

EFFECT OF MARKET SIZE AND INSTITUTIONAL QUALITY ON FDI INFLOWS IN SOUTH ASIAN COUNTRIES

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ABSTRACT

The importance of foreign direct investment (FDI) in the development process of an economy is well established. Many developing countries have constantly strived to improve their performance in terms of market size, infrastructure and the quality of its institutions as the amount of FDI inflows to a country are positively influenced by these factors. The South Asian countries have seen a healthy economic growth and taken steps to improve the quality of institutions and law and order in the country to attract a larger share of global FDI flows. The objective of the present study is to examine the independent and combined effect of market size and quality of institutions on FDI inflows in the South Asian countries for the period 2007-2020. Using pooled OLS regression method, we find that FDI inflows are higher when country experiences increase in market size along with improvement in the quality of institutions. Our results suggest a complementary relationship between traditional economic factors and institutional factors.

Key Words

South Asia, FDI, Market size, Institutions, Voice and Accountability

INTRODUCTION

A key driver of international economic integration, Foreign Direct Investment refers to the cross-border investment made by a resident in one economy (the direct investor) with the objective of establishing a lasting interest in an enterprise (the direct investment enterprise) that is resident in a country other than that of the direct investor (OECD, 2008)¹. The importance of foreign direct investment (FDI) in the development process of an economy is well established. It is argued that inflows of FDI help to bridge the gap between the desired and actual level of capital stock (Noorbakhsh et al. 2001; Hayami, 2001), generate employment possibilities and leads to productivity enhancement through its management and technology spillover effects (Pradhan, 2006; UNCTAD, 2006; Gordon, 2001; Balasundram, 2000; Azmat,

¹ OECD (2008) Benchmark Definition of Foreign Direct Investment, Fourth Edition, <http://www.oecd.org/daf/inv/investmentstatisticsandanalysis/40193734.pdf>

1999; Rodriguez-Clare, 1996). The recognition of positive effects of FDI to the host economy has been instrumental in pulling many countries to increasingly integrate in the global economy by the means of adopting market based economic reforms and liberalization of foreign investment policies. The gradual opening up of various developing economies since 1980s is one of the factors leading to a manifold increase in global FDI flows. As the amount of FDI inflows to a country are positively influenced by various factors including the market size, the growth potential of the host economy, quality of infrastructure and law and order situation, many developing countries have constantly strived to improve their performance on these grounds so as to attract the larger share of global FDI flows (Ramasamy & Yeung 2010; Singhania & Gupta, 2011; Khan & Nawaz, 2010; Sahoo, 2006; Bhavan et al., 2011).

Over the last decade, South Asian countries have experienced robust economic growth² and taken steps to improve the quality of institutions and law and order in the country to attract a larger share of global FDI flows. While the set of economic reforms so initiated has made the region potentially attractive with growing market size and rising middle class income and consumption, the quality of institutions remains a matter of concern for the foreign investors.

In this context, we address the following two research questions in this paper. 1. How do market size and institutional quality affect FDI inflows in South Asia?

2. How does institutional quality moderate the relationship between market size and FDI inflows in South Asia?

While many prior studies have examined the effect of economic factors and institutions separately, there is a dearth of studies examining the combined effect- therefore leaving an important research gap. We attempt to fill the gap by examining the independent and combined effect of gross market development as a proxy for market size and voice and accountability as a measure of quality of institutions on the FDI inflows in the eight countries of South Asia over the period 2007 to 2020.

Using pooled OLS regression method, we find support for our hypotheses. We find that large market size attracts FDI inflows in the region. FDI inflows are higher when country experiences increase in market size along with improvement in the quality of institutions. Our results suggest a complementary relationship between traditional economic factors and institutional factors.

The study contributes to the literature on FDI inflows in South Asian region by examining the combined effect of traditional locational factors and institutional factors. Our findings provide important implications for the policymakers. As such, it is important to focus on improvement in the institutional environment as economies undergo a process of economic growth. This provides confidence to the foreign investors, and they are more likely to commit greater amount of resources in the country.

The structure of the rest of the paper is as follows. Following the introduction section, section 2 presents the conceptual framework and review of existing literature. Section 3 discusses the hypotheses of the studies. The data and methods are discussed in section 4, results in section 5 and the final section concludes.

² https://elibrary.worldbank.org/doi/abs/10.1596/978-1-4648-0382-6_south_asia

2. CONCEPTUAL FRAMEWORK AND REVIEW OF LITERATURE

A number of theories have been propounded to explain the flows of foreign direct investment (FDI). This includes explanations based on monopolistic advantages (Hymer, 1971) and internalization of external market failures (Buckley & Casson, 1976). Dunning (1981, 1988) combined the explanations based on monopolistic advantages and transactions costs of external market failures in what came to be known as 'eclectic paradigm of international production', or 'the ownership-location-internalization' (OLI) theory. Dunning's OLI theory has remained the dominant analytical framework for examining the determinants of FDI and the foreign activities of multinational enterprises (MNEs). The eclectic paradigm builds its arguments on three type of advantages- ownership (O), location (L), and internalization (I). It proposes that FDI takes place when a firm possessing ownership specific advantages such as- proprietary technology, patents, brand names etc., decides to combine and exploit them with the immovable location advantages of a foreign country such as market size, natural resources, factors of production, infrastructure, investment incentives, strategic assets etc., and which they cannot do more profitably than through internalization (I).

The eclectic paradigm, therefore, brought forward the discussion on locational advantages that determine the attractiveness of a host country for foreign direct investors. The motives-location framework presents a complementary relationship between investing firm's motive of investment and associated location advantages of the host country (Dunning, 2000). According to this framework, motives for FDI can be classified under four categories, viz., market seeking, resource seeking, efficiency seeking, and strategic asset seeking (Dunning, 2000).

Market seeking FDI is motivated by the desire to capture a sizable market share and the need to exploit new markets or defend existing ones. It could be motivated by a desire to enter a new market before rivals or by a desire to stop rivals from taking similar action.

Resource seeking FDI is normally associated with the primary sector firms. The resource seekers are driven by their need for cheaper resources which includes physical, human, technological or organizational resources.

In efficiency seeking FDI, the idea is to take advantage of different factor endowments, economic systems, policies and market structures so that production is concentrated in few locations. It is of two types. First, and probably the most frequent type, is when firms try to transfer production, totally or in part, to low labor cost locations in order to increase their cost efficiency. This will most probably happen in industries where unskilled or semi-skilled labor is an important constituent of the cost of production. The second type of efficiency seeking FDI is when investment is done to rationalize the operations of existing MNEs. The objective may be the exploitation of comparative advantages in adjacent territories (e.g. following a process of economic integration, such as the creation of the Single European Market, in 1992) or to make use of economies of scale and scope across borders. However, prior market seeking FDI is a pre- condition for this kind of efficiency seeking foreign investment.

In Strategic asset seeking FDI, firms use this form of FDI as a means for sustaining or increasing their international competitiveness. Assets such as R&D or technical know-how, patents, brand names, local permits and licenses and supplier and distribution networks, often take time to develop and are important in increasing a firm's income-generating resources and capabilities.

Hence, host country factors such as market size, growth rate, availability of natural resources, low-cost factors of production, availability of strategic assets, infrastructure are important determinants of FDI inflows. There are a number of studies that have examined these factors in explaining the FDI inflows in various developed as well as developing countries (e.g., Beule & Duanmu, 2012; Nayyar et al., 2021)

The increasing share of FDI inflows in developing countries have led scholars to move beyond the consideration of traditional locational determinants explicated in the motives-location framework. Given the peculiar state of institutions in the developing countries, researchers have argued for the explicit consideration of institutional environment in addition to the traditional locational advantages (Peng et al., 2008). As a consequence, institutional theory has become a popular theoretical lens in examining the flows of foreign direct investment in developing and emerging economies (e.g., Wei, 2000; Benassy-Quere et al 2007; Beule and Duanamu, 2012).

Institutions are the rules of the game in a society or the humanly devised constraints that shape human interaction (North, 1990). They are composed of *formal rules* devised by human beings such laws and regulations governing protection of private property, crime, contract enforcement, political systems etc., and *informal constraints* such as norms of behaviour, customs, values, religion etc. (Boliari, 2007). The role of the formal institutions is that they serve to limit the transaction costs of conducting market exchanges in a country. This occurs as a result of reduced time and money involved in locating the trading partners, comparing their prices, evaluating the quality of good for sale, negotiating contracts and agreements, monitoring performance, and settling disputes (Acemoglu & Robinson, 2012; Nayyar & Prashantham, 2020). Formal institutions also underlie the manner in which governments are selected, monitored and replaced; the ability of the government to formulate and implement policies; and the respect that citizens and the state have for the institutions that govern economic and social interactions among them³. Strong formal institutions that support market transactions, promote transparency and efficiency provide confidence to the foreign investors to make long-term commitments, and are therefore found to have a general positive effect on FDI inflows (e.g., Azam et al., 2011; Steine & Daude, 2001).

Various studies have examined the role of traditional location as well as institutional factors in explaining the FDI inflows in developing countries and regions, including South Asia.

Kakar and Khikji (2011) reported a strong positive relationship between trade openness and foreign direct investment in Pakistan and Malaysia for the period from 1980-2010. Majumder (2019) found the same result holding for Bangladesh using Johansen cointegration test and Granger causality test. Seyoum et al (2014) concluded that there is a connection between trade openness and FDI inflows in 25 Sub-Saharan African nations. Using the Granger causality test on data from 1977 to 2009, they found a bidirectional causal relationship between trade openness and FDI inflows in these African countries. Nkoa (2018) for African countries; Tan et al (2018) for ASEAN; Adhikary (2017) for SAARC countries; Aziz and Mishra (2016) for Arab countries; and Al-Khoury (2015) for MENA countries found market size to be the most

³ <http://info.worldbank.org/governance/wgi/Home/Documents#doc-intro>.

significant determinant of inward FDI. According to Billington (1999), the larger the host market, total income, and its growth potential, the higher the amount of FDI investment. In the context of India, Iran and Pakistan, Sabir et al (2019) found that FDI inflows appear to be significantly influenced by traditional determinants like exchange rate, Inflation and GDP per capita.

In context of South Asia, Sahoo (2006) conducted a comprehensive study examining determinants of FDI inflows in South Asia during 1970 to 2003. Using panel cointegration test, the study found that FDI inflows in the region are positively influenced by market size (proxied by total GDP), infrastructure quality, labour force growth and trade openness. Bimal (2017) found that large market size, stable macroeconomic environment, a higher level of existing FDI, political stability increases FDI flows in South Asian region. The importance of market size as a determinant of FDI inflow in the region is further corroborated by Aziz and Mishra (2016), Hoang and Bui (2015), Alam and Shah (2013) and Ang (2008).

From institutional perspective, Ohlsson (2007) showed that corruption negatively and significantly affected FDI inflows in 46 developing countries from 1997 to 2004. Daude and Stein (2007) found that Institutional quality of the host country matters for FDI, especially institutions that create predictable regulatory and legal framework as well as policy stability. Globerman and Shapiro (2003) suggest that host country's effective governance affect both the probability of US firms investing in that country as well as the magnitude of amount invested. The results are more pronounced for investment in developing countries. Kolstad and Wig (2012) showed that Chinese OFDI is attracted to countries which combine large natural resources and poor institutions. Mishra and Daly (2007) showed that the quality of host country institutions- law and order, government stability, bureaucracy quality and corruption- have positive effect on source countries OFDI stock. Bringing institutional factors under consideration along with traditional location factors, Layla et al (2020) showed that while economic factors such as GDP, infrastructure development and trade openness play a highly significant role in attracting FDI inflows in the region, weak regulatory institutions, lack of transparency and accountability in public work deterred them.

An extensive review of literature shows a dearth of studies examining the combined effect of economic factors and institutional factors in influencing FDI inflows in South Asia. The examination of the combined effect is important as neither the economic factors nor the institutional factors alone provide a complete explanation of the decision of investors to choose a particular location for investment (Nayyar et al., 2021). This provides us a strong rationale to undertake this study. The conceptual framework is presented below (figure 1).

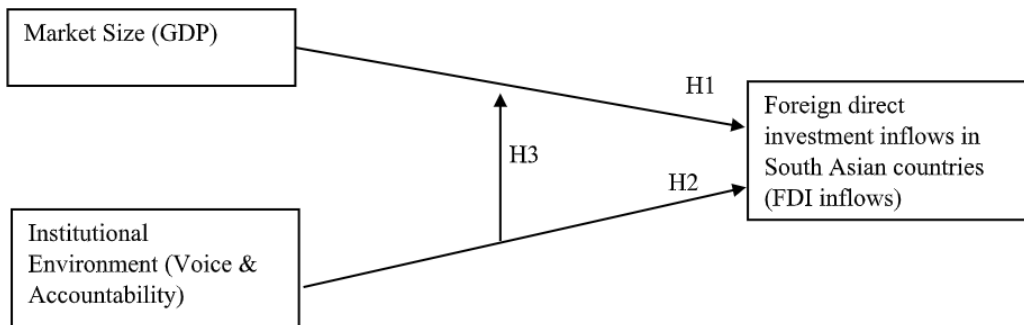


Fig1: Conceptual Framework

3. HYPOTHESIS

3.1 Market Size

Firm’s primarily enter an international market due to the “market opportunities” which might allow the forms to gain economies of scale and scope for their current products and thus earn a greater return (Hitt et al., 2007).

The aim of FDI in developing countries is to tap the domestic market (IMF, 2003), and thus the size of market as measured by GDP assume a significant role in determining the FDI attractiveness of the host country and thereby influencing the volume of FDI inflows.

Khamphengvong and Srithilat (2018) argued that a large market would be preferred by foreign investors when investing abroad. Chakrabarti (2001) argues that “market size has, by far, been the single most widely accepted as a significant determinant of FDI flows” (p.96). Adhikary (2017) found market size as the significant determinant of inward FDI for SAARC countries. Beloucif et al (2020) argue that the market size of the host country proxied by GDP per capita is statistically significant in attracting FDI in South Asia. Hence, market-seeking is an important motive of FDI in South Asian countries. This is in line with many studies such as Aziz and Mishra (2016), Hoang and Bui (2015), Alam and Shah (2013), Ang (2008), Bhatt (2008), Asiedu (2006) who also found a positive and significant impact of market size in the FDI inflow of the host country.

Based on this, we hypothesize the following-

Hypothesis 1: The amount of FDI inflows in South Asian countries are likely to be positively associated with the market size.

3.2 Institutional Quality

Being a long-term commitment, foreign investors tend to consider the institutional quality of the country before making an investment there. Formal institutions perform the functions that support market transactions, promote transparency, accountability and reduces the cost of doing business in a nation. They also underlie the manner in which governments are selected, monitored and replaced; the ability of the government to formulate and implement policies; and the respect that citizens and the state have for the institutions that govern economic and

social interactions among them⁴. Formal institutions are a multi-dimensional construct with each dimension playing an independent and interactive role with others (Batjargal et al., 2013).

Voice and accountability represent the way the society views institutions. It denotes the extent to which citizens are able to participate in selecting their government, along with the freedom they enjoy in forming an association and expression against government actions (World Bank, 2020). Prior researches consider voice and accountability as an indicator of institutions (Jensen 2003, 2008; Rodriguez-Pose & Cols, 2017; Shan, Zhibin, Yulei & Yan, 2018) that is likely to have a positive effect on FDI inflows by encouraging political reliability, participation in the political system, and promoting democratic institutions (Kurul & Yalta, 2017). Studies have suggested that higher levels of voice and accountability in a host country ensure protection of property rights, provides a credible and stable environment thereby positively influencing FDI inflows (Li & Resnick, 2003; Jensen, 2003).

Since the context of our study is South Asia- a region including one of the largest (India) as well as other democratic nations, voice and accountability as an institutional dimension is a relevant and interesting to examine. South Asia's history of democracy has presented a mixed picture. While some countries such as India and Sri Lanka have a better record of democratic rule, other countries- Pakistan, Bangladesh, Nepal, Afghanistan, Maldives and Bhutan have experienced significant struggle with the evolution of democracy and to date embrace authoritarian rule.

Therefore, we hypothesize the following:

Hypothesis 2: The amount of FDI inflows is likely to be positively associated with the higher voice and accountability in the host country.

3.3. Market Size and Institutional Quality

Understanding the combined effect of market-size and institutions contribute to more effective national and international policies. Host country institutions influence the market opportunities and vice versa. Therefore, it is likely that market-size and institutions may have an interaction effect on incoming FDI. Combining interaction of variables such as market-size and institutions, we test our third hypothesis:

Hypothesis 3: Higher voice and accountability in a country positively moderates the relationship between market size and FDI inflows.

4. Data and Methods

The empirical context of this study is 8 countries of South Asian Region- Afghanistan, Bangladesh, Bhutan, India, Myanmar, Nepal, Pakistan and Sri Lanka. We examine the FDI inflows over the period 2007 to 2020- time period guided by the availability of data on all the variables of interest.

⁴ <http://info.worldbank.org/governance/wgi/Home/Documents#doc-intro> (Accessed on: July 2, 2022).

Dependent Variable: FDI inflows (USD Millions) for the period 2007-2020 is collected from the UNCTAD (United Nations Conference on Trade and Development) FDI statistics database. In line with the extant literature, we took the natural logarithm of FDI inflows.

Independent Variables:

Market Size: In line with the existing studies, market size is measured via Gross Domestic Product (constant 2015 USD, natural logarithm).

Institutional Quality: As discussed above, institutional quality is proxied by voice and accountability measure obtained from World Governance Indicators of the World Bank. The value of this variable ranges from -2.5 to 2.5. Higher values indicate higher level of voice & accountability.

We also included an interaction term between market size and institutional quality to estimate the combined effect of traditional locational and institutional determinant of FDI inflows.

Estimation method: Given our objective is to examine the determinants of FDI inflows in the South Asian region as a whole, pooled OLS (POLS) regression method is a preferred method of testing the proposed model, represented in the equations below. Since endogeneity could be a potential issue, we use the lagged structure model (Greene, 2008).

$$\text{Equation (1): } Ln (FDI \text{ Inflows})_{it} = \beta_1 LnGDP_{it-1} + \beta_2 \text{Voice \& Accountability}_{it-1} + \mu_{it}$$

$$\text{Equation (2): } Ln (FDI \text{ Inflows})_{it} = \beta_1 LnGDP_{it-1} + \beta_2 \text{Voice \& Accountability}_{it-1} + \beta_3 GDP_{it-1} * \text{Voice \& Accountability}_{it-1} + \mu_{it}$$

We also estimated variance inflation factors (VIF) statistics to address the collinearity concerns. As shown in the descriptive table 1, the VIF of both the independent variables is 1.13, sufficiently below the acceptable limit of 10 indicating that the multicollinearity is not a problem in our data (Hair et al., 1998).

Table 1: Descriptive Statistics

Variable	VIF	Obs	Mean	Std. Dev.	Min	Max
FDI inflows (Log USD millions)	-----	110	6.134	2.477	.011	11.068
Market Size (Log GDP USD million)	1.13	112	10.713	2.172	7.11	14.807
Voice & Accountability	1.13	112	-.433	.463	-1.404	.462

5. Results and Discussion

The results of pooled OLS regression are presented in table II. Model 1 tests the independent effect of market size and voice & accountability, i.e., hypothesis 1 and 2. Model 2 tests the moderation effect as suggested in hypothesis 3.

As can be seen from the table II, the coefficient of GDP, our proxy for market size is found to be positive and significant at 1 % level of significance, thereby supporting our hypothesis 1. This result is consistent with studies conducted by Khamphengvong and Srithilat (2018),

Chakrabarti (2001), Aziz and Mishra (2016), Hoang and Bui (2015), Alam and Shah (2013), Ang (2008), Bhatt (2008), Asiedu (2006). Beloucif et al (2020). Similarly, the coefficient of voice & accountability as a proxy for the institutional quality in the country is found to be positive and significant at 5% level of significance, suggesting that higher levels of the same is attractive to foreign direct investors, hence supporting our hypothesis 2. This result is consistent with the findings of Li & Resnick (2003), Jensen (2003). Kurul & Yalta (2017). The coefficient of the interaction term in model 2 (GDP* Voice and Accountability) is found to be positive and significant supporting out theoretical prediction that a better quality of institutions acts as a catalyst to growing market size. When the market size is growing, i.e., when the GDP is increasing, more FDI is likely to flow into the country to take the advantage of growing demand, economies of scale etc. However, this effect is likely to be stronger in the presence of good quality of institutions.

Table II: Result of Pooled OLS Regression

Variables	Model 1	Model 2
GDP	0.9372*** (0.0587)	0.9847*** (0.001)
Voice and Accountability	0.6966** (0.2727)	-2.1128 (2.4207)
GDP* Voice and Accountability	-----	0.2453** (.1216)
Constant	-3.6491*** (0.6926)	-4.3177*** (0.7591)
R squared	0.753	0.762
Adjusted R squared	0.748	0.755
F-statistics	163.21	113.28
Prob>F	0.000	0.000
Number of observations	102	102

***, **, * denotes statistical significance at 1%, 5%, and 10% level of significance respectively.

6. CONCLUSION AND POLICY IMPLICATIONS

Building on traditional location advantages framework and institutional theory, the paper examined the independent and combined effect of market size and institutional quality as represented by voice & accountability on the FDI inflows in South Asia during the period 2007-2020. Using pooled OLS regression, we find that market size and quality of institutions play a positive and significant role in attracting FDI inflows in the region. More interestingly, we find that higher levels of voice & accountability, which is a representative of better quality of institutions, positively moderate the relationship between market size and FDI inflows. This suggests that economic factors and institutional factors play a complementary role in attracting foreign direct investors. In other words, good quality institutions catalyze the positive effect of market size on FDI inflows. Our results provide an important implication for the policymakers as developing countries design various policy measures to attract much needed foreign direct investment on their turf. While supportive economic policies are necessary to attract FDI, they might not give the desired results if the institutional environment is not supportive of protecting private property and individual’s rights and liberties.

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