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Abstract

Literature on foreign direct investment (FDI) has been focusing on its traditional determinants for a long time and lack of attention to institutional and political variables. However, in recent years, the pattern of the world FDI flows is observed to show a shift away from developed countries towards developing countries. Such shift is argued to be the result of the improvement in institutional qualities and political stability in developing countries to make investment climate more appealing to foreign investors. The impact of institutional qualities on FDI flows, however, have not been investigated by many studies in the field of FDI. To address this shortcoming, this research studies the relationship between institutional and political variables on FDI inflows in developing countries.

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Jade Phung

I. Introduction

Literature on foreign direct investment (FDI) has been focusing on its traditional determinants for a long time and lack of attention to institutional and political variables. However, in recent years, the pattern of the world FDI flows is observed to show a shift away from developed countries towards developing countries. Such shift is argued to be the result of the improvement in institutional qualities and political stability in developing countries to make investment climate more appealing to foreign investors. The impact of institutional qualities on FDI flows, however, have not been investigated by many studies in the field of FDI. To address this shortcoming, this research studies the relationship between institutional and political variables on FDI inflows in developing countries.

The process of globalization has accelerated rapidly over the last three decades. During the period 1993 – 2015, the volume of world merchandise trade has increased by 103.3%, from $3.7 trillion in 1993 to $16 trillion in 2015. Surprisingly, the large increase in world trade volume does not make trade the fastest growing channel of globalization. The flows of foreign direct investment[2], which refers to the type of investment made by multinational corporations to foreign countries, soared by 107% from $220 billion in 1993 to $1.7 trillion in 2015, at a much faster growth rate than volume of trade. Prior to 1990, the increase of inflows was mainly due to large increase of investment to developed countries. However, after the 1990s, the growth of FDI inflows into developing countries have gradually accelerated and contributed 55.5% to the world foreign investment flows in 2014, surpassing the amount of investment into developed countries to become the largest group countries of destination to world FDI inflows. The remarkable growth rate of FDI flows into developing countries plays an important role in making FDI the fastest growing channel of globalization and intrigues many scholars' interest in explaining why developing countries can attract such a large amount of foreign investment. Empirical research has supported the argument that large consumer base and trade liberalization in developing countries are factors that attract foreign investment. Per Chakrabarti (2000), prior to 2000, most eminent empirical studies on FDI find that market size has significant impact on FDI inflows into developing countries. Theoretically, market size is important in attracting foreign direct investment because the largest component of world FDI stock, FDI in services, is gravitated towards large consumer base developing countries. After 2000, using more advanced econometric approaches, Al-Sadig (2009), Noorbakhsh, Paloni, & Youssef (2001), Bénassy-Quéré, Coupet, & Mayer (2007), and Busse, & Hefeker (2007) also support the argument that market size is a determinant of FDI. The rest of the world's FDI inflows is FDI in manufacturing and primary products. For instance, numerous foreign corporation located in North African countries take

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[2] Formal definition of FDI obtained from the World Bank is "the net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor."

advantage of the region's natural resources by exporting primary products back to their home countries. Smartphones of Korean corporations, produced and assembled in South East Asian countries, are exported to the targeted customer countries. Consequently, FDI in manufacturing and primary products has gravitated towards developing countries with more liberalized trade regimes. Even though prior to 2000, the empirical studies did not consistently find trade to be a significant determinant of FDI, various recent research[3] have provided empirical evidence that countries with lower trade barriers attract more FDI (Chakrabarti., 2000).

Market size and trade, though predominantly found to be significant determinants of FDI in developing countries, may not be the only determinants. Since 1990, despite having larger consumer bases and more liberalized trade policy, developed countries have gradually receiving less increase in FDI than developing countries have. Indeed, from 2013 to 2014, FDI flows to developing countries decreases by approximately 28%[4]. Thus, with the improvement of institutional qualities in developing countries, some studies[5] suggest the rising importance of political and institutional variables to attract FDI into developing countries. The UNCTAD 2015 World Investment Report emphasizes that the improvement in institutional qualities and political stability in African countries draw an increase in FDI inflows to this region. Furthermore, since institutional qualities and political stability are important elements of investment climate, enhancement in institutional qualities and more stable political conditions such as enforcement of property rights and control for corruption encourages foreign investors. Because those variables have been introduced recently, there has not been much empirical research studying extensively those determinants.

This research, therefore, is going to study the importance of institutional and political variables in attracting FDI inflows to developing countries. I hypothesize that better institutional qualities and less political risk and instability increase the FDI inflows into developing countries. The study will apply pooled OLS and Arellano-Bond GMM estimation methods on two panel data sets consisting of 40 developing countries during 4 different time periods to test the hypotheses. The rest of the paper is organized as follows. The second section introduces the theoretical background and reviews related empirical studies. Then, the next section presents the data sets, the choice of measurements, and descriptive statistics, followed by methodology section which discusses estimation methods. The result section analyses the results of estimation, while the last section concludes.

II. Theoretical Background and Literature Review

In macroeconomic studies, FDI is usually studied from the aspect of a source of capital to boost the growth of a country. However, the study of FDI determinants are often based on microeconomic theories. According to Dunning (1988), the characteristic of each foreign direct investment varies by numerous factors, including the type of industry, source country, and the size of the corporation. Thus, it is not possible to specify the determinants of FDI because different factors have different level of importance to foreign direct investment depending on the type of investment. However, the data for FDI by industries are not often available and difficult to gather, especially data for investment in developing countries. The prominent theoretical framework

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[3] Noorbakhsh, Paloni, & Youssef (2001), Al-Sadig (2009), and Busse & Hefeker (2007).
[4] UNCTAD World Investment Report (2015)
[5] Glass and Saggi (2002), Bénassy-Quéré, Coupet, & Mayer (2007)

proposed by Dunning (2002) introduces an approach to examine the determinants of FDI from a macroeconomic perspective, which helps to overcome the unavailability of data.

The OLI paradigm, developed by Dunning (2002), consists of three key arguments, based on the assumption of profit maximization by multinational corporations. Foreign firms, which own competitive advantages such as innovative technology relatively to firms in the recipient countries, have incentive to invest abroad (O - ownership advantage). If the transaction cost of outsourcing to produce or distribute goods in foreign countries is higher than the cost of acquiring the business and self-operating production process, firms have an incentive to internalize the intermediate process to lower the cost (I – internalization advantage). Lastly, the investors are attracted to countries that can provide them with locational advantages such as immobile production factors (e.g. labor) and tax exemption (L – locational advantage). As political and institutional variables are the locational advantages of developing countries to attract investors, the arguments for those variables fit entirely in the L-location sub-paradigm. Furthermore, considering that in recent years a large amount of FDI flows into developing countries, it is possible that the improvement of political stability and institutional qualities in those countries play significant roles in attracting investment.

Indeed, several established empirical studies have focused on testing whether political variables are determinants of FDI. Those studies acknowledge that, theoretically and empirically, political variables have significant impact on driving the flows of FDI. Busse and Hefeker (2007), applying GMM methodology to a data set of 83 countries, test the hypothesis that political instability has negative impact on FDI inflows to developing countries. The study finds that out of 12 variables, 10 of those are significant with the expected signs, concluding that developing countries with higher political risk attract less FDI inflows. Habib and Zurawicki (2002) and Al-Sadig (2009), which hypothesize that corruption has negative impact on FDI inflows to developing countries, also find corruption to have significant and negative coefficients. Both studies utilize two types of data set, a cross sectional and a panel, to confirm the hypothesis. The estimations of empirical model for both data sets show that corruption has a negatively significant coefficient, which confirms the robustness of their findings. Furthermore, Wei (2000), applying a modified TOBIT model to a data set prior to 2000, finds that regardless of the type of source country, corruption in recipient countries leads to a decline in FDI. Interestingly, the study by Jiménez (2011) on the impact of corruption on FDI from Southern European countries to their neighboring developing countries finds that corruption is significant but positive. The author argues that corrupted governments are preferred by some investors because more corrupted government is easier to bribe so the foreign firms can obtain looser regulations and more advantages.

Institutional variables, on the other hand, have not been extensively studied. Intellectual property rights (IPR), an important component of institutional, are often considered a factor which attracts FDI, especially in R&D and technological products, by creating a barrier to enter the market for domestic firms in recipient countries. Contrary to this argument, Glass and Saggi (2002), modeling the situation when IPR regulation is introduced in developing countries, finds that IPR, indeed, discourages FDI. Bénassy-Quéré, Coupet, & Mayer (2007), using a cross sectional model on a data set with 75 institutional qualities, concludes that institutional variables are important determinant of FDI into developing countries. Through three steps of estimation to correct for endogeneity and multicollinearity, some institutional variables are found to be significant. Some of those are internal control of banks, intellectual property rights, easiness to enter a market, employment contract protection, contract laws, guarantee of bank lending, and information on the quality of goods and services. While the coefficient for IPR is significant and

positive, unexpectedly labor law enforcement is also found to have negatively significant coefficient. This indicates that developing countries with looser protection on labor are preferred by foreign investors.

Some control variables are also included for our empirical model. Based on the survey by Chakrabarti (2000), it is necessary to control for the market size of recipient countries. Following the survey by Faeth (2009) and recent studies[6] on FDI, I also consider infrastructure, trade, and labor force as control variables, since those variables, which represent the locational advantages of the recipient countries, are found in previous research to be significant determinants of FDI.

III. Data

Bénassy-Quéré, Coupet, & Mayer (2007) chooses bilateral FDI stock to be the dependent variable. Similarly, Wei (2000) also uses bilateral FDI stock as the dependent variable. However, since all independent variables in this research are measured annually in flows, I find FDI inflows to be the better choice of measurement as the dependent variable. Furthermore, to neutralize large country effect, the measurement of dependent variable is chosen to be FDI inflows as percentage of GDP.

Following Busse & Hefeker (2007), I consider three political variables including corruption, political risk, and government effectiveness. Corruption measurement is available in the three data sets, the Institutional Profile, World Governance Indicator (WGI), and Corruption Perception Index. The methodologies to determine the corruption level are different among those data sets, but all the measurements have a high level of correlation. Thus, to gather the largest number of observations, I choose the indicator *Control of Corruption: Estimate*[7] of the WGI to be the proxy for corruption. The only one indicator available as a proxy for political risk and government effectiveness is provided by the WGI. Thus, the proxies for those are the indicators *Political Stability and Absence of Violence/Terrorism* and *Government Effectiveness,* respectively.

An aggregate index which evaluates institutional qualities is not available. However, following the study by Bénassy-Quéré, Coupet, & Mayer (2007), this research obtains more than 70 measurements of institutional qualities from the Institutional Profile data set published by the Ministry of French Finance. The advantage of using an individual measurement of each institutional quality allows the study to specify which institutional quality has significant impact on FDI. However, I also acknowledge that while all institutional qualities may impact FDI inflows, it is not necessary one or a few institutional qualities will show significant influence. Thus, the significance of institutional qualities may be diminished. Bénassy-Quéré, Coupet, & Mayer (2007) tests all 75 indicators using a cross sectional estimation for only one period due to data unavailability. In this study, instead of examining all institutional qualities, I study 11 variables[8]

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[6] Asiedu (2006); Ranjan & Agrawal (2011); Jiménez (2011); Noorbakhsh, Paloni, & Youssef (2001).

[7] *Control of Corruption* captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. (World Bank)

[8] Those are *Transparency of economic policy (fiscal, taxation, monetary, exchange-rate, etc), Government respect for contracts, Settlement of economic disputes: justice in commercial matters, Administered prices and market prices, Information on the situation of firms, Information on the quality of the goods: international norms and standards, Intellectual property, Competition: productive sector: ease of market entry for new firms, Openness to foreign capital and loans, Existence and observance of labor legislation and measures,* and *Employment contract protection*

found to be significant in Bénassy-Quéré, Coupet, & Mayer (2007) out of 16 to investigate whether those variables are determinants of FDI in longer time span.

Control variables are obtained from the World Development Indicator of the World Bank. Trade is measured by *Exports plus imports (% of GDP),* suggested by the previous studies[9]. The proxies for market size, infrastructure, macroeconomic stability, and labor force are *GDP per capita (current US$), Mobile cellular subscriptions (per 100 people), Inflation, consumer prices (annual %),* and *Labor force participation rate, total (% of total population ages 15+),* respectively. The choice of those proxies follows the studies Asiedu (2006), Ranjan & Agrawal (2011), Jiménez (2011), and Noorbakhsh, Paloni, & Youssef (2001).

Table 1: Data Sources and Measurements

Determinant	Variable	Measurement	Abbreviation	Data sources
FDI	Dependent	Foreign direct investment, net inflows (% of GDP)	FDIGDP	World Bank
Market Size	GDP per capita (current $)	GDP per capita (current US$)	GDP	World Bank
Macroeconomic Factors	Stability	Inflation, consumer prices (annual %)	CPI	World Bank
Trade Openness	Trade level	Exports plus imports (% of GDP)	TRADE	World Bank
Infrastructure	Infrastructure capability	Mobile cellular subscriptions (per 100 people)	MOBILE	World Bank
Labor Factors	Labor force	Labor force participation rate, total (% of total population ages 15+)	LBFC	World Bank
Political Risk	Political risk	Political Stability and Absence of Violence/Terrorism	PVEST	World Bank
Government Effectiveness	Government effectiveness	Government Effectiveness	GEE	World Bank
Corruption	Corruption	Control for corruption	CCEST	World Bank

Since data for institutional variables are only available in three time periods, I consider two different data sets. Both data sets use the same measurements for control and political variables. However, the first data set has three time periods with time gap and includes institutional and political variables, while the second data set only considers political variables with an extended time span from 2002 to 2014. The first data set is limited to 40 countries, while the second data set

[9]

contains 111 developing countries. Data are obtained from the Institutional Profile data set collected by the Ministry of French Finance, the World Governance Indicator (WGI), and World Development Indicator (WDI) of the World Bank. Table 1 presents the data sources, the measures for each variable, and expected signs. Table 2 and 3 (in the appendix) present the descriptive statistics.

IV. Methodology

The estimated equation for the first data set is as follows:

$$FDIGDP = \beta_0 + \beta_{1n}INST_n + \beta_m POL_m + \beta_m CONTROL_m + \epsilon$$

where INST, POL, and CONTROL are vectors of institutional, political, and control variables. The second data set does not include institutional variables. Thus, I omit the vector INST to estimate coefficients for the second data set.

In the first data set, since institutional variables are highly correlated to each other, it is not possible to include several institutions in the same equation. Hence, I introduce each of the 11 institutional variables successively in a pooled OLS estimation. Despite neglecting the time and cross-country effects, pooled OLS, comparing to fixed/random effects, can include the lagged value of the dependent variable as independent variable to control for endogeneity. Furthermore, to overcome the limitation of pooled OLS, time and region dummies are also incorporated into the estimation equation. The exact estimation equation for this data set is as follow:

$$FDIGDP = \beta_0 + \beta_{1n}INST_n + \beta_m POL_m + \beta_m CONTROL_m + \beta_{m+1}FDI_{lag} + \beta_p time_p + \beta_r region_r + \epsilon$$

Since the second data set has a longer time span comparing to the first data set and includes 111 countries, generalized method of moments (GMM) estimation can be applied to effectively account for endogeneity. This method instruments the first lag of the dependent variable with its second and third lags. Thus, if the second and third lags of FDIGDP are not correlated with its present values, endogeneity can be tackled using this method[10]. Due to the shorter T and longer N of the second data set, the Arellano–Bond GMM estimator is preferred. The estimation equation is as follow:

$$FDIGDP = \beta_0 + \beta_m POL_m + \beta_m CONTROL_m + \epsilon$$

Dependent variable: Foreign direct investment	Expected signs
Infrastructure	+
Market size	+
Macroeconomic stability	-
Level of trade openness	+
Labor force participation	+
Control for corruption	+
Political risk	-
Government effectiveness	+

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[10] Cameron & Trivedi (2009).

V. Results
Table 4: Regression Results

Dependent Variable FDIGDP	First Data Set Pooled OLS	Second Data Set Arellano–Bond GMM
GDP	-.0001676 (-1.46)	-.0005097 (-0.98)
FDI lag	.4750539 (2.11)**	.3613264 (1.92)*
MOB	.0004125 (0.04)	.0181447 (1.70)*
TRADE	.0309989 (2.04)**	-.0013564 (-0.07)
LBPART	.0534439 (1.03)	-.138242 (-0.80)
CPI	-.0113116 (-0.30)	.0654122 (1.59)
PVEST	-.2315694 (-0.48)	-.311525 (-0.29)
GEE	-.3446391 (-0.33)	3.344584 (1.99)**
CCEST	1.133426 (1.06)	-1.319436 (-1.02)
Employment Contract Protection	-.7404039 (-2.26)**	
Constant	-1.342547 (-0.39)	16.67337 (1.53)
Observations	151	1169
Countries	40	111
Period	2006 – 2012 3-year time gap	2002 – 2014
F – Test (model)/Wald test	6.47***	76.68***
Sargan test		484.8355***
R-Squared	0.4856	

Notes: Standard errors are adjusted for heteroscedasticity and autocorrelation through cluster-robust VCE estimators provided by STATA. t/z-values are in parentheses. Data sources and definitions of variables are provided in Table 1. Region and time dummies are omitted from the table.
  *Significance at the 10% level
  **Significance at the 5% level
  ***Significance at the 1% level.

     All the regression results for the different data sets are presented in Table 4. The first column reports the pooled OLS regression results with the institutional variable being *Employment contract protection* for the first data set. Surprisingly, the coefficients for all institutional variables

are insignificant, except for employment contract protection that has a significant coefficient with the expected sign.

Per Bénassy-Quéré, Coupet, & Mayer (2007), employment contract protection impedes FDI since a loosely regulated labor market is considered a locational advantage of developing countries. Intellectual property is found to have insignificant impact on FDI, consistent with the model derived by Glass and Saggi (2002). Even though the result does not follow Bénassy-Quéré, Coupet, & Mayer (2007), since the previous study only considers a one period span, the results of this research can overcome its cross-sectional bias. None of the political variables shows significance, which indicates possible issue with multicollinearity and the absence of country effects caused by the limitation of pooled OLS method. The coefficients for trade and lagged FDIGDP are significant with expected signs, which imply that higher trade openness and FDI inflows in the past positively increases the present level of FDI in developing countries.

The second column of Table 4 reports the Arellano–Bond GMM estimation for the second data set. The coefficients for infrastructure and lagged FDI are significant with the expected signs. However, trade openness is no longer a significant determinant of FDI. Of three political variables, government effectiveness is the only variable with a significant coefficient with the expected sign. Though control for corruption and political risk are not significant, all political variables are so highly correlated that the significance of one variable may diminish the importance of others.

The regression results of both data sets indicate that market size, macroeconomic stability, and labor force are not significant determinants of FDI. It is possible that since the lagged value of FDI is included in the regression analysis the effect of those determinants is offset. Furthermore, the choice of measurement for market size is not the best choice even though it has the most data availability.

In short, the regression analysis of two data sets indicates that institutional qualities have not been important determinants of FDI in developing countries though the results support that employment contract protection has negative impact on FDI. On the other hand, consistent with previous studies, political variables are found to be significant determinants of FDI. Stable politics attracts more investment towards developing countries. The significance of trade openness and mobile also reinforces their importance as determinants of FDI. Lastly, the past level of FDI strongly impacts the present level of FDI in developing countries, which may explain the continuous increase of FDI flows into developing countries and decrease of FDI flows into developed countries.

VI. Conclusion

This study investigates the importance of institutional and political variables in driving foreign direct investment into developing countries. Institutional variables are expected to be important determinants of FDI in developing countries in recent decades, while political variables have been found to be significant driver of FDI in previous studies. Then, by applying pooled OLS and Arellano-Bond GMM methods on two data sets, I obtain the estimated coefficients. In contrast to the original expectation, the regression results indicate that institutional variables are not important determinants of FDI except for Employment contract protection. On the other hand, political variables are found to be significant determinants of FDI, reinforcing the previous studies. Trade openness, infrastructure, and past FDI level also impacts the flows of FDI to developing countries strongly.

Based on the results of this study, institutional qualities, though their importance to FDI is growing in recent years, are still not primary drivers of FDI into developing countries. Future research may extend the time span to reinvestigate the importance of institutional variables in FDI in developing countries. Employment contract protection is found to be a negatively significant determinant of FDI, suggesting possible future study on the impact of labor cost in FDI in developing countries. Political variables are found to play important roles in determining FDI. Thus, countries with less corrupted and more effective government attract more FDI. Lastly, countries with more trade openness and better infrastructure are more appealing to investors.

Appendix
Table 2: Descriptive Statistics (First Data Set)

Variable	Obs.	Mean	Std. dev.	Min	Max
FDIGDP	1437	4.869248	6.736008	-8.400837	89.47596
GDP	1440	3035.985	3133.17	106.017	23347.66
MOB	1433	55.68188	43.32695	0	189.3831
TRADE	1422	84.6888	38.96308	19.11879	321.6317
LBPART	1443	64.82155	11.255	37.8	89.6
CPI	1428	7.955685	17.70829	-35.83668	431.6998
PVEST	1443	-.4536978	.8444521	-3.184814	1.41685
GEE	1443	-.5141023	.5902153	-2.247729	1.24741
CCEST	1443	-.548647	.5585557	-1.836495	1.274802

Table 3: Descriptive Statistics (Second Data Set)

Variable	Obs.	Mean	Std. dev.	Min	Max
FDIGDP	153	3.824812	4.067667	-3.751147	26.49648
GDP	154	3740.413	3362.227	194.078	15154.47
MOB	156	71.38221	40.91105	1.107029	185.8216
TRADE	152	71.664	31.99841	22.10598	202.5777
LBPART	156	64.0359	11.6425	40.5	88.7
CPI	156	6.63617	5.499749	-2.248021	36.7023
PVEST	156	-.601439	.7874352	-2.691796	1.08013
GEE	156	-.3522287	.5019549	-1.492773	1.196392
CCEST	156	-.5215726	.4533292	-1.42297	.9195152

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