The Impact of Governance on Foreign Direct Investment in South Asian Countries

Wanigasuriya, W.M.T.J.

Department of Economics, Faculty of Arts,
University of Colombo, Sri Lanka

**Corresponding Author:*
Email: tharangizzzz@gmail.com

ABSTRACT

Foreign Direct Investment (FDI) plays a remarkable role in the economy of every country linking to social, economic, and political factors. Since the late 1990s, there was greater attention from various scholars exploring the relationship between foreign direct investment and good governance. There are several indicators for governance. Such as voice and accountability, political stability, absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. These indicators affect FDI in various ways and at various levels. The literature it is arguing that political and institutional factors are affecting the performance of the economy to a greater extent. This study empirically examined the impact of governance on FDI in South Asia Countries namely, Sri Lanka, India, Pakistan, Nepal, Bangladesh, Afghanistan, Maldives, and Bhutan using a balanced panel data set, from 1996 to 2019. The study used six government indicators as Government effectiveness, Control of corruption, Voice and accountability, Regulatory Quality, Rule of law, and political stability. The data was extracted from Worldwide Governance Indicators (WGI) and World Development Indicators (WDI. The Generalized Method of Moments (GMM) and Two-Stage Least Squares (TSLS) show that government effectiveness, voice and accountability positively and significantly affect FDI and political stability and rule of law negatively affects FDI in South Asian countries. These results produce a sensible basis for understanding that it needs policymakers to boost and implement sound laws still as a stable business environment to draw in FDI into rising countries.

KEYWORDS: Foreign direct investment, Generalized method of moments, Governance, South Asia

Introduction

Foreign Direct Investment (FDI) plays an essential role in the development of any country. It reduces poverty in countries as well. FDI is linked to social, economic, and political factors of the domestic country which make the determinants significant. The World Bank (2004) stated that "A good investment climate provides opportunities and incentives for firms – from micro-enterprises to multinationals – to invest productively, create jobs, and expand". Therefore, countries try to attract more FDIs.

The literature argues that the economic performance of a country is affected by the institutional quality of the country (Valeriani and Peluso, 2011; Perera and Lee, 2013). Therefore, it is very crucial to understand the relationship between these institutional qualities. When considering good governance of a country, leads to the development of a country as well. Corruption creates bad governance. This leads to the failure of any country. Therefore, if there is good governance in the country, more FDI can be attracted. Several studies have focused on the relationship between FDI and governance. Mengistu and Adhikary (2011) concluded that if a country can enhance the governance environment of a country, it can attract more FDI. Fazio and Talamo (2008) suggest that corporate governance and institutional quality are important in attracting FDI. Lien (2005) found that regarding Taiwanese FDI corporate governance impacts in different ways. Shah and Afridi (2015) also found that good governance significantly impacts FDI in the SAARC region.

For many countries, institutional quality plays an interesting role in their success. Therefore, it is very important to understand the role of institutional quality in attracting FDI inflows to a country and what institutional factors are affecting it. Therefore, the objective of this paper is to analyze the impact of governance on FDI in South Asian counties.

Literature Review

There are several empirical and theoretical literature that analyzes the impact of governance on FDI. By browsing through the literature, it can be found that the results are controversial. Different authors have used several methodologies, different periods, and different sample countries and found that there was a positive, negative or no relationship between governance and FDI. Ange-Patrick and Herve (2019) adopted system generalized methods of moments, showing that foreign direct investment crowds out domestic private investment. Also, the substitution effect (crowding-out effect) was greater in francophone West African countries with good governance in terms of political stability and control of corruption.

Using the system generalized method of moments (GMM) Appiah-Kubi et al., (2020) examined the factors that impact the level of FDI in African countries. The study recommended that West African countries should have maintained structures purely independent of political influences to ensure effective utilization of FDI to mitigate poverty. Using the econometrics of panel data for the MENA region (11 countries) during the period 1996-2014, Ben Ali (2016) showed that the functioning of the state (variable governance) and corruption (governance variable) were statistically significant. Aloui (2019), showed the impact of governance on FDI and its different effects among Maghreb Arab countries and Asian countries. It was revealed that governance positively and significantly contributed to improving the attractiveness of FDI in Asia purpose in the Arab Maghreb countries, while responsibility has a negative impact on FDI.

Many studies tried to examine the impact of governance indicators and macroeconomic variables on the attractiveness of the FDI.

Saidi et al., (2013) using fixed effect panel regressions over the period 1998–2011 of 20 developed and developing countries indicated that only two indicators of governance namely, political stability and regulatory quality have a significant impact on FDI inflows. Morisset (2000) in his study showed that corruption and bad governance increased administrative costs and therefore reduced FDI inflows.

Taking eight member countries of SAARC as the sample, using a descriptive research design over the period from 2002 to 2015 Nizam et al. (2018) found that Voice and Accountability (VA) and Government Effectiveness (GE) had a significant impact on the FDI inflow in the South Asian region. The other four variables, Control of Corruption (CC), Political stability and absence of violence (PV), Regulatory Quality (RQ), and Rule of Law (RL) had a negative impact on FDI inflow. Therefore, the study concluded that improved good governance of Voice and Accountability (VA) and Government Effectiveness (GE) may increase FDI inflows. Shah and Afridi (2015) studied the importance of good governance for FDI inflows in SAARC member countries for the period of nine years from 2006 to 2014 employing the random effects panel estimation technique and the results showed that political stability and regulatory quality significantly and positively affect the inflow of FDI.

Many studies have been done at the country level. Shahid et al., (2017) have done a study on Pakistan using ARDL-SIC econometric technique time series data from 1984 to 2012 and concluded that there is a significant and positive effect of governance and human capital on FDI in the short-run as well as in long run. Using 16 African countries with a balanced panel data set, between the years 2002 and 2015 Iheonu (2019), revealed that all the indicators of governance positively and significantly influence domestic investment in Africa, except for government effectiveness which happens to be insignificant. Also, Voice/Accountability and the Control of Corruption exert more influence on domestic investment as indicated by their coefficient values. Using time-series data a study was conducted in Nigeria. It shows that FDI is positively related to improvement in corporate governance.

Shahzad et al., (2014) analyzed the macro-economic factors like inflation rate, control of corruption, political stability, degree of openness, and GDP and showed their effect on FDI by taking the panel data from 2001 to 2011. This study has used India, Malaysia, Pakistan, Thailand, Indonesia, and Sri Lanka as the sample. Using the Random Effect econometric technique, it was concluded that governance indicators and market factors, political stability, control of corruption, degree of openness, and GDP, affect FDI positively while inflation and exchange rate are correlated to FDI negatively. Table 1 shows the expected sign from the variables and table 2 shows the summary of the literature.

Table 1: Expected Sign from the Variables

Variable	Expected Sign
Government Effectiveness	+
Corruption	-
Voice, and Accountability	+
regulatory quality	+
Rule of Law	+
Political stability	+

Table 2: Summary of the Literature

Variable	Relationship with FDI
Government effectiveness	Ange – Patrick and Herve (2019) found that government effective terms impact negatively domestic private investment Nizam et al (2018) found that Government effectiveness has a negative impact on the FDI inflow in the South Asian region
Control of corruption	Ange – Patrick and Herve (2019) found that control of corruption negatively domestic private investment Nizam et al (2018) found that control of corruption has a significant impact on the FDI inflow in the South Asian region
Voice and accountability	Ange – Patrick and Herve (2019)) found the interaction between foreign investment and Voice and accountability has an insignificant mediating effect on investment Nizam et al (2018) found that Voice and Accountability have a significant impact on the FDI inflow in the South Asian region Aloui (2019) found a positive relationship
Regulatory quality	Ange – Patrick and Herve (2019) found an interaction between foreign investment and Regulatory quality has an insignificant mediating effect on investment Nizam et al (2018) found that regulatory quality has a negative impact on the FDI inflow in the South Asian region Aloui (2019) found a positive relationship
Rule of law	Ange – Patrick and Herve (2019) found the interaction between foreign investment and Rule of law has an insignificant mediating effect on investment Nizam et al (2018) found that rule of law has a negative impact on the FDI inflow in the South Asian region Aloui (2019) found a positive relationship
Political stability	Morisset (2000) in his study showed that corruption and bad governance, increase administrative costs and therefore reduce FDI inflows Nizam et al (2018) found that political stability has a negative impact on the FDI inflow in the South Asian region Aloui (2019) found a positive relationship

Methodology

The study was conducted by using panel data from 1996 to 2019 for South Asian countries namely, Sri Lanka, India, Bangladesh, Bhutan, Pakistan, Nepal, Maldives and Afghanistan for the purpose of identifying the impact of governance on FDI. The data was taken from Worldwide Governance Indicators (WGI) and World Development Indicators (WDI) and analyzed through EVIEWS 10 software. The study used the Generalized Method of Moments (GMM) and Two Stage Least Squares (TSLS). According to the defenders of the GMM method, it makes it possible to provide solutions to the problems of simultaneity bias, inverse causality, and any omitted variables. GMM generates the instruments from the explanatory variables (Ange – Patrick and Herve,2019).

Model Specification

The influence of good governance over FDI can be estimated by using the following equation.

$$FDI\_it = f\ (CC, GE, PS, RL, RQ, VA) \quad [1]$$

$$FDI_{it} = \beta_0 + \beta_1 CC_{it} + \beta_2 GE_{it} + \beta_3 PS_{it} + \beta_4 RL_{it} + \beta_5 RQ_{it} + \beta_6 VA_{it} + \varepsilon_{it} \quad [2]$$

The dependent and independent variables are as follows.

FDI	:	Foreign Direct Investment
CC	:	The perceptions of the extent to which public power is used for private gain, including both minor and major kinds of corruption, as well as the "capture" of the state by elites and private interests, are all included in the control of corruption.
GE	:	Perceptions of the calibre of public services, the calibre of the civil service and the extent of its independence from political pressures, the calibre of policy formulation and implementation, and the credibility of the government's commitment to such policies are all included in the category of government effectiveness.
PS	:	Political Stability measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism.
RL	:	The term "rule of law" refers to perceptions of how much people respect and uphold social norms, particularly those pertaining to property rights, contract enforcement, the police, the courts, and the possibility of crime and violence.
RQ	:	Regulatory Quality measures how well the public believes the government can create and carry out solid laws and regulations that support and encourage the growth of the private sector.
VA	:	Voice and Accountability measures perceptions of a country's citizens' capacity to choose their government, as well as their freedom of expression, their freedom of association, and their access to a free press.
β_0	:	Intercept
ε_{it}	:	Error term.

Results and Discussion

Table 3 displays descriptive statistics for each variable. This descriptive statistic includes the median, maximum, minimum, standard deviation, skewness, etc.

Table 3: Descriptive Statistics

	FDI	CC	GE	PS	RL	RQ	VA
Mean	3.28E+09	-0.50	-0.41	-0.95	-0.47	-0.58	-0.53
Median	2.06E+08	-0.57	-0.40	-1.11	-0.47	-0.52	-0.51
Maximum	5.06E+10	1.65	0.90	1.28	0.63	1.03	0.48
Minimum	-16553760	-1.64	-2.23	-2.81	-1.90	-2.11	-1.64
Std. Dev.	9.43E+09	0.72	0.64	1.15	0.64	0.57	0.55
Skewness	3.54	0.98	-0.38	0.32	-0.57	-0.12	0.05
Kurtosis	14.49	3.71	3.43	2.11	2.50	4.28	2.32
Jarque-Bera	1458.25	35.01	6.04	9.63	12.31	13.54	3.82
Probability	0.00	0.00	0.05	0.01	0.00	0.00	0.15
Sum	6.30E+11	-96.88	-79.59	-181.68	-89.59	-111.59	-101.63
Sum Sq. Dev.	1.70E+22	97.74	78.68	252.40	77.63	61.98	57.38
Observations	192	192	192	192	192	192	192

Table 4 shows the correlation matrix. It shows the correlation among all the variables which have been used for the study.

Table 4: Correlation Matrix

	FDI	CC	GE	PS	RL	RQ	VA
FDI	1	0.04	0.19	-0.06	0.21	0.13	0.50
CC	0.038	1	0.79	0.75	0.83	0.42	0.33
GE	0.19	0.79	1	0.78	0.87	0.75	0.42
PS	-0.06	0.75	0.78	1	0.69	0.52	0.26
RL	0.21	0.83	0.87	0.69	1	0.72	0.65
RQ	0.13	0.42	0.75	0.52	0.72	1	0.40
VA	0.50	0.33	0.42	0.26	0.65	0.40	1

Table 5 shows the results for the Panel Generalized Method of Moments. According to this method Government effectiveness Voice and Accountability positively and significantly affect FDI and Political stability and the Rule of Law negatively affect FDI in South Asian Countries.

Table 5: Panel Generalized Method of Moments

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CC	4.05E+09	3.24E+09	1.25	0.21
GE	1.38E+10	2.87E+09	4.81	0.00***
PS	-4.06E+09	9.40E+08	-4.32	0.00***
RL	-1.66E+10	5.28E+09	-3.15	0.00***
RQ	1.00E+09	2.85E+09	0.35	0.73
VA	1.50E+10	2.23E+09	6.72	0.00***
C	8.10E+09	1.58E+09	5.13	0.00***

*Note:***- Significant at 1%, ** - Significant at 5%, * - Significant at 10%*

Table 6 shows the results for Panel Two-Stage Least Squares. According to this method also Government effectiveness Voice and Accountability positively and significantly affect FDI and Political stability and the Rule of Law negatively affect FDI in South Asian Countries. The same results were obtained from both the Panel Generalized Method of Moments and Panel Two-Stage Least Squares.

Table 6: Panel Two-Stage Least Squares

Variable	Coefficient	Std. Error	t-Statistic	Prob.
GE	1.18E+10	2.26E+09	5.24	0.00***
CC	5.90E+08	2.16E+09	0.27	0.79
PS	-3.49E+09	8.16E+08	-4.27	0.00***
RL	-9.16E+09	3.42E+09	-2.68	0.01***
RQ	-1.66E+09	1.97E+09	-0.84	0.40
VA	1.20E+10	1.66E+09	7.24	0.00***
C	6.32E+09	1.17E+09	5.41	0.00***

*Note:***- Significant at 1%, ** - Significant at 5%, * - Significant at 10%*

Conclusions

The present study analyzed the impact of governance on FDI using data from WDI and WGI over the period from 1996 to 2019. Panel data were employed in this study's analysis. The study adopted the Panel Generalized Method of Moments and Panel Two-Stage Least Squares to analyze the data. Results revealed that countries should more focus on improving Government Effectiveness and Voice. Government effectiveness Voice and Accountability were positively and significantly affected by FDI while Political stability and the Rule of Law negatively affect FDI in South Asian Countries. Governments must give more attention to the role of governance to secure domestic investment and boost FDI. The countries should focus more on taking policy directions that would attract more FDI inflows into the country since FDI impacts for economic growth of any country. Since the countries should enhance their governance structures to meet and attract FDI to sustain the level of economic development of the country.

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