ASSESSING THE ROLE OF GOVERNANCE INDICATORS ON FOREIGN DIRECT INVESTMENT: INSIGHTS FROM SOUTHEASTERN EUROPEAN COUNTRIES

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OPEN ACCESS

How to cite this paper: Sadriu, M., & Balaj, D. (2024). Assessing the role of governance indicators on foreign direct investment: Insights from Southeastern European countries [Special issue]. *Journal of Governance & Regulation, 13*(4), 316–321. https://doi.org/10.22495/jgrv13i4siart10

ISSN Print: 2220-9352
ISSN Online: 2306-6784

Received: 22.03.2024
Accepted: 16.12.2024

JEL Classification: D63, F02, F21, F43, F64
DOI: 10.22495/jgrv13i4siart10

Abstract

The purpose of this research is to highlight the way that governance indicators impact foreign direct investment (FDI) as a proportion of a nation's gross domestic product (GDP). Using data gathered from the World Bank, the authors in this research performed multiple regression for 13 Southeastern European nations using the pooled ordinary least squares (POLS) approach in order to assess the impact. According to the paper's main findings, net FDI is significantly positively impacted by government effectiveness (GE), and the political stability and absence of violence/terrorism (PSAV), while on the other hand, net FDI is significantly negatively impacted by the rule of law (RL). The other governance indicators regulatory quality (RQ), control of corruption (CC) and voice and accountability (VA), did not significantly affect FDI attraction for the Southeastern countries. The importance of this research is mostly focused on the role of FDIs in the economic growth and development of a country (Bajçinca et al., 2024), rationally reflecting the national levels of governance. Also, this paper will contribute to enriching the existing literature related to the research topic.

Keywords: Foreign Direct Investments, Governance Indicators, Southeastern European Countries

Authors' individual contribution: Conceptualization — M.S. and D.B.; Methodology — M.S. and D.B.; Investigation — M.S.; Writing — Original Draft —M.S.; Writing — Review & Editing — M.S. and D.B.; Visualization — M.S.

Declaration of conflicting interests: The Authors declare that there is no conflict of interest.

1. INTRODUCTION

Foreign direct investment (FDI), also described as cross-national investments, occurs when a foreign investor gains a significant amount of control and a long-term stake in a business that is headquartered in another nation, also being an important component of global economic integration, playing its role as an essential conduit for technology transfer between nations and in the meantime contributing to economic development (Organization for Economic Cooperation and Development [OECD], 2023). FDI at the global level declined by 12% in 2022 to $1.3 trillion after a sharp drop in 2020 and a robust recovery in 2021. The global crisis, which includes the conflict in Ukraine, inflation regarding food and energy, and debt pressure, is what caused the slowdown. In 2023, the environment is estimated to still be difficult for cross-border business and investment.

The economic headwinds that will influence investment trends in 2022 have partially abated, but they are still present. Geographical tensions, however high, and investor concerns have increased as a result of recent financial sector turbulence (United Nations Conference on Trade and Development [UNCTAD], 2023).

Western Balkan countries were included in a study by (Minović et al, 2020), investigating the relationship between FDI and institutional quality measures for the period 2002–2017. Results showed that between political stability, control of corruption (CC) and rule of law (RL), and inflow of FDI, a bidirectional relationship has been found, suggesting that improved institutional controls result in a rise in FDI inflow.

The impact of governance determinants on FDI was analyzed by Singh and Kapuria (2022), together with economic, environmental, and social determinants, indicating that CC, electricity consumption, and political stability influence FDI favourably. Also, Kayani and Ganic (2021) estimated the relationship between governance indicators and the flow of FDI in China, applying different regression techniques, including bivariate and multivariate regression, Prais-Winsten and Driscoll-Kraay regression, and the two-step generalized methods of moments (GMM). The authors concluded that CC, RL, and regulatory quality (RQ) have a significant positive impact on the inward flow of FDI.

This paper aims to analyze the impact that governance indicators have on FDI in Southeast European economies. Hence, thirteen countries have been chosen to be analyzed in this study: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Greece, Kosovo, Moldova, Montenegro, North Macedonia, Romania, Serbia, Slovenia, and Türkiye. Knowing that FDIs are being impacted by a variety of factors directly representing the governing structure of a country, the focus of those factors will be on the following areas: CC, government effectiveness (GE), political stability and absence of violence/terrorism (PSAV), RQ, RL, and voice and accountability (VA), seeking to understand how these factors would impact net FDI divided by gross domestic product (GDP). The basic notion here is that countries with a higher score on governance indicators should be more attractive to foreign investments since they can reflect the expectations of investors regarding the governance of the country where they are expected to invest, taking into consideration that investors will observe the economy in which they are going to invest in order to have a full picture of the environment they are investing in. All this with a particular aim, to avoid any unexpected negative events that can occur after investments and to have the maximum return from their investments.

This paper aims to answer the following research questions:

RQ1: What is the impact of governance indicators on foreign direct investment inflows for Southeastern European countries?

RQ2: How do the governance indicators impact foreign direct investment inflows for Southeastern European countries?

RQ3: How do the other indicators including inflation, GDP per capita and population impact foreign direct investment inflows?

Our paper presents several contributions, starting from enriching the existing literature related to the topic to the practical application, which will contribute to informing policymakers about the critical relationship between governance quality and FDI inflows. Consequently, by understanding this linkage, governments may devise focused strategies to draw in and keep foreign capital through implementing reforms, strengthening institutions, improving regulatory frameworks, and fighting corruption in order to maximize attractiveness to international investors, promote economic expansion, and accomplish long-term development goals.

The structure of this paper is as follows. Section 2 reviews the relevant literature. Section 3 analyzes the methodology that has been used to conduct the research on the impact of governance indicators on FDI inflows, including the table of variables. Section 4 describes the results and Section 5 discusses them. The last Section 6 presents a summary of the main results and conclusions.

2. LITERATURE REVIEW

Various authors have examined the governance indicators for various nations in attracting FDI. A selection of these authors' works are as follows below.

Fakiri and Cherkaoui (2022) analyzed the relationship between FDI and institutional quality, consisting of governance indicators, using the GMM. Findings showed that the index of worldwide governance indicators (WGI) is a strong predictor of FDI inflows in high-income countries, while the opposite was found for upper-middle-income countries. A study analyzing the impact of political governance, which contains six WGI, on FDI inflow, separately for groups of countries based on income level, was published by Bouchoucha (2022). The results showed that overall governance indicators entice FDI inflows in African sub-regions. A positive correlation, concluding that better institutions will result in higher FDI inflows, was also found by Kurul (2017) and Biro et al. (2019).

Siriopoulos et al. (2021) their study included countries of the Gulf Cooperation Council (GCC), finding that measures of governance related to norms, laws, and corruption had a greater impact in determining FDI. Using ordinary least squares (OLS) regression, Peres et al. (2018) concluded that institutional quality positively and significantly impacts FDI. in developed countries. Also, Zander (2021) and Nguyen et al. (2021) found that CC has a positive correlation with FDI inflows, mentioning that in the second paper, a positive correlation was found in the target countries, while for the origin countries, CC showed a negative correlation with FDI inflows. The same results that the CC improves FDI inflows were obtained for the Turkish economy by Tosun et al. (2014) analyzing the period 1992–2010. In their article, Ponce et al. (2020), confirmed the relationship between Chinese FDI and three governance indicators for Latin American countries.

Saha et al. (2022) examined how institutional quality affected the flow of FDI into lower-middle-income nations by using a panel data collection of 28 lower-middle-income nations spread over six different regions between 2002 and 2018 in order to achieve this purpose. The analysis was conducted by

utilizing the two-step approach of GMM (dynamic panel estimation). The empirical results indicate that in lower-middle income nations, high RL, voice, and accountability reduce FDI inflow, whereas RQ and CC improve it. Conversely, political stability and the efficiency of the government do not have any noteworthy effect on FDI. Ozekhome (2022) in their study used the GMM estimation approach, the fully modified (FMOLS) and dynamic ordinary least squares (DOLS) for robustness tests to analyze the impact of political, institutional, and governance variables on FDI inflows in the country of Nigeria during the period 1970–2020. The study's findings in particular highlighted Nigeria's inadequate institutional framework, bad macroeconomic environment, and poor governance, all of which tend to limit inflows of FDI. As evidence for this conclusion, we can rely on low and statistically significant coefficients for RQ, GE, RL, CC, and macroeconomic instability, whereas political stability and exchange rate showed positive relations to FDI, although there is no significance to those effects. Also, GMM was used by Matima and Gossel (2022) to conclude that FDI is attracted to improved institutional quality in 20 African countries, and by Aziz (2020) to conclude that the quality of institutions is important in absorbing FDI inflows. The same positive relationship for 42 G20 countries was also concluded by Chen and Jiang (2022). On the contrary (Jurčić et al., 2020), by using OLS regression, it was demonstrated that quality variables PS, GE, RL, and CC could not be identified as significant factors influencing FDI intake in Croatia over the period from 1996 to 2017. (Samimi et al., 2011) by applying a panel data regression analysis to a sample of 16 Organization of Islamic Conference (OIC) countries, including the period 2002–2009, the authors concluded that population, openness, and GDP showed a positive impact on FDI, while in OIC nations, political stability has a negative impact on FDI. The opposite results regarding the impact were obtained by Zhang and Liu (2021) showing that the RL has positive effects on FDI and concluding that countries aiming to attract more FDI into their countries need to enhance the overall level of the RL.

Also, according to Kurul and Yalta (2017), three government indicators have shown a significant positive impact on FDI flows in those countries.

In their respective papers, Staats and Biglaiser (2012) and Zangina and Hassan (2020) found that the RL has an impact on or is linked to FDI inflow for Latin countries and also for Social Security Administration (SSA) countries. Rashid et al. (2017) and Rauf et al. (2016) concluded that FDI inflow ispositively related to political stability and trade openness, while Hafilah and Ahmad (2022) found that partial political stability showed a significant positive effect on FDI for a sample of five Asian countries over the period 2010–2019. Kurecic and Kokotovic (2017) found that the impact of political stability on FDI is different based on the size and development level of economies, concluding that political stability is important to FDI only for the smallest economies. On the contrary, Bailey's (2017) results showed that in developed countries, the relationship between political stability and FDI is much stronger compared to other countries. Sabir et al. (2019) concluded that for developing countries, only CC, GE, and political stability show a significantly positive impact on FDI inflow. Countries with a higher level of political rights have higher FDI outflows, while countries that attract more FDI inflow are characterized by a higher level of corruption and a lower level, according to Kim (2010).

3. RESEARCH METHODOLOGY

In this paper, the authors used a deductive approach, starting with collecting data in order to draw conclusions regarding the topic that has been studied. The study was conducted using annual and secondary data for 13 Southeastern European countries, including the period starting from 2008 to 2022, aiming to explain the relationship that the independent variables included in this paper have on *FDI* inflow. Data used in this study were obtained from the World Bank (metadata), more specifically from the World Development Indicators (WDI) database. In order to analyze the relation between independent variables on *FDI*s, the authors used pooled ordinary least squares (POLS), taking into consideration that in this study, the data used are panel data. In Table 1, the list of dependent and independent variables is presented, and attached is information regarding every variable, including its type, definition, and source. The type is included since in this study three instrumental variables are used, of which two are expressed in natural logarithms, in accordance with the goal of obtaining the most accurate results. Aside from the model that was used in this research, taking into consideration other researchers related to this topic, other alternative methods would be suitable for the research, including the fixed effect model, or the two-step generalized method of moments (GMM) model.

Based on the variables used for this study, the regression equation that will be used in our study is presented below.

Table 1. Variables and their source

Variable	*ID*	*Type*	*Source*
Foreign direct investment, net inflows	*FDI*	Dependent	WDI (World Bank) metadata
Control of corruption	*CC*	Independent	
Government effectiveness	*GE*	Independent	
Political stability and absence of violence/terrorism	*PSAV*	Independent	
Regulatory quality	*RQ*	Independent	
Rule of law	*RL*	Independent	
Voice and accountability	*VA*	Independent	
Inflation	*INF*	Instrumental	
GDP per capita (Ln)	*GDPC*	Instrumental	
Population (Ln)	*POP*	Instrumental	

Source: Authors' elaboration.

$$FDI_{it} = \beta_0 + \beta_1 CC_{it} + \beta_2 GE_{it} + \beta_3 PSAV_{it} + \beta_4 RQ_{it} + \beta_5 RL_{it} + \beta_6 VA_{it} + \beta_7 INF_{it} + \beta_8 GDPC_{it} + \beta_9 POP_i + \mu_{it} \quad (1)$$

where, μ_{it} represents the error over the given period.

4. RESULTS AND FINDINGS

The authors in this paper used the POLS method to perform multiple regression analysis, including variables mentioned in the previous sections.

Table 2 displays the model summary results from regression analysis, which was conducted to determine the relationship between *FDI* and the independent variables (*CC, GE, PSAV, RQ, RL, VA, INF, GDPC*, and *POP*), using 182 observations, including 13 cross-sectional units with a time series length of 14.

Table 2. Model summary

Variable	*Coefficient*	*Std. error*	*t-ratio*	*p-value*
Constant	19.5773	8.8259	2.2180	0.0279**
RQ	0.0018	1.3941	0.0013	0.9990
RL	-4.4780	1.9953	-2.2440	0.0261**
GE	3.1064	1.2973	2.3940	0.0177**
PSAV	1.9053	0.8424	2.2620	0.0250**
VA	-1.7538	1.4063	-1.2470	0.2141
CC	-2.5233	1.8632	-1.3540	0.1774
INF	0.0575	0.0439	1.3100	0.1919
GDPC	1.1401	1.0740	1.0620	0.2899
POP	-1.6930	0.3196	-5.2980	< 0.0001***
Mean dependent var.	4.4058	S.D. dependent var	4.1195	
Sum squared resid.	1.950.9300	S.E. of regression	3.3679	
R-squared	0.3649	Adjusted R-squared	0.3316	
F (9.172)	10.9787	P-value (F)	0.0000	
Log-likelihood	-474.1038	Akaike criterion	968.2076	
Schwarz criterion	1.000.2480	Hannan-Quinn	981.1962	
Rho	0.4524	Durbin-Watson	0.6337	

*Note: ** Statistically significant at 95% level of significance. *** Statistically significant at 99% level of significance.*
Source: Authors' elaboration.

Based on the model summary table, the R-squared result shows that only 36.49% of the variation of *FDI* net inflow (percent of GDP) can be explained by the independent variables, also meaning that the R-value, or as it is known, correlation coefficient, stands at level 0.604, showing that the relation between the dependent variable, in our case, *FDI*, and the other eight independent variables is a positive relationship of 60.4%, indicating that there exists a moderately strong relationship and that the variability observed can be explained by linear regression. Results related to analysis of variance (ANOVA) show that independent variables (*CC, GE, PSAV, RQ, RL, VA, INF, GDPC*, and *POP*) have a significant impact on *FDI* F (9.172) = 10.98, based on the model's significance level of p-value = 0.00 < 0.01, indicating that the model is suitable for the development of the mentioned relationship.

The regression analysis coefficient shows us the impact of every independent variable on *FDI*s through the POLS model. Results show that four independent variables have a significant impact on *FDI*, of which three are part of governance indicators and the fourth is population, as an instrumental variable. This means that half of the governance indicators significantly impact *FDI* in Southeastern European countries, which indicates that the other three indicators didn't show any significant impact, while regarding the instrumental variables, *INF* and *GDPC* didn't show any significant impact.

5. DISCUSSION

Referring to the regression results, it can be seen that at a confidence level of 95%, *CC* and *VA* have a negative impact reflected by a negative coefficient, but with a non-significant impact since the p-value for *CC* is 0.18 and for *VA* is 0.21, in both cases higher than the significance level (p-value = 0.18 > 0.05, p-value = 0.21 > 0.05). On the contrary, *RQ* has an almost inexistent positive impact, with a very high p-value (0.99 > 0.05) representing the most insignificant variable included in this study. If we go back to the equation, the results validate that if *CC* increases by one unit, *FDI* Inflow will decrease by 2.52 units, while for *VA*, the decrease will be limited to 1.76 units. Meanwhile, for every unit of *RQ* that is increased, *FDI* inflow will increase by only 0.002 units, almost a negligible impact. There are other authors whose results show a non-significant impact on *FDI*, like Fakiri and Cherkaoui (2022), where WGI were not a noteworthy predictor of *FDI* inflows in upper-middle-income countries. While the three above-mentioned variables don't have a significant impact, the other three variables have a significant impact on *FDI*. *GE* with a p-value less than the significance level (p-value = 0.02 < 0.05) means that, based on our evidence, this variable impacts significantly and positively the *FDI*, where for every increase of the *GE* by one unit, the *FDI* will increase by 3.11 units. Similar results were found in Ponce et al. (2020) and Bouchoucha (2022), confirming that in order to increase *FDI* inflow, governance should improve. *RL*'s p-value = 0.03 < 0.05 and the negative coefficient show a significant negative impact on *FDI*, meaning that for every unit that *RL* increases, *FDI* will decrease by 4.48 units.

As with *GE*, also the *PSAV* have a significant impact on *FDI* at a 95% level of confidence, with a p-value lower than the significance level (p-value = 0.02 < 0.05). Further, regression results show us that for every unit that *PSAV* will increase, *FDI* will increase by 1.90 units, thus showing a positive relationship. Results showing a positive impact of *PSAV* on *FDI* were found by Bouchoucha (2022), Rauf et al. (2016), Rashid et al. (2017), and similar conclusions were also found by Sabir et al. (2019), a study concluding a significantly positive

impact of *CC*, *GE*, and *PSAV* on *FDI* in developing countries, while *GDPC* and *INF* showed negative impact. The same results as in this paper, regarding the impact of *GDPC* on *FDI* were found by Alshamsi et al. (2015), finding that *GDPC* had a significant positive relationship with *FDI*.

6. CONCLUSION

Based on the results of our study, the main governance indicators that have a significantly positive relationship regarding the attraction of net FDI as a percentage of GDP in 13 South European countries for the period starting from 2009 to 2022 are GE, and PSAV, while only the RL showed a significant negative impact on FDI, whereas other variables showed no significant impact on FDI. Regarding the instrumental variables, only population has a significant impact on attracting FDI, with a negative sign, meaning that an increasing population of the countries will correlate with a decrease in FDI as a percentage of GDP, while two other instrumental variables, GDP per capita and inflation, have an insignificant impact on FDI. In terms of FDI net inflows as a percentage of GDP, it is noted that the 2008 post-financial crisis period had a negative impact, lowering this percentage in average terms for 13 countries from 6.77 in 2009 to 4.68 in 2010, also continuing to decrease until 2014, when the recovery of FDI started, marking an upward trend until the end of the study period. At the country level, Bulgaria, Montenegro, and Greece had the worst decline, whereas, for the two first countries, recovery wasn't very successful, while Greece had a very upward trend until 2022. In total, including all countries, even though the upward trend has continued in recent years, there is still a way to catch up to the level of FDI net inflows as a percentage of GDP in 2009.

The importance of this paper for future research, apart from the several contributions that were mentioned in the second section, starting from enriching the existing literature to the governance impacting strengthening institutions, is that it can be used to perform a comparative analysis between regions regarding the factors impacting FDI inflow, also taking into consideration that some of the countries included in this paper are emerging economies, it can be useful for comparative analysis between groups based on economic development.

However, the present study has certain limitations as it does not include the impact of ease doing business indicators, which by including them in the model, would create a wider set of impactable variables on FDIs. Therefore, future research should address this by incorporating variables related to ease of doing business.

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