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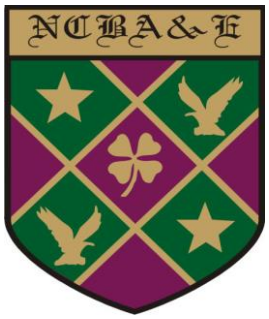


# IMPACT OF INSTITUTIONS ON FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

**BY**

*NADIA TAHIR*

**MASTER OF PHILOSOPHY**
**IN**
**ECONOMICS**

**SEPTEMBER, 2021**

# NATIONAL COLLEGE OF BUSINESS ADMINISTRATION & ECONOMICS

# IMPACT OF INSTITUTIONS ON FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES

**BY**

**Nadia TAHIR**

**A dissertation submitted to**
**Faculty of Social Sciences**

**In Partial Fulfillment oft he**
**Requirements for the Degree of**

**MASTER OF PHILOSOPHY**
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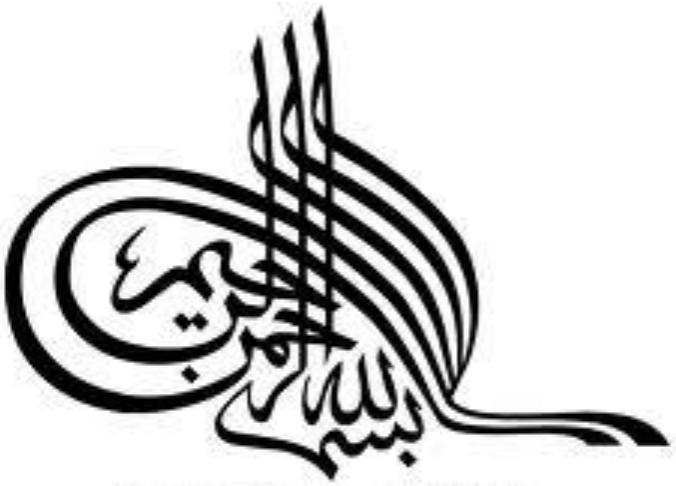

***In the name of ALLAH,***
***The Most Beneficial,***
***The Most Merciful,***

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**Dissertation Committee:**

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**Chairman**

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**Member**

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**Member**

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**Director Research**
National College of Business Administration & Economics

# DECLARATION

It is to declare that this research work has not been submitted for obtaining similar degree from any other university/college.

**NADIA TAHIR**
**SEPTEMBER, 2021**

*DEDICATED*

*TO*

*My Parents*

# ACKNOWLEDGEMENT

All praises and thanks to Almighty Allah who has given us the wisdom and knowledge to identify the right path and reach the truth. With profound gratitude, I wish to thank some marvelous people who have encouraged and helped me in the completion of my research work.

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# RESEARCH COMPLETION CERTIFICATE

Certified that the research work contained in this thesis entitled **"Impact of Institutions on Foreign Direct Investment in Developing Countries"** has been carried out and completed by **Nadia Tahir** under my supervision during her **M.Phil. Economics** Programme.

***(Dr. Zahid Pervaiz)***
**Supervisor**

# SUMMARY

The present study tries to investigate the impact of institutions on foreign direct investment inflows in 22 developing countries by using the panel data for the period of 1990-2018. Institutions have been further classified into formal institutions and informal institutions. Because of the multidimensional nature of the concept of institutions, different proxies have been used in literature to measure the quality and effectiveness of institutions. For our study, we have used two indices named as economic freedom and intergroup cohesion for formal and informal institutions respectively. Economic freedom has been used as proxy of formal institutions as it tells us that to what extent environment is conducive for economic activities. Intergroup cohesion has been used as a proxy of informal institutions as it indicates about the ability of societies to resolve conflict. The empirical results of the study indicate that economic freedom and intergroup cohesion have positive effects on foreign direct investment inflows. It implies that the quality of formal as well as informal institutions plays an important role in determining the foreign direct investment inflows in developing countries. The moderation term of economic freedom and intergroup cohesion has also a positive effect on foreign direct investment. It suggests that both formal and informal institutions are complementary to each other. These two types of institutions reinforce the effects of each other on foreign direct investment inflows in developing countries.

# LIST OF ABBREVIATIONS

| | |
|---|---|
| **FDI** | Foreign Direct Investment |
| **QI** | Quality of Formal institutions |
| **QII** | Quality of Informal Institutions |
| **EC** | Economic Activity |
| **TO** | Trade Openness |
| **INF** | Infrastructure |
| **FD** | Financial Development |
| **EF** | Economic Freedom |
| **IG** | Intergroup Cohesion |
| **IMF** | International Monetary Fund |
| **FI** | Fraser Institute |
| **ISD** | Indices of Social Development |
| **WDI** | World Development Indicators |

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# CHAPTER 1

# INTRODUCTION

## 1.1 BACKGROUND

Institutions have important role to play in an economy. According to North (1990), institutions are bindings and limitations that govern social, economic, and political connections in a society. They consist of rules, regulations, customs, traditions, social norms and moral values. Institutions are important in regulating law, protecting property rights and formulating as well as implementing economic policies. There are two types of institutions which are termed as formal institutions and informal institutions.

Formal institutions are written laws, policies, constitution, rights and rules implemented by government officials. These institutions are codified and linked with human interactions (North, 1990). Informal institutions include customs, traditions norms, and values that are helpful in shaping thought and behavior of individuals in a society. Helmke and Levitsky (2006) defines informal institutions as "socially shared rules, usually unwritten, that are created, communicated and enforced outside officially sanctioned channels". They have further described four types of informal institutions. The first type can be complementary informal institutions; in which both formal and informal institutions strengthen each one. Second set of informal institutions can work as a substitute to formal institutions. Thirdly, accommodating informal institutions exist where formal one is successful however the aim of formal and informal institutions is different. Finally, competing informal institutions exist where there are unsuccessful formal institutions and there are contradictory aims between formal and informal institutions.

Holmes (2011) describes three types of formal institutions; first type is regulatory institutions which reflect government rules and regulations that limit the activities of organizations. Second type is political formal institutions which describe the distribution of power in the government and the individuals who are allowed to participate in it. Third type is the economic formal institutions which control country's monetary and fiscal policies.

Chang (1998) identified that coordination and management, learning and innovation, income relocation and social cohesion are the three functions of the institutions. These features help to promote economic development.

The performance of the economy of a country significantly depends on the quality of its institutions. The presence of efficient economic institutions lowers the transaction costs which in return increase the economic growth and development (Wang, 2000). Institutions are considered as the engine of economic development as they create better economic and investment environment, increase trade and technological progress. The better the economic system of a country, the lower the physical loss and higher the economic growth. An improved economic institution encourages the adaption of the current technologies and promotes economic growth (Li et al. 2018)

Foreign direct investment (FDI) is considered essential for the development of economy in developing countries. It can bring economic prosperity by providing physical capital, foreign exchange, innovation and by increasing competition and access to foreign markets. It can be helpful for technological progress through the use and circulation of improved production techniques (Quere et al. 2007). Foreign firms provide financial, managerial, and entrepreneurial skills to developing countries and domestic firms also take advantage from these skills. It helps to boost their productivity. Developing countries rely on FDI inflows for external financing (Gao, 2004). FDI is helpful in enhancing exchange reserves, productivity, employment level, exports and technology (Mughal and Akram, 2011).

Institutions play important role in enhancing FDI inflows in developing countries (Peres et al. 2018; Guiso et al. 2009). Good institutional environment opens the door for mutual trade. High institutional quality results in political stability, improved rule of law situation and development in economic and financial institutions in the economy (Alvarez et al, 2017). Kedia and Mukherji (1999) state that countries with better quality institutions can attract more FDI. Keefar and Knack (1997) assert that institutional environment such as low level of corruption, efficient bureaucracy, and secure property rights will attract more FDI.

Besides formal institutions, Informal institutions can also be important to attract FDI. Informal institutions can take part in coordinating economic activity through the means of trust (Da Rin et al. 2019). Such institutions affect economic development through their influence on people's behavior (Seyoum, 2011). Fukuyama (1995) describes trust as an important factor of economic prosperity and business success. According to Fukuyama when there will be no shared values then there will be no trust and as a result no business will happen. Societies having good informal institutions are in better position to create a peaceful environment. In such societies there will be less likelihood of conflict and hence more economic activities are expected. Informal institutions can work to strengthen the role and effectiveness of formal institutions. They can work as

complementary as well as substitute to formal institutions. Hence, they can play a moderating role to enhance the effect of formal institutions on FDI inflows. The present study aims to investigate the role of formal and informal institutions on FDI inflows into developing countries. It will also assess the moderating effects of formal and informal institutions on FDI**.**

## 1.2 PROBLEM STATEMENT

Saving and investment gap exists in developing countries where saving rate is low. As a result of it, investment level remains low and therefore growth rate of Gross Domestic Product also remains low which creates vicious circle of poverty. To cope with this situation, FDI plays vital role in developing countries. However, FDI inflows can be significantly affected by the effectiveness and quality of institutions in FDI recipient countries. This study aims to investigate the role of institutions in attracting FDI. The study will analyse the role of formal as well as informal institutions to determine the FDI inflows. It will further investigate the moderating effects of formal and informal institutions on FDI.

## 1.3 SIGNIFICANCE OF THE STUDY

The study will focus on the impact of formal and informal institutions on FDI inflows in developing countries. This study will also try to empirically examine the moderation effects of formal institutions and informal institutions on FDI inflows in developing countries. It will provide guidelines for policy makers to adopt right policies to attract FDI.

## 1.4 OBJECTIVES OF THE STUDY

The basic objectives of this research are specified below:

- To estimate the impact of formal institutions on FDI in developing countries.
- To estimate the impact of informal institutions on FDI in developing countries.
- To check the moderating effects of formal and informal institutions on FDI in developing countries.

## 1.5 RESEARCH QUESTION

Does the quality of formal and informal institutions matter to attract FDI in the developing countries?

## 1.6 HYPOTHESES OF THE STUDY

In order to achieve the above mentioned objectives, following null hypotheses have been formulated.

- Formal institutions do not affect FDI inflows.
- Informal institutions do not have an effect on FDI inflows
- Formal and informal institutions do not have interactive effects on FDI inflows

## 1.7 ORGANIZATION OF THE STUDY

Besides Chapter 1 which contains the introduction of the study, chapter 2 provides an overview of the relevant literature. The theoretical Framework and methodology are provided in chapter 3. The results and discussion are taken up in chapter 4. Chapter 5 presents the conclusion of the study and provides some policy recommendations.

# CHAPTER 2

# LITERATURE REVIEW

FDI inflows are defined as the investment which is made by the non-resident investors in a country (OECD, 2019). FDI can bring many benefits to FDI recipient countries as well as for foreign investors. FDI enables foreign investors to utilize the benefits of reduced labor costs and do necessary decisions rapidly according to the market needs. It also helps them to produce and modify their products according to the needs of the local markets in FDI host countries. They can also take benefits by making rapid decisions according to market needs. They can produce and deliver their products timely. It reduces the transportation costs and enhances their efficiency.

Dunning (1988) developed "Eclectic or OLI (ownership, location and internalization) paradigm theory". According to this theory, (O) represents the ownership factor, which is important for multinational companies to make foreign investment decisions. This factor includes the protection of property rights, the enjoyment of monopolies, and the control of the country product supply. Secondly, (L) belongs to the location factor that determines the decision of multinational companies on FDI in developing countries. The location factors can be classified according to the market search factors and the efficiency search factors of MNCs. When companies believe that the benefits outweigh the costs, the term (I) internalized. When internalization leads to foreign investment, the company may be exposed to political and commercial risks due to its ignorance of the foreign environment.
Kukaj and Ahmeti (2016) found two characteristics of foreign direct investments. First, foreign investors have the right to control the organization. Second, foreign investors have the right to profit based on the level of investment or the profit of participating organizations

## 2.1 IMPORTANCE OF FDI IN DEVELOPING COUNTRIES

For FDI host countries, the benefits include the creation of employment opportunities and positive externalities in the form of technological spill over effects. FDI enhances the economic development by creating more conducive environment for the other investors (Himachalapathy, 2015). Kumari and Sharma (2017) described that most developing countries lack technological skills. They concluded that foreign direct investment provides a way to promote the transfer of new technologies, thereby minimizing the technology gap

between developed and developing countries. Countries can benefit from stable capital flows because capital can promote technological progress through the use and distribution of more efficient production technologies (Peng et al. 2008).

Kok and Ersoy (2009) found that FDI affects income, production, prices, employment, economic growth, development, and the wide-ranging wellbeing of beneficiary countries. Masry (2015) stated that FDI positively affects the economy of developing countries as it delivers capital and effective management techniques. Moreover, developing countries compete with each other and attract more FDI by implementing different policies like offering incentives to the foreign investors, and liberalizing trade system establishing special economic zones.

According to Vig (2018) foreign direct investment plays essential part in enhancing the development of the economy. Moreover, FDI has provided latest tools as well as know-how about the modernization of significant and important processing industries. Foreign direct investment contributes to the development of training and labor management. Foreign investors provide information about foreign markets so developing countries can enter and get hold of foreign markets that these foreign investors have already mastered.

There are many motivational factors that support foreign investors to invest in a country. Dunning and Lunding (2008) divided motivational factors into the four categories, including access to resources, market security, improving effectiveness and establish strategic advantages for investors to improve their durable competitiveness.

Mallampally and Sauvant (1999) stated that FDI is like private external finance for developing countries. This type of financing is motivated by the long-lasting a scenario of investors who profit from directly controlled production activities. Although foreign direct investment is the investment in production facilities, it is of greater importance to developing countries.

FDI in developing countries mainly goes to the developed industries. It is concentrated into small group of countries, which reflects partly the size of their economies and partly their attractiveness as destination for FDI (Weigel et al 1997).

Brewer (1991) explained the role of FDI in developing countries and considered it as a package of resources. In his working paper he discussed that FDI is helpful in transferring technology and managerial skills to developing countries. Further he concluded that FDI projects provided access to world markets for host country exports.

### 2.1.1 Trends of FDI in Developing Countries

World Investment Report (WIR, 2018) showed that FDI flows in advanced economies and transition economies have unexpectedly declined, while inflows of FDI in developing countries increased by 2% and remained stable. But there have been significant differences between regions. FDI increases in Asia and Africa in 2018, whereas FDI shows a falling trend in Latin America and the Caribbean The figure 2.1 given below shows that FDI has increased significantly over the last decade, global FDI investment was $1.87 trillion in 2016, down 23% in 2017 to $1.4 trillion. Developing Asia is the main beneficiary of the FDI flow, with positive growth in all sub regions, reaching $512 billion in 2018. South-East Asia's flow reached a new record ($149), up 3% for the third consecutive year.

Africa's FDI flow is up 11% to $46 billion, but still below the average annual rate of the past decade (about $50 billion). The increase in flow is primarily due to continued investment in the pursuit of resources and gradual expansion of diversified investment in some countries. This has more than doubled south africa's FDI flow (from $2 billion to $5.3 billion). FDI in Latin America and the Caribbean fell 6% in 2018 ($147 billion) and gained momentum in 2017 (from negative growth for five years).

In South America, FDI declined due to a decline in Brazilian and Colombian inflows. The influx of Central America was stable. FDI flows to structurally vulnerable and weak countries continued, accounting for less than 3% of the world's total. Since 2017, the recovery in the poorest countries has averaged $24 billion over a decade. FDI flows into the transition economy continued to decline in 2018, with flows in the Russian federation down 49% to $34 billion, down 28%.

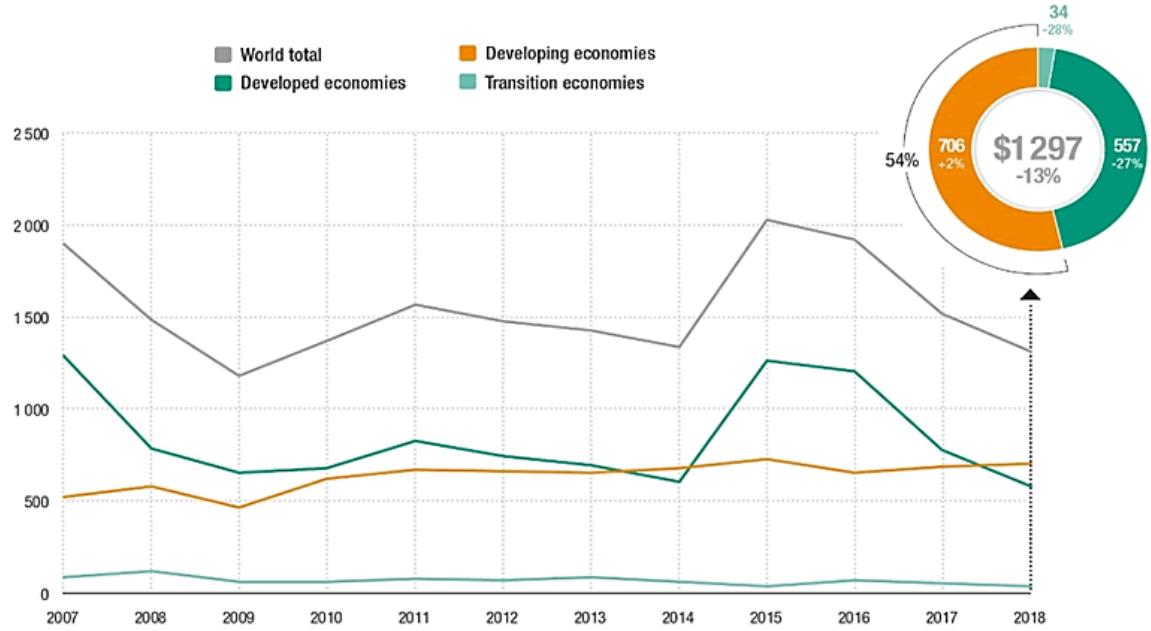


**Figure 2.1: Global FDI Inflows 2007–2018**
**(Billions of Dollars and Percent)**
**Source: UNCTAD, FDI/MNE**

Dunning and Lundan (2008) studied the FDI determinants in terms of the location components of O-L-I and reflected that the choice of FDI location has an increasing impact on the host country. They found that there are 3 types of factor that persuade the preference of FDI location. These factors are endowment effect, agglomeration effect and policy-induced effect. Endowment effect is explained by the presence of inexpensive labor and natural resources. Agglomeration effect has made it clear that the attractiveness of a company generally makes it more attractive for different companies to be placed in the same location in the same area. Policy-inducing effect points out the effects of location decision policy intervention and institutions.

### 2.1.2 Determinants of FDI

There is a lot of research to understand the determinants of FDI in developing countries. Edwards (1990) found that FDI and trade openness linked in positive way of any country. Asiedu (2002) surveyed 34 Sahara Desert African countries between1980 and 2000. The analysis of the panel information indicates that the degree of openness, high income, infrastructure and institutional frameworks increase foreign investment.

Globerman and Shapiro (2003) described those countries with good infrastructure increases FDI investments in developing countries the result of their findings showed that foreign direct investment will be attracted to the more favorable governance infrastructure remaining all other things constant.
Kang and Shouzhen (2003) conclude that the global network of multinational companies will improve the economic efficiency of foreign companies in China. Theoretically, it is suggested that with increasing global competition, asset efficiency plays a special role in the FDI strategy of multinational companies.

Demirhan and Masca (2008) observed FDI determinants in the developing economy via cross-sectional econometric model for the 38 developing economies. According to their research, the GDP growth rate, infrastructure and tax rate are vital factors in attracting FDI. Suliman and Mollick (2009) used data collected between 1980 and 2003 to investigate the FDI determinants of 29 SSA countries, while per capita GDP growth, rate of literacy, infrastructure and openness positively associated with FDI, while political rights, civil rights and the size of liquidity have negative effect on FDI.

Kok and Ersoy (2009) studied the determinants of FDI into developing countries. Their study is based on panel data FMOLS from 24 developing countries from 1983 to 2005 and cross sectional SUR data for that period. The results show that total debt service/GDP and inflation are negatively impacted, while communication positively link to FDI.

Anyunwa (2011) observed determinants of FDI in Africa from the year1980-2007. For this purpose, author applied OLS and GLS techniques. Results indicated that urbanization, openness, infrastructure, siz of government and international remittance were positively related with FDI. While GDP per capita, indices of financial development, inflation, the exchange rates, and political rights are negatively associated to FDI.

Mphigalale (2011) found that identical trade openness strategies which have large market sizes, lower real wages and lower price inflation will attract more investment inflows to the economy as compared to those who have small market sizes, large real wages and high price inflation.

Hlaváček and Olšová (2011) investigated relation between globalization and foreign investment in Czech Republic. It was indicated that globalization is important in the economic changes on different regions of Czech Republic. Further it was found that exports increases at international level because of globalization and this would develop the FDI of the Czech economy.

Mughal and Akram (2011) illustrated that FDI is a blessing in developing countries because it is useful in attracting exchange reserves, productivity,

employment level, exports and technology. Leitao (2012) conducted the considerable and positive link between globalization and foreign direct investment of 33 countries for the year 1990-2008 using static and dynamic panel data. It was also concluded that globalization control the decisions of the foreign investors.

Jadhav (2012) analyzed the effect of economic, political and institutional factors for the location of FDI decisions in BRICS countries including Brazil, Russia, India and China. This study highlighted that the real GDP as the proxy for market size considered as a strong determinant of FDI. In addition to openness and rule of law, foreign investment improves in BRICS countries.

Sichei and Kinyondo (2012) used data from 1980 to 2009 to explore the FDI determinants of 45 African countries with data from 1980-2009. Observed result showed that GDP growth, openness and natural resources have a direct impact on FDI. Kohler (2013) found market size as an important part of improving FDI in developing countries.

Gareth (2014) assessed impact of the trade openness on sectoral FDI inflows in emerging market countries. Panel data technique was used for the year 1990-2010. Results indicated that openness to trade has positive relationship with total FDI and secondary FDI inflows. It was also suggested that liberalizing in trade openness will bring out an increase in total and secondary foreign direct inflows in emerging market countries. Moreover, results of the primary and tertiary sectors were positive, but not significant to draw conclusions.

Kariuki (2015) used the least squares method to study the determinants of FDI in 25 African countries for the year 1984-2010 using least square method. The estimated results indicated that political risk, economic and financial factors negatively affect FDI while political risks, inflation, stock market indexes, investment and trade openness have a positive impact on FDI.

Mijiyawa (2015) used the GMM model to study the determinants of FDI in 53 African countries. For this purpose, the data is taken from 1970-2009. The results revealed that political stability, trade openness, infrastructure, market size and GDP per capita positively correlated with FDI.

Shah and Khan **(**2016) indicated the relationship between trade liberalization and foreign direct investment. Panel random effect model from the year 1996 to 2014 was used for six emerging countries. Result of the study

showed positive relationship between trade liberalization and foreign investment. Moreover, it was concluded that reduced economic border and transaction costs, flexible government policies will push further countries to enter into preferential trade agreements with the given emerging economies. This trade agreement will affect multinationals decisions which showed positive effect on inward FDI.

Kumari and Sharma (2017) investigated the determinants of FDI by unbalanced panel data for the years 1990- 2012. 20 developing countries were selected from South Asia, South-East Asia and East Asia. The results of the fixed effect show that market size, trade openness, interest rate and human capital are significantly related to FDI.

Gopalan et al. (2019) suggested the quality of infrastructure as important determinant of FDI inflows in China and ASEAN countries from the period 1995-2016. Results of the study highlighted that physical infrastructure is helpful in enhancing foreign investment inflows in China and ASEAN.

## 2.2 INSTITUTIONS AND FDI

Different studies (North 1990; shleifer and vishny 1993; Acemoglu 2005) suggest that institutions play an important role in the process of economic development. It can also be crucial for the attraction of foreign investment in developing countries.

Alfaro et al. (2008) empirically supported the importance of institutions by using the ordinary least squares estimates. Study shows quality of the institutions is measured by other factors such as internal and external conflict, government constancy, corruption, efficiency of law enforcement and quality of bureaucracy. Improvement of the institutions will boost FDI into developing economies.

Williamson (2000) in his work “The New Institutional Economics: Taking Stock, Looking Ahead” described the performance of institutions in four levels of social analysis.

| Level | Theory |
|---|---|
| ⇩ | |
| Embeddedness | Social Theory |
| ⇩ | |
| Institutional Environment | Economics of Property Rights/ Positive Political Theory |
| ⇩ | |
| Governance | Transaction Cost Economics |
| ⇩ | |
| Resources | Neo Classical Economics/ Agency Theory |

Source: Williaoson (2000)

**Figure 2.2: Economics of Institutions**

Williamson's (2000) definition provides a valuable framework for analyzing functioning of institutions and illustrates how these institutions depend on each other. The above figure (2.2) shows these levels. The first level is the social embeddedness level with traditions, customs and norms. Religion plays most important role here. Institutions at this stage change very slowly. The second level is defined in the institutional environment. The structures seen here are partly the product of development. Design tools at the second level are the administrative, legal, and practical features of government and distribution of powers across a number of levels of government. The definition and application of property rights and contractual provision is an essential feature. In the third level institutions of governance are located. Transaction cost is not the only basic units but governance also plays important role to alleviate conflicts and realize mutual gains. Therefore, governance is important in getting incentives. The fourth level is the neoclassical analysis works. Where most favorable tools employed and for this purpose firm is usually described as a function of production. By summing up the first level is the level of norms, customs, and traditions. First level manipulates the other three levels, including the official rules of the game, governance and finally the allotment of resources.

### 2.2.1 Formal Institutions and FDI

North (1990), Stein & Daude (2001), Bevan and Estrin (2004) and Quéré et al. (2005) among many others have discussed the importance of formal institutions and considered them as the source of increasing FDI inflows into developing countries.

Dunning (2002) identified that institutions like excellent governance and economic freedom became more general factors of FDI because, multinational corporations (MNCs) are shifting from the pursuit of markets and resources to the pursuit of efficiency. While traditional factors of FDI including natural resources and lower cost of labor, are relatively insignificant, non-traditional factors like governance or economic freedom, are increasingly popular.

Li and Resnick (2003) empirically studied the impact of democratic institutions on foreign direct inflows into developing countries. They applied general least squares method from 1982-1995 using a modified standard error on a panel of samples from 53 developing countries. It was argued that when democracy increases then property right protection become improved which in turn enhanced foreign inflows. Moreover, no relation was found between governance and FDI in developing countries.

Quéré et al. (2005) examined that institutions affect FDI in developing countries. Results indicated that bureaucracy, corruption and legal institutions are the important determinants of FDI in developing countries. Good institutions help developing countries to attract more foreign investment.

Busse and Hefeker (2007) studied 20 years of cross-country analysis. The findings show that institutional indicators such as political risk and government stability, law and order, and quality of bureaucracy associated to FDI. The panel analysis also showed that the lack of internal conflicts and tensions between ethnic groups that ensure the stability of the government are very important determinants of the influx foreign investment in basic democratic rights, law and

Fan et al. (2008) examined that institutional factor bring more foreign inflows in Chinese economy. Different institutional factors like rule of law and freedom from corruption were used. Findings revealed that control of corruption has no association with foreign direct investment. While there was a positive link studied between rule of law and foreign investments. Foreign investors attracted by the rule of law of the Chinese economy.

Buchanan et al. (2011) used the panel estimation method to examine the role of economic institutions in the volatility of FDI in 164 countries for the year 1996 to 2006. The study showed that governance positively affects foreign direct investment whereas governance was negatively associated with the volatility of FDI. Further it is explained that good governance not only attracts more FDI inflows but it also decreases the volatility of inflows.

Thi et al. (2013) established a positive association of institutions with foreign investment inflows in Vietnam. Fixed effect technique was used from

the year 1996 to 2011. In addition, political stability and the lack of violence, quality regulation and control of corruption were main components of institutional quality. These components strengthen the foreign inflows in Vietnam. Results stated that Vietnam needs to improve the quality of its institutions to become more competitive.

Skabic (2013) analyzed the impact of institutional factors on foreign investment inflows in 8 Southeast European countries using random effect and fixed effect models for the time period of 2001 to 2010. The study indicated that on the one hand corruption, large scale privatization, development of trade and infrastructure reform have positive link with foreign direct investment inflows while property rights, freedom and small scale privatization has no impact on FDI in Southeast European countries.

Esew and Yaroson (2014) discussed the role of institutional development in studying the foreign investment of Nigeria using sample period 1980 to 2011. The results found indicated that political stability and corruption had positive relationship with foreign inflows.

Yildirim and Gökalp (2016) studied the association among institutional and macro-economic performance in 38 developing countries from 2000 to 2011. Panel regression analysis indicated that law integrity, trade barrier regulation, restrictions on foreign investments, and the proportion of private sector, and employment variables of the banking system have positive link with the macroeconomic performance in developing countries.

Nondo et al. (2016) studied the relation of economic institutions and foreign direct inflows using 45 sub Saharan African countries in 1996-2007. Fixed effect technique was used to study the impact of institutions on foreign direct investment. The result generated shows that composite index and institutional quality individual dimensions are not significantly linked in sub Saharan African countries. This was studied that most of the African countries scored very low on all aspects of quality of institutions. The African countries with the low economic and political institutions have to encourage institutions and political structure to bring more investments from other countries.

Bailey (2017) using Meta-analysis techniques derived from 97 main studies discovered that institutions like democracy, political stability and the rule of law encourage FDI. The study found a positive correlation between institutional factors including democratic institutions, political stability, rule of law and FDI. The study suggested that countries with strong institutions enhance more FDI.

Malik and Chowdhury (2017) empirically examined the influence of social and economic institutions on FDI. The relation was investigated by fixed effect and ordinary least squares on data from 156 countries. The findings suggested that corruption negatively influence FDI while government stability, law and order, civil and political rights have significant positive impact on FDI inflows.

Good institutional environments open the door for bilateral trade. High institutional quality means political stability, better rule of law conditions and progress in economic and financial institutions in the economy (Alvarez et al, 2017).

Asif and Majid (2017) used time-series data from 1984 to 2013 to conduct a study to assess the quality of institutions and macroeconomic indicators impact on Pakistan's FDI. Results of co integration test indicated a short- run and long-term relationship between institution quality and FDI.

Ahmad et al. (2018) empirically studied the relationship between quality of institutions and sector-level FDI in Pakistan for the period of 1980–2015. Results of ARDL approach are long term in Pakistan, suggesting that the quality of institutions is helpful in attracting FDI to manufacturing and services sectors.

Peres et al. (2018) studied the relationship between institutions and foreign inflows. The relationship was investigated using panel data from 110 developed and developing countries for the time period 2002-2012. Two indicators of governance control of corruption and rule of law were used. The results in developed countries indicated that governance indicators positively associated with foreign investment in developed countries. The result indicated that because of poor control of corruption and rule of law instability developing countries failed to boost the foreign investments. Further it was suggested that strong institutions played an important role to develop FDI inflows in developed countries.

### 2.2.2 Economic Freedom and FDI

This study takes economic freedom as a main determinant of foreign direct investment inflows. We use economic freedom as a proxy for formal institutions. Different studies discussed the link between economic freedom and foreign direct investment inflows. The value of index ranges from 1 to10. Value of index closer to 1 means higher level of economic freedom, whereas a value closer to 10 shows lower level of economic freedom.

Bengoa et al. (2003) studied the correlation among economic freedom and FDI in 18 Latin American countries from 1970-1999. For this study panel data was used. The results show a positive relationship between economic freedom and FDI.

Quazi (2005) analyzed the impact of economic freedom on foreign direct investment. The Heritage Foundation's economic freedom index was used in seven East Asian countries from 1995 to 2000. Using panel data techniques, result suggested economic freedom as a crucial as well as strong determinant of FDI

Berggren and Jordahl (2006) signified five domains of Fraser Institute's Economic Freedom index including wide range of interconnected economic institutions and policies such as government size, legal structure and protection of property rights, rational access to money, freedom of trade with foreigner, and regulation of credit, labor and business. Results showed that protection of legal structures and property rights can indirectly increase the rate of economic growth by promoting the effects on social trust.

Gwartney (2009) studied that countries with greater economic freedom would increase the proportion of private investment in GDP, increase private investment productivity, increase growth rates, and increase per capita income levels than countries with low economic freedom.

Saini et al. (2010) look into relation between economic freedom, foreign direct investment (FDI) and economic growth in 85 countries over the year 1975-2004. Generalized method-of moment system estimator (GMM) technique was applied and results of technique point out economic as an important factor into the development of countries.

Empirically it is stated that countries which provide more economic freedom will attract more foreign investment and promote economic development in the economy.

Mathur and Singh (2013) examined the importance of economic freedom in 29 countries including emerging markets and developing countries from the year 1980-2000. Panel random effect model was used and the results suggested that foreign investors and multinationals are more interested in economic freedom than political freedom in decision making and execution. These results are related to the process of democratization in developing countries, especially the difficulties that arise when implementing economic reforms in favor of FDI for competing political interests.

Miller and Kim (2013) defined economic freedom as economically free society where every individual's success and failure depends upon their abilities. In this free society government encourage equal resources of production and consumption. People in this country pay taxes to ensure public security, safety of property, of that country pays taxes that would ensure public safety, property protection, and general defense and sustain the financial stability.

Miller et al. (2013) found that those who benefit from economic freedom are responsible for respecting economic rights and freedom of others under the rule of law, but the state was created to provide the basis for active protection of economic rights like ownership and contracts.

This result shows that EFI's macroeconomic factors support FDI inflows from South Asia, Latin America, East Asia, North Europe, and West European countries.

Mansour et al. **(**2015) examined the positive effect of economic freedom on foreign direct investment in the Arab countries from 2008 to 2014. According to the results of the regression, commercial freedom has negative link with FDI, while economic freedom, financial freedom, and the freedom to work are positive with FDI.

Moussaa et al. (2016) concluded a positive impact of economic freedom on FDI using fixed effects model in the study. Their study based on global and regional panel analysis including 156 countries from the period 1995-2013. Results showed that on average one unit change in economic freedom brings out 0.0835 units increase in FDI inflows.

Singh and Gal (2020) discovered the impact on Foreign Direct Investment (FDI) inflow in South Asia, East Asia, Latin America, Middle East, and North Africa, Northern Europe, Southern Europe, Western Europe, Eastern Europe and Sub Saharan Africa. This study uses data from the Heritage Foundation's index of economic freedom for the period 1999-2018 a step by step multiple regressions is applied for economic freedom variables. The result explained that economic freedom significantly and positively affects FDI in South and East Asia, Latin America, North and West Europe. On the other hand, in the Middle East and North Africa, Eastern and southern European economic, freedom was slightly related to FDI inflow.

### 2.2.3 Informal Institutions

Seyoum (2011) in his study observes that informal institutions play vital role in developing and developed countries. Research also suggested that informal institution improve the flow of information and support market based activities, built on a high degree of credibility and reputation. Members have information on the characteristics of each exchange, the location and consistency of market participants and reducing transaction costs. This study selected 119 countries from different geographical areas. The results of the regression analysis showed that quality of informal institutions positively affect FDI inflows. Results suggested that as compare to formal institutions, informal institutions have a noteworthy and better effect on inward FDI flows.

In view of Kogut and Singh (1988) foreign companies are attracted to with similar cultures. Sharing the same attitudes and values will give you a better understanding of local markets their customers and the way of doing business. Due to the cultural differences between the host country and source country, it costs more to run a business with a different culture.

Grief (1996) found that Maghreb merchants build secure relations and facilitate the achievement of contracts throughout repute and social control mechanism. In other words, informal institutions help companies meet each other's obligations by providing a foundation for trust and fame.

Knack and Keefer (1997) examined the relationship between interpersonal trust, norms of civil cooperation, and economic activity, using a representative sample of 29 market economies. According to their analysis trust is the most important factor of social capital. The experimental results point out statistically significant and positive association between trust and growth.

Wang (2000) studied the influence of informal institutions on foreign direct investment in China. In his study he used networks of personal connections (*guanxi*) based on a wide-range of interviews in the mid-1990s and at the end of the 90s. He found, personal network attracts more FDI in China. In fact, they balance formal law by illuminating legal uncertainty and providing access to legal mechanism for enforcing contracts and resolving disputes.

Alesina et al. (2003) found that ethnicity and language are key factors of economic accomplishment in terms of GDP growth, quality of policies and quality of institutions. These factors lead to better results in terms of the quality of each country's government, and are attracting the attention of foreign investors.

Inkpen and Tsang (2005) theoretically described the importance of informal institutions through social networks. Their study highlighted that trust which is represented by social networks closely related to Informal institutions. These institutions based on social connections develop via interpersonal and inter-organizational relationships between every individual and firm.

Easterly et al. (2006) examined the relation between social structures, political institutions, and economic growth. Particularly, they found that sometimes even good politicians in low income countries adopted bad policies due to social constraints. These constraints formed by ‘‘social cohesion’’ in their country. They show that social cohesion determines the quality of institutions and it has a profound influence on how strategies that support growth are planned and implemented.

Siegel et al. (2008) differentiate cultural aspects and find that distance on social equality adversely affected FDI. While when there are more differences in cultural harmony then more FDI enhanced. They concluded that FDI tends to flow from low harmonization countries to high harmonization countries, companies appear to be more risk taking in low harmonization countries and seeking growth as compared to high harmonization countries.

Bhardwaj et al. (2007) studied the relation between cultural factors on location of foreign firms of 43 countries. Trust and uncertainty avoidance were used as cultural variables. The study indicated that culture of host country plays vital role to strengthen foreign direct investment.

Ahlerup et al. (2008) concluded that interpersonal trust affects economic outcome when the court system is weak. This finding shows that when social capital has the more impact on the total surplus of the game at low levels of institutional power and when the institution is very strong, the effect of social capital disappears.

Guiso et al. (2009) examined positive association between level of trust and inward foreign direct investment in European countries. It was argued that cultural aspects like history of conflicts and religion, genetic and somatic similarities also affect the level of trust. Zhao and Kim (2011) empirically tested the impact of trust and associative activity on foreign direct inflows. Weighted Least Square analysis of 165 countries from the World Value Survey and World Bank was used. Results showed positive impact of trust and associative activity on FDI inflows.

Kukharsky (2012) assessed the positive relation of trust and economic exchange in cross sectional of countries. The results of the study indicated that when trust level is higher, there will be an increase in the level of foreign direct investment.

Méon and Sekkat (2014) found that in the absence of formal institutional arrangements, the effect of social trust in FDI is stronger. They emphasize the significance of an informal institutional framework.

Da Rin et al. (2019) found that trust increased the FDI by industrial investors and not by financial and individual ones. Further it was suggested that trust increased the probability of co investing with a partner from recipient.

### 2.2.4 Intergroup Cohesion and FDI

Intergroup cohesion is used as a proxy for informal institutions and is also the main variable of this study.

**"**Intergroup cohesion refers to relations of cooperation and respect between identity groups in a society. Where this cooperation breaks down, there is the potential for conflictual acts such as ethnically or religiously motivated killing, targeted assassination and kidnapping, acts of terror such as public bombings or shootings, or riots involving grievous bodily harm to citizens, with concomitant effects upon growth and development" (ISD,2015). The index of Intergroup cohesion uses a variety of indices including race, religion, political riots, violence, strikes, terrorism, clashes, abductions, and murders. The index value range is 0 to 1. The closer the index is to 1, the higher the cohesive factor between groups, and the closer it is to 0, the lower the cohesive force between groups.

Ethnic homogeneity can lead to more educated people, higher income levels, and strong civic rules in society (Knack and Keefer 1997). Tolsma et al. (2009) studied that neighborhood tolerance and social attitudes are affected by education and income levels. Higher-educated and affluent individuals need more tolerance and better contact with society. Hahn and Bunyaratavej (2010) indicated that high levels of avoiding uncertainty and a tendency of youth in a host country affect FDI negatively, while greater power distance and greater propensity to independence support FDI inflows.

Joseph et al. (2020) point out that local business activities promote peace and encourage conflict, and peace building improves when differences between groups in the business environment decreases. Additionally, the significance of

economic development was prominent for local businesses and it is recommended that peace can be achieved through social development, rule of law and training and when these measures improve economic demands. We draw conclusions by citing how appropriate factors during conflict zones can increase differences between groups and how those factors can be addressed and how peace building can be promoted.

Zimdars and Tampubolon (2012) explained the modern influence of diversity on traditional beliefs. Characteristics of socio economic shortcomings are more important than ethnic or cultural diversity in explaining people's social ties. Spear (2002) theoretically revealed that equal power sharing in African multi-ethnic societies is often damaged by local traditions that hinder the process of development. According to him in South Africa power-sharing maybe served as a peacekeeping device during a time of transition. In Somaliland, power-sharing appears to have resulted as much from competition between the southern and northern regions of Somalia as from reconciliation among the local disputants.

Tong (2005) empirically studied the role of ethnic Chinese networks on foreign direct investment. Results suggested that ethnic networks are significant and plays important role in enhancing foreign investment between countries. Standard gravity model was used for this study. Huang et al. (2013) examined Chinese network at the firm level and suggested that ethnicity significantly affect the volume of cross-border transactions.

Oliwer and Wong (2003) studied the racial attitudes among Asian Americans, blacks, Latinos, and whites. Data were used from Multi City Study of Urban-Inequality from 1992 to 1994 and the 1990 Census. This study indicated, the background of neighbors is that in metropolitan areas with a large population of ethnic minorities, the proximity among ethnic minorities is high in response low-level prejudice and external competition among ethnic minorities.

According to Hergueuxn (2012) at the national level, religious diversity and religious similarity are associated with an increase in FDI. Religious multiplicity is high than the religious similarity and religious similarity promoted FDI comparatively in countries with low institutional quality and the opposite is true for religious diversity.

Beugelsdijk et al. (2014) investigated that as the influence of cultural distance on sales of foreign subsidiaries decreases, the level of cultural diversity in imported domestic countries increases. They concluded that higher cultural diversity offers more opportunities to multinationals to target more culturally

related host groups, thus overestimating the impact and limits of cultural distance.

Filippaios (2007) discriminate among political and civil liberation and suggested that international firms would invest in low civil liberties and high political liberties. Lucke and Eichler (2015) discovered the influence of institutional and cultural factors on developed countriesof 29 and 65 developing countries of bilateral FDI from 1995-2009. The main focus of the study was institutional and cultural factors effect on bilateral FDI. They found that foreign investors invest in countries which have better regulatory environment. Additionally, countries with less diverse societies also promote foreign investment.

Fenga et al. (2018) empirically estimated the impact of language on bilateral FDI. According to this study common language is helpful to encourage bilateral FDI between countries. Study analyzed that countries that use a common official language, common native languages, or a languages close to each other tend to have higher FDI between the two.

## 2.3 CONCLUSION

This chapter concludes that there are different determinants of foreign direct investment including quality of institutions. Institutions play vital role in promoting foreign investment whether they are formal or informal institutions. This study with the help of existing literature on institutions tries to identify the impact of institutions on foreign direct investment. Institutions influences transaction costs and by reducing uncertainty and building trust and strengthening cooperation for productive sectors of economic activity, affecting the macroeconomic performance of each country (Yildirim and Gökalp, 2016).

Foreign investors are attracted to countries where burden of regulatory is low, less religiously and linguistically diversified and are less corrupt (Lucke and Eichler, 2015).

For formal institutions we study economic freedom while for informal institutions we study intergroup cohesion. We concluded in this chapter that due to poor quality of institutions of developing countries, they do not protect property rights and do not support efficient investment. Institutions in developing countries generally lack sufficient activity to support effective investment and resolve inefficiencies. In such societies the legal principal is that the elite who discriminate against individuals and do not use property rights for the majority of the population have unlimited economic and political power, and

only lucky citizen get higher education, earn credibility and production opportunities.

In case of developing countries with dictatorial structure, countries that seek to seize society compete with the country and society, leading to weakening and collapse of production. When ethnic diversity is involved in developing countries without strong institutions, the development of political rights is insufficient, resulting in ethnic conflicts where policy-making cannot be applied successfully and adversely affecting the economic structure of the country (Luiz, 2009; Fosu, Bates and Hoeffler, 2006). In this case, society should implement Institutional reforms for economic development to create good institutions.

# CHAPTER 3

# THEORETICAL FRAMEWORK AND METHODOLOGY

## 3.1 THEORETICAL FRAMEWORK

In previous chapter, we have discussed that different factors such as degree of trade openness (Asiedu, 2002; Kang and Shouzhen, 2003; Hlaváček and Olšová, 2011), financial development (Anyunwa, 2011), size and volume of economic activities measured as GDP (Yasmin et al, 2003; Mijiyawa, 2015) and quality of infrastructure (Demirhan and Masca, 2008; Gopalan et al., 2019) play important role to attract FDI inflows in developing countries. Besides these factors, formal and informal institutions can also be crucial determinants of FDI inflows. Formal institutions ensure law and order in the society whereas informal institution help to create an environment of mutual trust. Hence, good quality institutions can create an environment which is conducive for investment. To examine the effects of institutions on FDI, the theoretical framework of our study is as given in figure (3.1).

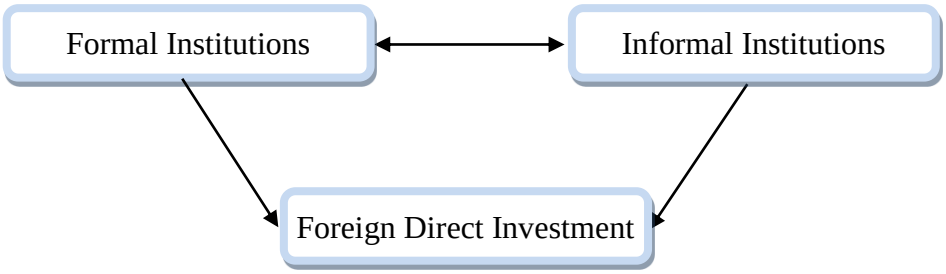


**Figure 3.1: Theoretical Framework**

## 3.2 THE MODEL

The functional form of the model of our study can be given as below:

$$FDI = f\,(QI, QII, EA, TO, INF, FD) \qquad (3.1)$$

where,

**FDI** = Foreign Direct Investment
**QI** = Quality of formal Institutions
**QII** = Quality of Informal Institutions
**EA** = Economic Activity
**TO** = Trade Openness
**INF** = Infrastructure
**FD** = Financial Development

We are interested to analyse the effects of institutions on FDI. In doing so, we intend to check the impact of quality and effectiveness of formal as well as informal institutions on FDI. In addition to separate effects of formal and informal institutions on FDI inflows, we also aim to analyze the interactive effects of formal and informal institutions on FDI. The rationale of use of interactive term is based upon the argument that sometimes formal institutions do not work effectively in the society and informal institutions work as a substitute for formal institutions. As a substitute, informal institutions can help to meet the gaps left by formal institutions. This is so when norms and values of society provide a mechanism for business contracts instead of some legal mechanism. On the hand, informal and formal institution may prove complementary to each other. In such situation, these two kinds of institution reinforce the effectiveness of each other. As a complementary to each other, informal institutions help to improve the performance and effectiveness of the formal institutions.

Based upon the above mentioned functional form of the model (equation 3.1) of our study, we have used two different econometric models provided in the following equations 3.2 and 3.3. In equation 3.2, the effects of institutions on FDI have been analysed whereas equation 3.3 has been used to investigate the interactive effects of formal and informal institutions on FDI.

$$FDI_{it} = \alpha_0 + \alpha_1 QI_{it} + \alpha_2 QII_{it} + \alpha_3 EA_{it} + \alpha_4 TO_{it} + \alpha_5 INF_{it} + \alpha_6 FD_{it} + e_{it} \quad (3.2)$$

$$FDI_{it} = \alpha_0 + \alpha_1 EA_{it} + \alpha_2 TO_{it} + \alpha_3 INF\,it + \alpha_4 FD_{it} + \alpha_5 QI_{it} * QII_{it} + e_{it} \quad (3.3)$$

## 3.3 DESCRIPTION OF VARIABLES

A brief description of the variables of the study is given below.

### 3.3.1 Foreign Direct Investment

Foreign direct investment is the dependent variable in this study. The study used FDI net inflows data for the period of 1990-2018 for 22 developing countries from World Development Indicators. The net inflow of FDI refers to the value of direct investments between economies as reported by non-resident investors. This includes return on reinvestment earnings and intra-company loans, capital gains and net loan repayments.

### 3.3.2 Quality of Formal Institutions

Institutional quality can not be measured easily because it has multiple dimensions. The law and order situation is considered as an important dimension of institutional quality which plays a crucial role for domestic investment as well as to attract FDI. Similarly, rules and regulations related with regulatory frameworks are important for economic activities. FDI is likely to flow towards those countries where such rules are not very strict. We have used an Index of Economic Freedom as proxy of institutional quality because it captures these rules and regulations more effectively. The index indicates about the individuals' ability to make economic decisions without interference or restrictions by government and government's anti-market behavior for powerful groups (McMahon, 2014).

The index developed by Fraser Institute was first published in 1970. The index was reported with five years intervals till 2000. Since then, it has been reported annually. The index measures the degree of economic freedom that exists in five main areas including government size, security of legal System and property, a sound currency, and freedom of international trade and supervision. The five main areas are composed of 26 components of the index. Many components are composed of several sub-components. Overall, the index incorporates 43 different variables. All variables come from a variety of sources including the International Country Risk Guide, the Global Competitiveness Report, and the World Bank's Doing Business project. The value of index ranges from 1 to10. Value of index closer to 1 means no economic freedom, whereas a value closer to 10 shows complete economic freedom.

### 3.3.3 Quality of Informal Institutions

There are different indicators which can be used to define informal institutions. An index intergroup cohesion has been used as a proxy for informal institutions. Intergroup cohesion describes the likelihood and ability of resolving of conflict of a society in a peaceful way. Law and order situation is expected to be good where such likelihood of resolving conflict is high. This ability of countries and societies can be conducive to attract FDI in developing countries. Therefore, we have used this index as a measure of effectiveness of informal institutions. Intergroup cohesion shows the strength of cooperation and harmony between identity based groups in a society. The value of index lies between 0 and 1. When there is no intergroup cooperation and harmony, the value of index would be lower and it would be higher in the presence of harmony and peace among groups. The index has been constructed by Indices of Social Development project based at International Institute of Social Studies, The Hague. Data of the variety of variables reported by different data sources such as riots, acts of terrorism, assassinations, strikes, kidnappings and social insecurity has been used in the construction of the index.

The likelihood of conflict in a society can discourage FDI inflows therefore, we have used this index as an independent variable in our analysis. A positive relationship is expected to exist between intergroup cohesion and FDI inflows.

### 3.3.4 Economic Activity

The volume and size of economic activities in an economy can matter for FDI inflows. More economic activity means that there can be more need of FDI. Foreign investors invest to those economies where they find opportunities for making more profits. Thus, it can be a possible determinant of FDI in any economy. GDP per capita growth has been used as a proxy for economic activity in this study. GDP is the sum of the total value added by all resident producers in the economy.

### 3.3.5 Trade Openness

Trade openness has used as a control variable to study its impact on FDI. The data on trade openness is measured by the country's total imports and exports as a percentage of that country's GDP. Foreign firms may be interested in investing in those countries which open their economies to free trade. That’s why trade openness has been used as an independent variable in the study.

### 3.3.6 Infrastructure

Infrastructure is another control variable. It can be measured by number of variables and proxies such as availability and length of roads, railways and facilities of communications. In today's modern world, communication facilities are thought to be an important dimension of infrastructure. Fixed telephone lines has been used as a proxy for infrastructure. Landline subscriptions are the sum of VoIP (Voice-over-IP) subscriptions, fixed wireless local loop (WLL) subscriptions, ISDN voice channel equivalents and fixed payphone activity for analog fixed lines (World bank, 2018). Better telecommunications in developing countries attract foreign investors in the country. According to Erdal and Tatoglu (2002), foreign firms are attracted to investing in countries with sufficiently developed infrastructure. Excellent infrastructure helps to ensure a smooth flow of products and services, as well as efficient communication and transportation. This means a positive relationship between infrastructure and FDI inflows is expected.

### 3.3.7 Financial Development

Good financial system of an economy provides a conducive environment for domestic as well as foreign investment. It helps to build trust of the investors. Financial development has been measured by an index developed by International Monetary Fund (IMF). Its value ranges from 0 to 1. A value closer to 1 indicates high financial development and value closer to 0 indicates lower financial development. The index has been developed by considering the comparative ranking of countries in terms of depth, access, and effectiveness of their financial institutions and financial markets.

## 3.4 DATA AND METHODOLOGY

### 3.4.1 Data

The study has been conducted by using data of developing countries of the world over the period of 1990-2018. World Bank's classification of countries has been used to define developing countries. Low and middle income countries have been considered as developing countries. However, data for all variables of the study was available only from a smaller set of countries. It has restricted our sample of study to only 22 countries. These countries are Algeria, Armenia, Bangladesh, Brazil, China, Colombia, Ghana, Indonesia, India, Jordan, Kenya, Malaysia, Mexico, Moldova, Morocco, Nigeria, Pakistan, Peru,

Philippines, South Africa, Sri Lanka and Turkey. Data for these countries was available with some missing observations so our data is unbalanced panel data.

Data for FDI, GDP per capita growth (used as a proxy of Economic Activity), total value of imports and exports as a percentage share of GDP (used as proxy of trade openness), and subscription of fixed telephone lines (used as a proxy of infrastructure) has been taken from World Development Indicators of World Bank. Data for Financial Development Index (used as proxy of the degree of financial development in a country) has been taken from International Monetary Fund (IMF). Data for Economic Freedom Index (used as proxy of quality of formal institutions) has been taken from Fraser Institute whereas the data for Index of Intergroup Cohesion (used as proxy for the quality of informal institutions) has been taken from Indices of Social Development (ISD) maintained and developed by International Institute of Social Studies, The Hague.

## 3.5 METHODOLOGY

The data of our study is unbalanced Panel data for 22 countries over the period of 1990-2018. Data of two variables of our model out of total seven variables was not available on yearly basis. Index of Economic Freedom was available with five year intervals till 2000 and after that it was available on yearly basis. Data of Intergroup Cohesion was also available with five year intervals i.e. for 1990, 1995, 200, 2005, 2010 and 2015. We have converted such data into yearly data. In doing so, the same value available at initial time period has been used for the subsequent four years. For example, the value of Intergroup Cohesion for the year of 1990 has also been used for the year 1991, 1992, 1993 and 1994.

Panel data is considered superior as compared with cross sectional or time series data. Panel data contains different variables for entities or cross sections observed at different time periods. Panel data provides more information, is more flexible, and has less risk of colinearity between variables (Batlagi, 2015). Panel least square analysis can be used with two different effects termed as fixed effects and random effects.

### 3.5.1 Fixed Effects

In fixed-effects model, the intercepts of the regression model is assumed to be different while slope or coefficient of variables is assumed to be same among cross sectional units. The assumption of different intercepts is devised to capture the distinctive characteristics of individual units.

### 3.5.2 Random Effects

In random effects, the single unit intercept value is a random draw from a larger set with constant average. The basic principle of the random effects model is that, as compare to fixed effect model, variability between individuals supposed to be random and independent of the predictors contained into the model. The random effects is suitable in situations where the intercept of the unit of each section is not related to the regression variable.

### 3.5.3 The Hausman Test

The Hausman Test makes it possible to choose between fixed effects and random effects. The Hausman test statistic is calculated only for regression variables that change over time. Use random effects if the Hausman test is insignificant. On the other hand, apply fixed effects if the Hausman test is significant. We have also applied this test to choose among the available fixed effects and random effects models.

### 3.5.4 Moderation Effects

Moderation effects are also termed as interactive effectives. In order to study the moderation or interactive effects, a product term of two variables is used as independent variable in regression. The significance and coefficient of interactive term indicates about the moderation or interactive effects. In order to study the interactive effects of formal and informal institution on FDI inflows, we have used a product term of Economic Freedom and Intergroup Cohesion in our analysis.

## 3.6 DESCRIPTIVE STATISTICS AND GRAPHICAL ANALYSIS

The descriptive statistics of the variables of our study are presented in table 3.1.

**Table 3.1**
**Descriptive Statistics**

| | Foreign Direct Investment | Economic Freedom | Intergroup Cohesion | Economic Activity | Trade Openness | Infrastructure | Financial Development |
|---|---|---|---|---|---|---|---|
| **Mean** | 2.586861 | 6.507973 | 0.514586 | 3.180497 | 62.25911 | 9.829046 | 0.325534 |
| **Median** | 2.002065 | 6.560000 | 0.527634 | 3.270114 | 54.13227 | 8.123785 | 0.307054 |
| **Maximum** | 23.21190 | 7.920000 | 0.725652 | 14.74562 | 220.4068 | 29.97783 | 0.667827 |
| **Minimum** | -2.757440 | 3.080000 | 0.204020 | -13.56957 | 15.16176 | 0.073003 | 0.096192 |
| **Std. Dev.** | 2.442929 | 0.762300 | 0.109392 | 3.307991 | 34.93087 | 8.256310 | 0.151148 |
| **Skewness** | 2.911971 | -0.914740 | 0.009314 | -0.311880 | 1.942319 | 0.610006 | 0.480207 |
| **Kurtosis** | 18.45653 | 4.789983 | 2.415998 | 5.725410 | 7.491816 | 2.264797 | 2.262726 |
| **Jarque-Bera** | 4990.378 | 119.8294 | 6.244869 | 142.9848 | 645.0889 | 37.11297 | 26.81501 |
| **Probability** | 0.000000 | 0.000000 | 0.044050 | 0.000000 | 0.000000 | 0.000000 | 0.000002 |
| **Sum** | 1135.632 | 2857.000 | 225.9031 | 1396.238 | 27331.75 | 4314.951 | 142.9096 |
| **Sum Sq. Dev.** | 2613.942 | 254.5223 | 5.241391 | 4792.949 | 534432.4 | 29857.00 | 10.00641 |
| **Observations** | 439 | 439 | 439 | 439 | 439 | 439 | 439 |

Table 3.1 contains the descriptive statistics of variables of the study. Measures of dispersion, central tendency i.e. mean and median, measures of skewness, and kurtosis has been shown in the table. Mean refers to average computed by dividing the sum of averages to the number of observation under study. Thus the average of FDI is 2.586861 which means that, on average, the value of foreign direct investment for all cross section is 2.58. The mean value for economic freedom is 6.507973 for overall panel data. The mean value for intergroup cohesion is 0.514586. The mean value for economic activity appears to be 3.180497. The mean value for trade openness appears to be 62.25911. The

average value of infrastructure is 9.829046 while the mean value for financial development for overall cross sections is about 0.325534.

Median is actually the mid value of data, yet another average type. Foreign direct investment median is 3.71. While the median for economic activity is 3.270114. Trade openness median appears as 54.13227. The median for infrastructure is 8.12, while the median value of financial development is 0.307.

The maximum and minimum values are generally intended for the range, which is a measure of distance, from which we can draw a conclusion: if there is a large spread in the data or if the data has a small spread. Data with more dispersion and variation have a disadvantage because they not help with valid estimation or consistent data. The maximum value for foreign direct investment is 23.21190 whereas the mini value is -2.757440. While the maximum and minimum value of economic freedom is 7.920000 and 3.080000 respectively. The maximum and minimum value for intergroup cohesion is 0.725652 and 0.204020. The maximum value and minimum value for economic activity is 14.74562, -13.56957 respectively. Trade openness shows the maximum value as 220.4068 while the minimum value is 15.16176. Moreover, the results for infrastructure show that the maximum value is 29.97783, and the minimum value is 0.073003. Financial development illustrates maximum and minimum value as 0.667827; 0.096192 respectively.

### 3.6.1 Graphical Analysis

Figure 4.1, 4.2 and 4.3 exhibits line graph of foreign direct investment, economic freedom and intergroup cohesion. These variables are graphed against time to get an idea of their behavior. This part of study examined the trend of selected developing countries.

The given graphs represent the trend of foreign direct investment (% GDP), Economic freedom index and inter group cohesion in 22 developing countries from the year 1990-2018. Line graph shows upward and downward trend of developing countries with the change of time. The graphs of economic freedom and intergroup cohesion show breaks due to missing values in the data.

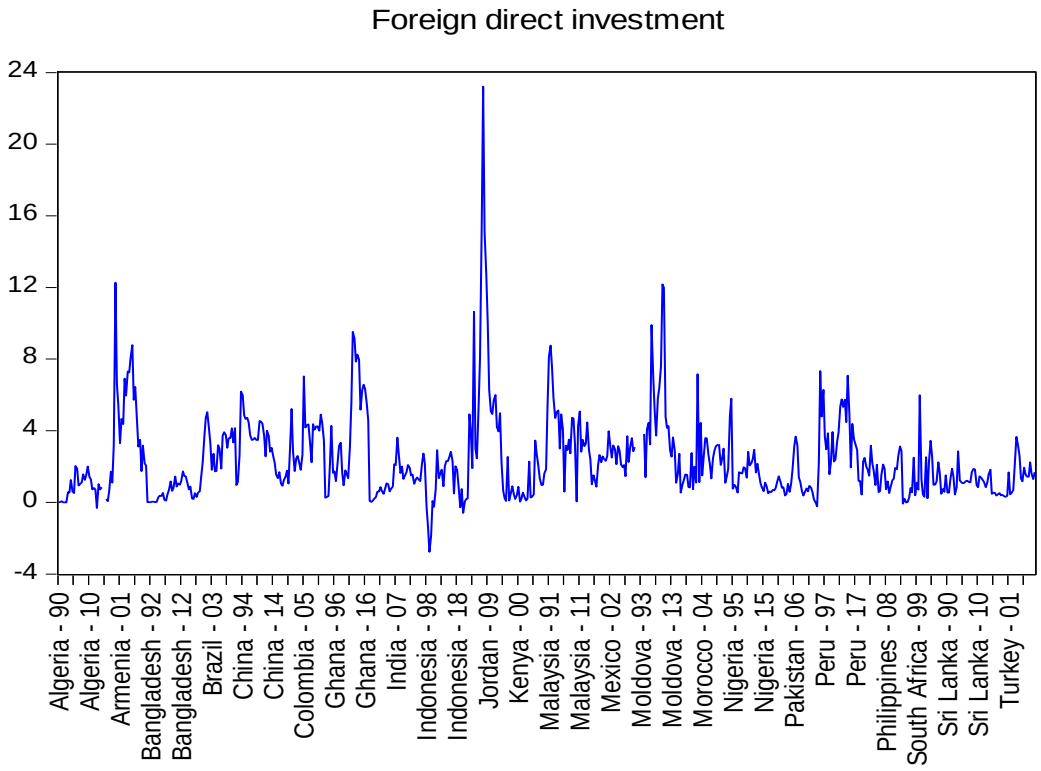


**Figure 4.1: Foreign Direct Investment**

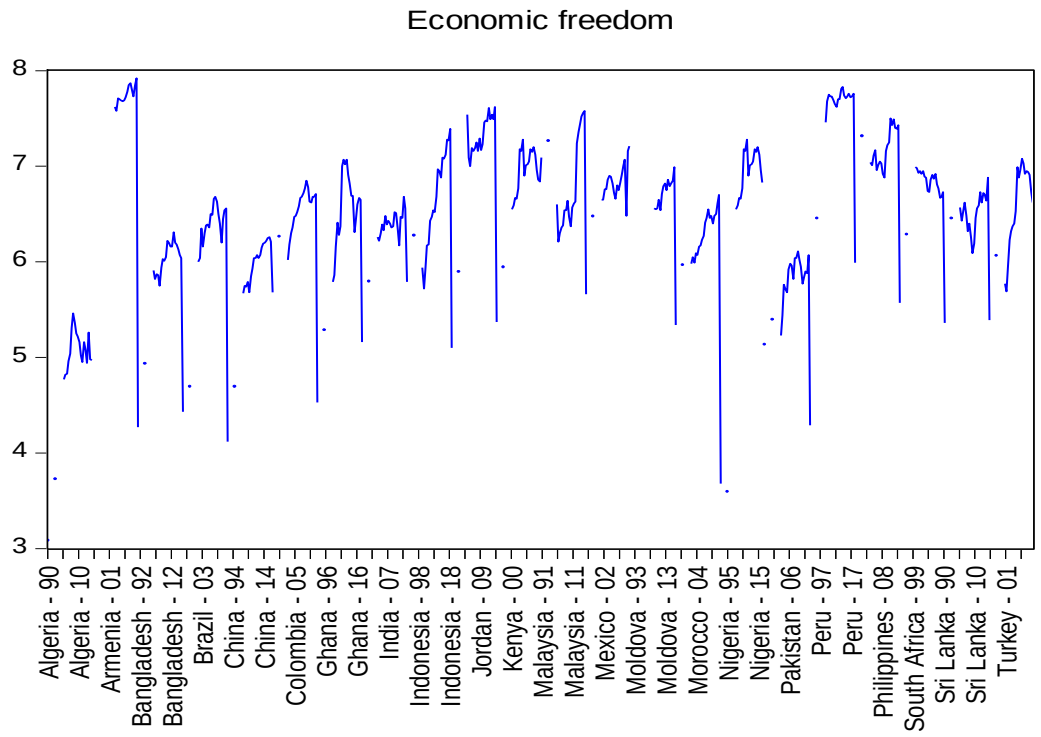


**Figure 4.2: Economic Freedom**

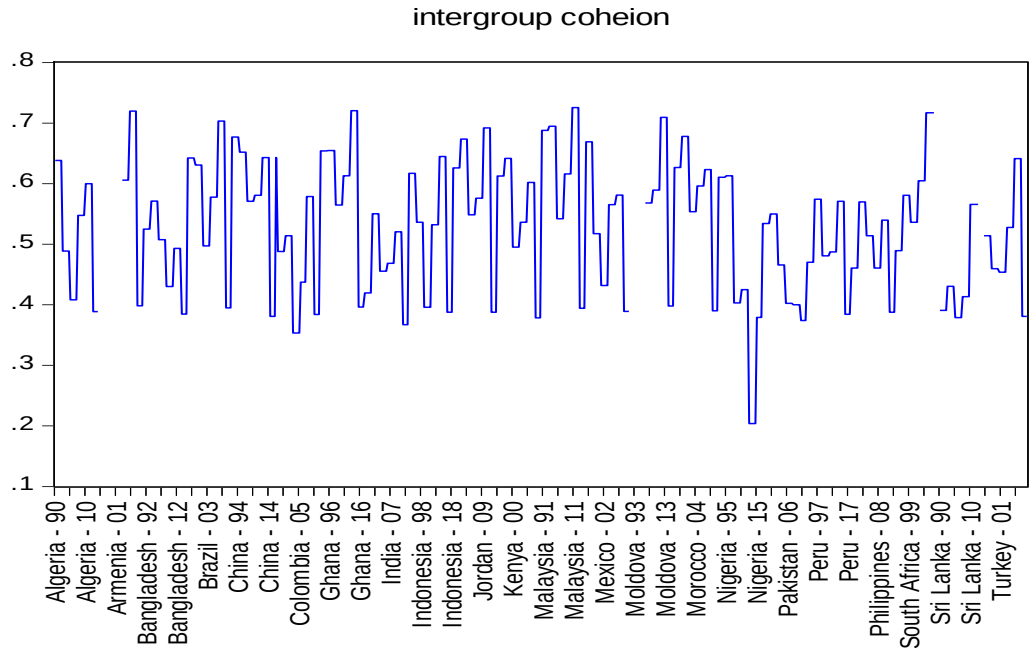


**Figure 4.3: Intergroup Coheion**

# CHAPTER 4

# RESULTS AND DISCUSSION

## 4.1 EMPIRICAL RESULTS

The empirical results of our study have been presented in this chapter. We used two econometric models for our analysis. In first model, the effects of the quality of formal and informal institutions on FDI inflows have been analysed. In the second model, moderation effects of formal and informal institutions on FDI inflows have been investigated. The results of both of these models have been presented in the following sections.

### 4.1.1 The Hausman Test

The Hausman Test has been used to decide whether Random Effects or Fixed Effects Model is suitable for our analysis. The results of the test have been reported in the table 4.1

**Table 4.1**
**Hausman Test**

| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f. | Prob. |
|---|---|---|---|
| **Cross-Section Random** | 0.000000 | 6 | 1.0000 |

Hausman test is used to decide whether Fixed Effects or Random Effects Model is appropriate to use. If the p-value is less than 0.05 then Fixed Effects is considered suitable. The result of the Hausman test reported in table 4.1 indicate that probability value is 1 which is more than 0.05. So the test suggests the use of Random Effects Model instead of Fixed Effects.

### 4.1.2 Effects of Formal and Informal Institutions on FDI

The results of our estimated Random Effects Model have been provided in the following table 4.2.

**Table 4.2**
**Effects of Formal and Informal Institutions on FDI**
**(Random Effects)**

| Variable | Coefficients |
|---|---|
| C | -6.645651<br>(0.0000) |
| Economic Freedom | 0.893820<br>(0.0000) |
| Intergroup Cohesion | 2.204883<br>(0.0030) |
| Economic Activity | 0.106902<br>(0.0293) |
| Trade Openness | 0.024020<br>(0.0378) |
| Infrastructure | 0.023916<br>(0.0405) |
| Financial Development | 0.636499<br>(0.5867) |

***$R^2$=0.621193; Adjusted $R^2$=0.596308; Prob (F-Statisitic) = 0.000000***

The results reported in the above table 4.2 indicate that index of economic freedom has positive and significant relationship with foreign direct investment. The coefficient of the index of economic freedom is 0.893820 with a p-value of 0.0000. The positive relationship between economic freedom and foreign direct investment implies that effectiveness and quality of formal institutions is important for FDI inflows. It means that with increase in economic freedom in developing countries, more FDI takes place. Therefore, by providing more economic freedom, FDI can be attracted in developing countries.

The coefficient of index of intergroup cohesion is 2.204883 with a positive sign and a p-value closer to 0. It implies that informal institutions can also be important for FDI inflows. Intergroup cohesion is an indication of the abilities of societies to resolve their conflicts in a peaceful way. It helps to create a good environment for FDI.

Economic Activity also has positive and statistically significant effect on FDI with a coefficient of 0.106902 and the p-value of 0.0293. It means that

foreign firms prefer to invest in the countries where they expect that the opportunities to earn profits would be higher due to large market size.

Trade openness has positive and significant relationship with FDI. The result shows a coefficient with positive sign and p-value of 0.0378 which means trade openness has significant and positive effect On FDI. Increase in trade results improvement in a country's import and export environment which helps to attract more FDI.

Infrastructure is significantly and positively related to FDI. The positive association shows that if transportation and telecommunication of a country is in better shape, foreign investors will invest more in that economy. As Erdal and Tatoglu (2002) argue that foreign firms are attracted to invest in countries where there is well developed infrastructure.

Financial development has a positive but statistically insignificant impact on FDI. Financial development may be more important factor to boost domestic investment instead of FDI.

### 4.1.3 Moderation Effects of Formal and Informal Institutions on FDI

The moderation effects of the quality of formal and informal institutions on FDI inflows have been presented in table 4.3.

**Table 4.3**
**Moderation Effects of Formal and Informal Institutions on FDI**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | -1.227510 | 0.420640 | -2.918196 | 0.0037 |
| Economic Activity | 0.076475 | 0.013202 | 5.792499 | 0.0000 |
| Trade Openness | 0.023530 | 0.004298 | 5.474513 | 0.0000 |
| Infrastructure | 0.029060 | 0.010027 | 2.898113 | 0.0040 |
| Financial Development | 3.726723 | 0.547009 | 6.812913 | 0.0000 |
| Economic Freedom *Intergroup Cohesion | 0.181368 | 0.059434 | 3.051597 | 0.0024 |

The results reported in table 4.3 show that there exists a positive relationship between moderation term of economic freedom and intergroup cohesion with FDI. It means that formal and informal institutions reinforce the effects of each other on FDI.

## 4.2 DISCUSSION

Quality of formal and informal institutions along with other factors such as size and volume of economic activity, trade openness and infrastructure play crucial and important role to attract FDI in developing countries. The volume and size of economic activities in an economy can matter for FDI inflows because more economic activity means that there can be more need of FDI. Thus, foreign investors will be inclined to invest to those economies where size of economic activities are larger. The positive impact of trade openness on FDI shows that foreign firms may be interested to invest in those countries which are open to free trade. Infrastructure is an important of FDI because foreign firms are attracted to invest in those countries with have sufficiently developed infrastructure. Good quality infrastructure helps to ensure a smooth flow of products and services, as well as efficient communication and transportation.

# CHAPTER 5

# CONCLUSION AND POLICY RECOMMENDATION

## 5.1 CONCLUSION

The present study has investigated the impact of institutions on FDI inflows in 22 developing countries for the period of 1990-2018. Panel Least Square with Random Effects has been used for the analysis. An index of Economic Freedom has been used as a proxy for the quality of formal institutions. Economic freedom has been used as proxy of formal institutions as it tells us that to what extent environment is conducive for economic activities. Quality of informal institutions has been measured by using an index of Intergroup Cohesion. The index of Intergroup cohesion has been used as a proxy of informal institutions as it indicates about the ability of societies to resolve conflict. Moreover, moderation effects of formal and informal institutions on FDI have also been analysed. For this purpose, a product term of Economic Freedom and Intergroup Cohesion has been used in the regression.

The quality of formal as well as informal institutions has been found to be important for FDI inflows in developing countries. The moderation term of economic freedom and intergroup cohesion has also a positive effect on foreign direct investment. It suggests that both formal and informal institutions are complementary to each other. These two types of institutions reinforce the effects of each other on foreign direct investment inflows in developing countries.

## 5.2 POLICY IMPLICATIONS

To attract more FDI, developing countries need to improve the quality of institutions. Better law and order conditions, more economic freedom and ability of societies to resolve conflict in a peaceful way can boost FDI inflows. Some of the important policy suggestions are as given below

- The governments of developing countries should be concerned to raise the quality of institutions. Policies of economic freedom should be adopted to attract FDI. Law and order should be ensured to boost the confidence of foreign investors.

- In order to enhance the abilities of societies to resolve conflict through an informal way, attempts must be made at government

and societal level. Foreign investors would prefer to invest in a society which is more cohesive due to the lower risk of political instability in such societies. In addition to the role of state, the role of civil society is also important to make a society cohesive and hence to attract more FDI.

- There is a need to adopt liberal policies to promote trade in the country. To attract more FDI in developing countries, these countries need to pursue the policies of trade liberalization. Openness to trade can be an important factor to attract foreign investors.

- Governments should ensure safe and peaceful atmosphere to attract more FDI.

- Better and good quality infrastructure is very important to attract FDI. Thus, Governments in developing countries should focus on the improvement of infrastructure. Modern facilities of communications can be helpful to attract foreign investors.

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