

Effect of Governance Infrastructure on Foreign Direct Investment.

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ABSTRACT

This study investigates the effect of governance infrastructure on FDI in both developed and developing countries during 2007 to 2015. 78 developing and 36 developed countries are considered depending on the data constraint. Considering the persistence behavior of FDI inflows a dynamic panel model is developed in this regard. Two-Step System-GMM estimator is used as the estimation technique as it provides most consistent estimates for dynamic models. Findings indicate that the lagged dependent variable of FDI is positively significant irrespective of development levels of the countries and the proxies used for the governance indices. Further, governance infrastructure in developed countries are found FDI encouraging, while it is in the developing countries FDI hindering. This suggests that developing countries need to place greater emphasis on reducing political instability by improving governance standards in order to prevent capital flight and encourage capital inflows.

Keywords: Foreign Direct Investment, Governance Infrastructure, Political Risk, and Two-Step System-GMM estimator.

Introduction

Foreign Direct Investment (FDI) has grown faster rate than most other international transactions, particularly trade flows between countries, in the present global system (Blonigen, 2005). This increasing trend in FDI flows across countries has taken the attention of researchers on its underline determinants. Studies that concentrate on economic factors on this regard are abundant. This is because economic factors play a significant role in the decision-making process of FDI, as economic actors want a return to their investment and profit maximization is a major incentive for investors. Meanwhile, political factors in countries where investment capital is coming in and/or going out are also significantly influence the decision of FDI, due to the fact that a country in which there is high political unrest or instability has more risk and uncertainty. The unequal distribution of FDI across different countries has mainly resulted due to this political risk. Political risk, which is concerned with issues such as government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government and quality of bureaucracy, is more critical in importance due to the multifaceted nature of its impact (Kriifa-Schneider and Matei, 2010). According to Busse and Hefeker (2007) changes in

government policy and/or political institutions could affect investment behavior of multinational corporations as that will also affect the risk premium associated with investment projects; thus, the location decision of the investment is influenced by political risk. This is especially important when looking at developing countries that are largely characterized by an unstable political environment. After all, in the contemporary world, developing countries are the ones that heavily seek FDI due to the lack of domestic savings.

Contribution of the present study to the literature is twofold. On the one hand, this enriches prevailing literature by comparing the effect of governance infrastructure on FDI in both developed and developing countries. On the other hand, according to the best knowledge of the researcher, studies that concentrate on determinants of FDI always ignored the persistency of FDI. The persistence behavior of FDI is adjusted through a dynamic econometric model in this study.

Methodology

With this study, the effect of governance infrastructure in attracting FDI is investigated during 2007 to 2015. 114 countries are selected to the sample considering the availability of data. Further, sample includes 36 developed and 78 developing countries. Considering the persistence behavior of FDI inflows, the model is specified as dynamic model by introducing a lagged dependent variable as a regressor. Governance indicators estimated by Kaufmann, et al. (1999) is used to proxy the governance infrastructure as they cover a wide range of governance factors. They are: Control of Corruption (CC), Government Effectiveness (GE), Political Stability and Absence of Violence/Terrorism (PS), Regulatory Quality (RQ), Voice and Accountability (VA), and Rule of Law (RL). According to Globerman and Shapiro (2002) these indicators are considered as superior to other indices that have been used elsewhere, because they are estimated using 31 different qualitative indicators from 13 different reliable sources. Thus, these metaindices would encompass most of the other measures on this regard. Because these indices highly correlate with each other, they cannot be included in to one model. Therefore, the effect of these factors is separately tested. Further, an aggregate measure is obtained by estimating their first principal component, GI, which would efficiently represent the overall effect of governance infrastructure. Several other determinants of FDI inflows that are chosen from the literature are also included to the model as control variables.

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$$FDI_{it} = \alpha_1 FDI_{i,t-1} + \alpha_2 GI_{it} + \sum_{i=3} \alpha_i CV_{it} + u_{it} \quad \dots \dots \dots (1)$$

Where, FDI_{it} is the FDI inflows to country i in the year t . GI_{it} is the governance infrastructure of country i in the year t . Here GI_{it} is represented by Kaufmann, et al. (1999) six indices and their first principle component separately. CV_{it} represents the control variables used, namely, GDP growth, physical investment (PI), human capital (HC), population (POP),

Trade (Td) and Technology (Tech). β_i represents coefficients of independent variables in the model. α_i are the country specific factors. u_{it} is the error term of the model. The endogeneity in the right-hand side regressors and resulting estimate bias would be a major issue that should be considered when selecting an appropriate estimation technique for the equation 1 above. Therefore, Two-Step System-GMM estimator is used as the estimation technique in this study. Sargan-test is then used to test the validity of instruments.

Discussion of Findings

Initially, Equation 1 is measured seven times for the full sample (114 countries) depending on the governance infrastructure proxy selected to the model. The coefficient estimates for all the seven models are considered un-biased and consistent because the calculated p-values for the Sargan-test are greater than 0.05, which confirm the hypothesis that over identified instruments are valid. The results depict a positive coefficient for GI and it is statistically insignificant. This indicates that governance infrastructure does not significantly encourage FDI inflows. Similar effect is observed when governance indices are regressed individually. However, when the sample is divided among developed and developing countries results depict an interesting pattern. As in the full sample, coefficient estimates for developed and developing country models are consistent because the calculated p-values for the Sargan-test are greater than 0.05. The coefficient of GI variable in the developed country model is positively significant, while it is in the developing country model negatively significant. This indicates that governance infrastructure in developed countries are positively influencing FDI and in the developing countries, it acts as a major barrier in attracting FDI. Above relationship is further confirmed when governance indices are regressed individually for both developed and developing countries. The lagged dependent variable is positively significant irrespective of development levels of the countries and the proxies used for the governance indices. This confirms the importance of considering the persistency of FDI when measuring its determinants.

Conclusion

Governance infrastructure in developing countries tend to hinder FDI inflows. Therefore, policy makers in developing countries should ensure a stable political, institutional, and legal environment, because poor institutional factors in the home country, such as regional protectionism, quota allocations, high tax rates, corruption, regulatory uncertainty, insufficient protection of intellectual property rights and governmental interference, may push firms to invest abroad in pursuit of more efficient institutions (Das, 2013). Hence, as political risk increases in the home country, capital tends to move out of the country to escape from that risk by being invested abroad. This suggests that developing countries need

to place greater emphasis on “reducing political instability by improving governance standards” in order to prevent capital flight or outflows (Das, 2013).

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