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Impact of Good Governance Indicators on the Inflow of Foreign Direct Investment (FDI) In Pakistan

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A B S T R A C T

Foreign Direct Investment (FDI) occupies extensive importance in socio-economic development of any economy. High inflow of Foreign Direct Investment (FDI) helps in reduction of poverty, unemployment, and in achieving high economic growth in developing countries, like Pakistan. In home country, good governance environment significantly affects the inflow of FDI. In this connection, the purpose of this study is to analyze the scenario of good governance in Pakistan and its impact on attracting FDI. For this study, time series data was used covering the period from 1996 to 2017. ABDL approach was used for estimation, the findings prove that there is significant impact of Political Instability, Regulatory Quality and Effectiveness of Government, whereas, Rule of Law (RL) as well as Corruption (CC) and exert insignificant effect on the inflow of FDI in Pakistan during mentioned time period. The study suggested that the Pakistani government needs to develop good governance environment through better law and order situation, transparent legal system and effective policies with proper implementation; to ensure high FDI inflows in the country.

Key Words: Foreign Direct Investment (FDI), Time Series Analysis, Good Governance.

1. INTRODUCTION

Countries with high growth rates afford desirable quality of life to its citizens. On the other hand, countries that do not make economic progress are found stuck in poverty, crime and social backwardness José Pedro Pontes, (2007), Dierk Herzer, (2008) & Ongena, S., Popov, A., & Van Horen, N. (2019). If a country was a lonely island on a planet, it would grow only by its indigenous resources. But no country lives in isolation. When a country fails to develop from within, it usually resorts to external assistance in the form of foreign aid, trade or investment. However, it is controversial if a country can

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Article info
Received Dec 03,2019
Accepted June 17,2020
Published June 30,2020

make sustainable progress through aid only. However, now than ever before, Foreign Direct Investment (FDI) is brought into increasing attention due to its tangible contribution to economic growth (Khan, Muhammad Arshad, 2007) W.N.W.Azman-Saini, Siong Hook Law, Abd Halim Ahmad, (2010). An abundant amount of research has been done, emphasizing the importance of Foreign Direct Investment (FDI) for the economic development of the state. Borensztein & et al., (1998) comparatively analyzed the contribution of FDI and domestic investment in economic growth and found the more significant impact of FDI as compare to domestic investment in economic enlargement of the state. Kh Zhang, (2007) & Pol Antràs, Mihir A. Desai, C. Fritz Foley, (2009) states that FDI not only brings finance for host country but it moves associated with the number of other advantages for the recipient like efficient management techniques, advanced technologies and jobs for the people as a whole. However, Foreign Direct Investment (FDI) does not work as magic. According to Dierk Herzer, Mechthild Schrooten, (2008) & Khondolker (2007) countries which having high and sustainable GDP growth rate, equipped with modern infrastructure, developed business responsive situations can successfully attract Foreign Direct Investment (FDI). On other side, Foreign Direct Investment (FDI) itself significantly affects the economic growth of a country.

FDI inflows could be affected by various economic and non-economic factors. The non-economic determinants of FDI can be considered under the governance indicators (i.e. regulatory quality, political stability, rule of law, etc.). According to World Bank, “Governance consists of the traditions and institutions by which authority in a country is exercised” (World Bank, 2018). Good governance influence on the enlargement of FDI has been analyzed by numerous empirical studies. In this regard the significant impact of various noneconomic factors on the inflow of FDI was confirmed, [King and Levine (1993), Brewer (1993), (Biglaiser, G. & Staats, J., 2010)].

A developing state, like Pakistan-has hindered economic growth and stunted development, needs foreign direct investment. However, figure 1 show that during past decades FDI inflows in Pakistan is not encouraging. United Nations Publication (2016), reported that in the year 2015, Pakistan was ranked 66th globally among the countries receiving FDI.

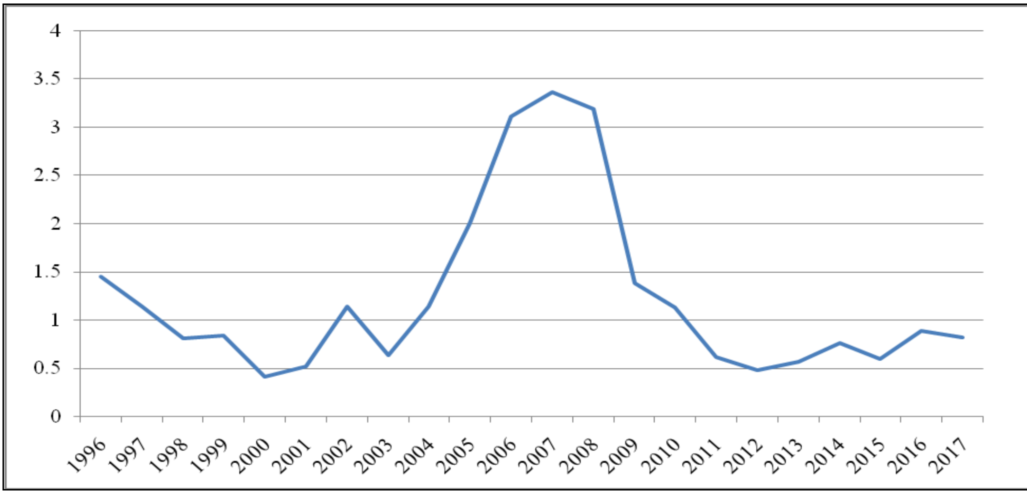

Figure 1. FDI Inflow in Pakistan in % of GDP Growth Rate n=23

*Data Source: World Bank (2019)

In Pakistan a range of factors, which is economic and non-economic contributes for low amount of FDI inflow. Therefore, this research analyzes the influence of Good Governance on the inflow Foreign Direct Investment (FDI) in Pakistan, covering the era of 1996 to 2017. The study consists of five different parts. Part one gives introduction, part two presents the literature study, section three illustrate the methodology of the study. Part four presents the study outcomes. Finally, Section five describes the conclusions and recommendations.

2. LITERATURE REVIEW

Theoretically and empirically the importance of FDI inflows for the economic progress of a country has been proved. McGrattan, Ellen R., & Andrea Waddle (2020) in their research study applied neoclassical growth model and highlighted the significant impact of foreign investment in economic growth of United Kingdom. Paula Nistor (2014) in his case study on Romania found the strong association between GDP growth rate and FDI inflows. Theoretically importance of FDI inflows frequently discussed by numerous economists such as in early 18th century David Ricardo (1817) presented his theory “comparative cost advantage and disadvantage” (Axel Berger, 2011). According to this theory the countries having comparatively low production cost will be more successful in attracting international capital or foreign investment. Theories on 'agency cost' (Jensen & Meckling 1976, Berle and Means 1932), 'modern property rights' (Coase 1960, Demsetz 1967), 'transaction cost' (Coase 1937, Williamson 1975) and 'information asymmetry' (Arrow 1963, Akerlof 1970) explain that safe, secure and encouraging business environment in a country that safeguard the property rights of peoples and facilitate investors through minimizing business transaction costs will be more attractive for foreign investors. Yang, L. (2019), Quaresima, F., Fiorillo, F. (2020) & Eimantas Blažys (2020) in his research study explore the importance of good governance as a significant input of economic development of a country and found that institutional reforms can play positive and influential role in economic development of a state. Epstein, G.S., Gang, I.N. (2019) focused to investigate the association between basic socio-economic obstacles (i.e. poverty, corruption, underutilization of resource etc) and good governance. Study found that the effective and efficient government policies are the basic requirement for the economic development of a country.

According to The theory of 'institutions' presented by North (1990), FDI inflows affected by various factors this includes macro-economic factors, formal institutional factors and informal factors/norms (i.e. habits, customs and traditions which affect the willingness of the people to invest). According to this theory formal institutional factors are playing an important role to develop investor's trust in transaction ultimately which affect the inflow of FDI across countries. Good governance is an attempt to develop rule of law, put off corruption among state institutions and dire management (Globerman, S. and Shapiro, D., 2003 & Daniel Haberly, & Dariusz Wójcik (2015). State that good governance encourages economic liberty; low down political risk and the simplicity of doing business are also shown to be key driving forces of FDI. According to Biglaiser, G. & Staats, J., (2010) & Dilek Temiz, (2014). the good quality of state institutions can play significant role in the development of capital inflows. In addition, regulatory quality & political stability also significantly affect the FDI inflows. Pravin Jadhav (2012) study outcomes highlight that the economic determinates are more important than non-economic determinants for attracting FDI from abroad (this includes institutional and political factors). The majority of the FDI inflows in BRICS economies are stimulated by the market-seeking reason. Most of the institutional and political factors are remaining statistically insignificant. According to Capasso, S., Goel, R.K. & Saunoris, J.W. (2019) & Wang, X., Gu, X. (2019) corruption is very harmful for the development of a country and in their study found that the good governance indicators such as rule of law and regulatory quality can play significant and positive role in order to control corruption and to develop an economy. S. Anwara, L. Nguyen, (2010), Brewer (1993) & King and Levine (1993), analyze the influence of governance indicators on the inflow of FDI. These studies found that formal institutional factors such as rule of law, effectiveness of government policies and their implementation facilitates investors and encourage inflow of FDI. Chen, C., Tian, W., & Yu, M. (2019) in their research study found that bad governance leads to outflow of FDI from home country. According to Hayat, Arshad (2019) & Kaufmann (2005), good governance infrastructure is correlated with inflow of foreign capital as well as it provides better opportunities for the effective use of domestic resource that is both human and financial which are essential for economic development of a country. Wang and Swain (1995) & Kevin Honglin Zhang, (2015) in their research studies focused on the particular variables that influence the FDI inflow in economically transforming states particularly in China. Studies found that politically instable environment of an economy having absence of transparency in institutions; negatively affect the business environment resulting low down FDI inflows in the economy. According to René Cabral, André Varella Mollick, Eduardo Saucedo, (2019) & Morisset (2000) corruption and bad governance is harmful for business environment that enhance the administrative expenses due to which FDI inflows becomes low. Mengistu and Adhikary (2011) used panel data and analyze the impact of governance indicators on FDI, within fifteen Asian countries during reported period (i.e. 1996 to 2007). Study found that FDI inflows significantly affected by good governance indicators therefore, existence of good governance environment in any economy will attract more FDI within the country. Samimi and Ariani (2010) in their research study analyze impact of good governance on the foreign capital inflows. Study analyzed the annual data for the sixteen states of Middle East and North Africa (MENA) during 2002 to 2007. Research found that the control of corruption & political stability has significantly positive impact on the

FDI inflow within selected states. In the light of study results better good governance was suggested by the researchers.

3. RESEARCH METHODOLOGY

This research empirically analyzes the good governance influence on FDI inflows in Pakistan. Keeping in view the existing literature and constrained by the reliable data availability the econometric model is expressed as follows:

$$FDI_t = \beta_0 + \beta_1 CC_t + \beta_2 PS_t + \beta_3 RL_t + \beta_4 RQ_t + \beta_5 GE_t + \varepsilon_t ---------- (1)$$

Where, FDIt is Foreign Direct Investment in percentage of GDP growth rate at time t, β0 denotes intercept. εt is the error term, β_1, β_2, β_3, β_4, β_5 is coefficients. CC is Corruption at time t. PS is Political Instability at time t, RL is Rule of Law at time t, RQ is Regulatory Quality at time t and GE is Government Effectiveness at time t. This annual time series research analysis covering the era of twenty-one years (i.e. from 1996 to 2017). Table 1 shows the details of variables and sources of data.

Table 1. Variables & Data Sources

Variables	Data Source	Explanation/Definition and Data Source
Foreign Direct Investment (FDI)	World Bank Official, 2019	"A Foreign Direct Investment (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country" (Shima Elkomy et al., 2016).
Corruption (CC)	World Bank Official, 2019	"Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as capture of the state by elites and private interests" (World Bank Official, 2019).
Political Instability (PS)	World Bank Official, 2019	"Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism" (World Bank Official, 2019).
Rule of Law (RL)	World Bank Official, 2019	"Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence" (World Bank Official, 2019).
Regulatory Quality (RQ)	World Bank Official, 2019	"Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development" (World Bank Official, 2019).
Government Effectiveness (GE)	World Bank Official, 2019	"Reflects perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies" (World Bank Official, 2019).

3.1. Unit Root Test and Estimation Technique

In time series analysis, statistical tools and techniques such as Augmented Dickey–Fuller (ADF) occupies very important role in for having more authentic statistical outcomes [Chen, T., et al., (2019) Patton, A. J. et al., (2019) & Machado, C., et al., (2019)]. In this study all variables are in time series so, Augmented Dickey–Fuller (ADF) applied to ensure the stationarity of each variable. Angeliki N. Menegaki. (2019), Bitto, A., & Frühwirth-Schnatter, S. (2019) & Person et al., (2001) introduce Auto Regressive Distributed Lag (ARDL) for estimations. On basis of ADF test results Auto Regressive Distributed Lag recommended was used as appropriate estimation technique. In ARDL model single equation is used to express the relationship between dependent and independent variables (Wang, W., Zhang, X., & Paap, R., 2019 & He, Z., & Krishnamurthy, A., 2019).ARDL can be applied on small sample size and suitable for estimating long and short run associations among variables. Therefore, ARDL approach was selected for estimation. Following equation 1 is originated into ARDL equation. Whereas, ARDL model in short and long run form presented in equation 2 and 3 respectively.

$$FDI_t = \beta_0 + \beta_1 CC_{t-1} + \beta_2 PS_{t-1} + \beta_3 RL_{t-1} + \beta_4 RQ_{t-1} + \beta_5 GE_{t-1} + \varepsilon_t ----------(2)$$

$$\Delta FDI_t = \alpha_0 + \sum_{i=1}^{n} \alpha_{1i} \Delta CC_{t\_i} + \sum_{i\_0}^{n} \alpha_{2i} \Delta PS_{t-i} + \sum_{i-0}^{n} \alpha_{3i} \Delta RL_{t-i} + i - \sum_{i-0}^{n} \alpha_{4i} \Delta RQ_{t-i} + \sum_{i-0}^{n} \Delta GE_{t-i} + EC_{t-1} + \varepsilon_t ---------(3)$$

In equation 2 (β1, β2, β3, β4, β5) are the dynamics of long run model, while short run dynamics (α1, α2, α3, α4, α5) presented in equation 3. The first difference of the variables denoted byΔ while, ECt-1 shows the speed of adjustment. Earlier than using ARDL model, Bound test was applied to validate the presence of long run association among selected variables.

4. RESULTS AND ANALYSIS

In order to handle the issue of spurious analysis, stationarity of data was checked by applying ADF test. Table 2 presents the analyses of unit root test. The analysis outcome shows that out of six two variables become stationary at level while; 4 variables become stationary at 1st difference. Therefore, model is the combination of order I(1) and I(0).

Table 2. Results of Augmented Dicky Fuller (ADF) Test

Variables	At Level	At 1st Difference	Inference
Foreign Direct Investment (FDI)	-2.526060 (0.1253)	-3.183356** (0.0363) **	I (1)
Corruption (CC)	-3.270725** (0.0313)	________	I (0)
Political Instability (PS)	-1.233298 (0.6386)	-3.764815** (0.0115)	I (1)
Rule of Law (RL)	-3.877074** (0.0091)	________	I (0)
Regulatory Quality (RQ)	-2.335320 (0.1719)	-3.358406** (0.0263)	I (1)
Government Effectiveness (GE)	-1.326762 (0.5972)	-3.427378 (0.0222) **	I (1)

*Data Source: World Bank (2019) available at (http://data.worldbank.org/)

- ( ) are probabilities & * shows < 5% probability
- 2 lags selected by the Akakike Information Criterion.

Table 3 presents bound testing results which shows that the value of F-statistics is higher than lower and upper bound critical values and validate the long run co-integration among selected variables in equation.

Table 3: Bound Testing Results

F-Statistics	Lag Length	Significant level	Bound Critical Values	
			Lower Bound	Upper Bound
6.971	2	10 %	2.26	3.35
		5%	2.62	3.79
		2.5%	2.96	4.18
		1%	3.41	4.68

Table 4 presents the short run outcomes of good governance indicators on FDI by applying ARDL model.

Table 4. Short run Equation Outcomes				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
D(CC)	-0.026990	0.027023	-0.998764	0.3744
D (CC (-1))	0.074544	0.037073	2.010732	0.1147
D(GE)	-0.084383	0.038333	-2.201285	0.0925
D (GE (-1))	-0.136752	0.061899	-2.209279	0.0917
D(PS)	-0.257891	0.066956	-3.851638	0.0183
D (PS (-1))	-0.177834	0.078200	-2.274091	0.0853
D(RL)	0.049147	0.043581	1.127720	0.3225
D(RQ)	0.218714	0.052153	4.193710	0.0138
D (RQ (-1))	-0.072239	0.050325	-1.435449	0.2245
CointEq(-1)	-1.928339	0.386149	-4.993772	0.0075
Cointeq = FDI - (-0.0132*CC + 0.0907*GE -0.0429*PS -0.0024*RL + 0.1480*RQ -5.2473)				

The significant and negative value of error correction term i.e. 92% explains the speed of adjustment over the long run period. Result shows that in short run, Political Instability (PS) has significantly negative impact on the FDI inflows. These outcomes are similar with earlier researches like Mengistu and Adhikary (2011) and Wang and Swain (1997). Result also shows that the in short run, Regulatory Quality (RQ) significantly and positive affect the FDI inflows in Pakistan. This result also similar with earlier presented research studies like King and Levine (1993), Brewer (1993), Biglaiser, G. & Staats, J., (2010) and Dilek Temiz, (2014). Whereas, also in short run Government Effectiveness (GE), Rule of Law (RL) and Corruption (CC) found insignificant impact on the inflow of FDI in Pakistan, these outcomes also analogous with preceding researches like Pravin Jadhav (2012).

Table 5 presents long run findings. Results show evidence of significantly positive impact of GE and RQ in long run. This indicative that in long period Government Effectiveness (GE) and Regulatory Quality (RQ) exert positive impact of FDI inflows. These outcomes are similar with earlier researches like Mengistu and Adhikary (2011) and Kaufmann (2005). In addition, these results also follow the theory of ‘institutions’ presented by North (1990). On other side, Corruption (CC), Political

Instability (PS) and Rule of Law (RL) exert insignificant impact on FDI inflows in Pakistan during reported period. These outcomes are consistent with previous studies like Pravin Jadhav (2012).

Table 5. Long Run Equation Results

Variable	Coefficient	Std. Error	t-Statistic	Prob.
CC	-0.013208	0.014837	-0.890262	0.4236
GE	0.090739	0.013374	6.784956	0.0025
PS	-0.042890	0.018380	-2.333485	0.0799
RL	-0.002425	0.031762	-0.076341	0.9428
RQ	0.148006	0.017502	8.456576	0.0011
C	-5.247321	1.105136	-4.748122	0.0090

In table 6, value of R2 (i.e. 0.98) indicates good model while, the value of F-statistics shows that equation is significant. Insignificant value of LM test shows no autocorrelation.

Table 6. ARDL Long Run Model

Statistical Measures	Results
R-Square	0.985
Adjusted R^2	0.928
F-Statistics	17.447(0.006)
Breusch-Godfrey Serial Correlation LM-	9.131711 (0.0987)
Heteroskedasticity Test Breusch-Pagan-	2.643869 (0.1793)
DW –Statistics	2.9
J.B test	0.4666(0.792)

Cumulative Sum (CUSUM) and Cumulative Sum (CUSUM) of square test on residuals of the model used to confirm the reliability of the ARDL model. Figure 2 shows that the critical values lie down less than 5% of significance of CUSUM test. Furthermore, figure 3 shows that CUSUM square also lies under 5 % of significance & reveals that model is fit.

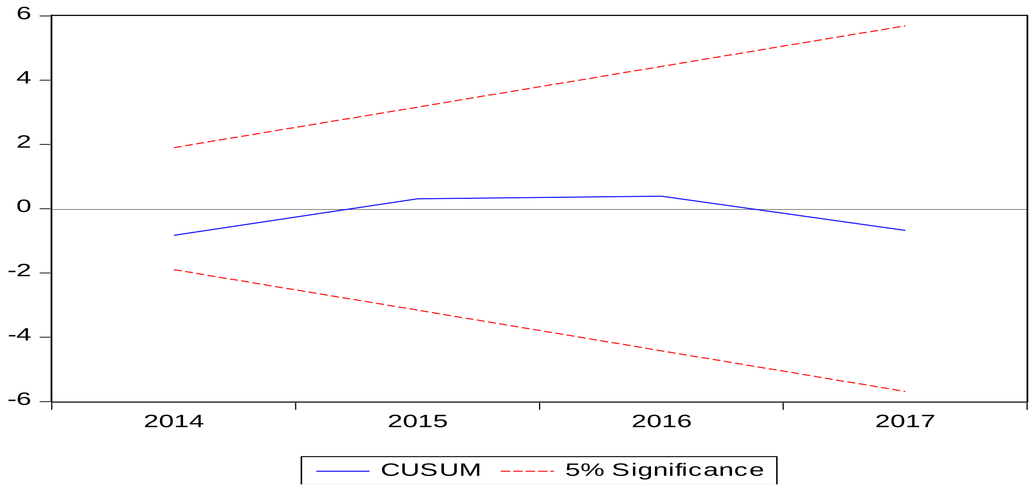

Figure 2. Cumulative Sum of Recursive Residuals

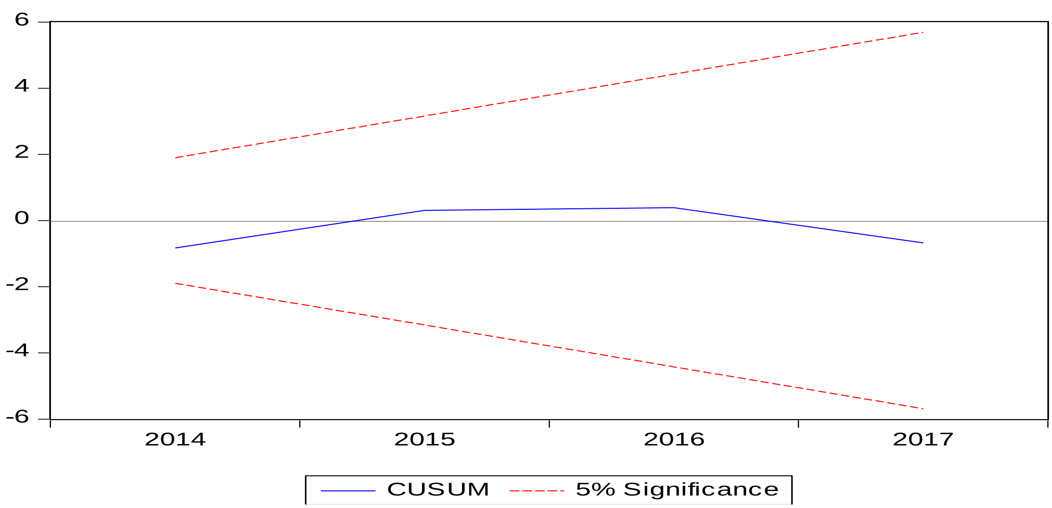

Figure 3. Cumulative Sum of Squares of Recursive Residuals

5. CONCLUSION

During last decades FDI inflows in Pakistan has not been encouraging. Keeping in view the worth of FDI inflows for economic progress, this research examine the impact of Good Governance on the inflow of FDI in Pakistan for the period 1996 to 2017.Therefore, good governance indicators selected as independent variables and FDI (i.e. in percentage of GDP growth rate) selected as dependent variable. ARDL was applied for estimating long run and short run association between FDI inflows and good governance. The result shows that in both long run and short run regulatory quality (RQ) significantly and positive affect FDI whereas; Government Effectiveness (GE) in long run exerts significantly positive effect on FDI. The significant impact of RQ and GE highlights the importance of government role to attract the FDI. The significantly negative impact of political instability (PS) in short runs shows that the overseas financiers are interested to do their business in politically stable state. Whereas, in short as well as in long run corruption and rule of law exerts insignificant impact on FDI. To sum up, it is sated that the countries having good governance system will be able to enlarge FDI inflow as compare to economies that have low quality of governance. More importantly, creating more favorable environment for private sector along with policies formulation for encouraging private sector and the level of government's commitment to ensure proper implementation of such policies are the major tools for attracting long-term foreign investment. On the bases of study outcomes to increase the FDI inflows in Pakistan various policy implications can be drawn. It is suggested that policy makers must adopt proper strategies for promoting effective governance environments in Pakistan. Government should have to give proper attention to develop better law & order situation. In addition, government also must ensure the availability & better quality of public and civil services. Policy makers should have to develop more effective policies to promote private sector and to ensure policy implementation and, to build a free and fair legal structure, which are currently important for getting FDI.

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