

Economic growth, foreign direct investment and governance oscillation: Empirical evidence from SAARC economies (1996-2015)

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Abstract. Foreign direct investment (FDI) considered as one of the conventional determinant of Economic growth. Economies that are pursuing for better tomorrow must focus on attracting foreign direct Investments. FDI depends on a number of factors in a country such as market size, level of openness, natural resources, labor cost and productivity, economic growth rate, macroeconomic stability, technology level and so on. Beside these factors, Governance in the recipient economy is also an important pre-determinant of FDI. This study seeks to investigate the impact of FDI (inflows) on Economic growth via Governance through empirical evidence from SAARC economies by using Panel data technique. The data is cross-sectional time series for the period 1996-2015. GDP per capita growth has been used as a variable to assess Economic growth; foreign direct Investment (inflows) and governance data has obtained from World Bank, World Development Indicators. The results indicate that governance does not exert their impact on FDI (inflows) and fails to act as a mediating factor of FDI (inflows) in case of SAARC economies However the SAARC economies should focus on improving level of institutions for catalyzing domestic financial markets.

Keywords. Foreign direct investment (inflows), Governance, Economic growth, Human capital, Gross capital formation.

JEL. F21.

1. Introduction

In any economy foreign direct investment (FDI) is a quintessential measure to evaluate the level of direct investment by foreign investors. It also indicate the inclination of potential investors towards most desirable economies. The higher the FDI index, the more it reflects enticing domain for foreign investment. This study circumscribed by SAARC economies. SAARC consists of 28% of world population including eight developing economies such as Afghanistan, Bangladesh, Bhutan, India Maldives, Nepal, Pakistan and Sri Lanka. These economies are thriving for better tomorrow and for attaining this goal, SAARC should focus on

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improving growth enhancing components particularly foreign direct investment (FDI).

FDI is used as one of the conventional determinant of the economic growth of countries. There is a colossal amount of literature on the contribution of FDI to economic growth. Notwithstanding the evidence found ambiguity in relationship between FDI and economic growth. Some authors emphasize that there is a positive effect of FDI on economic growth on the contrary many authors understate that there is a negative relationship or no effect of FDI on economic growth at all. This debate has come forth an issue to focus on the channels through which FDI may help to raise economic growth in recipient economies. Therefore it is important to assess the factors affecting FDI, as countries can base their economic policies to raise FDI and hence foster economic growth.

FDI depends on a number of factors in a country such as market size, level of openness, natural resources, labor cost and productivity, economic growth rate, macroeconomic stability technology level and so on. Beside these factors Governance in the recipient economy is also an important pre-determinant of FDI. This research study argues that the strong institutions of the recipient country are the important preconditions for FDI to exert their impact on economic growth. This study particularly revolves around the debate that “Do economies accelerate high Economic growth that depends and focus on improving level of Governance needed for attaining foreign direct investment”? The core objectives of this study is to investigate the impact of FDI on Economic growth via Governance and to highlight the importance of institutions towards the absorption of FDI inflows. The paramount importance of this study is to identify the impact of FDI inflows in host economy and the current situation of Governance in concerned economies and their joint impact on economic growth of these economies.

The foreign direct investment policies and trends in SAARC economies varies from one country to another. Figure 1 depicts FDI inflows in SAARC region from the period 1996-2015. The FDI inflows as percentage of GDP is lowest in all SAARC economies including Sri Lanka, Pakistan, India, Bangladesh, Bhutan and Nepal. However Maldives show upward trend among all SAARC economies in the year 2010 and 2011.

FDI INFLOWS AS % OF GDP

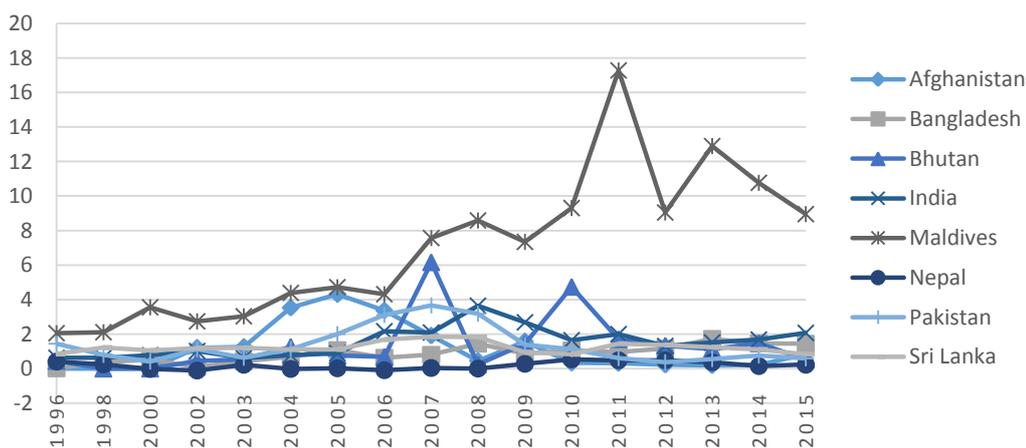


Figure 1. FDI inflows as percentage of GDP

Source: World development Indicators [Retrieved from] accessed September 24, 2017.

Maldives is the smallest South Asian island country, lies southwest of India and Sri Lanka, known for its beaches, blue lagoons and immense natural coral reefs. The beauty of this island country drag most of the investors in investing in tourism

sector. Maldives has a flexible and free economic environment, although investor encountered weak and fragile property rights. Historically low FDI inflow observed in Maldives but in 2016 the FDI inflow upswing by 45% as compared to the previous year, reached USD 449 million. Currently the FDI stock at USD 3.2 billion. In 2017 Doing Business report published by World Bank, ranking 135th out of 190 countries, the ranking of Maldives fall down due to political instability in 2012. India engaged with Maldives and pool investment in Telecommunication and Transportation sectors. Maldives and Pakistan desiderate bilateral trade between the two countries to strengthen relation between SAARC countries. Likewise other island nation Maldives also facing global warming and Pakistan seeks to help them as well as in resolving global environmental issues.

As stated by UNCTAD (2016) total inflows to South Asia increased by about 22% to \$50 billion due to upswing of flows to India. India became the tenth largest recipient of foreign direct investment in the world and the fourth largest in developing Asia with inflows reaching \$44 billion. India shares land border with Pakistan to the west, China, Nepal and Bhutan to the northeast and Bangladesh to the east. In the Indian Ocean, India is in the close proximity to Sri Lanka and Maldives. The world Investment Report published by UNCTAD in 2016 declared India as enticing domain for attracting FDI in South Asia and within three consecutive years India secured 10th position in Asia over all. In 2016 India acquire USD 46.4 billion to the economy and amplify FDI inflows by 18%. India also ranked 130th out of 190 states in Doing Business report World Bank, (2016) Services including banking and finance, IT, healthcare, education, trade, automobiles, defence, aviation, infrastructure, retail, energy, petroleum and natural gas, media and broadcasting are dominant sectors of India. The FDI inflows prohibited in following sectors, real estate business, e-commerce, manufacturing of tobacco or of tobacco substitutes, cigars and cigarettes. The prominent investors of state are Singapore, United States, Japan, Mauritius, Netherland and United Kingdom. In 2012 Doing Business in SAARC rank India fourth among Afghanistan, Pakistan, Bangladesh and Sri Lanka. The reason of dropping interest of investor in state was mainly by political immobility, the stigma of corruption and debt catastrophe in Eurozone. Although in order to attract FDI Indian officials offers tax and non-tax investment incentives in particular sectors such as electronics. Recently officials reboot FDI strategy and allow investors to invest either through “government route” supervised by foreign investment promotion board (FIPB) or by “automatic route” without prior approval either of the government or Reserve bank.

FDI in labor intensive manufacturing, inflows to Bangladesh reached to historically high level jumped by 44% to 2.2 billion. Due to availability of cheap labor and raw material many advanced Asian economies outsourced their manufacturing plants in Bangladesh. In the last decade many domestic investors of Pakistan outsourced their manufacturing plants mainly textiles, due to power shortage supply and extortion. In year 2015 FDI increases 47% added up to USD 1.7 billion in oil, gas energy and manufacturing sector and trade. Bangladesh secure third position in Doing Business in South Asia in year 2012.

Though Bangladesh is plenteous in natural resources and human resources, the country badly trapped in vicious circle of poverty, unpredictable socio-political dilemma and destroying natural catastrophe. Bangladesh possess the advantage of being situated in a strategic geographic location amongst South East and South Asia and shares its border with India on all three sides and near to the Nepal and Bhutan. Bangladesh board of investment (BOI) striving for accelerating foreign investment inflows to the economy predominantly in the areas of infrastructure and energy. The main investor are South Korea, Egypt, China, India, Malaysia and United Arab Emirates although the investors encounter rigid and less privileged FDI policies than domestic investor.

In contrast inflows to Pakistan and Sri Lanka declined to 865 million and 681 million respectively. Pakistan has unique geo strategic importance in South Asia,

bordered by China in the North East and by India to the East. The two superpowers of Asia and member of BRICS (Association of 5 Emerging Economies) while Afghanistan borders the country to the West and Iran to the South West and also blessed with biggest coastal areas of the Arabian Sea in the South. No doubt the country is rich in natural resources and human resources but unfortunately bound with unfavorable circumstances such as terrorism, lack of security, poor condition of rules and laws relating to property and intellectual assets, arbitrary management and regulations, political instability, weak state of infrastructure and last but not the least corruption that sabotage economy more than terrorism commonly referred as Economic terrorism. These all factors hinder in attracting FDI in Pakistan. Although during the period of 2015, as in 2014, FDI extended simply under USD 1 billion, with in the three sectors namely Oil, Gas and Energy.

Numerous equipment agreements and cooperation have been done in the Defence and Energy sectors with China. Pakistan's board of investment (BOI) encourages local and foreign investors to invest in services, social, infrastructure and agriculture sector, though limited FDI inflows to manufacturing sector only. The equal treatment to both local and foreign investors is the mandate of investment policy 2013. Pakistan firmly believe that FDI needed to achieve the following economic targets such as growth, employment, knowledge-based economy and for global competitiveness. Pakistan secured second position in Doing Business for South Asia region in year 2012 ([Investment Guide, 2013](#)).

Sri Lanka is an island country located southeast of the India and northeast of the Maldives. The country possess geostrategic position near to Southeast Asian economies including Singapore, Malaysia, Indonesia, Thailand and Vietnam top FDI host economies in 2015.

Telecommunication, tourism, electricity and textiles are the major sectors of Sri Lanka. In 2012 doing Business in SAARC Sri Lanka secured first position among five other SAARC countries including Afghanistan, India, Bangladesh and Pakistan.

The Board of Investment (BOI) announced total FDI inflow in state as USD 1391 million in different sectors including manufacturing, agriculture service and from infrastructure sector respectively. In 2013 the largest investor of Sri Lanka was China followed by Singapore and Hong Kong. The other prominent investors are Germany, Japan, Australia and India. Interestingly Sri Lanka propel fierce competition against India in telecommunication sector and with China in energy sector as well ([Annual Report, 2013](#)).

Sri Lanka secured 107th positioned out of 189 countries in Doing Business Report published by World Bank in 2016. Sri Lanka possess free trade agreements (FTA) with China, Pakistan and India and recently negotiating an Economic and Technology agreement (ETCA) with India. Although foreign investment prohibited in non-bank money lending, pawn-brokering, retail trade and coastal fishing. Foreign investors are not permitted from purchasing land and real estate, few sectors restricted foreign investment to 40% ownership include primary processing industries, deep-sea fishing, mass communication, education, travel services and shipping services.

In 2015 FDI inflows rose by 74% to \$51million in Nepal. Nepal bordering China in the north and India in the south, east and west, experienced the same geographical limitation problem as Bhutan as it is the landlocked country. Unfortunately Nepal failed to gain privileged from immediate vicinity to these two countries, the two super power of Asia, China and India due to unclear and ineffective FDI policies and lack of good governance, in ineffective management, inadequate promotion and absence of protection of investors, although as per World Investment Report ([UNCTAD, 2014](#)), 247 million dollars investment made by China and 2.2194 billion dollars investment by India in Nepal respectively. Investment board of Nepal (IBN) without interruption active in upgrading legal adequacy in FDI policies in Nepal and resolving issue of convertible currency and for tax concession in reinvestment of dividend because these are the major reasons

for reducing amount of FDI inflows. Investor also desire to prioritise manufacturing sectors over trading business, during fiscal year 2014 FDI flows increased by USD 200 million.

The earthquake of 2015 and the border dispute with India had adverse effect on FDI inflows for the reason that India is the major investor in Nepal. In 2016 Nepal officials disseminate renew Investment Guide, the Minister of Industry declared 2016 as “Year of FDI”, in the same year Doing Business report ranked Nepal 99th out of 189 economies ([Investment Guide, 2013](#)).

Geographical limitations erratically slow down the pace of enticing investors in any country. Unfortunately Bhutan victimize by the same situation, due to extremely hilly and landlocked region in South Asia, developing infrastructure is hugely expensive and problematic. As compared to other developing countries the contribution of FDI in the GDP is poor substantially. The low level of unskilled labor is another stumbling block in development. In 2016 Bhutan positioned 71st out of 189 countries in Doing Business report by World Bank.

Bhutan administration constrained foreign investment to specific zone in order to avoid conflicts with domestic investors. Although construction sector and air service management slightly successful in dragging little chunk of FDI in Asia while the manufacturing and farming sector barely attract FDI. Moreover Investors experienced controlled structure of FDI policies. In 2015 government officials relaxed FDI regulations and successful in appealing more foreign investors for investment in Bhutan. In order to continue interest of investors in country government keep working on improving territories trade, finance, work and industrial licensing. In 2015 a railroad project has been devised to connect Bhutan from Bengal by India.

FDI also plays pivotal role in speedy development of those economies where resources and domestic investments are limited. The gross domestic investment as a percentage of GDP in SAARC economies presented in figure 2. The trend line shows that Sri Lanka has highest gross domestic investment as percentage of GDP, followed by Pakistan, Nepal, India and Bhutan. The gross capital formation as percentage of GDP found low in Bangladesh and Afghanistan.

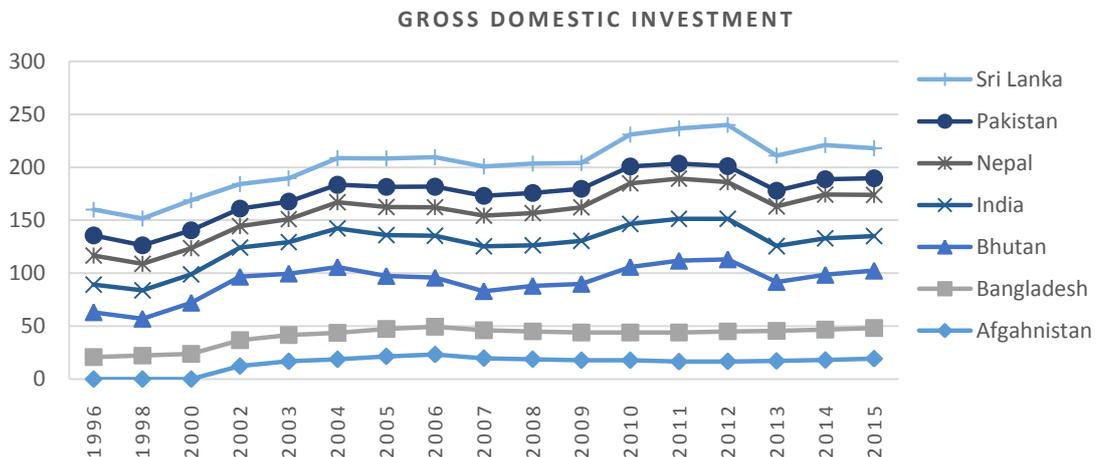


Figure 2. Gross domestic investment as percentage of GDP
 Source: World development Indicators [Retrieved from] accessed September 24, 2017.

The level of Governance in Afgahnistan is the lowest among all SAARC economies, follwed by Pakistan, Nepal and Bangladesh. The level of governance in India, Maldives and Sri Lanka is somewhat moderate and Bhutan remarkably shows better level of governance among all SAARC economies. The result shown as in figure 3

GOVERNANCE

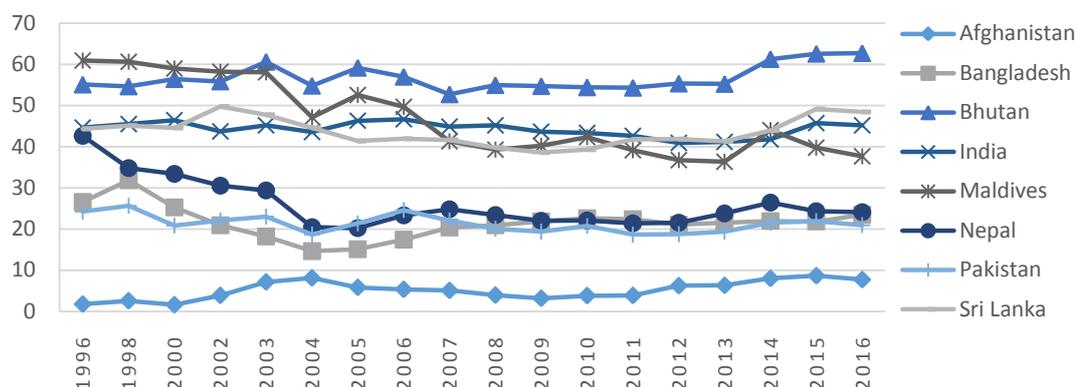


Figure 3. Governance percentile rank

Source (Compiled): World development Indicators [Retrieved from] accessed September 24, 2017.

The September eleven attack in United States in 2001 changed the whole scenario of Asian region. The invasion of US in Afghanistan and flagship “war against terrorism” immersed the whole region especially Pakistan. Afghanistan is a land locked country bordered by Pakistan in the South and China in the far North East. Afghanistan economy became more fragile after 2001. Investors were unwilling to invest in this state of affairs. Although the substantial inflow of FDI in country due to intervention of NATO (North Atlantic Treaty Organization) military and related development projects and FDI inflows increased by 25% in 2013.

Afghanistan ranked fifth in Doing Business in South Asia region in annual report presented by (World Bank, 2011). Afghanistan facing corruption as uncontrolled factor, unfledged financial markets, inadequate infrastructure and presence of unskilled and non-talented doer. Afghanistan joined hand with Turkmenistan and Tajikistan in 2013 for railroad projects. And for improving the underlying structure of railroad China eager to fully support the project in 2015 as well as for the development of a hydroelectric plant. Likewise China, India also took interest in investing in Afghanistan, put their resources into the mining sector and oil industry respectively. Not only this Afghanistan and Turkmenistan signed a pipeline project connecting the two countries to India and China. China emerged as regional investor in the Asia, China turned into Afghanistan’s biggest investor by 2014. It is estimated that Afghanistan will create USD 4 billion in income by 2024 through mining sector of country that will contribute to 42-45% of its GDP by 2024. In spite of the fact, that the security issues of the country are main obstacle in these future projects.

2. Literature review

A number of studies have been conducted in pursuance of erect theoretical and empirical foundation of the association between FDI, economic growth and governance. The affiliated literature stated as follows:

2.1. Governance, FDI and economic growth: Theoretical review

In order to establish a nexus between Governance, investment and economic growth, the Dunning’s eclectic paradigm and Douglas North’s approach of institutions help out in refining theoretical and conceptual underpinning (Ahmad & Ahmad, 2014). According to (North, 1990) institutions influence economic activities through transaction cost and production cost. Production cost usually associated with inefficient institutions that cause interruption in supply chain and excessive regulations and delays in getting permits. While transaction cost related

with cost of protecting and enforcing property rights and cost of uncertainties involved in economic exchange. Three preconditions a) ownership advantage b) locational advantage and c) internationalization advantage stated by (Dunning, 1994) in OLI paradigm in order to successfully engaged in international activity by any multinational enterprise (MNEs). Ownership advantage are asset specific, the ownership of intangible assets such as technology and managerial skills. The legal and institutional environment in the firm's host country may or can affect this advantage. Location specific advantage associated with economic benefit such as factors of production, size of market, telecommunication, trade cost related to transportation and artificial barriers to trade, political advantage such as legal and regulatory framework, economic system, government policies and social advantage such as cultural diversity, language, business ethics, infrastructure and education. Lastly internationalization advantage associated with negotiation and contract enforcement cost and can easily control supplies of input and the quality of intermediate and final products. Neumayer & Spess, (2005) advocates strong bond between institutions and FDI (inflows). They further proceed that immunity from political and other risks such as economical and legal risks leads to an increase in FDI.

2.2. Governance, FDI and economic growth: Empirical review

Most developing economies considered FDI as a prominent factor for economic growth. A vast past empirical literature have been explored defining the linear and causal relationship between FDI and economic growth. Zekarias (2016) study the effect of Foreign direct investment (FDI) on economic growth by using generalized method of movement (GMM) estimator by employing 34 years panel data for 14 eastern African economies have found significantly positive impact of Foreign direct investment (FDI) on economic growth. Gui-Diby (2014) examined panel data for fifty African economies for the period 1980 to 2009 by using GMM generalized method of moment for empirical estimation in order to investigate the impact of FDI on economic growth found the impact of FDI on economic growth positive and significant. Furthermore the researcher restricted model for the period 1980 to 1994 and from 1995 to 2009 to diagnose parameter stability found the negative impact of FDI on economic growth due to low level of human capital. Ray (2012) used OLS method in order to investigate the impact of FDI on economic growth in India for the period 1990 to 2011 established positive and significant impact of FDI on economic growth.

Azman-Saini *et al.*, (2010) estimated the impact of FDI on economic growth by using GMM method for panel data set of eighty five selected economies observed that FDI has no positive direct impact on economic growth, unless the absence of economic freedom perceived in any economy. The importance of open economy, industrialization, exports and FDI studied by Sun & Parikh (2001) found strong and positive association between exports and economic growth in developing economies. Yao (2006) identified the positive and significant impact of FDI and export on economic growth and proposed export promotion policies in twenty eight provinces of China by using panel root test of Pedroni's and dynamic panel estimation of Arellano and Bond's.

In order to explore the impact of foreign investment on economic growth Alfaro *et al.*, (2004) select different sector to quantify magnitude of investment, detect positive impact of foreign investment in manufacturing sector, negative impact of foreign investment in primary sector and ambivalent effects of foreign investment in service sector on economic growth.

De Mello (1999) By using fixed effect model, examined the impact of FDI on economic growth. The main motive of the study was to examine the degree of substitution and complementarity of FDI towards economic growth. De Mello (1997) empirically analyzes the effect of foreign direct investment on economic growth from time series and panel data of OECD and non-OECD countries in the

period 1970-1990. The study shows that FDI led growth in long run via technological upgrading and knowledge spillovers.

Balasubramanyam *et al.*, (1999) explored the role of FDI for the elevation of economic growth found that FDI and human resource are important precondition for economic growth. In addition the study explored the relationship between labor (human capital) and FDI highly significant and positively related to economic growth.

Chan *et al.*, (2014) examined causal relationship between FDI and economic growth by using Granger causality test found FDI stimulate growth both in long run and short run. Anwar & Nguyen, (2010) explore the bi directional relationship between FDI and economic growth in perspective of Vietnam. The study used simultaneous equation model for analyzing panel data set comprises for the period of 1996 to 2005. The study claimed that increase investment in human capital development and financial market leads to increase in level of FDI inflows in Vietnam. Moreover researcher found technology gap as the main hindrance in FDI inflows.

Kinoshita & Campos (2003) claimed that economic growth and FDI are causally associated through geological and natural resource advantage and by spillover effects, they encourages relief in taxes, privatization and liberalization as main factor for creating business opportunities and hence elevate FDI. They further emphasized on upgrading structural reforms that can lead to attract foreign investment.

Ahmad *et al.*, (2003) found positive and significant impact of FDI spillover effect on economic growth of Pakistan for the period 1972 to 2011. Furthermore study found long run causality between FDI export and economic growth. Liu *et al.*, (2002) found causal association between FDI inflows, trade and economic growth. They argued that more open economies exploit more FDI spillover benefits.

Zhang (2001) analyze the causal link between foreign direct investment and economic growth for eleven economies in East Asia and Latin America have found that impact of FDI on economic growth was country specific moreover FDI led growth in host economies that maintained macroeconomic stability, improved human capital condition and adopted liberalized trade policies. Choe (2003) ascertain the causal association between economic growth and foreign direct investment (FDI) and gross domestic investment (GDI) in eighty countries by using panel VAR model over the period 1971-1995. The result found bidirectional relationship between FDI and economic growth as economic growth led FDI more prominent than FDI led growth, and found unidirectional relationship between economic growth and GDI as economic growth led GDI.

Nair-Reichert & Weinhold (2001) in their econometric analysis of finding causal relationship between foreign direct investment (FDI) and economic growth of panel data of 24 developing economies over the period of 25 years from 1971 to 1995 by using mixed fixed and random (MFR) coefficient approach found heterogeneous relation between FDI and economic growth across counties.

Hsiao & Hsiao (2006) by using time series and panel data for eight developing east and southeast Asian countries including China Korea Taiwan Hong Kong Singapore Malaysia Thailand Philippines over the period 1986-2004 exert unidirectional relationship between foreign direct investment and GDP in panel analysis and different causal relation between FDI and GDP across countries in time series analysis.

Hansen & Rand (2005) studied causal relationship between foreign direct investment and growth of 31 developing economies including panel data of Asian, Latin America and African economies covering 31 years form 1970-2000 observed bidirectional relationship between FDI and GDP furthermore perceived strong long run impact of FDI on growth as compare to effect of growth on FDI.

Basu *et al.*, (2003) investigated causality between foreign direct investment and economic growth for the period 1978-1996 considering 23 developing economies

of Asia Latin America Africa and Eastern Europe revealed two way links between FDI and growth. Chakraborty & Basu (2002) examined bidirectional link between foreign direct investment and economic growth in India over the period 1975-1997 with the help of structural co integration model and vector error correction model (VECM).

Many economists and research analysts emphasize on the significance of the association between governance and economic growth. Governance has been deliberately used in economic growth regression by many researchers in their work. But recently a new paradigm shift towards the literature from the importance of Governance and its relationship with economic growth, researchers acknowledge the linkage between Governance and foreign investments both inflows and outflows. Governance emerges as a mediating factor for FDI spillover, and act as one of the factor of absorptive capacity. Reliable institutions in the host economy guarantees positive FDI spillover (Khordagui & Saleh, 2013). Various studies prove that good institutions are the key to unlock the jammed economic system trigger the investment and stimulate economic growth.

Shleifer & Vishny (1993) argued that inadequate governance and fragile legislation are biggest hurdle in economic growth and genesis of corruption that not only agitates economic progress but a prominent hindrance in attracting domestic and foreign investment as well. Similarly Gastanaga, Nugent, & Pashamova (1998) investigated the main obstacles that derail

FDI in the developing economies and they are ill law and order situation, bureaucratic constraint and corruption. Brunetti & Weder, (1998) and Campos, Lien & Pradhan (1999) explored that palm greasing phenomenon is one of the dominant factor that hinder the foreign investment.

To identify and quantify the magnitude of the effect of corruption and other institutional factors on economic growth Mauro (1995) conducted first systematic cross-country empirical analysis. He found a significant negative relationship between corruption and investment that decelerate the economic growth. He further concluded that bureaucratic efficiency and political stability play a pivotal role to increase investment. Bardhan (1997) advocated Mauro's research in 1995 and concluded that corruption has an adverse effect on efficiency and growth process. Gliberman & Shapiro (1999) proclaimed that effective institutions steamrolled the path for Multinational Companies and hence exert positive influence on FDI inflows.

Shao *et al.*, (2007) who asserted a quantitative relationship between Corruption, Investment and country's wealth found a negative correlation between corruption and foreign investment. Habib & Zurawicki (2002) who argued that technological advancement and level of corruption in host country impede foreign investment, due to high level of corruption in host country foreign investors found predilection towards joint ventures while due to inefficiency in technology many foreign investor are less inclined towards joint ventures. Treading on the heels of such researchers, Habib & Zurawicki (2002) and Stein & Daude (2001) suggested that corruption act a stumbling block for FDI inflows, and inward FDI rely on institutional factors, foreign investor hedge from those economies where corruption level is elevated using OLS regression model and PROBIT model for total 89 developed, developing and the transition economies taking corruption as independent variable while FDI inflows as dependent variable. Similarly Ahmad *et al.*, (2012) used panel data of 71 developed and developing countries, data extract from Political risk services' International country risk guide ICG and International monetary fund's International financial statistics year book for the year 1984-2009. Research finding proposes that Corruption hinders Foreign Direct Investment although it is not the only indicator for static economic growth.

Extending the studies, corruption can be ruinous at firm level also. In 2009 (Asiedu & Freeman, 2009) explored the impact of Corruption at firm and country level on Investment growth at firm level for the year 1995-1998, using World bank economic survey WBES conducted by World bank in 1999-2000. Percentage

growth in firm investment was selected as the dependent variable. The result generated negative and significant effect of corruption on investment growth and implies corruption as a prominent determinant of investment.

The sample of 63 to 71 countries between 1970 and 1998 were taken by Méon & Sekkat (2005) using regression model to test the hypothesis either corruption sand or grease the wheels through the impact of corruption on investment and growth on the basis of quality of governance using two Corruption indices published by Transparency International and World Bank, GDP per capita and Investment are taken as proxies for macroeconomic data and five governance indicators including voice and accountability, lack of political violence, government effectiveness, regulatory burden and rule of law. The results were consistent with other studies showing a negative effect of corruption on both growth and investment but striking part of result was that corruption had negative impact on growth independently from its impact on investment, accountability of leaders and regulatory framework had insignificant effect on growth, weak rule of law and an inefficient government and political violence tends to deteriorate the negative impact of corruption on investment. Similar results were generated by Méon & Sekkat (2004) in another study of MENA countries proposed that institutional quality are notably related to FDI. Al-Sadig (2009) used cross sectional regressions for 117 countries from the year 1984 to 2004 and proposed that corruption dissuade foreign Investment. Masron & Nor (2013) figured out the favorable consequences of institutional quality on FDI inflows in ASEAN region.

Some researcher found positive impact of corruption on investment. Aidt (2009) tried to find out the impact of Corruption at macroeconomic level and microeconomic level, failed to propound negative impact of Corruption on GDP per Capita at macroeconomic level, Corruption seen as an efficiency amplifier at microeconomic level to some extent but it is not uphold that Corruption is efficacious for economic growth at macroeconomic level.

Quazi *et al.*, (2014) found the impact of corruption on foreign direct Investment, either it grease or sand the wheels of growth in investment, including 53 countries of Africa for the time period from 1995 till 2011, he found a positive relationship between Corruption and Foreign Direct Investment, due to weak institutions Corruption act as a facilitator.

On the contrary, some researchers were unsuccessful in creating a connection between institutional quality and FDI. Wheeler & Mody (1992) found no link between institutional quality and FDI. Jun & Singh (1996) proclaimed that Institutions are not held for promoting FDI. Asiedu (2002) and Harms & Ursprung, (2002) indicate that political instability and country risk have no strong impact on attracting FDI. This study aims to scrutinize the impact of FDI on economic growth via governance in the SAARC economies and role of institutions towards the absorption of FDI (inflows).

3. Research methodology

This part of study provides full insight of methods and techniques which have been used to achieve the core objective of this research, including data description and sources, econometric methodology, model and hypothesis.

3.1. Data Description and Sources

For the empirical analysis data is obtained from World development Indicators, the World Bank data base. The scheme of present study revolves around the association between FDI and Governance and their net impact on economic growth that is treated as regressand or dependent variable in study. Annual percentage growth rate of GDP per Capita used as proxy for measuring economic growth, denoted by (EG). In current study foreign direct investment net inflows as percentage of GDP used as proxy for FDI inflows and symbolizes as (FDI). Governance represented by (G) and is measured by simply computing average of six components of Worldwide Governance indicators produced by Daniel

Kaufmann and Aart Kray, these six dimensions of governance include Control of Corruption, Government Effectiveness, Political Stability and Absence of Violence/Terrorism, Regulatory Quality, Rule of Law and Voice and Accountability. Each of these variables is measured in percentile rank. A higher value indicating better performance.

3.2. Econometric methodology

The paradigm of this research study is exclusively quantitative in nature. This study is purely founded on secondary data analysis and conducted on the basis of panel data econometric technique for the period 1996-2015. The panel data include eight SAARC economies. Panel data holds a property of both cross sectional and time series data, sometimes referred as longitudinal data or cross-sectional time series data. Baltagi (2001) states that, “panel data give more informative data, more variability, less collinearity (correlation of an independent variable with another independent variable) among variables, more degree of freedom and more efficiency”. Panel data also provide ways of dealing with heterogeneity among entities as well. In addition the presence of another econometric problem that is likelihood of endogeneity (correlation of an independent variable with the error term) also compressed by using panel data. Due to missing figures and unavailability of data the panel is unbalanced. This study estimate both fixed effect (FE) and random effect (RE) panel technique in order to employ robust standard error. Fixed effect estimation is based on within variation of the data in each economy only while random effect estimation is based on both cross-country and within variation. Lastly the Hausman specification Test performed in order to select between (FE) and (RE) (Gujarati, 2009).

3.3. Empirical model equation

The model is derived from standard neoclassical simple production function,

$$Y=f(K, H) \quad (1)$$

Where Y is GDP per capita, K is the stock of physical capital, and H is the human capital; differentiating the function we get the following:

$$Y= \beta_1k + \beta_2h \quad (2)$$

FDI affects growth directly by increasing the stock of physical capital and indirectly by inducing human capital development and promoting technological upgrading (De Mello, 1999) therefore FDI is introduced as an additional variable in the production function we get

$$Y=f(K, H, FDI) \quad (3)$$

Differentiating (3) we get

$$y= \beta_1k + \beta_2h + \beta_3fdi \quad (4)$$

To empirically examine the impact of FDI on Economic Growth via Governance this study hypothesize a model as follows:

$$EG= \beta_0+ \beta_1M + \beta_2FDI + \beta_3G+ \beta_4FG+ \beta_5K+ \epsilon \quad (5)$$

The dependent variable is the growth rate of real GDP per capita, (EG). The vector M include generally accepted variable to economic growth. There are 2 variables in vector M; namely gross capital formation (formerly gross domestic investment) it is denoted as (GKF) and computed as ratio to GDP. Tertiary school

enrollment as percentage of gross enrollment ratio (the ratio of total enrollment) used as a proxy for human capital, represented as (HC). The variable (FDI) represents foreign direct investment inflows as percentage of GDP. The variable (G) depicts constitutive term of variable of interest that is Governance. (FG) represents interaction term of FDI and Governance. The vector K include two conditional variables, namely Inflation (INF) used as a proxy for measuring macroeconomic stability and Government expenditures denoted as (GE) is measured as GDP ratio.

3.4. Null hypothesis for governance interaction term

In order to investigate the complementarity relationship between FDI inflow and Governance multiplicative interaction model is used and generate conditional hypotheses, a hypothesis in which relationship between two or more variables depends on the value of one or more other variable.

$H_0 =$ An increase in FDI is associated with an increase in economic growth when condition governance is met but not when governance is absent

Brambor *et al.*, (2006) and Braumoeller, (2004) argued that in conditional hypothesis analyst must introduce interaction term along with constitutive term. They further concluded that including constitutive term in interaction model increases multicollinearity, as a result of that the size of standard errors increased and making it less likely that the coefficient of the interaction term will be significant. However this may be true but not justify the omission of constitutive terms.

The analysis starts by estimating the impact of gross domestic investment, human capital, FDI (inflows) and governance on economic growth by using fixed effect and random effect technique and it is termed as base equation. (FE) is appropriate when unobserved effect that is error term and regressors are correlated whereas (RE) assumed that error term and regressors are uncorrelated. (FE) wipes out the effect of time-invariant variables in contrast (RE) estimator accommodate time-invariant variables. These time-invariant variables are culture, language, climate and geographical location.

For fixed effect technique the required model is as follows:

$$EG_{it} = \beta_0 + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \mu_{it} \quad (6)$$

For random effect technique the required model is as follows:

$$EG_{it} = \beta_0 + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \omega_{it} \quad (7)$$

Where the subscripts “i” is used for cross-sectional unit that is eight SAARC economies and “t” for time period from 1996 to 2015. It is observed that β_0 in fixed effect model holds “i” subscript only reflects that intercept of each economy differ across economies but do not vary over time that is fixed or time-invariant (Gujarati, 2009). The assumption of this model is that ϵ_i is correlated with the independent variables. Whereas in random effect model β_0 reflects common mean value for the intercept of selected eight economies and the individual differences in the intercept value of each economy reflected in the error term ω . Here ω is composite error term consist of two components ϵ_i which is the cross section or country specific error component and μ_{it} which is combined time series and cross section error component (Gujarati, 2009) The assumption of this model is that ϵ_i is uncorrelated with the independent variables in all time periods. In order to check the impact of FDI (inflows) on economic growth via governance interaction term of both variables include in base equation along with their constitutive terms.

For the fixed effect technique the required model is as follows:

$$EG_{it} = \beta_{0i} + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \mu_{it} \quad (8)$$

For the random effect technique the required model is as follows:

$$EG_{it} = \beta_0 + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \omega_{it} \quad (9)$$

Furthermore one conditional variable that is inflation add in model to check their impact. For the fixed effect technique the required model is as follows:

$$EG_{it} = \beta_{0i} + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \beta_6 INF_{it} + \mu_{it} \quad (10)$$

For the random effect technique the required model is as follows:

$$EG_{it} = \beta_0 + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \beta_6 INF_{it} + \omega_{it} \quad (11)$$

Lastly another conditional variable that is government expenditure add in model to check their impact. For the fixed effect technique the required model is as follows:

$$EG_{it} = \beta_{0i} + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \beta_6 GE_{it} + \mu_{it} \quad (12)$$

For the random effect technique the required model is as follows:

$$EG_{it} = \beta_0 + \beta_1 GKF_{it} + \beta_2 HC_{it} + \beta_3 FDI_{it} + \beta_4 G_{it} + \beta_5 FG_{it} + \beta_6 GE_{it} + \omega_{it} \quad (13)$$

The null hypothesis and alternate hypothesis for Hausman test are as follows:

H_0 = RE is appropriate

H_A = FE is appropriate

4. Findings

The p-value of hausman test is insignificant; depicts that unobserved effect are uncorrelated with independent variables therefore this study supports random effect estimation results.

Table 1. *Base Equation*

	FE	RE
C	7.39** (4.19)	0.79 (1.02)
GKF	0.03 (0.06)	0.05 (0.04)
HC	-0.06 (0.09)	0.05 (0.06)
FDI	0.99*** (0.35)	0.97*** (0.30)
G	-0.14 (0.10)	-0.002 (0.03)
R ²	0.29	0.21
d	1.02	0.94
f-stats	2.66***	4.77***
OBS	74	74
H Test-P	0.14	

Notes: Standard Error are reported in parentheses: The significance level indicated by (*). One (*) indicates significance at the 10% level, (**) indicates significance at the 5% level, while (***) indicates significance at the 1% level.

The result of fixed effect analysis can be shown in the form of model equation as in equation 14:

$$EG_{it} = 7.39_i + 0.03GKF_{it} - 0.06HC_{it} + 0.99FDI_{it} - 0.14G_{it} \quad (14)$$

For random effect analysis, the resultant model equation is given in equation 15 below:

$$EG_{it} = 0.79 + 0.05GKF_{it} + 0.05 HC_{it} + 0.97 FDI_{it} - 0.02G_{it} \quad (15)$$

The generated results shows that foreign direct inflows (FDI) has positive and significant impact on Economic growth (EG) of SAARC economies at the 1% significance level. The result implies that 1% increase in FDI inflows as a percentage of GDP will lead to 0.97% increase in GDP per capita growth. But the striking part of the result is that variable of interest that is governance (G) along with other variable that are important for economic growth that are human capital (HC) and gross domestic investment (GKF) found insignificant. The result proves the volatility of institutions, low level of domestic investment and fragile state of human development in SAARC economies.

Table 2 explores the empirical results of inclusion of interaction term of FDI and governance (FG) along with constitutive terms that are governance (G) and foreign direct investment (FDI) by using fixed effect (FE) and random effect (RE) least squares technique.

Table 2. Base Equation with Governance Interaction Term

	FE	RE
C	6.87* (4.05)	2.99** (1.34)
GKF	0.05 (0.06)	0.03 (0.04)
HC	-0.08 (0.09)	0.04 (0.05)
FDI	-0.91 (0.88)	-0.67 (0.75)
G	-0.14 (0.10)	-0.04 (0.04)
FG	0.04** (0.02)	0.04** (0.01)
R ²	0.35	0.27
d	0.83	0.78
f-stats	3.1***	5.1***
OBS	74	74
H Test-P		0.23

Notes: Standard Error are reported in parentheses: The significance level indicated by (*). One (*) indicates significance at the 10% level, (**) indicates significance at the 5% level, while (***) indicates significance at the 1% level.

The results of including governance in the analysis of FDI through fixed effect technique is represented in equation 16 below:

$$EG_{it} = 6.87_i + 0.05 GKF_{it} - 0.08HC_{it} - 0.91FDI_{it} - 0.14G_{it} + 0.04FG_{it} \quad (16)$$

The results of similar analysis through random effect is represented in equation 17 below:

$$EG_{it} = 2.99 + 0.03 GKF_{it} + 0.04HC_{it} - 0.67FDI_{it} - 0.04G_{it} + 0.04FG_{it} \quad (17)$$

The inclusion of interaction term of FDI and governance (FG) turns (FDI) insignificant while interaction term itself became significant at the 5% significance level. Although human capital (HC), gross capital formation (GKF) and governance (G) remains insignificant.

Table 3 explores the empirical results of inclusion of conditional variable that is inflation (INF) by using fixed effect (FE) and random effect (RE) least squares technique.

Table 3. *Inclusion of Inflation as Conditional Variable*

	FE	RE
C	7.77** (3.43)	3.63*** (1.19)
GKF	0.10* (0.05)	0.10*** (0.03)
HC	-0.04 (0.07)	0.06 (0.05)
FDI	1.74* (0.92)	1.64** (0.78)
G	-0.16** (0.08)	-0.06** (0.03)
FG	-0.00 (0.02)	-0.001 (0.01)
INF	-0.37*** (0.09)	-0.43*** (0.08)
R ²	0.54	0.50
d	1.37	1.33
f-stats	5.9***	10.9***
OBS	72	72
H Test-P		0.45

Notes: Standard Error are reported in parentheses: The significance level indicated by (*). One (*) indicates significance at the 10% level, (**) indicates significance at the 5% level, while (***) indicates significance at the 1% level.

At the inclusion of conditional variable of Inflation in analysis, the resultant equation of fixed effect technique is given in equation 18 below:

$$EG_{it} = 7.77_i + 0.10 GKF_{it} - 0.04HC_{it} + 1.74FDI_{it} - 0.16G_{it} - 0.00FG_{it} - 0.37 INF_{it} \quad (18)$$

The results of above analysis through random effect are shown in followed equation 19:

$$EG_{it} = 3.63 + 0.10 GKF_{it} + 0.06HC_{it} + 1.64FDI_{it} - 0.06G_{it} - 0.00FG_{it} - 0.43INF_{it} \quad (19)$$

Table 4. *Inclusion of Government Expenditure as Conditional Variable*

	FE	RE
C	6.80 (5.68)	3.82** (1.51)
GKF	0.05 (0.06)	0.05 (0.04)
HC	-0.08 (0.09)	0.003 (0.06)
FDI	-0.91 (0.90)	-0.68 (0.75)
G	-0.14 (0.10)	-0.03 (0.04)
FG	0.04** (0.02)	0.04** (0.01)
GE	0.006 (0.40)	-0.15 (0.12)
R ²	0.35	0.29
d	0.83	0.78
f-stats	2.7***	4.61***
OBS	74	74
H Test-P		0.43

Notes: Standard Error are reported in parentheses: The significance level indicated by (*). One (*) indicates significance at the 10% level, (**) indicates significance at the 5% level, while (***) indicates significance at the 1% level.

The conditional variable (INF) as a measure of (macroeconomic stability) found negatively significant at the 1% significance level. The result shows an inverse association between inflation and economic growth. The inclusion of conditional variable (INF) turns (GKF) significant at the 1% significance level and (FDI) and (G) at the 5% significance level. The result implies that 1% increase in FDI inflows

as a percentage of GDP will lead to 1.64% increase in GDP per capita growth although (G) holds negative sign with it. That means an increase in governance leads to decrease in economic growth.

Table 4 explores the empirical results of inclusion of another conditional variable that is government expenditure (GE) by using fixed effect (FE) and random effect (RE) least squares technique.

The inclusion of government expenditure in FDI analysis through fixed effect showed results as given in equation 20:

$$EG_{it} = 6.80_i + 0.05 GKF_{it} - 0.08HC_{it} - 0.91FDI_{it} - 0.14G_{it} + 0.04FG_{it} + 0.006 GE_{it} \quad (20)$$

Above analysis through random effect technique showed results as given in equation 21:

$$EG_{it} = 3.82 + 0.05 GKF_{it} + 0.003HC_{it} - 0.68 FDI_{it} - 0.03G_{it} + 0.04FG_{it} - 0.15 GE_{it} \quad (21)$$

The inclusion of government expenditure (GE) as conditional variable turns all variables insignificant except the interaction term of FDI and governance (FG) that found positively significant at the 5% significance level. The result imply that there is no complementarity relationship between FDI and governance in case of SAARC economies. The current findings refute vast past literature, and claimed done by many researchers such as Shleifer & Vishny, (1993) and Gastanaga *et al.*, (1998) embrace elevated governance to fetch FDI inflows, yet it is not an anomalous situation, some researchers like Quazi *et al.*, (2014) found that improved governance suppressed FDI inflows. Researchers such as Khordagui & Saleh (2013) found that the governance does not act as a mediating factor for FDI inflows, Kose, Prasad, & Terrones, (2009) asserts that low level of governance is affiliated with a high FDI impact, in other words economies with high level of institutional development hinder FDI inflows, they also claimed that even FDI is not very influential to economic growth in presence of inflated quality of institutions.

5. Conclusion

Decline in Investment barriers create a push towards globalization. Economies are interconnected and started investing in different economies. Foreign Direct Investment (FDI) is the way to invest resources in business activities outside the home country. FDI flows record the value of cross-border transactions related to direct investment during a given period of time, usually a quarter or a year. Financial flows consist of equity transactions, reinvestment of earnings and intercompany debt transactions. FDI creates stable and long-lasting links between economies. Over a period of time Foreign Direct investment (FDI) Inflows increased in developing economies especially in the region of Asia. However South Asian economies failed to attract FDI inflows only about 7% FDI were attracted by India and Pakistan aggregately, 6% and 1% respectively UNCTAD (2016) The impediments in the flow of inward FDI in SAARC economies shift the attention of the researchers towards factors that affect FDI inflows. These pre-conditions are termed as absorptive capacity factors. This study aims to find the complementarity relationship between FDI inflows and absorptive capacity factors such as governance. The empirical findings in this study do not support that governance is significant mediating factors of FDI inflows to the SAARC economies.

Before to jump to any conclusion that governance has no impact on economic growth and this variables are not acting as a mediating factor for FDI inflows the researchers should focus on indirect effect of other variables. In the light of past studies and current empirical analysis this study came across to the result that development of domestic financial market have key role in absorbing the FDI inflows. In case of level of governance such as political stability, government

effectiveness, regulatory quality, rule of law and level of corruption have major impact on developing domestic financial market.

Indeed, FDI inflows has positive impact on economic growth of SAARC economies regardless of level of governance therefore the effort should continue to support and encourage FDI inflows in SAARC economies and in order to get privileged from FDI inflows and exploit more benefits from FDI spillover SAARC countries must focus on polishing and improving factors or preconditions needed for absorbing more FDI inflows.

The estimated result have some recommendations and these are as follows:

SAARC economies should focus on improvement of investment climate and an attractive ambiance that suits foreign investors in order to attract higher FDI inflows.

The SAARC economies should improve their level of governance in order to attract foreigners to invest in SAARC region.

In this study average of six governance indicator used as proxy for governance, to further test the robustness of results and magnitude of impact of institutions quality on FDI inflows each component of governance can be observed separately.

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