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GOOD GOVERNANCE FOR FOREIGN DIRECT INVESTMENT

MALRAJ B. KIRIELLA¹

ABSTRACT

This is a study of the impact of good governance on foreign direct investment (FDI) inflows. The effect of six Worldwide Governance Indicators on FDI inflows are analysed for eleven selected countries in South Asia and South-East Asia, namely, Bangladesh, Cambodia, India, Indonesia, Malaysia, Pakistan, the Philippines, Singapore, Sri Lanka, Thailand and Vietnam over the period of 20 years from 1996 to 2015. Gross domestic product (GDP) growth is used as a controlled variable. In order to measure the impact of governance indicators on FDI, the study used two tests. The Spearman Correlation Coefficient Analysis was used for country-wise analysis, while Panel Data Analysis was used to measure the overall results. Hausman Test results favoured the Fixed Effect Model for the study. The results indicate that three variables – political stability, the absence of violence and regulatory quality – have a significant impact on FDI inflows in these countries.

Keywords: governance, foreign direct investment, South Asian countries, fixed effect models and panel data

INTRODUCTION

Governance is the traditions and institutions by which the authority in a country is exercised (Kaufman, Kraay and Zoido-Lobaton, 1999). Good governance is concerned with an independent judiciary, impartiality, equality, accountability and responsibility with the effective continuation of public trust (Li, 2005). Good governance is the manner in which the main actors of the society, governments, businesses and civil society work together to make society better (UNCTAD, 2004).

One of the important determinants for FDI is good governance (Loree and Guisinger, 1995; Noorbaksh, Paloni and Yousef, 2001; Addison and Hesh, 2003; and Becchhetti and Hasan, 2004). On the other hand, traditional determinants such as natural resources, low labour costs and good infrastructure become less important (Dunning, 2002). FDI is encouraged by good governance according to Gliberman and Shapiro (2003), Biglaiser and DeRouen (2006), Gani (2007), and Staats and Biglaiser (2012).

Although most empirical investigations show the link between good governance and FDI, some investigations in the selected transition countries reflect the negative results. For example, empirical studies suggest that corruption attracts multinational companies in the selected transition countries (Subasat, 2012). It is convincingly shown that the countries with good governance tend to receive more FDI, whereas the countries with political instability, corruption, bribery, political risks and institutional corporate malpractice experience negative results, and finally end up with socio-economic chaos.

The worldwide indicators of the good governance – voice and accountability, political stability and non-violence, effective and transparent machinery of the government, regulatory quality, rule of law and judiciary and eradication of corruption and bribery – are used in this study to measure good governance. This research investigates the impact of these indicators on the foreign investment flows of selected South Asian and South-East Asian Countries. The selected countries are Bangladesh, Cambodia, India, Indonesia, Malaysia, Thailand, Pakistan, the Philippines, Singapore, Sri Lanka, Thailand and Vietnam over a period of 20 years (1996–2015). Two tests are used in the study to measure the impact of governance variables on FDI

¹ B.A (Econ.) Hons., LL. B, M.A (Econ.), FCMI (UK), FCIM (UK), Chartered Marketer, Attorney at Law and PhD Candidate, University of Colombo, Sri Lanka.

flows. One is country-wise analysis by using Spearman Correlation, and the other is Panel Data Analysis to measure the overall results. The Fixed Effect Model was favoured by Panel Data Analysis by using the Hausman Test.

THEORY AND LITERATURE REVIEW

The empirical studies of various experts identified a number of determinants showing the positive and negative influence on FDI. The empirical study conducted by Singh and Jun (1995), which focused on the influence of political risk and macroeconomic variables on FDI inflows in developing countries, confirms the significance of these factors in explaining the determinants of FDI. In their study, Singh and Jun (1995) used FDI as a percentage of GDP as the dependent variable, and political risk and macroeconomic variables (manufacturing exports and the fiscal system) as explanatory variables. Also, they used control variables. Both authors conducted an econometric study with a panel data set of 31 developing countries in the period 1970–1993. Wang and Swain showed that political instability negatively affects the FDI of multinational corporations and their subsidiaries. Indeed, political instability, corruption and a lack of transparency contribute to unfavourable business climate and thus reduce the possibilities of the entry of FDI. Similarly, other works have shown that political and institutional factors are determinants necessary for the entry of FDI in developing countries (Stein and Daude, 2001) and in Latin America (Stevens, 2001).

Morisset (2000) in his study showed that corruption and bad governance increase administrative costs and therefore reduce FDI inflows. Globerman and Shapiro (2002) stated that a large market would seek more FDIs for a number of reasons, such as robust client base, possible economic clusters, or because of the expected economies of scale in bigger markets. Also, Globerman and Shapiro (2002) studied the relationship between governance and FDI in the USA. In general, governance infrastructure represents attributes of legislation, regulation and legal systems that affect the security of property rights, the transparency of government and legal processes. Their results indicate that the governance infrastructure, including the nature of the legal system, is an important determinant to receive FDI. Globerman and Shapiro in 2003 argue that good institutions establish a conducive climate for multinational companies abroad.

Singh and Jun (1995) studied macroeconomic variables such as GDP, manufacturing, exports and fiscal systems besides their economic study with panel data in 31 developing countries in the period 1970–1993. They say that the foreign developed countries barely invest in the countries with negative factors such as political instability, corruption and political risk. However, good governance infrastructure, including good legal systems and regulation, create good confidence among the foreign donor nations and financing institutions which are instrumental for the inflow of foreign fund to developing countries. Wang and Swain too showed that the political instability and lack of transparency contribute to negative results and affect multinational corporations.

Asiedu (2006) argued that investment restriction, macro-economic instability, corruption and political instability have a negative impact on FDI in Africa. He used panel data for 22 countries during the period 1984–2000 to analyse the influence of market, natural resources, government policies, political instability and the quality of the institutions in the host countries of FDI. He also stated that major markets, natural resources, an educated population, good infrastructure, less corruption and a reliable legal system have a positive impact on the inflow of FDI to the country.

Bénassy-Qu'éré, Coupet and Mayer (2007) investigated institutional determinants from 1985 to 2000 and concluded that low corruption, efficient bureaucracy, vibrant courts, access to information, and a developed banking sector are crucial factors for FDI inflows. Bissoon (2011) analysed the impact of institutional quality on FDIs from African, Asian and Latin

American countries. The results show that the strong regulatory laws, low corruption in the institutions, and political stability enhance inward FDIs in these countries. Daude and Stein (2007), using 34 source countries and 152 host economies, found that regulatory quality and government effectiveness have a vital effect on FDI inflows. Other variables such as corruption, rule of law, political stability and voice and accountability had no significant impact on FDIs.

Mishra and Daly (2007) focused on the effect of institutional quality of OECD and Asian host countries on FDI during the period 1991–2001 using the International Guide to Country Risk. They argue that respect for human rights, the strength and justice of the legal system and government stability in host countries have a direct, positive impact on FDI inflows. Similarly, Shah (2011) showed that corruption, ineffective government and poor rule of law have a negative influence, whereas political stability and regulatory quality have a positive impact on FDI inflows. Samimi and Ariani (2010) used annual data from 16 countries in the Middle East and North Africa during 2002–2007 and found three governance indicators: – political stability, control of corruption and rule of law – that have positive impact on FDIs in those regions.

Mengistu and Adhikary (2011) analysed the impact of six indicators of good governance on FDI inflows in 15 Asian countries for the period 1996–2007. They used a panel data model with fixed effects and found that out of these indicators government effectiveness, political stability and the absence of violence, the rule of law and control of corruption are the main factors for FDI location. They conclude that improving the governance environment attracts more FDI.

Hassen and Anis (2012) studied the impact of FDI on the economic growth of Tunisia over the period from 1975 to 2009. They found that there is a relationship of co-integration in the long term between the coefficients of financial development, FDI, human capital, trade openness and the real GDP of the Tunisian economy.

According to Brada, Drabek and Perez (2012), excessive corruption could ruin the volume of incoming FDIs. Voyer and Beamish (2004), studying how the level of corruption affects Japanese FDIs in 59 developed and developing countries, found that corruption and FDIs were negatively related.

Balasubramaniyam (2002) studied the influence of good governance on FDI inflows in South Asian Association for Regional Cooperation countries and considered infrastructure as another key to FDIs. Poor governance is associated with excessive regulation, the arbitrary interpretation of rules, red tape, unskilled workers, low levels of bureaucratic quality and a lack of transparency. Jensen (2003) stated that democratic accountability is important for two reasons. First, it reduces the likelihood of undesirable policies such as nationalisation and expropriation. Second, in democratic countries, the leaders are accountable not only to their voters but also to businesses. If not, it may lead to business retaliation through a refusal to invest.

According to the suggestion made in the OECD report (2002), when good governance conditions prevail, they attract FDI. Poor governance leads to exploitation and malpractice, even by multinational companies and, as a result, an inconsistency impact is made on FDIs, but the good governance of democratic institutions has an enhancing impact.

Campos and Kinoshita (2008) tested the impact of structural reforms and institutional quality on FDIs and found that bureaucratic quality has a positive and significant coefficient when Latin American and transition countries are included for the study. However, when they are not included, it becomes insignificant. Furthermore, political stability and regulatory quality have a significant impact on FDI inflows (Yosra, Ochi and Ghadri, 2011).

According to Staats and Biglaiser (2012), judicial strength and rule of law are important determinants. Daddi (2013) explored the case of Ethiopia to find governance and FDIs and found that three parameters – efficiency, accountability and the decency of public officers –

have a significant impact on FDIs. Shah and Faiz (2015) found that the countries affected by terrorism deter FDIs.

METHODOLOGY

A sample of 11 countries from South Asia and South-East Asia has been taken using the Baptist (2005) model to show the effect of the indicators of the governance on inducing FDI which resulted in either a positive or negative impact.

The complete model is the following:

$$\text{FDI net inflows} = \beta_0 + \beta_1 \text{PSAVit} + \beta_2 \text{RQALit} + \beta_3 \text{ROLit} + \beta_4 \text{VAit} + \beta_5 \text{COCit} + \beta_6 \text{GEit} + \beta_7 \text{GDPGit} + \epsilon_{it}$$

The complete model uses the country subscript alphabetically using the English letters as the following:

i	stands for the country subscript,
t	represents time subscript,
β_0	remains constant,
β_i	as coefficients with different variable,
FDI	Foreign Direct Investment (net inflows) BoP current USA,
PSAV	stands for political stability and the absence of violence,
RQAL	quality of regulations,
ROL	is for rule of law,
VA	represents voice and accountability,
COC	stands for control of corruption and red tape administrative procedures,
GE	shows the effectiveness of the government,
GDPG	growth rate of gross domestic product.

Further, to facilitate the research, a number of hypothetical assumptions are made, as follows:

The first hypothesis makes the assumption that political stability and the absence of violence (PSAV) positively induces FDI.

The second hypothesis makes the assumption that the quality of regulation (RQAL) has a positive impact on FDI.

The third hypothesis relates its assumption to the control of corruption (COC) as positive and its significant role on FDI inflows.

The fourth assumption is based on the hypothesis that voice and accountability (VA) is positively related to FDI inflows.

The fifth hypothesis makes the assumption that the rule of law (ROL) has a positive impact on FDI.

The sixth hypothesis makes the assumption that government effectiveness has a positive impact on FDI.

The seventh hypothesis makes the assumption that the economics of GDP as the macroeconomic factors on the influence for FDI.

THE DATA AND VARIABLES

a) Data

This data for this study was taken from the World Bank website, the World Development Indicators (Worldwide Governance Indicators (1996–2015)). Empirical investigation focuses on the study of the impact of the six governance indicators on inflows of FDI. The sample is an unbalanced panel data over a 20-year period between 1996 and 2015 consisting of 187 observations.

b) Variables description

There are two types of variables: dependent and independent.

The variables that are used empirically are as follows:

The dependent variable of the model is FDI inflows (current US BDP).

The independent variables are the six governance indicators, namely:

- (1) The fight against corruption and bureaucratic red tape (COC),
- (2) The rule of law (ROL),
- (3) Political stability and the absence of violence (PSAV),
- (4) Voice and accountability (VA),
- (5) Regulatory quality (RQUAL)
- (6) Government effectiveness (GE), and
- (7) The control variable is GDP growth (GDPG).

EMPIRICAL RESULTS

Eleven countries were taken for the study to present statistically the empirical results that effect governance indicators.

a) The Global Model

i. Descriptive statistics

Table 1. Descriptive Statistics for the Study Variables

	Observations	Mean	Maximum	Minimum	Ecart-type	CV
COC	187	-0.31048	2.42	-1.49	0.900046	-2.898
FDI	187	8.20E+09	6.85E+10	-4.55E+09	1.32E+10	1.609
GE	187	0.050267	2.43	-1.07	0.845321	16.816
GDPG	187	5.484542	15.24038	-13.1267	3.073919	0.560
PSAV	187	-0.69802	1.34	-2.81	0.961582	-1.377
ROL	187	-0.17856	1.89	-1.25	0.752294	-4.213
RQ	187	-0.05273	2.26	-1.1	0.767833	-14.561
VA	187	-0.41326	0.51	-1.56	0.529009	-1.280

To estimate the model, the study used the econometric technique for estimating panel data using statistical software for data analysis (E Views 9). In this context, Table 1 reports the descriptive statistics that characterise the series of FDI net inflows retained on the sample period from 1996 to 2015.

Table 1 shows the descriptive statistics of all variables used in the empirical analysis for 11 countries in the sample. The study reveals that the FDI variable is between -4,550 billion and 68,500 billion USD with an average of 8,200 billion USD and a coefficient with a variation of 1.609. In fact, FDI variable shows a higher volatility, more than 50%. The variable COC has an average of -0.31048 with a range between -1.49 to 2.42. GE variable has an average of 0.050 with a highest volatility recorded a coefficient variation of 16.816 in the sample. The growth variable shows an average of 5.48% while recording the lowest volatility of 56% in the sample. Further variables of PSAV, ROL, RQ and VA have averages of -0.69802, -0.1785, -0.0527, and -0.413, respectively, with a standard deviation of 0.96, 0.75, 0.76 and 0.522, respectively.

Table 2. The Impact of PSAV, RQUAL and COC ON FDI

Variables	PSAV	RQUAL	COC
PSAV	2.5** (0.0827)	2.42** (0.0906)	2.85** (0.0551)
RQUAL		8.29** (0.0668)	9.51* (0.0417)
COC			-4.81 (0.2888)
RL			
GDPG	0.310 (0.2155)	0.315 (0.206)	0.363 (0.1553)
GE			
VA			
R2	0.64088	0.6495	0.6531
F	25.877 (0.000)	24.664 (0.000)	23.130 (0.000)
HAUSMAN TEST	0.418 (0.8111)	1.1665 (0.7610)	0.912 (0.9228)

In Table 2, the first line shows the coefficients and the second line shows Probability Value. First the study introduces the variable PSAV to examine its impact on the attractiveness of FDI. The examination of the Fisher statistic reveals the global significance of the model. Indeed, the results have obtained a value statistically significant at the 1% level to confirm the overall significance of the model ($F=25.877$, $P=0.000$) and conclude that this model is homogeneous.

Next, the study uses the variable RQUAL to measure its impact on FDI inflows. This model is globally significant ($F=24.664$, $P=0.000$) and homogeneous. It then includes the variable of control of corruption (COC) in the model in order to clarify its influence on FDI. The results in Table 2 explain that the model, including PSAV, RQUAL and COC, is globally significant ($F=23.130$, $P=0.000$).

The coefficient of determination (R^2) gives an idea of the percentage of variability. When the study uses the variables of PSAV, it shows the percentage of variability at 64%. However, 65% of the variability of FDI is explained by the variables of PSAV, RQUAL, and COC.

Control Variable GDP growth rate is not statistically significant at 5% significant level. However, the variable PSAV has a positive impact at 10% significant level. This result confirms the hypothesis of regulatory quality (RQUAL) and political stability and the absence of violence (PSAV) positively affect FDI inflows. Finally, control of corruption is negative and statistically insignificant. The results of the study confirm that political stability and regulatory quality are important factors in the choice of multi-national enterprises to invest in South Asian or South-East Asian Countries while other factors are held constant.

Table 3. The Impact of RL, VA and GE on FDI

Variables	RL	GE	VA
PSAV	6.95 (0.4808)	0.736 (0.6153)	0.646 (0.6967)
RQUAL	6.27 (0.1864)	5.49 (0.2442)	5.34 (0.2588)
COC	-7.28 (0.1114)	-7.62* (0.092)	-7.95* (0.089)
RL	12.1* (0.0097)	12.3** (0.0090)	12.0** (0.013)
GDPG	0.413* (0.10)	0.398 (0.1026)	0.39* (0.10)
GE		3.9 (0.321)	4.14 (0.2968)
VA			0.856 (0.7957)
R2	0.6683	0.6577	0.6569
F	22.97077 (0.000)	20.42151 (0.000)	19.0330 (0.000)
HAUSMAN TEST	1.269 (0.9380)	10.6531 (0.0997)	12.51 (0.0848)

* and ** indicate 5% and 10% significance levels, respectively.

In Table 3, the first line shows the coefficients and the second line shows the Probability Value. The study includes rule of law (RL) with the variables of PSAV, RQUAL and COC to clarify its impact on FDI. This model is globally significant ($F = 22.97$, $P=0.000$). The study then introduces GE to the model and Fisher Statistics can give the global significance of this model at 1% significant level. Finally, the study includes VA to study the influence on FDI inflows with the variables of PSAV, RQUAL, COC, RL and GE. This model is globally significant at 1% ($F=19.03$, $P=0.000$). The coefficient of determination (R2) indicates 0.65, which indicates that 66% of the variability of FDI is explained by the variables of PSAV, RQUAL, COC, RL, GDPG, GE and VA.

Table 4 Correlation Matrix of Country-wise Variables

	Bangladesh	Cambodia	India	Indonesia	Malaysia	Pakistan	Philippines	Singapore	Sri Lanka	Thailand	Vietnam
VA	-0.029	-0.676**	.616**	0.823**	0.135	0.066	-0.052	-0.262	-.750**	-0.441	0.17
	0.911	0.003	0.008	0	0.605	0.8	0.844	0.309	0.001	0.076	0.513
PSNV	-0.458	0.865**	-0.083	0.910**	-0.039	-.502*	0.459	.545*	.580*	-0.676**	-0.463
	0.064	0	0.75	0	0.881	0.04	0.064	0.024	0.015	0.003	0.061
GE	-.500*	0.318	0.399	0.757**	0.155	-0.162	0.750**	0.344	.575*	0.012	.706**
	0.041	0.214	0.113	0	0.553	0.534	0.001	0.176	0.016	0.963	0.002
RQ	0.284	-0.183	-0.161	0.393	.536*	.492*	0.212	-0.001	-.543*	-0.08	0.194
	0.27	0.482	0.537	0.119	0.027	0.045	0.413	0.996	0.024	0.761	0.456
ROL	.741**	0.601*	-.687**	0.717**	0.232	-0.318	0.455	0.828**	-.722**	-0.419	0.149
	0.001	0.011	0.002	0.001	0.371	0.214	0.067	0	0.001	0.094	0.569
COC	0.226	-0.218	-0.31	0.726**	-0.112	0.142	0.286	-0.652**	-0.206	-0.385	0.16
	0.384	0.401	0.225	0.001	0.669	0.586	0.266	0.005	0.427	0.127	0.541
Growth	.605*	-0.071	0.103	0.639**	0.081	0.047	0.11	0.108	0.365	0.135	-.502*
	0.01	0.786	0.694	0.002	0.758	0.859	0.673	0.68	0.149	0.606	0.04

Table 4 shows the results of country-wise analysis.

The P value indicate that Rule of Law (ROL) has a strong positive correlation with FDI inflows in the cases of Bangladesh, Cambodia, Indonesia and Singapore ($P < 0.05$).

Voice of Accountability (VA) is strongly correlated with the FDI of India and Indonesia at 5% significant level.

Political stability and the absence of violence (PSNV) too has a strong positive association with FDI inflows in Cambodia, Indonesia, Singapore and Sri Lanka.

Further, the variable of Control of Corruption (COC) has been a major factor for FDI inflows in Indonesia, but has limited association among most of the countries.

Government Effectiveness (GE) is strongly associated with FDI inflows to Indonesia, Philippines, Sri Lanka and Vietnam.

Regulatory Quality (RQ) has a positive correlation on FDI inflows to Malaysia and Pakistan.

GDP growth (GROWTH) has a strong association with FDI inflows to Bangladesh and Indonesia.

CONCLUSIONS

The main objective of this research is to examine the influence of governance indicators on the attractiveness of FDI in 11 selected countries in South Asia and South-East Asia over the period 1996–2015 using a fixed effect model, for a majority of models each with an explanatory variable in the equation.

The study found that two governance indicators that have a significant and positive impact on the attractiveness of FDI and indicators of governance are political stability and the absence of violence; regulatory quality also have a significant impact on FDI inflows.

This finding indicates that foreign investors are interested in political stability and the absence of violence, and regulatory quality in their choice of investment abroad.

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