and Winner (2005) argue that corruption has a positive impact on FDI. Similarly, Tokunova (2015) concluded that corruption has positive effects on FDI in developed countries and it is negative in developing countries. Moreover, Kurul and Yalta (2017) also found a significant positive impact of control of corruption on FDI.

The aforementioned discussion concluded that overall there are two streams such as positive and negative aspects of corruption on FDI. However, corruption has an adverse effect on FDI inflows and it also becomes a big threat to the government and thus has a negative effect on FDI. However, if there is a proper mechanism to control corruption in a country, then it will increases FDI inflows. Therefore, a positive relationship is expected between FDI and control of corruption.

Hypothesis 4: There is a positive relationship between FDI and control of corruption.

Regulatory Quality and FDI

Most of the developed countries enjoy the advantages of democracy, freedom, transparency, and other historical factors, as the regulations of these countries, are better as compared to underdeveloped and developing countries. Bénassy-Quéré, Coupet and Mayer (2007) investigated the effect of institutions and regulatory quality on FDI inflows in different countries and found a significant positive relationship between regulatory quality and FDI.

Based on the above discussion it is clear that the countries which have strong regulatory quality not only increase the FDI inflows but also increase the economic growth of the country. Therefore, the current study also expects a positive association between FDI inflows and regulatory quality.

Hypothesis 5: The level of regulatory quality has a significant and positive effect on FDI.

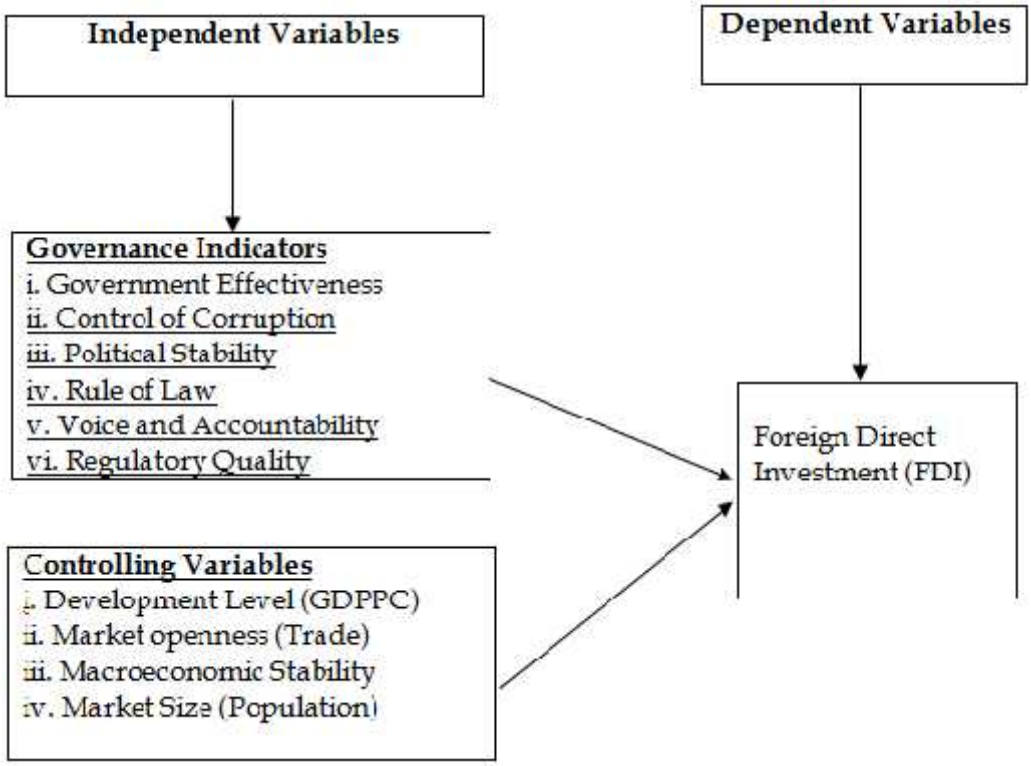
Political Stability and FDI

According to Harms and Ursprung (2001),the investor is highly attracted by the countries which have strong democratic structures, while due to policy reversal in autocratic societies FDI is less attracted. Similarly, Pajunen (2008) discussed that among other institutional factors political government and political risk are important factors to attract FDI and it has a positive impact on FDI. Moreover, Asiedu (2006) and Steven and Daniel (2002) determined that political stability plays a significant positive role in FDI inflows. Furthermore, Michael Holmes and Toyah Miller Michael Hitt M Paz Salmador (2013) found that FDI is highly attracted by the democratic government and it is less in autocratic government. In a democracy, the system of a country is influenced by the managers of MNEs through interest groups, lobbying, and elections. However, due to power confined to a limited number of people, there is instability and unpredictability seen in autocratic governments. Additionally, Ahlquist(2006) found that FDI is more attracted by the stable government regime and democratic political institutions.

The above literature concluded the two streams of political regimes such as autocratic and democratic governments. However, the study extends the above arguments and argues that political stability is an important element to improve infrastructure, education level, and better human capital, etc. which leads to improving more inward FDI. Therefore, it is expected that political stability has a positive effect on FDI inflows.

Hypothesis 6: There is a positive relationship between the level of political stability and FDI.

Figure-1 describes the theoretical framework of the study.



Material and Methods

The methodology of the study provides the detail of variables, sample, data collection method, and model of the study.

Variables' Explanation

Dependent Variable

Foreign Direct Investment

The investment of multinationals in foreign markets either by broadening the existing business activities or acquiring a firm in the host country is known as a foreign direct investment (M. H. Shah & Afridi, 2015). Two different proxies are used to measure the FDI (Aziz, 2018), first is the natural logarithm of FDI in current US dollars (Asiedu, 2006; Sabir, Rafique, & Abbas, 2019) and second is the FDI inflows as a percentage of GDP (Cavallari & d'Addona, 2013; Seth, 2018).

Independent Variables

i. Government Effectiveness
ii. Control of Corruption
iii. Political Stability

iv. Rule of Law
v. Voice and Accountability
vi. Regulatory Quality

Control Variables

i. Development Level
ii. Market openness
iii. Macroeconomic Stability (Inflation)
iv. Market Size

In Table 1 the proxies of variables their abbreviations and sources of data collection are given.

Table 1
Variables, their proxies and sources

Variables	Proxy	Abbreviation	Sources
Foreign direct investment	LNFDI in Current US Dollars	LnFDI	WB. WDI
Foreign direct investment	FDI as a %age of GDP	FDI	WB. WDI
Market openness	Ln trade as a % of GDP	LnTrade	WB. WDI
Development Level	LnGDP Per Capita	LnGDPPC	WB. WDI
Macroeconomic stability	Inflation rate	INF	WB. WDI
Market size	Ln population	LnPop	WB. WDI
Institutional Governance *	Government effectiveness	GovEf	WB. WGI
	Rule of law	RulLaw	
	Voice and accountability	VoAcc	
	Control of corruption	CoCr	
	Regulatory qualityand	RegQu	
	Political stability	PolStab	

*As the values of governance variables are between -2.5 to +2.5, thus these are used without log.

Sample and Data Collection

In this study the impact of institutional governance on inward FDI is observed by taking the sample of five out of eight South Asian emerging countries; such as Bangladesh, Bhutan, India, Pakistan, and Sri Lanka for the period of 1996 to 2017. For this purpose secondary data is collected from the World Bank, World Governance Indicators (WB.WGI) World Bank, World Development Indicators (WB.WDI).

Model Specification

The multiple regression model of Baptiste (2005) is used to measures the influence of institutional governance on FDI inflows. As in this study, two different proxies are used to measure FDI, therefore, the following two models are employed;

Model 1

$$FDI_{it} = \alpha_0 + \beta_1 GovEff_{it} + \beta_2 CoCr_{it} + \beta_3 PolStab_{it} + \beta_4 RulLaw_{it} + \beta_5 VoAcc_{it} + \beta_6 RegQu_{it} + \beta_7 LnTrade_{it} + \beta_8 LnGDPPC_{it} + \beta_9 INF_{it} + \beta_{10} Pop_{it} + \varepsilon_{it}$$

Model 2

$$LnFDI_{it} = \alpha_0 + \beta_1 GovEff_{it} + \beta_2 CoCr_{it} + \beta_3 PolStab_{it} + \beta_4 RulLaw_{it} + \beta_5 VoAcc_{it} + \beta_6 RegQu_{it} + \beta_7 LnTrade_{it} + \beta_8 LnGDPPC_{it} + \beta_9 INF_{it} + \beta_{10} Pop_{it} + \varepsilon_{it}$$

Where,

Ln is used for natural logarithm, i = Number of countries (i.e. 1 to 5), t = Time period (i.e. 1996 to 2017), α_0 = Intercept and ε_{it} = Error term.

Results and Discussions

In this study, secondary data of five emerging countries of South Asia are selected for the period of 1996 to 2017. Detail results of descriptive statistics, correlation matrix, model specification tests, and regression analysis are presented in this section.

Descriptive Statistics

The results of the descriptive statistics are given in table 4.1. It showed the total observations of all the variables and the values of minimum, maximum, mean, and standard deviation. The result showed that LnFDI has the highest mean value of 20.157 with a standard deviation of 2.653, its minimum value is 14.152 and the maximum value is 24.518. Similarly, the variable which has the smallest mean value is political stability, the values of its mean and standard deviation are -0.919 and 1.075 respectively, its minimum value is -2.81 and the maximum value is 1.283.

Table 2
Descriptive Statistics

Variables	Proxies	Obs	Mean	Std.Dev.	Min	Max
Foreign Direct Investment	FDI %age of GDP	95	0.012	0.011	-0.007	0.062
Foreign Direct Investment	LnFDI	95	20.157	2..653	14.152	24.518
Government effectiveness	GovEf	95	-0.220	0.452	-0.911	0.829
Political stability	PolStab	95	-0.919	1.075	-2.81	1.283
Regulatory quality	RegQu	95	-0.539	0.342	-1.169	0.276
Voice and accountability	VoAcc	95	-0.362	0.502	-1.29	0.477
Rule of law	RulLaw	95	-0.257	0.500	-1.048	0.628

Control of corruption	CoCr	95	-0.337	0.752	-1.497	1.568
Market size	LnPop	95	17.765	2.551	13.202	21.015
Market openness	LnTrade	95	3.881	0.448	3.088	4.733
Macroeconomic stability	INF	95	7.048	4.536	-18.109	22.564
Development level	LnGDPPC	95	3.044	0.279	2.596	3.613

Correlation Matrix

Table 3 presents the result of the correlation matrix. It is used to show the correlation among all the independent variables and FDI. Generally, it is expected that all the independent variables are positively associated with inward FDI as stronger institutions attract more FDI (Pajunen, 2008). The variables which have more than 90% correlation value show the existence of multicollinearity. Thus, in order to avoid the problem of multicollinearity in regression analysis, these variables should not be included (M. H. Shah & Afridi, 2015). The result showed that all the variables have less than 90% correlation values; therefore, there is no problem of multicollinearity.

Table 3
Correlation Matrix

Variables	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)
FDI/GDP	1.000											
LnFDI	0.350	1.000										
GovEf	0.102	-0.478	1.000									
PolStab	-0.072	-0.689	0.798	1.000								
RegQu	-0.003	0.133	0.270	-0.032	1.000							
VoAcc	0.075	0.501	0.136	-0.003	0.246	1.000						
RulLaw	0.079	-0.296	0.841	0.651	0.490	0.418	1.000					
CoCr	0.042	-0.649	0.891	0.836	0.171	-0.002	0.823	1.000				
LnPop	0.067	0.887	-0.618	-0.756	0.049	0.470	-0.453	-0.787	1.000			
LnTrade	0.197	-0.582	0.716	0.707	0.169	-0.050	0.707	0.826	-0.792	1.000		
INF	0.200	0.221	-0.148	-0.376	0.075	0.083	-0.088	-0.178	0.155	-0.011	1.00	
LnGDPPC	0.202	-0.067	0.415	0.357	0.200	0.063	0.445	0.468	-0.405	0.519	0.00	1.00

Model Specification Tests

In order to choose the most suitable method for panel data regression analysis, three different tests are used.First, the F-Test is used to select either a pooled OLS or fixed-effects model (FEM).The null hypothesis of F-Test suggested that pooled OLS is an adequate model. However, results rejected the null hypothesis as the value of the F-test is 12.222 and its probability value is 0.00000; therefore it is concluded that the fixed effects model is adequate estimation technique. Secondly, the Breusch-Pagan Langrage Multiplier test is used to select between the pooled OLS and random effects models (REM).Results showed that the null hypothesis is accepted as the value of Chi-square is 0.0123 and its probability is 1.0000, thus the pooled OLS model is adequate.

Table 4
Model Specification Tests

Tests	Choose Between	Null Hypothesis	P-Value	Results
F-Test	Fixed Effects Model and Pooled OLS	Pooled OLS is better	0.0000	Use Fixed Effects
Breusch Pagan Langrage Multiplier-test	Random Effects Model and Pooled OLS	Pooled OLS is better	1.0000	Use Pooled OLS
Hausman Specification Test	Random Effects Model and Fixed Effects Model	Random Effects and Fixed Effects Give the same results	0.0000	Use Fixed Effects

Regression Results

The regression results of both models are given in this section. In this study, different regression models are used for institutional governance.

The results of the first proxy i.e. the natural logarithm of total FDI inflows in current US dollars is given in table 4.4. The regression results of all the controlling variables are shown in model-1. It highlights that market openness (LnTrade) hasa significant positive impact on FDI inflows. It means that a high level of trade openness in the host country leads to high integration and lower transaction costs(Asiedu, 2006; Villaverde & Maza, 2015). Moreover, the countries which have more open economies attract more foreign investors to invest in FDIs. This result validates the findings of Belloumi (2014), Goh, Wong and Tham (2013), Liargovas, Konstantinos and Skandalis (2012)and Goh, Wong and Tham (2013).

Finally, y adding rule of law (RulLaw) in model-7, an insignificant positive relationship is found between the rule of law and inward FDI. Therefore, it means that in South Asia, FDI is less attractive due to the biased legal system and poor property and civil rights. The same results are also found by Gangi and Abdulrazak (2012) and Samimi and Ariani (2010).

Table 5
Regression results of First proxy (LnFDI)

Proxies	(Model1)	(Model2)	(Model3)	(Model4)	(Model5)	(Model6)	(Model7)
LnTrade	1.736***	1.799***	1.787***	1.816***	1.862***	1.862***	1.863***
	(0.336)	(0.341)	(0.338)	(0.336)	(0.324)	(0.326)	(0.324)
LnGDPPC	3.323***	3.141***	3.975***	3.641***	3.360***	3.362***	3.671***
	(0.552)	(0.577)	(0.768)	(0.794)	(0.772)	(0.777)	(0.798)
INF	0.012	0.011	-0.006	-0.008	0.005	0.005	0.004
	(0.015)	(0.015)	(0.018)	(0.018)	(0.018)	(0.018)	(0.018)
LnPop	0.162	0.674	-1.483	-0.945	0.206	0.194	-0.255
	(1.338)	(1.421)	(1.935)	(1.953)	(1.929)	(1.956)	(1.964)
GovEf		0.526	0.659	0.799	0.642	0.634	0.874
		(0.495)	(0.497)	(0.502)	(0.487)	(0.510)	(0.531)
PolStab			-0.384	-0.351	-0.166	-0.166	-0.230
			(0.236)	(0.235)	(0.237)	(0.238)	(0.240)

RegQu				-0.527*	-0.684**	-0.691*	-0.741**
				(0.349)	(0.341)	(0.365)	(0.364)
VoAcc					-0.728***	-0.733**	-0.951***
					(0.268)	(0.283)	(0.316)
CoCr						0.022*	-0.258*
						(0.435)	(0.470)
RulLaw							0.939
							(0.622)
Constant	0.349	-8.318	27.297	18.440	-1.638	-1.417	5.651
	(22.094)	(23.535)	(31.992)	(32.288)	(31.977)	(32.461)	(32.547)
Obs.	95	95	95	95	95	95	95
R-squared	0.700	0.704	0.713	0.720	0.743	0.743	0.751

Standard errors are in parenthesis
**** p<0.01, ** p<0.05, * p<0.1*

Table 6 presents the results of FDI as a percentage of GDP. Model-1 highlights the results of all the controlling variables. Results concluded that market openness (LnTrade) has a significant positive impact on FDI. Thus, the countries which have more open economies attract more foreign investors. The same results are also found by Shirazi, Gholami and Higón (2010), Liargovas, Konstantinos and Skandalis (2012) and Blonigen and Piger (2014).Similarly, the development level (LnGDPPC) also has a significant positive impact on FDI inflows. This result is consistent withNigh (1985); Resmini (2000); Shah (2011)and Hussain Shah and Faiz (2015).Conversely, market size (LnPop) showed a significant negative impact on inward FDI. Moreover, macroeconomic stability (INF) has an insignificant positive impact on FDI. This result is inconsistent with Nonnenberg and Mendonca (2011); Shah (2011) and Hussain Shah and Ali (2016). Government effectiveness (GovEff) is added in model-2 and it shows insignificant negative affect FDI. Henceforth, any increase or decrease in government effectiveness does not play any role in inward FDI.

Table 6
Regression Results of Second Proxy (FDI as a %age of GDP)

Proxies	**(Model1)**	**(Model2)**	**(Model3)**	**(Model4)**	**(Model5)**	**(Model6)**	**(Model7)**
LnTrade	0.020***	0.021***	0.021***	0.021***	0.021***	0.021***	0.021***
	(0.005)	(0.005)	(0.005)	(0.005)	(0.005)	(0.005)	(0.005)
LnGDPPC	0.018**	0.016*	0.031***	0.027**	0.025**	0.025**	0.026**
	(0.008)	(0.008)	(0.011)	(0.011)	(0.011)	(0.011)	(0.011)
INF	0.000	0.000	-0.000	-0.000	-0.000	-0.000	-0.000
	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)	(0.000)
LnPop	-0.032*	-0.026	-0.066**	-0.059**	-0.051*	-0.051*	-0.053*
	(0.019)	(0.020)	(0.027)	(0.027)	(0.027)	(0.028)	(0.028)
GovEf		0.006	0.009	0.011	0.009	0.009	0.010
		(0.007)	(0.007)	(0.007)	(0.007)	(0.007)	(0.008)
PolStab			-0.007**	-0.007**	-0.005	-0.005	-0.006
			(0.003)	(0.003)	(0.003)	(0.003)	(0.003)
RegQu				-0.007*	-0.008*	-0.008	-0.009
				(0.005)	(0.005)	(0.005)	(0.005)
VoAcc					-0.005	-0.005	-0.006
					(0.004)	(0.004)	(0.005)

CoCr						0.001	-0.001
						(0.006)	(0.007)
RulLaw							0.004
							(0.009)
Constant	0.444	0.343	1.014**	0.894**	0.750	0.754	0.785*
	(0.307)	(0.328)	(0.440)	(0.444)	(0.454)	(0.461)	(0.468)
Obs.	95	95	95	95	95	95	95
R-squared	0.252	0.259	0.300	0.319	0.334	0.334	0.336

Standard errors are in parenthesis

*** *p<0.01*, ** *p<0.05*, * *p<0.1*

Conclusions and Future Recommendations

The main purpose of the study is to find out the impact of institutional governance on FDI inflows in South Asian emerging countries for the period of 1996 to 2017 by using the fixed-effects model. The sample includes five out of eight countries of South Asia. The selected countries are Bangladesh, Bhutan, India, Pakistan, and Sri Lanka, while Afghanistan, Maldives, and Nepal are excluded due to incomplete or deficiency in data. Two different proxies are used to measure the FDI inflows. The empirical results showed that governance variables such as political stability, regulatory quality, control of corruption, and voice and accountability have a negative and significant impact on FDI. Moreover, the results of the market size have negative whereas, the level of development and trade openness are found to have a significant and positive effect on FDI.

The findings of the study have significant implications for both policymakers and academics. For academics, this study extends Dunning's OLI paradigm by incorporating many important institutional governance factors such as political stability, regulatory quality, control of corruption, and voice and accountability. Moreover, these factors influence the locational advantage of the host countries and play an important role in FDI inflows. Similarly, it also confirmed that the institutional factors along with the traditional factors such as GDPPC, market size, and market openness are also important for the locational advantage of the host country. From a policy perspective, this study provides several guidelines to policymakers and makes them able to set their policies to attract international investors for investment. The study also concluded that the country should enhance its government effectiveness in the public sector, improve its political stability, regulatory quality, trade openness, and development level to attract more inward FDI.

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