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An investigation on the role of good governance as a mediating factor in the FDI-Growth nexus: An ASEAN Perspective

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Abstract

This study involves an investigation into the FDI-Good Governance-Economic growth nexus for ASEAN for the period of 14 years from 2002-2015. All ten ASEAN Member Countries (AMC) are included in this study. The governance variables are obtained from the World Governance Indicators (WGI). Since the data used in this study involves both cross-sectional and time series, a panel statistical analysis is carried out using the Pooled Mean Group (PMG) estimation method. A preliminary test of the unit root is carried out to verify stationarity level of the variables chosen. The PMG results show that FDI has a positive and significant effect on economic growth as expected. When FDIIQ variable is included in the estimation model, it is found that its impact on economic growth is stronger suggesting that FDI although is seen to be beneficial to economic growth, its impact via good governance, as signified by the FDIIQ coefficient value seems to have a greater impact on growth. Hence, the study implies that the presence of good governance in FDI host countries acts as an important absorptive capacity to harness the benefits of FDI on growth. Therefore, the policy implication from this study points towards creating a good governance environment for optimal benefit from FDI inflows.

1. Introduction

ASEAN Member Countries (AMC) comprises of 10 countries in the South East Asian (SEA) region. These countries include Brunei and Singapore which are categorized as High Income Nations. Others include Cambodia, Laos, Myanmar and Vietnam known as the CLMV countries which are in low income status. The middle income countries are further divided as Upper Middle Income countries comprising of Malaysia, Indonesia and Thailand and the lower middle income country, Philippines. ASEAN has been a popular FDI destination over the past few decades and this has been attributed to both economic and non-economic factors. FDI inflows are considered a very important impetus for economic growth as foreign direct investment injection helps to boost total investments necessary for bolstering the economy. From the perspective of FDI inflows, ASEAN has been a popular destination as FDI host countries due to its' large influx of foreign capital (UNCTAD, 2012). It has been well acknowledged that these FDI inflows are much desired and anticipated by the host countries as the benefits they bring via technology transfers and employment opportunities could enhance economic growth of the FDI recipient countries.

However, it has been also acknowledged that FDI inflows into a host country do not automatically transform into economic growth. The host country's ability to transform the foreign capital injections into economic growth is dependent on its absorptive capacity. Some of the absorptive capacity that has been playing a mediating role in facilitating FDI induced economic growth is trade openness, financial innovation, human capital development and more recently institutional quality or good governance.

Foreign direct investment (FDI) is defined as an investment involving a long-term relationship and reflecting a lasting interest and control by a foreign entity in one economy (foreign direct investor or parent enterprise) in a resident economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate) (United Nations, 2007). The World Bank report in 1992 had defined governance as a mode of power exercise in the management of social and economic resources of a country. UNCTAD had defined governance as "the manner in which the main actors of the society, governments, businesses and civil society work together to make society better." On the other hand, the UNDP defined governance as "the exercise of authority in government and political arena". Good governance among other things participatory, transparent and accountable, It is also effective and equitable and it promotes the rule of law" (UNDP, 2003). The term institutional fitness or institutional quality in the context of FDI refers to a country's ability to attract, absorb, and retain FDI. Theoretically, FDI has a strong and significant effect on economic growth not just through the direct effect by contributing to the host countries' stock of capital but more so, through the spillover effect through which, the host countries experience higher productivity. The home country which invests in the host country may have the competitive advantage of a more superior technology which is transferred via FDI inflows in the host country.

Despite the large influx of FDI inflows into developing countries inclusive of ASEAN countries, the effect of FDI inflows on economic growth on host countries remains somewhat ambiguous. While modern economic growth theories claim that FDI can be a catalyst for economic growth on FDI hosts, empirical findings however render ambiguity and suggest that growth effects of FDI on the host country are conditional on the host's characteristics. It is worth examining why all FDI host countries may not have homogenous or identical effects on their economic growth. For

example, a country may successfully attract more FDI inflow compared to another but it may not be experiencing higher economic growth compared to the lesser FDI recipient. This had instigated investigations among researchers who coined in the notion of absorptive capacity.

Hence, many countries knowing the beneficial direct effect of foreign capital injections and its indirect impact on growth, attempt to formulate policies not just to attract FDI but also to strengthen their absorptive capacities in order to make the most from FDI spillovers. So, absorptive capacities are understood as the ability of the host countries to absorb the potential benefits from FDI inflows which can be reflected through higher growth of the host country. As in most previous studies that will be visited in the following sub-sections, it can be concluded that the magnitude of the spillovers or simply put, the impact of FDI on economic growth of host countries varies with the absorptive capacities of the said countries, which depends on a minimum threshold level of human capital, well-developed financial sectors, trade openness, and more recently the institutional quality or good governance. However, the objective of this study is confined to investigating the importance of good governance as an absorptive capacity in enhancing FDI-led economic growth.

The Asian Development Bank (2013) in its' annual report reiterates that the Asia Pacific region that is inclusive of ASEAN has been lagging behind more developed countries in terms of keeping good governance. The World Bank (2010) stressed that it is important that ASEAN countries enhance local capabilities and absorptive capacities to induce FDI inflows and capture the positive spillover effects from the FDI inflows. Further in its news released by the Asian Development Bank (2011) entitled, "Accountability, transparency keys to inclusive growth in Asia", stresses that both macroeconomic and institutional factors play an important role in FDI attraction and retaining the FDI benefits to the host country. Buracom (2014) mentions that with the exception of Singapore, the other ASEAN countries are afflicted with relatively poor governance which can cause the flight of foreign investments to safer havens.

The significance of this study points to the fact that good governance is a necessary prerequisite for transforming FDI inflows into economic growth of the host country.

2. Literature Review

A vast number of theories on FDI determinants have expanded and evolved over the years taking into consideration the conventional and emerging issues in FDI literature. The focus of theoretical literature for this study centers around the FDI motivation theory which captures the objectives and the motivation for venturing in FDI initiatives by Behrman (1972) which is an adaptation of the original theory by Dunning (1958). This theory centers around four objectives or motives of FDI location determinations namely resource seeking, market seeking, efficiency seeking and the strategic asset and capabilities seeking FDI. Henceforth, potential FDI investors are keen to invest in a location where there is an abundance of resources be it in natural resources such as raw material, good climate and soil conditions or labor. Alternatively, based on the market seeking criterion, potential investors are motivated on the availability of vast market size which will be a source of ready demand for the finished products from the FDI operations. On the other hand,

efficiency seeking FDI will focus on how business operations can be carried out efficiently by lowering production cost by means of higher productivity from skilled labor or technology availability in the location. Whereas, the strategic asset and capabilities motive seeking investors will be attracted to the availability of good physical and communication infrastructure as well as good governance practices to carry out business ventures with ease and economic viability.

Some of the empirical evidences which validated the theories mentioned above are discussed as follows. In a study on the determinants of FDI in BRIC countries employing panel data regression method, Vijayakumar, Sridharan, and Rao (2010) found that economic stability measured by inflation rate and economic growth was not significant in influencing FDI inflows using data from 1975 to 2007. On the other hand, economic openness, exchange rates, infrastructure quality and wages seem to significantly influence FDI inflows. Ranjan and Agrawal (2011) seem to have almost similar findings in their study on BRIC countries' FDI determinants for the years 1975 to 2009, whereby infrastructure, market size and trade openness and labor cost seem to be significantly influencing FDI. However, macroeconomic stability meant very little for FDI inflows. Gross capital formation and labor force did not matter at all for FDI determination.

Using a panel data approach, Hoang and Bui (2015) revealed that market size, trade openness, infrastructure quality human capital, labor productivity are the main determinants which have a significantly positive impact on FDI inflows in ASEAN. Sabir, Rafique and Abbas (2019) conducted a panel data analysis for the period of 1996-2016. The estimation method of Generalized Method of Moments (GMM) was employed. It was found that all aspects of governance played a significant and positive role in FDI determinations. Hence the author emphasized on giving due considerations to uphold governance issues such as control of corruption, government effectiveness, political stability, rule of law, regulatory quality and voice and accountability as crucial for ensuring good governance in FDI attraction and sustainability. Abdulqader, Pandurengan, and Kalam (2018) employed time-series data from 1985-2014 and tested for the FDI determinants in Malaysia using multiple regression technique. It was found that market size, education level, exchange rate and inflation rate together with infrastructure quality have significantly positive impact on FDI inflows into the country.

In summary, there are many researches done on FDI determinants covering a wide array of both macroeconomic and institutional factors, using varying techniques and estimation methods and with either similar and contrasting findings. However, what seems lacking is the lack of such studies on South East Asia and ASEAN in particular.

Despite the large influx of FDI inflows into developing countries inclusive of ASEAN countries, the effect of FDI inflows on economic growth on host countries remains somewhat ambiguous. While modern economic growth theories claim that FDI can be a catalyst for economic growth on FDI hosts, empirical findings however render ambiguity and suggest that growth effects of FDI on its host country are conditional on the host country's characteristics. These characteristics are termed as absorptive capacities. So, absorptive capacities can be understood as the ability of the host countries to absorb the potential benefits from FDI inflows which can be reflected through higher economic growth.

Past studies on FDI determinants have brought into attention the issue of institutional fitness as an important factor for sustainable FDI flows into a host country (Wilhelms, Witter, and Stanley

1998). Governance issues take precedence in determining long term economic growth. Good governance is a reflection of sound institutions (World Bank, 2002). In other words, the presence of absorptive capacities acts as a mediating factor or complements the FDI inflows. The impact of FDI on economic growth of host countries varies with the absorptive capacities of the said countries, which depends on a minimum threshold level of human capital, well-developed financial sectors, trade openness, and more recently the institutional quality or good governance. A study on the impact of financial sector on economic growth by Hermes and Lensink (2003) explained that the cost of innovation falls with increasing FDI inflows as FDI inflows allow technology transfer from foreign firms to local ones.

As one of the pioneers in the study of political economy, Olson (1993) had warned of high levels of corruption and insecure property rights to have a negative impact on total factor productivity, which will in turn impact competitiveness and economic growth and this will definitely turn off foreign direct investors. The author concedes that policy makers should take into account the governance factors in FDI-growth issues as it is an important absorptive capacity. Khordagui and Saleh (2016) in a study that examined the existence of absorptive capacity and FDI spillovers on growth in the MENA economies found similar results that supported previous studies. It was concluded that human capital, trade openness and institutional quality were significant mediating factors in the FDI-growth nexus. Further, in contrast to previous studies, it was found that lower level of schooling was positively associated with higher FDI spillover, on which the authors recommended further investigation.

Meanwhile in a literature survey by Kumari (2014), the author concluded that policy makers should take into account the absorptive capacities and socio-economic and political conditions of an economy to ensure economic growth. The author goes on to recommend slow and gradual FDI inflows to enable checks and mitigate possible negative effects of FDI inflows. Hoang (2016) carried out a study on how FDI inflows contributed to economic growth in Vietnam through in-depth interviews. The interviews were designed to obtain opinions of selected survey partners' views concerning the theoretical FDI/absorptive capacity model. In summary, the findings were supportive of the host country's absorptive capacities in enhancing the FDI benefits. This indicates that the benefits derived through foreign capital are dependent on the strength of the host country's absorptive capacity. Specifically, the results yielded that human capital development was the most prominent factor that determined the absorptive capacity followed by infrastructure and technological levels and more importantly the institutional quality.

Bokpin (2017) used a 24- year panel data (1990-2013) across Africa to investigate the impact of FDI inflows on environmental sustainability. Although the study confirmed that FDI enhances economic growth, it nevertheless cautions that FDI does have a negative impact on host countries and hence needs to be well governed by the nation's regulatory/governance institutions to ensure that growth is enhanced without compromising the environmental quality.

3. Methodology

This study employs the secondary data from various sources such as UNCTAD, IMF, WDI which is summarized in Table I. The model for this study hinges on the Solow Growth theory and is

further accentuated with inclusion of institutional quality hence it is known as the Institution augmented Solow growth model.

The estimated empirical model designed to carry out the objectives of the study can be expressed as follows.

$$\ln gdp_{it} = \alpha_0 + \alpha_1 \ln fdi_{it} + \alpha_2 \ln capital_{it} + \alpha_3 \ln iq_{it} + \alpha_4 \ln fdi_{it} + \alpha_5 \ln lf_{it} + \epsilon_{it} \quad (1)$$

where; $\ln gdp$ refers to the log of gross domestic product ; $\ln fdi_{it}$ refers to the log of fdi with the interactive term iq ; $\ln capital$ refers to the log of capital stock; $\ln iq$ refers to the institutional quality or governance; $\ln fdi$ refers to foreign direct investment; $\ln lf$ refers to labor force; α_0 is the constant while $\alpha_1, \alpha_2, \alpha_3, \alpha_4$ and α_5 being the coefficients of the variables concerned respectively and ϵ_{it} refers to the error term.

Table I: Description of the variables chosen and their sources

Variable	Description /Proxy	Source	Expected impact
Gross Domestic Product (GDP)	GDP of a country. Proxy for economic growth.	UNCTAD	Dependent Variable
Foreign Direct Investment (FDI)	Foreign Capital Inflow in USD	UNCTAD	Positive
Stock of capital	Proxy for physical capital. Assuming that the depreciation rate is 5% as suggested by previous studies (Demetriades & Hook Law, 2006; Hall & Jones, 1999)	WDI	Positive
Institutional Quality as an interactive term of FDI (FDIIQ)	This variable is obtained from the computation of FDI multiplied by IQ and it measures the absorptive capacity of FDI Institutions growth nexus	Author's computation	Positive
Labor Force (LF)	Labor force participation rate, total (% of total population ages 15+) (modeled ILO estimate)	WDI	Positive
Institutional Quality (IQ)	Proxy for governance based on the geometric mean of the six components of governance indicators: Rule of law, Government Efficiency, Voice and Accountability, Control of Corruption, Political Stability, Regulatory Quality.	WGI	Positive

The data covers a period of 15 years from 2002 to 2015 and involves 10 ASEAN countries. Since both time series and cross sectional data are used, a panel data is deemed appropriate. The estimation method used is the pooled mean group (PMG) which has the advantage over the Mean Group (MG) estimation that is, commonly in panels involving both T, the number of time series and N, the number of groups or cross sections, the usual practice is either to estimate N separate regressions and calculate the coefficient means which is known as the mean group (MG) estimator. Alternatively, pooling the data with the assumption of identical slope coefficient and error variances can be considered. However, an intermediate estimation method among these two procedures referred to as the pooled meal group (PMG) estimator can be considered. This estimator constraints the long run coefficient to be identical but allows the short run coefficient and error variances to differ across groups.

Prior to carrying out the estimation procedure, a robustness test to ensure that the variables used in this model are stationary is done using the root unit test. Often, due to the fluctuations and shocks in the economy, the macroeconomic time series data is subjected to non-stationarity or is said to contain elements of unit root. The issue of stationarity is important for estimation as application of least square techniques on non-stationary variables can lead to misleading parameter estimates of the relationships between tested variables (Diebold and Kilian, 2001). Hence unit root testing is seen as a mandatory exercise to be carried out prior to estimation of a given model. Therefore, to comply with the authors and reasons mentioned above, unit root test is initiated on the variables used in this research.

4. Results

Table II: Results of Im, Pesaran and Shin (IPS) unit root test

Series		FDI	GDP	Capital	FDIIQ	LF	IQ
IPS	At Level	2.2865 (0.9889) (3)	8.3375 (1.0000) (4)	-1.1640 (0.1222) (2)	-10.6610** (0.0000) (1)	-1.7922 (0.3671) (3)	1.0514 (0.8535) (3)
	1 st Difference	-9.4934** (0.0000) (1)	-2.5684** (0.0051) (4)	-6.9166** (0.0000) (2)	11.6260** (0.0000) (1)	1.4635** (0.0017) (2)	-11.1920 (0.0000) (1)

Note: Figures in parenthesis on the top are probability values while at the bottom are the lag values. The t values are shown above the p values and lag values.

It can be concluded from the table above that while the variables were found to be not stationary when tested at level as it surpasses the 0.05 significance level, it however is deemed fit at 1st difference being lower than 5 % , thus can be used for further analysis.

Table III: PMG results (Summary)

Variables	Dependent	Independent				
	GDP	FDIIQ	GFCF	FDI	LF	IQ
Coefficient		1.6950**	3.2887**	0.0126***	4.5360**	3.8727**
t-statistics		(9.4065)	(8.0150)	(11.6587)	(2.6905)	(3.0816)
Probability		(0.0000)	(0.0000)	(0.0000)	0.00012)	(0.0052)

SE of regression 0.065099

The equation hence based on the results can be written as follows:

$$\ln \text{gdp}_{it} = 1.6950\text{fdi}_{it} + 3.2887\text{capital}_{it} + 3.8727\text{iq}_{it} + 0.0126\text{fdi}_{it} + 4.5360\text{lf}_{it} + \varepsilon_{it} \quad (2)$$

The results obtained from the PMG shown in table III above show that all the explanatory variables tested for its influence on GDPPC are significant. Elaborating further on the results in the table above, it can be concluded that an increase in FDI by 1% leads to an increase in economic growth by a 0.0126%. This finding is consistent with past studies that FDI inflows into a host country can boost economic growth via technology transfer which improves productivity and reduces cost hence motivates more FDIs. Further it is able to create jobs and reduce unemployment that in turn enhances economic growth. These observations mentioned here are supported by Lee and Tan (2006) and in recent years by Magombeyi and Odhiambo (2017).

Moving on to the institutional quality, it has a significant positive influence on economic growth by 3.97% for every 1% improvement. This result is in consensus with the Asian Development Bank (2010) which concedes that institutional quality and good governance play a key role in enhancing economic growth in Asian economies. The impact of gross fixed capital formation on economic growth is one that is expected to be positive. With the availability of gross fixed investment, there is an advancement of technology and other capital goods which is deemed necessary for economic growth. In this study, the coefficient value of 3.887 implies that for an increase of fixed investment of 1%, there will be a substantial positive effect in economic growth of 3.887 %. The finding is supported by Hussin, Mat Ros, and Zamzuri (2013) who conducted an economic growth study in Malaysia. It is further in line with an African sub-continent study by Ongo and Vukenkeng (2014)) and a study on MENA countries by Acikgoz, Ben Ali, and Mert (2016). Lastly, the institution augmented foreign capital denoted by the FDIIQ variable shows a significantly positive influence on economic growth. Notably the size of the impact on economic growth is seen to be much stronger than FDI taken on its own suggesting that FDI via good governance environment can bring about a greater impact on economic growth. Hence this concludes the objective of the study which intended to investigate whether institutional quality is an important absorptive capacity for FDI induced growth. This finding is supported by Adeleke (2014) which validates institutional quality as an important absorptive quality in the FDI-growth nexus in Africa.

Labor force is an important determinant of economic growth as seen from the results above where a 1% increase in labor force is expected to yield an approximately 4.5 % increase in GDPPC which is supported by previous studies as found in a research paper by Hong, Lee, and Tang (2009) which pointed out that labor force and total factor productivity are equally important reason for rapid economic growth in the Asian region. They further suggested that policy reforms in education will

enhance labor force and improve productivity, thus sustaining and improving economic growth. Petreski, Elena, and Tumanoska (2016) assert that labor force is a determinant in economic growth but more so, the quality of labor that has to be given due priority hence human capital development policies must be enhanced to achieve this end.

The S.E of regression which represents the average distance of the observed values from the regression line is considered small at 0.065099 hence indicating the goodness of fit of the model.

5. Conclusion and Policy Recommendations

In conclusion, while it is widely acknowledged that FDI inflows are needed for the host country to boost its economic growth via employment opportunities and technology transfers, there is a growing awareness from evidences derived from empirical literature that these benefits that accompany FDI inflows can only be realized when and if certain conditions in the host country exist. This study implicates the importance of institutional quality or good governance for the absorption of FDI into growth benefits.

Based on the findings of the study and the discussions on the results above, a few policy recommendations are suggested to enhance economic growth. Adequate level of capital is a prerequisite for the enhancement of economic growth which is necessary for the provision of physical infrastructure, inclusive of an integrated transportation system for ease of human mobility as well as movement of goods to ease supply chain by time and cost reductions. To achieve this end, there is an aggressive call for the Private Public Partnership (PPP) initiatives to pool adequate capital formation due to its many beneficial aspects especially to the host country in terms of job opportunities for the local populace and rapid technological advancements and transfers. Hence FDI inflows are not only directly enhancing the host country's GDP but also churn out job opportunities thus reducing unemployment and enhance host countries' technology expansion. FDI friendly policies must be mooted to lure foreign capital inflows. For instance, the government should ensure the availability of a skilled and knowledgeable work force to meet the labor demands for potential FDI investors. A comprehensive human capital policy encompassing education at all levels, skill enhancement via internet and communication technology (ICT) is also crucial to ensure labor is capable to undertake global demands. Furthermore, the host country's institutional environment must be given the utmost priority as foreign investors are susceptible to bad governance deeming the host country's institution unfit thereby increasing investment risks. While FDI is crucial in bringing about economic growth the quality of institutions is important in attracting FDI inflows. So it appears that institutional quality which is directly linked to good governance plays a crucial role in the FDI growth nexus. Hence good governance is a double-edged sword as it is pivotal in FDI attraction and it is also needed to transform the FDI into growth benefits. The issue of good governance for institutional fitness for FDI attraction and economic growth cannot be overlooked.

The rule of law is the pinnacle of all other governance measures mentioned above as the absence of it can impede quality of all other elements thereof, thus compromising good governance practices and institutional fitness and integrity. A judiciary system that is independent of political pressure is vital for upholding rule of law. The Law is deemed to be above and all are subjected to the rule of law regardless of socio-economic or political status. Once the rule of law is established

the control of corruption becomes the next pursuit towards achieving good governance. Anti-money laundering act and the implementation of it must be carried out regionally to curb ill-gotten wealth through corruptive and graft activities. Declaration of assets by high ranking public servants must be carried out periodically to curb accumulation of wealth through abuse of power. This will require the effort of whistle-blowers and whistle blowers protection act to enable disclosures of malpractices of vested power especially political power. The voice and accountability dimension of the WGI is of relevance here.

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