



# Economics and Business Quarterly Reviews

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**Sumiyati, E. E. (2024). Do Economic Growth and Institutional Quality Affect Foreign Direct Investment Inflow? *Economics and Business Quarterly Reviews*, 7(4), 276-291.**

ISSN 2775-9237

DOI: 10.31014/aior.1992.07.04.637

The online version of this article can be found at:  
**<https://www.asianinstituteofresearch.org/>**

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Published by:  
The Asian Institute of Research

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# Do Economic Growth and Institutional Quality Affect Foreign Direct Investment Inflow?

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## Abstract

Foreign Direct Investment (FDI) inflows play a crucial role in the ASEAN (Association of Southeast Asian Nations) region's economic growth, as they contribute capital, technology, managerial expertise, and enhance economic integration among member states. However, FDI distribution across ASEAN countries is uneven, with larger and more open markets receiving a larger share, while smaller or less developed countries attract less investment. This research aims to identify the determinants of FDI inflows in the ASEAN-10 region from 2010 to 2021. A quantitative approach is employed, utilizing panel data regression analysis. The models tested include the Common Effect Model (CEM), Fixed Effect Model (FEM), and Random Effect Model (REM), with the FEM selected as the most appropriate. The results of the partial test reveal that economic growth and regulatory quality positively influence FDI inflows in ASEAN-10, while the Voice and Accountability indicator has a negative effect. Conversely, political stability, government effectiveness, rule of law, and control of corruption do not significantly impact FDI inflows. Overall, these variables account for approximately 87.20% of the variance in FDI flows in the region. The findings suggest that ASEAN countries should formulate more effective policies to attract FDI, particularly by implementing sound economic strategies, enhancing institutional quality, improving the investment climate, and boosting global competitiveness.

**Keywords:** FDI Inflow, Economic Growth, Institution Quality

## 1. Introduction

The global environment for international investment has undergone significant changes, particularly following the outbreak of the war in Ukraine, which occurred while the world was still grappling with the effects of the COVID-19 pandemic. This conflict has had a more profound impact than anticipated, leading to a cost-of-living crisis affecting billions globally. Rising energy and food prices have diminished real incomes and exacerbated debt pressures. As a result, investor uncertainty and risk aversion have increased, potentially exerting significant downward pressure on global Foreign Direct Investment (FDI), particularly affecting investment flows to developing countries (World Investment Report, 2022). Restrictions on multinational company investments have prompted nations to enhance their competitiveness and attractiveness to foreign investors, as FDI plays a crucial role in national development through the transfer of assets, management expertise, and technology (Doytch, 2021; Lee et al., 2009; Liu et al., 2016; Pradhan, 2004).

However, unstable internal conditions—whether economic, political, or institutional—can reduce a country's ability to attract capital inflows. Thus, it is essential to investigate the determinants of FDI inflows. Numerous studies have explored these determinants, and it is well established that stable conditions and robust economic growth are key factors in attracting FDI. For instance, research by Ho et al., (2013) and Mengistu & Adhikary, (2011) demonstrate a positive correlation between economic growth and FDI inflows. In addition to macroeconomic variables such as economic growth, a conducive investment climate is crucial for attracting FDI. Such a climate is shaped by government policies and systems designed to foster a favorable environment by reducing uncertainty and associated costs for long-term capital investments (Alfaro, 2017). Each country employs its own strategies to attract FDI, and the quality of government services offered to stakeholders, particularly investors, is a critical factor in determining the success of these efforts.

Governance can be analyzed through the lens of New Institutional Economics (NIE), which emphasizes the compatibility of governance solutions with underlying dependency patterns and the transaction cost implications of these solutions. The NIE approach also underscores the role of social capital in influencing transaction costs, governance effectiveness, and outcomes (Paavola & Adger, 2002). A key element of NIE is the quality of the business environment and institutional frameworks, which are often used as operational definitions within this approach. NIE has a diverse influence on Foreign Direct Investment (FDI) decisions in the Middle East and North Africa (MENA) region, with indicators such as investment freedom, monetary freedom, regulatory quality, business freedom, and voice & accountability playing critical roles (Sedik, W. M., & Seoudy, 2012).

The World Bank identifies six primary dimensions of governance globally: voice & accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption (World Bank, 2023). These indicators serve as benchmarks for assessing governance across different regions and countries.

The recovery of global FDI flows in 2021 marked a significant rebound, with growth in all regions reaching 64 percent from a previous contraction of minus 35 percent in 2020. Much of this growth in developed economies was driven by financial flows and mergers and acquisitions (M&A), with strong indications of increased investment in new projects. Investor confidence, particularly in the infrastructure sector, was bolstered by favorable long-term financing conditions and the expansion of infrastructure stimulus packages. However, investment in new industrial projects remained fragile, especially in developing countries (World Investment Report, 2022).

In developing Asia, FDI rose to its highest levels for three consecutive years despite the challenges posed by successive waves of COVID-19. In 2021, FDI reached \$619 billion, surpassing the \$519 billion recorded in 2020. Asia remains the largest recipient region, accounting for 40 percent of global FDI. FDI inflows to Asian countries increased by 19.27 percent, with most of the investment directed toward East and Southeast Asia. Southeast Asia has experienced steady growth in FDI inflows over the past two decades, except during periods of global financial instability in 2009, 2011, 2016, and during the COVID-19 pandemic in 2020. In 2020, the region experienced a sharp contraction in FDI inflows, with a decline of 30.08 percent compared to 2019's 18.18 percent growth, due to lockdowns, supply chain disruptions, and economic uncertainty. However, FDI rebounded in 2021, with growth of approximately 44 percent. Singapore emerged as the largest recipient of FDI in the ASEAN region, attracting US\$99.1 billion in 2021, accounting for more than half of the total FDI flows into ASEAN, followed by Indonesia (11.2%), Vietnam (8.7%), and Thailand (8.2%).

The growth of Foreign Direct Investment (FDI) inflows in the ASEAN region during the 2020–2021 period outpaced that of other developing regions in Asia, including East Asia, South Asia, West Asia, and Central Asia. However, within ASEAN itself, the distribution of FDI remains uneven, raising the question of why some ASEAN countries attract significantly more FDI than others. Thus, it is crucial to examine the factors influencing FDI inflows in the ASEAN-10 countries (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam). The selection of ASEAN-10 is significant because this region is a major recipient of FDI and is highly susceptible to global economic fluctuations and the middle-income trap.

This research seeks to address the question of how economic growth and institutional quality affect FDI inflows in the ASEAN-10. Poor institutional quality can exacerbate the effects of external threats on FDI, and higher economic growth and stronger economic integration in other regions may divert FDI away from ASEAN. Therefore, improving institutional quality within ASEAN is essential for ensuring a more equitable distribution of FDI flows. Strengthening the institutional environment should be a key objective of ASEAN's economic integration efforts. The theoretical implications of this research extend the international economic literature by offering practical insights that can assist policymakers in formulating more effective strategies to attract foreign investment, particularly through economic policy reforms, improving the investment climate, and enhancing the region's competitiveness in the global economy.

Given the changing conditions and evolving dynamics within ASEAN, it is vital to conduct research that explores the factors influencing FDI inflows into the ASEAN-10. Furthermore, discrepancies in previous research findings and existing theories underscore the need for a more in-depth investigation. The concept of FDI has been explored through various theoretical and empirical studies. FDI refers to the flow of international capital whereby companies from one country establish or expand operations in another, involving not only the transfer of resources but also the exertion of control over foreign companies (Graham & Krugman, 1993). Empirical evidence shows that FDI flows predominantly to developing countries rather than developed ones.

Several theories explain international capital flows (Ullah & Khan, 2017). David Ricardo's (1817) theory of comparative advantage suggests that international transactions occur more frequently between countries with lower relative production costs. Dunning's (2001) eclectic theory, or the OLI paradigm, posits that FDI decisions are based on three factors: Ownership Advantage (O), Location Advantage (L), and Internalization Advantage (I). This framework suggests that the goals and strategies of multinational companies in conducting FDI are influenced by these three advantages. However, with the rise of globalization, competition, and internationalization, the location and ownership factors alone cannot fully explain why certain countries attract more FDI than others, necessitating further exploration of the determinants of FDI.

There are three primary motivations for investors engaging in Foreign Direct Investment (FDI): natural resource seekers, market seekers, and efficiency seekers. The natural resource-seeking motive is driven by a company's need to secure and manage vital natural resources essential for its operations, as well as to support global production and expansion efforts. The market-seeking motive, on the other hand, emphasizes increasing sales and expanding the company's market presence abroad. Finally, the efficiency-seeking motive is focused on optimizing costs and enhancing productivity by leveraging the advantages offered by the host country, such as lower production costs, superior technology, or economies of scale.

The New Institutional Economics (NIE) framework highlights the critical role of institutions—such as laws, policies, and social norms—in shaping economic decisions. Institutions, as defined by North (1991) are "rules devised by humans to structure political, economic, and social interactions." In the context of FDI, NIE suggests that the quality of a country's institutions, including political stability, property rights protection, transparency, and law enforcement, significantly influences foreign investor decisions. Countries with strong institutional frameworks tend to attract more FDI, as they provide legal certainty and help reduce transaction costs. Conversely, countries with weak institutions pose higher risks to investors, which can deter FDI inflows. Therefore, strengthening institutional quality is a crucial factor in attracting foreign investment and fostering a favorable economic environment for FDI.

The World Bank publishes the Worldwide Governance Indicators (WGI), which measure the quality of governance and institutional performance across countries or groups of countries. The WGI is based on research initiated by Kaufmann et al. (2011) in their research, "The Worldwide Governance Indicators: Methodology and Analytical Issues." These indicators summarize governance assessments from a broad range of respondents in both developed and developing nations. Governance refers to the traditions and institutions by which authority is exercised within a country, and it is categorized into three main components (Kaufmann et al., 2011). The first component involves the processes for selecting, monitoring, and replacing governments, captured by the indicators of voice and accountability, and political stability and absence of violence/terrorism. The second component addresses the

government's ability to formulate and implement effective policies, represented by the indicators of government effectiveness and regulatory quality. The third component pertains to the degree to which the state and its citizens adhere to rules governing social and economic interactions, reflected by the indicators of rule of law and control of corruption.

The WGI consists of six indicators that measure institutional quality on a scale from -2.5 to +2.5, where scores closer to +2.5 indicate stronger institutional performance, while those nearer to -2.5 indicate weaker performance. These indicators are as follows: voice and accountability, which reflects the extent of public participation in governance, including freedoms of expression, association, and the press, aligning with the principle of accountability outlined in Law No. 28 of 2009, which ensures that government activities are accountable to the public; political stability and absence of violence/terrorism, which measures the likelihood of unconstitutional or violent changes in power and politically motivated violence; regulatory quality, which assesses the government's ability to develop and implement effective regulations that promote private sector development; government effectiveness, which captures the quality of public services, the professionalism and independence of civil servants from political influence, the quality of policy formulation and implementation, and the government's commitment to its policies; rule of law, which reflects perceptions of the extent to which individuals and institutions respect and adhere to societal rules, especially in contract enforcement, property rights, and the effectiveness of the judiciary and police; and control of corruption, which measures the extent to which public power is exploited for private gain, including both petty and large-scale corruption.

There is a substantial body of literature that examines the factors influencing Foreign Direct Investment (FDI), utilizing a wide range of variables, methodologies, subjects, measurements, and time periods. These factors can be categorized into economic and non-economic determinants. Macroeconomic indicators, along with the government's role in improving governance and strengthening institutions, play a crucial role in determining the inflow of FDI into a country (Othman et al., 2018). Empirical studies often position economic growth as both an outcome of FDI inflows and, in some cases, as a driver of FDI itself. One of the key motives for investors is the market-seeking motive, which is influenced by factors such as real GDP, economic growth, and GDP per capita. Several studies (Asamoah et al., 2016; Busse & Hefeker, 2007; Mengistu & Adhikary, 2011; Škuflic & Botric, 2006) indicate a positive relationship between economic growth and FDI inflows, whereas Buchanan et al. (2012) report a negative correlation.

The relationship between institutional factors, macroeconomic variables, and FDI inflows presents mixed results in the literature. For instance, institutional factors are found to play a more significant role in attracting FDI in the ASEAN region compared to the Central Asia and SAARC regions (Ullah & Khan, 2017). Sabir et al. (2019) argue that institutional quality is a more critical determinant of FDI in developed countries than in developing ones. Several other researchers have explored the influence of both institutional and macroeconomic factors on FDI inflows (Alguacil et al., 2011; Asamoah et al., 2016; Bannaga et al., 2013; Buchanan et al., 2012; Busse & Hefeker, 2007; Chaib & Siham, 2014; Daniele & Marani, 2011; Epaphra & Masawe, 2017; Fedderke & Romm, 2006; Gani, 2007; Githaiga & Kilong'i, 2023; Ho et al., 2013; Kasasbeh et al., 2018; Khan & Ahmad, 2013; Lucke & Eichler, 2016; Masron & Abdullah, 2010; Mengistu & Adhikary, 2011; Nguyen Van, 2015; Paul & Jadhav, 2020; Quazi, 2014; Rammal & Zurbrugg, 2006; Raza et al., 2021; Rehman, 2016; Sabir et al., 2019; Sabir & Khan, 2018; Saidi et al., 2013; Sedik, W. M., & Seoudy, 2012; Yakubu, 2020).

Regarding specific institutional factors, the voice and accountability indicator has been found to positively affect FDI inflows (Raza et al., 2021; Sabir et al., 2019). However, other studies (Bannaga et al., 2013; Chaib & Siham, 2014; Gangi & Abdulrazak, 2012) report a negative relationship, while Mengistu & Adhikary (2011) find no significant effect of voice and accountability on FDI inflows. Similarly, political stability and the absence of violence/terrorism have been shown to have a positive impact on FDI inflows in studies by Bannaga et al. (2013), Mengistu and Adhikary (2011), Rehman (2016), Sabir et al. (2019), Sabir and Khan (2018), and Saidi et al. (2013), while Raza et al. (2021) report a negative effect. Gangi and Abdulrazak (2012), on the other hand, find no significant effect of political stability on FDI inflows.

Research findings indicate that political stability and the absence of violence/terrorism positively influence foreign direct investment (FDI) inflows (Bannaga et al., 2013; Mengistu & Adhikary, 2011; Rehman, 2016; Sabir et al., 2019; Sabir & Khan, 2018; Saidi et al., 2013). However, Raza et al. (2021) found that political stability negatively affects FDI inflows, while Gangi & Abdulrazak (2012) concluded that political stability has no impact on FDI inflows.

Regulatory quality is another significant determinant of FDI. A positive relationship is found between regulatory quality and FDI inflows (Bannaga et al., 2013; Buchanan et al., 2012; Sabir et al., 2019). In contrast, the effect of regulatory quality on FDI inflows was found insignificant (Gangi & Abdulrazak, 2012; Mengistu & Adhikary, 2011).

The effect of government effectiveness on FDI inflows is similarly mixed. Some researchers suggest a positive influence (Chaib & Siham, 2014; Gangi & Abdulrazak, 2012; Mengistu & Adhikary, 2011), whereas Bannaga et al. (2013) reported a negative relationship.

The rule of law is another factor considered attractive to investors. A strong rule of law positively impacts FDI inflows (Gangi & Abdulrazak, 2012; Mengistu & Adhikary, 2011; Sabir et al., 2019). However, Bannaga et al. (2013) did not find such effect. Alexander (2014) argues that countries with weak legal frameworks can still attract FDI by leveraging personal relationships with business partners and government connections, which help mitigate uncertainties arising from weak rule of law. This suggests that investors may sometimes prioritize personal networks over formal legal structures, such as bilateral investment treaties or special economic zones.

Corruption control is another governance indicator affecting FDI inflows. A positive correlation is identified between corruption control and FDI (Busse & Hefeker, 2007; Khan & Ahmad, 2013; Mengistu & Adhikary, 2011; Quazi, 2014; Raza et al., 2021; Sabir et al., 2019; Ullah & Khan, 2017). Whereas, other researchers find the opposite, where corruption control has no significant effect on FDI inflows (Epaphra & Masawe, 2017; Gangi & Abdulrazak, 2012; Rehman, 2016),

Building on these theoretical insights and empirical findings, this research aims to examine how economic growth and institutional quality influence FDI inflows in ASEAN-10 countries (Bannaga et al., 2013). The institutional quality indicators considered include voice and accountability, political stability and absence of violence/terrorism, regulatory quality, government effectiveness, rule of law, and control of corruption.

Building on theoretical frameworks and prior empirical studies, this research aims to investigate the impact of economic growth factors and institutional quality on FDI inflows in ASEAN-10 countries. Key indicators of institutional quality include voice and accountability, political stability and absence of violence/terrorism, regulatory quality, government effectiveness, rule of law, and control of corruption.

Voice and accountability are crucial in attracting FDI, as they provide transparency regarding a country's internal conditions. The presence of a free press ensures access to information, which mitigates information asymmetries between the government and the public, thus enhancing government accountability in policy implementation. Freedoms of speech, the press, and robust policy accountability have the potential to limit government overreach. Effective policies that promote efficient resource utilization can boost economic productivity, thereby attracting greater capital inflows.

Political stability and the absence of violence or terrorism play a vital role in fostering innovation and creating a conducive investment climate. Political instability, in contrast, can lead to national fragmentation and social unrest, creating uncertainty that disrupts economic decision-making, such as investments and production activities. Consequently, political stability is essential for attracting FDI.

Regulatory quality significantly influences FDI, as clear and well-structured regulations regarding investments help guarantee ownership rights and outline business operations. High-quality regulations streamline business processes, thereby creating an environment that encourages FDI inflows.

In addition, effective government performance is necessary to attract investment. Countries with high levels of government effectiveness are perceived as capable of efficiently allocating resources and providing quality public services. A strong government effectiveness index can increase FDI inflows by creating a stable and attractive investment environment.

The rule of law is another key factor affecting FDI. Investors seek countries with robust legal frameworks, as the consistent implementation of laws provides security and certainty. A strong legal system assures foreign investors that their rights will be protected, fostering a stable investment climate (Gangi & Abdulrazak, 2012; Mengistu & Adhikary, 2011; Sabir et al., 2019).

The relationship between corruption control and FDI inflows is complex. Asiedu (2016) identifies two perspectives on corruption's impact on investment. On one hand, insufficient monitoring of corruption raises operational costs and creates uncertainty, deterring investment. On the other hand, in some cases, corruption can create opportunities for private firms to gain illicit advantages, such as securing government contracts or favorable business terms through bribery. In many developing countries, firms may resort to paying bribes for access to raw materials, subsidized credit, or reduced taxes. However, strategies aimed at curbing corruption and enforcing anti-corruption policies are likely to promote a healthier economic environment, which is more conducive to attracting and sustaining FDI. By reducing corruption, countries can create a stable and predictable economic landscape that enhances investor confidence (Quazi, 2014).

### *1.1. Research Hypotheses*

In regard to the background of this research, the research hypotheses were proposed as follows.

1. Economic growth significantly influences FDI inflows in ASEAN-10 during the period 2010–2021.
2. Political stability and the absence of violence/terrorism significantly influence FDI inflows in ASEAN-10 during the period 2010–2021.
3. Voice and accountability significantly influence FDI inflows in ASEAN-10 during the period 2010–2021.
4. Regulatory quality significantly influences FDI inflows in ASEAN-10 during the period 2010–2021.
5. Government effectiveness significantly influences FDI inflows in ASEAN-10 during the period 2010–2021.
6. Rule of law significantly influences FDI inflows in ASEAN-10 during the period 2010–2021.
7. Control of corruption significantly influences FDI inflows in ASEAN-10 during the period 2010–2021.
8. Economic growth, political stability and the absence of violence/terrorism, voice and accountability, regulatory quality, government effectiveness, rule of law, and control of corruption collectively influence FDI inflows in ASEAN-10 during the period 2010–2021.

## **2. Method**

This research employed a quantitative approach to analyze the effects of economic growth and institutional quality on Foreign Direct Investment (FDI) inflows in ASEAN-10 countries over the period from 2010 to 2021. The research included 120 observations, derived from 10 countries over 12 years.

In this research, secondary data in the forms of foreign direct investment inflow and economic growth data sourced from the World Bank's World Development Indicators (WDI) were used. Meanwhile, the institutional quality data were obtained from the World Governance Indicators (WGI). Additional data sources included the World Investment Report and the Central Bureau of Statistics.

The analysis was conducted using panel data regression techniques. The dependent variable was FDI inflow, which represents an international capital flow in which companies from one country establish or expand operations in another country. This process involved a transfer of resources and the imposition of control over foreign companies. For the purpose of this research, FDI inflow was measured using a natural logarithm of the annual FDI inflow values for the ASEAN region during the 2010-2021 period.

The variables of this research are explained as follows.

**1. Economic Growth**

Economic growth refers to the increase in the production of goods and services within an economy over a specific period. In this research, economic growth is represented by the annual percentage change in gross domestic product (GDP), which serves as the primary indicator.

**2. Voice and accountability**

Voice and accountability reflect the extent of public participation in a country's governance, encompassing freedoms of expression, association, and the press (Kaufmann et al., 2011). This variable is measured on a scale ranging from -2.5 to 2.5, where a score of 2.5 signifies the highest level of public participation and government accountability in implementing optimal policies, whereas a score of -2.5 indicates minimal public participation and poor government accountability. The voice and accountability variable is expressed in index units.

**3. Political Stability and the Absence of Violence/ Terrorist**

Political stability and absence of violence/terrorism measure the likelihood of government instability due to unconstitutional actions, violence, or terrorism, including politically motivated disruptions (Kaufmann et al., 2011). This variable is assessed on a scale from -2.5 to 2.5, where 2.5 represents the highest political stability and the lowest likelihood of violence or terrorism, while -2.5 indicates the opposite. The political stability and absence of violence/terrorism variables are expressed in index units.

**4. Regulatory Quality**

Regulatory quality evaluates the government's capacity to develop and implement sound policies and regulations that foster private sector development (Kaufmann et al., 2011). This variable is quantified on a scale of -2.5 to 2.5, with 2.5 representing the highest regulatory quality conducive to private sector growth, and -2.5 indicating the poorest regulatory environment. Regulatory quality is expressed in index units.

**5. Government Effectiveness**

Government effectiveness captures perceptions of the quality of public services, the professionalism and independence of civil services from political interference, the quality of policy formulation and implementation, and the reliability of the government's commitment to these policies (Kaufmann et al., 2011). This variable is measured on a scale from -2.5 to 2.5, where a score of 2.5 denotes the highest effectiveness, including superior public service quality and absence of political pressures, while -2.5 reflects the lowest level of government effectiveness. Government effectiveness is expressed in index units.

**6. Rule of Law**

Rule of law reflects perceptions of the degree to which public officials and private citizens respect legal frameworks, including the quality of contract enforcement, property rights, and the effectiveness of the police and judiciary in addressing crime and violence (Kaufmann et al., 2011). This variable is rated on a scale from -2.5 to 2.5, where 2.5 represents the highest adherence to the rule of law, and -2.5 denotes the lowest. The rule of law variable is expressed in index units.

**7. Control of Corruption**

Control of corruption measures the extent to which public power is exercised for personal gain, including both petty and grand forms of corruption, as well as the influence of elite groups on state governance (Kaufmann et al., 2011). This variable is assessed on a scale from -2.5 to 2.5, where a score of 2.5 signifies the most effective control over corruption, while -2.5 represents the poorest control. Control of corruption is expressed in index units.

*2.1. Data Analysis Technique*

The data analysis in this research employed panel data regression techniques, which include the Pooled Least Squares (Common Effect) Model, the Fixed Effect Model, and the Random Effect Model (Gujarati, 2009). The Pooled Least Squares (Common Effect) Model combines cross-sectional data with time series and uses the Ordinary Least Squares (OLS) method to estimate the panel data model. This model assumes that the behavior of the data across entities is identical over time.



The Fixed Effect Model (FEM) utilizes dummy variables to capture differences in intercepts. It assumes that the regression coefficients (slopes) are constant across entities and over time, but the intercepts may differ across entities while remaining the same over time (time-invariant). A limitation of the FEM is the reduction in degrees of freedom, which can lead to lower parameter efficiency. Typically, fixed effect modeling is implemented using the Least Squares Dummy Variable (LSDV) method.

The Random Effect Model introduces disturbance variables (error terms) that account for variations in relationships across time and between entities or regions. Since the OLS method is not suitable for obtaining efficient estimators in this model, the Generalized Least Squares (GLS) method is applied instead.

To determine the most appropriate model for estimating the regression coefficients, the research conducted three tests: the Chow Test, the Hausman Test, and the Lagrange Multiplier Test. The Chow Test is used to compare the Common Effect model with the Fixed Effect model, with the following hypothesis:

H<sub>0</sub>: Common Effect Model

H<sub>1</sub>: Fixed Effect Model

Whereas, the Hausman *Test* compared the fixed effect and random effect models based on the following hypotheses.

H<sub>0</sub>: Random Effect Model

H<sub>1</sub>: Fixed Effect Model

The Lagrange Multiplier test was employed to select the Random Effect model and Common Effect model using the following hypothesis.

H<sub>0</sub>: Common Effect Model

H<sub>1</sub>: Random Effect Model

In the Random Effect Model, it is assumed that individual error components are uncorrelated with each other, and there is no autocorrelation in either the cross-sectional or time series data. Both the cross-sectional and time series variables are assumed to be normally distributed, with degrees of freedom that are not reduced. The Random Effect Model can be estimated using Generalized Least Squares (GLS) regression, which produces an estimator that satisfies the Best Linear Unbiased Estimation (BLUE) properties. Given that the model assumes normal distribution for the classical assumption disturbances, no further adjustments are required for potential violations of classical assumptions, such as autocorrelation, multicollinearity, and heteroscedasticity.

However, if the chosen model is the Common Effect Model (CEM) or Fixed Effect Model (FEM), classical assumption tests will be conducted. These tests are necessary because the Common Effect Model is essentially an extension of linear regression based on the OLS method.

## 2.2. Classical assumption test

The classical assumption test was conducted to ensure that the developed model satisfied the criteria of a Best Linear Unbiased Estimator (BLUE). This test included normality, multicollinearity, heteroscedasticity, and autocorrelation tests (Gujarati, 2009). The normality of residuals in the regression equation was assessed using the Jarque-Bera test. A model was deemed robust if its residuals followed a normal distribution. The hypothesis for testing residual normality was outlined as follows:

H<sub>0</sub>:  $\mu=0$  Normally-distributed residuals

H<sub>1</sub>:  $\mu\neq 0$  Abnormally-distributed residuals

The multicollinearity test was conducted by calculating the correlation coefficients among the independent variables. In multiple regression analysis, it is essential for the model to be free from multicollinearity. This test was performed using the Variance Inflation Factor (VIF), where a VIF value exceeding 5 indicates the presence of multicollinearity among the independent variables. According to [20], the model was considered free from collinearity if the correlation coefficient between independent variables did not exceed 0.8.

The Heteroscedasticity Test is an assumption test that determines whether the residual has a constant variance or not with the following hypothesis:

H0:  $\text{var}(e_i) = \sigma^2$  (Constant residual variance or Homoscedasticity)

H1:  $\text{var}(e_i) \neq \sigma^2$  (Residual variance is not constant or Heteroscedasticity)

A good regression model maintains a constant residual variance. In this research, the heteroscedasticity test is conducted using the Glejser test, which involves creating a new variable (absolute residual) and regressing it against the independent variables.

The Autocorrelation Test is another critical assumption that must be satisfied for the regression equation to be BLUE (Best Linear Unbiased Estimation). In parameter estimation, the error terms are assumed to be independent random variables, uncorrelated with one another. The hypothesis for the autocorrelation test is as follows:

H0:  $E(e_i e_j) = 0$  and  $i \neq j$  (no autocorrelation)

H1:  $E(e_i e_j) \neq 0$  and  $i \neq j$  (autocorrelation is present)

The autocorrelation test in this research employed the Durbin-Watson (DW) test by comparing the DW test statistic with critical values from the DW table, which consisted of two bounds: the lower limit ( $d_L$ ) and the upper limit ( $d_U$ ). The interpretation of the DW test followed these rules:

1.  $DW < d_L$  shows a positive autocorrelation
2.  $d_L \leq DW \leq d_U$  shows no conclusive decision
3.  $d_U < DW < 4 - d_U$  shows the absence of either positive or negative autocorrelations
4.  $4 - d_U < DW \leq 4 - d_L$  shows no conclusive decision
5.  $DW > 4 - d_L$  shows a negative autocorrelation

In the Fixed Effects model, issues of autocorrelation and heteroscedasticity in panel data were addressed by transforming the model into the Cross-Section SUR (Seemingly Uncorrelated Regression) form.

### 2.3. Research Model Specification

The specifications of the research model are expressed in the following formula:

$FD\ INFLOW = f(G\_GDP, VOICE, POL, REG, GOV, RUL, COC)$

Description:

FDI INFLOW	:	Foreign Direct Investment Inflow
G_GDP	:	Growth of GDP / Economic Growth
VOICE	:	Voice and accountability
POL	:	Political stability and absence of violence/ terrorism
REG	:	Regulatory Quality
GOV	:	Government Effectiveness
RUL	:	Rule of Law
COC	:	Control of Corruption

Furthermore, hypothesis testing was conducted both partially, using the t-test, and simultaneously, using the F-test. The decision-making process was based on a comparison of the p-values with a predetermined significance level, typically ranging from 5% to 10%.

(1)

## 3. Results

### 3.1. Research Results

Table 1 presents the results of the panel data regression estimation conducted using three approaches: the Pooled Least Squares method (Common Effect Model), the Fixed Effects Model, and the Random Effects Model.

Table 1: Panel Data Regression Estimation Results

Variable	Common Effect Model)		Fixed Effect Model		Random Effect Model	
	Coefficient	Prob.	Coefficient	Prob	Coefficient	Prob.
G_GDP	0.004568	0.0000***	0.001178	0.0001***	0.001969	0.0000***
VOICE	-0.048917	0.0001***	-0.024691	0.0040***	-0.040724	0.0000***
POL	0.007724	0.3553	0.007437	0.1348	0.010993	0.0763*
REG	0.103815	0.0000***	0.023486	0.0021***	0.048623	0.0000***
GOV	-0.047343	0.0229**	0.002508	0.7663	-0.007206	0.5145
RUL	-0.050375	0.0657*	-0.005605	0.3972	-0.014863	0.2990
COC	0.044555	0.0035***	-0.004444	0.6537	0.015543	0.1575
C	-0.020176	0.3855	0.036115	0.1426	-0.016736	0.3836
Adjusted R-squared	0.560259		0.871984		0.319026	
Prob(F-statistic)	0.000000***		0.000000***		0.001454***	
Durbin-Watson stat	0.478165		1.856341		0.951454	

*Source: Data Analysis Outcome*

Notes: The sign\*, \*\*, and \*\*\* indicate significance at the level of 10%, 5%, and 1%, respectively

A model selection test was first conducted using the Chow test to choose between the Common Effect Model (CEM) and the Fixed Effect Model (FEM). The test results indicated that the Fixed Effect Model was the preferred model, as the P-value for the Cross-section F was 0.0000, which is smaller than the 5% significance level, leading to the rejection of the null hypothesis.

The next step involved conducting a Hausman test to select between the Fixed Effect Model and the Random Effect Model (REM). The results of the Hausman test also favored the Fixed Effect Model, as the P-value for the Cross-section F was again 0.0000, smaller than the 5% significance level, which led to the rejection of the null hypothesis. Since the Hausman test indicated the selection of the Fixed Effect Model, the Lagrange Multiplier test was not necessary. The following table summarizes the results of the Chow and Hausman tests:

Table 2: Chow Test and Hausman Test Results

Effects Test Cross-section F				
	Statistic	d.f.	Prob.	Decision (Selected Model)
Chow test	44.164454	(9,103)	0.0000***	FEM
Hausman Test	96.459406	7	0.0000***	FEM

*Source: Data Analysis Outcome*

Notes: The sign \*\*\* indicate significance at the level of 1%, respectively

Based on the selection of the Fixed Effect Model, a classical assumption test was conducted to ensure that the model meets the conditions for being a Best Linear Unbiased Estimator (BLUE). A model is considered BLUE if the residuals are normally distributed, free of autocorrelation, exhibit no heteroscedasticity, and have no multicollinearity. The results of the normality and autocorrelation tests are presented in Table 3.

Table 3: Results of Normality Test and Autocorrelation Test

Normality test	Prob ( Jarque-Bera Statistic)	0.840260
Autocorrelation test	Durbin-Watson Statistic	1.856341

*Source: Data Analysis Outcome*

The results of the residual normality test indicated that the residuals are normally distributed, as the P-value of the Jarque-Bera Statistic was 0.840260, which is greater than the 5% significance level. This led to the acceptance of the null hypothesis, confirming that the residuals are normally distributed.

For the autocorrelation test, the Durbin-Watson (DW) statistic was used. The model does not exhibit autocorrelation if the DW statistic falls between the upper limit of the table DW (DU) and 4 minus DU. With 120 observations and 6 independent variables, the upper limit (DU) was 1.8270. The calculated DW value of 1.856341 falls within the range of  $1.8270 < 1.856341 < 2.1730$ , indicating that the model does not contain autocorrelation. The heteroscedasticity test was not conducted, as the selected Fixed Effect Model employs the Weighted Least Squares (WLS) method, which effectively addresses heteroscedasticity issues. Therefore, it can be concluded that the model does not exhibit heteroscedasticity.

Lastly, the multicollinearity test was performed by calculating the correlation coefficients between the independent variables. If the correlation coefficient is less than 0.8, it indicates the absence of multicollinearity. Based on the correlation coefficient calculations, the regression model was found to be free from multicollinearity. The results of the multicollinearity test are as follows:

Table 4: The Results of Multicollinearity Test

	G_GDP	VOICE	POL	REG	GOV	RUL	COC
G_GDP	1	-0.08044	-0.08912	-0.22993	-0.21006	-0.19375	-0.19085
VOICE	-0.08044	1	-0.01935	0.642243	0.562203	0.491259	0.489026
POL	-0.08912	-0.01935	1	0.640754	0.676304	0.70965	0.694748
REG	-0.22993	0.642243	0.640754	1	0.662037	0.750003	0.731852
GOV	-0.21006	0.562203	0.676304	0.662037	1	0.674852	0.635212
RUL	-0.19375	0.491259	0.70965	0.750003	0.674852	1	0.763688
COC	-0.19085	0.489026	0.694748	0.731852	0.635212	0.763688	1

Source: Data Analysis Outcome

The best model utilized in this research is the Fixed Effects Model (FEM), estimated using the Weighted Least Squares (cross-section weight) method, as presented in Table 5 below.

Table 5: The Estimation Outcome of the Fixed Effect Model

Variable	Coefficient	Prob.	Description
G_GDP	0.001178	0.0001***	Positive significant
VOICE	-0.024691	0.0040***	Negative significant
POL	0.007437	0.1348	Not significant
REG	0.023486	0.0021***	Positive significant
GOV	0.002508	0.7663	Not significant
RUL	-0.005605	0.3972	Not significant
COC	-0.004444	0.6537	Not significant
C	0.036115	0.1426	
Adjusted squared	R-	0.871984	
Prob(F-statistic)		0.000000***	

Source: Data Analysis Outcome

Notes: The sign \*\*\*, indicates significance at the level of 1%, respectively

Based on the results of the Fixed Effect Model (FEM) estimation presented in the table above, the analysis was conducted using both the t-test (partial test) and the F-test (simultaneous test).

Partially, the variables of economic growth (G\_GDP) and regulatory quality (REG) were found to have a positive effect on FDI inflow in ASEAN-10 countries at a significance level of 1%. Conversely, the Voice and Accountability factor (VA) was found to have a negative effect on FDI inflow in ASEAN-10 at a significance level of 1%.

Other factors, including Political Stability and Absence of Violence/Terrorism (POL), Government Effectiveness (GOV), Rule of Law (RUL), and Control of Corruption (COC), were found to have no significant effect on FDI inflow in ASEAN-10 countries.

However, when examined simultaneously, all variables collectively had a significant effect on FDI inflow in ASEAN-10 at a significance level of 1%. The model explained 87.20% of the variation in FDI inflow, with the remaining 12.80% influenced by other factors not included in the research model.

#### 4. Discussion

The results of this research indicate that economic growth has a positive effect on FDI inflow in ASEAN-10 countries for the period 2010-2021. These findings support the hypothesis of this research and align with the results of previous research (Asamoah et al., 2016; Busse & Hefeker, 2007; Mengistu & Adhikary, 2011; Škuflic & Botric, 2006). Economic growth, particularly as reflected in GDP growth or domestic production, is a key factor in attracting foreign investment, especially in relation to the market-seeking motive. An increase in economic growth signals a country's strong economic competitiveness, encouraging foreign investors to direct capital to countries with high growth rates. This growth also signals an expansion of market size and an increase in real income, which are attractive factors for foreign direct investment, particularly in the long term due to positive expectations for economic activity.

Voice and accountability, as one of the indicators of institutional quality, was found to have a negative effect on FDI inflow in ASEAN-10 at a significance level of 1%. The negative impact of the Voice and Accountability factor may be attributed to situations where democracy is not supported by robust government infrastructure. Although voice and accountability are generally regarded as indicators of good governance, in the ASEAN-10 context, when not managed properly, they can contribute to political instability, heightened business risks, and unstable policies. In some cases, greater transparency and political participation might worsen investor perceptions of political and economic risks, thereby reducing FDI inflows (Bannaga et al., 2013; Chaib & Siham, 2014; Gangi & Abdulrazak, 2012).

On the other hand, the Regulatory Quality factor was found to have a positive effect on FDI inflow in ASEAN-10 during the 2010-2021 period, significant at the 1% level. These findings support the hypothesis of this research and are in line with the results of previous research (Bannaga et al., 2013; Buchanan et al., 2012; Sabir et al., 2019). Good regulatory quality in ASEAN-10 countries fosters a more transparent, stable, and efficient business environment, providing foreign investors with clear and predictable regulations. This regulatory certainty reduces investment risks and costs, making countries with high regulatory quality more attractive to foreign investors and thereby encouraging higher FDI inflows.

Furthermore, this research found that political stability and the absence of violence did not significantly affect FDI inflow in ASEAN-10 countries for the period 2010-2021 (Gangi & Abdulrazak, 2012). While political stability remains a crucial factor in attracting FDI, in the context of ASEAN-10, larger economic factors—such as economic growth, access to broader markets, lower production costs, and improved investment policies—often exert a stronger influence on investor decisions. Additionally, sectors less sensitive to political uncertainty, along with ASEAN's integration as an economic region, further diminish the influence of political stability on FDI flows. In high-income countries, political stability and the absence of politically motivated violence or terrorism may not be major determinants for foreign investors. However, in low-income countries, investors are more likely to consider political stability as a critical factor when making investment decisions.

Meanwhile, the factors of government effectiveness, rule of law, and control of corruption did not have a significant effect on FDI inflows in ASEAN-10. It is possible that investors prioritize other factors such as economic conditions, domestic market potential, labor costs, access to natural resources, infrastructure, and government incentives when choosing investment destinations. This finding is consistent with the research by Bannaga et al. (2013), which found that rule of law and control of corruption did not significantly influence FDI inflows. The variation in law enforcement across ASEAN countries, coupled with practical challenges such as

corruption and legal uncertainty, suggests that the rule of law is not always a decisive factor for FDI flows into this region. In some cases, the level of government corruption may even be exploited by foreign investors to engage in practices such as bribery.

## 5. Conclusion

This research concludes that economic growth has a positive effect on FDI inflow in ASEAN-10 countries. Economic growth fosters a more conducive environment for foreign investment by enhancing market prospects, ensuring economic stability, and supporting favorable policies. These factors collectively make developing countries more attractive to foreign investors, particularly those seeking opportunities for business growth. A country with robust economic competitiveness, where market size and real income are improving, becomes an appealing destination for foreign direct investment, driven by positive expectations for future economic activities. Regulatory quality also positively influences FDI inflows in ASEAN-10 countries. Good regulatory quality in these countries helps establish a transparent, stable, and efficient environment for business. This creates certainty for foreign investors, who benefit from clear and predictable regulations, which in turn reduce investment risks and costs. Countries with high regulatory quality are more likely to attract foreign investors, thus stimulating greater FDI inflows.

On the other hand, voice and accountability have a negative effect on FDI inflows in ASEAN-10 countries. This may be due to the situation where democracy is not adequately supported by strong governance infrastructure. Although voice and accountability are generally seen as indicators of good governance, if not properly managed in the ASEAN-10 region, they can lead to increased political uncertainty, exacerbate business risks, and cause policy instability. In some cases, heightened transparency and excessive political participation may worsen investor perceptions of political and economic risks, thereby reducing FDI flows to these countries.

The research found that political stability, absence of violence, government effectiveness, rule of law, and control of corruption do not significantly affect FDI inflows in the ASEAN-10 region. This suggests that investors may prioritize other factors such as economic conditions, domestic market potential, labor costs, access to natural resources, infrastructure, and government incentives when choosing investment destinations. These findings align with previous research, including Bannaga et al. (2013), which concluded that the rule of law and control of corruption do not significantly influence FDI inflows. Variations in law enforcement across ASEAN countries, coupled with practical issues like corruption and legal uncertainty, may reduce the significance of these institutional factors in attracting FDI.

In certain cases, foreign investors may even exploit corruption or legal ambiguities to facilitate their business operations. This points to the need for ASEAN countries to focus on policy reforms that improve governance. Key strategies should include the establishment of rules-based programs that promote legal certainty, enhance democracy, and address financial and non-financial violations. Regulatory reforms tailored to the business and investment sectors are also essential to keep pace with rapid technological advancements. Strengthening institutional quality can create a more attractive investment climate, which would ultimately encourage foreign investors to engage in long-term investments.

The selective granting of permits to multinational companies is crucial to ensure maximum benefits, such as employment opportunities, knowledge transfer, and the development of managerial skills among domestic workers. Moreover, it is vital to ensure that the presence of multinational corporations does not threaten domestic industries or lead to environmental harm.

The research has limitations related to its short research period, which may not fully capture long-term relationships. Furthermore, many economic and non-economic factors that could affect FDI inflows were not considered. Future research could expand by incorporating additional variables, extending the research period, and examining a broader set of countries to assess the consistency of these findings.

**Funding:** Not applicable.

**Conflicts of Interest:** The authors declare no conflict of interest.

**Informed Consent Statement/Ethics approval:** Not applicable

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