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EXPLORING THE MEDIATING PROCESSES OF QUALITY OF GOVERNANCE BETWEEN FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH

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Abstract

Foreign direct investment contributes to the changes in economic growth of ASEAN countries. Past studies showed mixed nature of relationship between foreign direct investment and economic growth. Good governance factors such as government effectiveness, political stability and absence of violence, rule of law, voice and accountability, control of corruption and regulatory quality also showed positive significant effect on economic growth. However, there is a lack of evidence on the mediating process of quality of governance between foreign direct investment and economic growth. Hence, this study aims to explain the process of quality of governance in mediating the relationship between FDI and economic growth. This study analysed secondary data for the period from 2009 to 2020 of five ASEAN countries with high human development scores based on the 2020 Human Development Report by the United Nations. Findings indicated that quality of governance mediates and improves the relationship between foreign direct investment and economic growth. The findings have significant policy implications as they suggest that policymakers in ASEAN countries can foster economic growth by further promoting FDI whilst considering the appropriate governance mechanism that can enhance economic growth.

Keywords: Foreign Direct Investment, Quality of Governance, Economic Growth, ASEAN countries

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Introduction

Foreign direct investment (FDI) inflow is a fundamental contributor to the economic growth of many countries. FDI inflows can play a critical role in improving the rate of economic growth through different channels like supplying foreign exchange, capital deepening and improving overall productivity via fostering innovation and technology transfers (Sokhanvar and Jenkins, 2022). Since FDI can bring much-needed additional foreign capital, and advanced technology and improved managerial skills, it is considered as an essential part of economic growth and the financial globalisation process (Alfarro, 2017). Ramzan *et al.* (2019) highlighted that even though FDI has been shown to have positive impact on economic growth, the size of impact vary across countries. Factors such as human capital, domestic investment infrastructure, macroeconomic stability and trade policies play a role in determining the size of impact (Makki and Somwaru, 2004). However, recent studies suggest that certain conditions need to be met before FDI can benefit economic growth including the roles of trade openness, government expenditure, and technology gap (Asafo-Agyei and Kodongo, 2022) as well as governance (Fon and Alon, 2022).

The effect of national institutions of governance on FDI has attracted a great deal of attention, with several studies suggesting a positive relationship between governance-related factors and FDI flows

(Fon and Alon, 2022). Several dimensions of Quality of Governance (QoG) have been found as key determinants of FDI inflows. The Worldwide Governance Indicators defines QoG using six dimensions; voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption (World Bank, n.d). Mengistu and Addhikary (2011) suggest QoG dimensions consisting of political stability and absence of violence, government effectiveness, rule of law, and control of corruption, significantly influence FDI.

Prior research has also examined the effect of governance on economic growth. Huang and Ho (2017) noted that governance plays an important role in generating economic growth through increased competitiveness and improved quality of life within a country. Dickson *et al.* (2021) found that QoG positively impact economic growth in Sub-Saharan African countries from 2006 to 2018. In addition, the rule of law, control of corruption, regulatory quality, government effectiveness and political stability are strongly correlated with FDI (Gani, 2007). Huang and Ho (2017) study on twelve Asian countries found that not all countries experience significant economic growth due to QoG. In addition, different dimensions of QoG benefit economic growth differently. For instance, significant causal relationship between government effectiveness and rule of law dimensions and economic growth was evident only in Cambodia, China, Laos, and Vietnam (Huang and Ho, 2017).

The mixed results of studies on FDI and economic growth indicate that the nature of relationship between the FDI and economic growth is not conclusive. Given that the ASEAN countries depends on FDI as catalyst to economic growth, knowledge on how foreign capital inflows leads to favourable economic consequences are critical. Moreover, there are still lack of evidence on the effect of quality of governance on the relationship between FDI and economic growth. Although extant literature suggests that higher QoG leads to higher economic growth (e.g., see Fon and Alon, 2022), the significance of elements within the governance framework is still unclear, particularly in ASEAN countries. Hence, this study aims to explain the process of QoG mediating the relationship between FDI and economic growth. We use the Worldwide Governance Indicators from the World Bank as our key governance measures for the current study. Findings from this study potentially provides policy makers in ASEAN countries recommendation on which dimensions of QoG that needs more attention to improve economic growth.

Literature Review

According to Chew (2009), there is a long-run relationship between FDI and GDP when FDI is the dependent variable but the long-run relationship between GDP and FDI when GDP is the dependent variable is not found. In addition, there are studies that have found that FDI has a negative impact on economic growth and income distribution (Tiwari and Mutascu, 2011). On the other hand, Hooi and Bee (2011) stated that FDI has positive impact on the economic growth. Moreover, FDI helps stimulate economic growth in the long run, although it has a negative impact in the short run (Dinh *et al.*, 2019). In addition, Rakhmatillo *et al.* (2021) shows that the FDI has a positive effect on economic growth and employment, and the economic growth has a positive effect on foreign direct investment and employment. However, scarcity of capital and technological expertise is most likely to face slower growth rate than those that have abundance of capital and technological expertise (Ogbonna *et al.*, 2022). In general, economic growth could be measured by the increase of gross domestic product (GDP) and the quality of life and living standards (Botha *et al.*, 2020). According to Beyene (2021), economic growth mainly depends on labour and capital inputs thus emphasised the importance of saving and capital formation as sources of growth.

A study by Radulović (2020) showed a positive long-run relationship between economic growth and the rule of law and control of corruption, while there is a negative long-run relationship between economic growth and voice and accountability, political stability and absence of violence, government effectiveness and regulatory quality. According to Alfarro (2017), the FDI contains many management dimensions, such as bonds, portfolio investment in foreign stocks. Since FDI can bring much-needed additional foreign capital, and advanced technology and improved managerial skills, it is considered as an essential part of economic growth and the financial globalisation process.

Over the years, experts studied the connection between investment and economic growth, in different countries or economies. Furthermore, even though institutional factors are important at influencing the long-run economic growth, their effect differs across countries depending on the level of economic development of the countries (Saima *et al.*, 2014). Recently, the number and quality of the analyses regarding the relationship between the economic growth and FDI are increasing.

In research focusing on China, Chew (2009) stated that the FDI affects Chinese growth through the diffusion of ideas and this FDI presents a significant positive effect on Chinese long-term growth through its influence on technical change (this is significant only in the 1990s). According to a previous study in Myanmar using descriptive methods over the period from 2000-2001 to 2010-2011, it was found out that the growth of Myanmar's economy does not depend on the foreign direct investment (Myint, 2012). On the other hand, in Phyoe (2015), finding shows that there is a positive relationship between FDI and economic growth only in the high-income countries (Hong Kong, Japan, Singapore, Taiwan and South Korea) and middle-income countries (Indonesia, Malaysia, Thailand, China, India and Philippines) which have the appropriate economic structure. But for the lower income countries, there is no positive relationship between FDI and growth of economies. The reason is that lower income countries (Myanmar, Cambodia, Laos, and Vietnam) have lower ability to absorb the benefits of FDI like technology transfer from developed countries to host countries (Kotrajaras, 2010). Pradhan (2009) also found that there is bidirectional causality between two variables, FDI and economic growth in only four countries (Indonesia, Singapore, Thailand, and Philippine) except Malaysia among ASEAN-5 countries.

Research Framework and Hypothesis Development

This study confines its research on the conceptual relationship between variables of FDI, QoG and economic growth as presented in Figure 1.

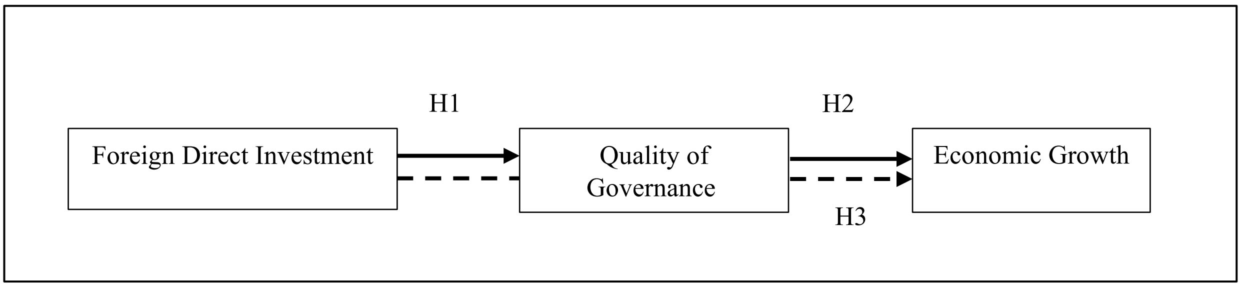

Figure 1. Research Framework

Despite variation of good governance in countries, it still attracts positive response in terms of FDI. Moreover, there is a strong correlation between FDI and some of QoG dimensions (rule of law, control of corruption, regulatory quality, government effectiveness and political stability) as found by Gani (2007). There is lack of empirical evidence that investigate the relationship between FDI and all dimensions of QoG to provide holistic view on how FDI could influence implementation of good governance in ASEAN countries. FDI has proven to be a push factor for countries to enhance their governance for the interest of investors (Fon and Alon, 2022). Therefore, this study proposed the following hypothesis:
H1: FDI has a significant positive effect on QoG.

Governance has a role in aiding economic growth (Barro, 2001). There exists mixed evidence on the relationships between QoG and economic growth. Some of QoG dimensions (control of corruption and political stability and absence of violence (Samarasinghe, 2018); rule of law and control of corruption (Radulović, 2020) has a significant positive impact on economic growth. On the other hand, the other

dimension of QoG (voice and accountability, political stability and absence of violence, government effectiveness and regulatory quality) proved to cause negative effect to economic growth (Radulović, 2020). This study hypothesised that good governance would restrict and reduce foreign investors' interests to invest, thus resulting in deflation of economic growth. Therefore, this study proposed the following hypothesis:
H2: QoG has a significant negative effect on economic growth.

There are consistent results that found positive relationship between FDI and economic growth (Hooi and Bee, 2011; Alfarro, 2017; Rakhmatillo *et al.*, 2021). In addition, past studies found that QoG has influenced on economic growth (Barro, 2001; Samarasinghe, 2018; Radulović, 2020). Knowledge on how FDI leads to favourable economic consequences is vital since ASEAN countries depends on FDI as a medium to economic growth. However, the role of QoG in explaining the process of FDI in influencing the economic growth is yet to be explored. Thus, this study hypothesised the following:
H3: QoG mediates the relationship between FDI and economic growth

Methods

This study involved secondary data spans for the period from 2009 to 2020 of five ASEAN countries with high human development scores based on the 2020 Human Development Report by the United Nations. The scores of Human Development Index (HDI) between 0 and 1 indicate the economic development and economic welfare of a country. The selected countries of Indonesia, Philippines, Thailand and Vietnam were based on the values of HDI between 0.7 to 0.8, with the exception of Malaysia (HDI 0.810). The FDI data was extracted from the World Development Indicators (WDI) whilst the quality of governance was extracted from the World Governance Indicators (WGI) based on estimates from -2.5 (weakest) to 2.5 (strongest) of six dimensions consist of voice and accountability; political stability and absence of violence or terrorism; government effectiveness, regulatory quality, rule of law and control of corruption. Data extracted were analysed using the SmartPLS 3.0 to examine the following research framework in Figure 1.

Result and Discussion

Evaluation of measurement model

We followed the suggestions of Anderson and Gerbing (1988) to test the model developed using a two-step approach. Firstly, we tested the measurement model to test the validity and reliability of the instruments used following the guidelines of Hair *et al.* (2020) and Ramayah *et al.* (2018) then we ran the structural model to test the hypothesis developed. Before interpreting the results of our structural models, we evaluate the quality of our measurement models. All the variable under study namely Quality of Governance (QoG), Foreign Direct Investment (FDI) and Economic Growth (EG) are single measured item as illustrated in Table 1, thus, did not require reliability testing and validity testing. The measurement model of the study is depicted in Figure 2.

Table 1. Single-item measurements and quality criteria

Single-item measure	**Loading > 0.70**	**AVE > 0.50**	**CR > 0.70**	**HTMI CI without 1**
EG	1	Na	Na	Na
FDI	1			
QoG	1			

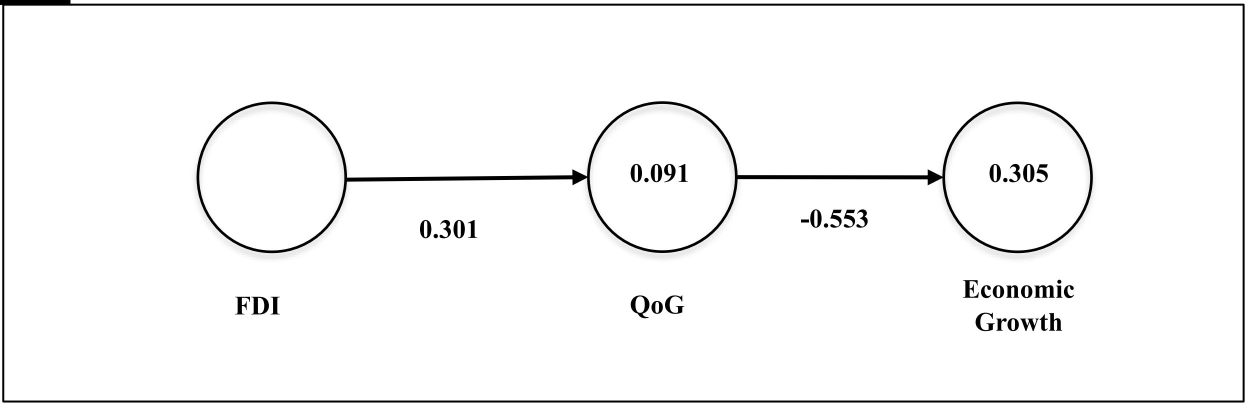

Figure 2. Measurement Model

Evaluation of structural model

Figure 3 depicts the structural model of this study which illustrated the result of path coefficient and t-values for each hypothesized relationship.

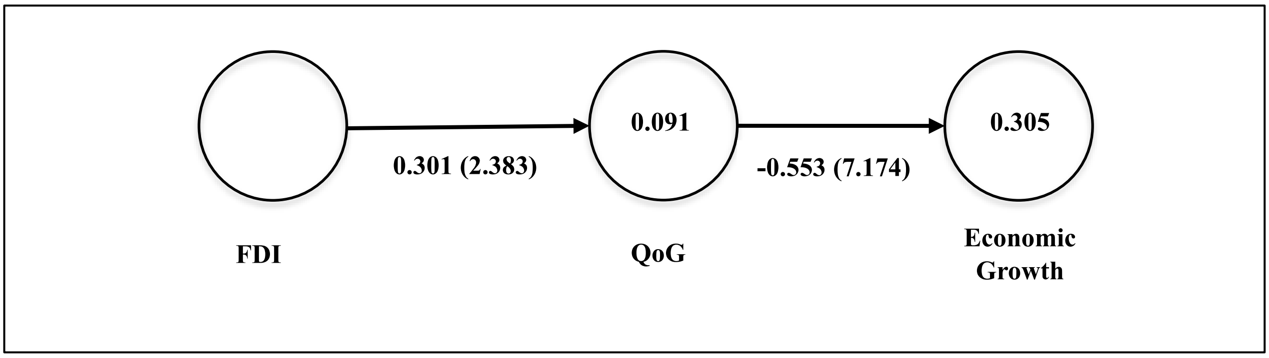

Figure 3. Structural Model

Following the suggestion of Hair *et al.* (2020), path coefficients, standard errors, t-values and p-values for the structural model using a 5,000-sample re-sample bootstrapping procedure were reported. The study also reported confidence intervals and effect size for testing of hypothesis. Table 2 shows the summary of the criterion used for hypotheses testing.

Table 2. Hypothesis testing

Hypothesis	Relationship	Std beta	Std error	t-value	p-value	BCI LL	BCI UL	f2
H1	FDI → QoG	0.301	0.126	2.383	0.009	0.095	0.483	0.100
H2	QoG → Economic Growth	-0.553	0.077	7.174	0.000	-0.664	-0.419	0.440
H3	FDI → QoG → Economic Growth	-0.166	0.081	2.064	0.020	-0.301	-0.047	

Firstly, we tested the effect of the FDI on QoG, the R^2 was 0.305 which shows that it explained 30.5% of the variance in quality of governance. As shown in Table 2, FDI have a significant effect on QoG ($ß = 0.301$, $p < 0.05$), thereby providing support to H1. This finding is consistent with previous studies (Gani, 2007; Radulović, 2020; Alfarro, 2017) which supported the fact that increases of FDI in the countries does require higher and stricter quality of governance.

Furthermore, we also tested the effect of the QoG on Economy Growth, the R^2 was 0.091 which shows that it explained 9.1% of the variance in economic growth. QoG was found to have a significant negative effect on Economy Growth ($ß = - 0.553$, $p < 0.05$). Thus, H2 was supported. This is due to the possibility that when there is good governance, the “dirty” money is not able to circulate back into the economy. Hence, better quality of governance will have a negative effect on economic growth which is consistent with Noha and I-Ming Chiu (2016).

Bootstrapping procedure was run to investigate the mediating effect of quality of governance on the relationship between FDI and economy growth as hypothesised in H3. As depicted in Table 2, the mediation effect is significant (t-values = 2.064) which confirmed H3. The path coefficient of -0.166 indicates that FDI has an indirect negative effect on economic growth via its positive effect on QoG. In other words, FDI deflated economic growth as it strengthens the quality of governance.

Conclusion

In this study, we examined the relationship between FDI, QoG and economic growth. Using secondary data from 2009 to 2020 of five ASEAN countries, we found significant positive relationship between FDI and QoG. However, QoG was found to negatively affect economic growth. Practically, the findings imply that the increase in foreign direct investment force ASEAN countries to enhance their quality of governance to protect the interest of investor. However, it was found that high quality of governance did not contribute to better economic growth. Most importantly, the findings contribute to the knowledge of the FDI-economic growth by providing empirical evidence on the process of foreign direct investment indirectly deflate economic growth via its positive effect on quality of governance The findings have significant policy implications as they suggest that policymakers in ASEAN countries can foster economic growth by further promoting FDI whilst considering the appropriate governance mechanism that can enhance economic growth.

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Author Contribution

Fazlida Mohd Razali –Methodology, Formal analysis, Writing - original draft, Writing – review and editing; Norlaila Md Zin – Conceptualization, Data curation, Writing - original draft, Writing – review and editing; Hazlina Mohd Padil - Supervision, Conceptualization, Data curation, Writing – review and editing, Project administration; Eley Suzana Kasim Conceptualization, Data curation, Writing - original draft, Writing – review and editing

Conflict of Interest

The authors declare no conflict of interest.

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