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Original Article

Good Governance and Foreign Direct Investment in ASEAN

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Abstract

The Association of Southeast Asian Nations (ASEAN) region has become one of the most sought-after foreign direct investment (FDI) destinations in recent years. However, there is still room for improvement. This research aims to study the importance of good governance for FDI inflows, along with other classical factors (market size, development level, trade openness, and human capital), in the ASEAN region from 2000 to 2022. Using the fixed effects panel data technique, the results show that the control of corruption exerts a positive and significant influence on FDI in ASEAN. Meanwhile, voice and accountability, though significant, still swayed FDI in the opposite direction, while political stability is found to be insignificant for FDI in ASEAN. Market size, development level, and human capital proved equally important in positively influencing FDI. Trade openness is significant but negatively associated with FDI. The key finding is that improving good governance factors like the control of corruption can play an imperative role in further enhancing the FDI attractiveness of ASEAN.

Keywords: good governance, panel data, FDI, corporations

JEL Classification Codes: *C330, F130, F140, F210 and G380*

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Introduction

Countries around the world are competing to secure Foreign Direct Investment (FDI) (Gonchar & Greve, 2022; Shah, 2011c). This trend is particularly pronounced among emerging and developing economies (Shah, 2021). Over the last three decades, there has been a significant increase in global FDI flows. The statistics for worldwide FDI inflows have risen from approximately US$ 55 billion in 1980 to about US$ 1.3 trillion in 2023 (UNCTAD, 2024). Good Governance (GG) is integrated into various aspects of the international investment arena. Consequently, GG has experienced a rise in attracting FDI. The International Monetary Fund (IMF) defines good governance as a broad term that encompasses how a nation is governed, taking into account economic policies, the rule of law, and regulatory quality (IMF, 2018). A growing number of research studies discuss the conventional factors influencing FDI; however, when it comes to governance and its impact on FDI, there remains a need for further research (Shah & Tahir, 2024). This paper aims to examine the importance of good governance for inward FDI in the Association of Southeast Asian Nations (ASEAN).

FDI has become a major driver of economic growth since the 1980s. Therefore, to secure FDI, emerging economies are integrating it into their policy frameworks (Deng, Delios & Peng, 2020; Shah, 2009). In the past, emerging nations have employed various incentives like cost reduction, cost-effective labor, and tax incentives to attract and promote FDI (Shah, 2011d). Newman, Rand, Talbot, and Tarp (2015) noted that FDI serves as a means of technology transfer, stimulates job creation, fosters strong business competition, increases capital flow, and acts as a critical revenue source. Dang and Nguyen (2021) confirmed that FDI is driven by long-term objectives.

The Asian Development Bank (2017) reported that with a combined population of over 600 million, ASEAN has the third-largest labor force in the world after China and India. Additionally, ASEAN has liberalized trade through tariff reductions. The organization is focused on building remarkable infrastructure and exceptional cross-border links to enhance market access and production capabilities (Shah, 2011b; 2014b). According to the World Investment Report (2024), the top 100 MNCs are significantly present in ASEAN. Compared to developed countries, the emerging nations attracted more FDI, despite the 2009 slowdown (UNCTAD, WIR, 2024). In light of the aforementioned benefits and incentives, it's clear that there is immense FDI potential in ASEAN. However, there is still room for improvement in governance (Shah & Gulelala, 2017). The events of the 1997 Asian Crisis stirred international finance experts and researchers to further investigate the

governance quality of a country and determine if better governance enhances capital flows and improves the economy of a country (Peres, Ameer & Xu, 2018).

The significance and role of good governance cannot be overlooked, especially since all major developmental bodies are currently working towards making GG an essential part of their programs (Ross, 2019). This can be summed up by the following quote of former United Nations Secretary-General Kofi Annan: "Good governance is perhaps the single most important factor in eradicating poverty and promoting development" (United Nations, 1998). Mahmood, Shakil, Akinlaso, and Tasnia (2019) stated that, although the classical factors (such as trade openness, market size, and infrastructure) remain important for FDI, nations with strong institutional quality and governance policies prove to be more appealing to foreign investors. The significance of the relationship between GG and FDI is becoming more pertinent in today's globalized world (Shah, 2023). It's increasingly clear that the presence of good governance factors leads to increased inward FDI. This paper is expected to contribute to the FDI literature in several ways. The findings of this work will provide insights into the factors that require consideration in order to augment inward FDI and enhance growth in ASEAN (Kannen, 2020). Improving good governance not only attracts inward FDI but also proves rewarding for domestic businesses and industries, resulting in economic prosperity (Shah & Zeb, 2017).

Due to the unavailability of data for states such as Myanmar, Laos, and Cambodia, several relevant and potentially important variables and proxies—like interest rate spread, education expenditure as a percentage of GDP, and research and development expenditure as a percentage of GDP—were not included in this study. The economic situation of a country depends on various dynamic determinants, some of which are unique to specific regions. Generalizing findings from one country to another unrelated country can lead to misleading results (Shah 2018a; 2019). Therefore, the outcomes of this research are limited to ASEAN for the period from 2000 to 2022. The results should not be generalized to other groups of states or individual countries unless they share similar economic and social environments as ASEAN members.

This research consists of seven parts. The first part provides an introduction and a brief description of FDI, good governance, and ASEAN. The second part offers a literature review. The third part reviews the methodology and overall research design. The fourth part discusses the tools and techniques used for data collection and analysis. The fifth part contains the results,

analysis, and their interpretation. The sixth part presents recommendations, while the seventh part concludes this research with some conclusions and future extensions.

Literature Review

The majority of empirical research regarding FDI determinants has been conducted using classical factors such as market size, gross domestic product (GDP), gross national product (GNP), trade openness, human capital quality, exchange rates, and inflation rates (Shah 2016a; 2018b). Thus, these factors are considered key motivators in the investment decisions of overseas investors (Shah & Jamil, 2016). However, as the modern world continues to evolve, good governance (GG) has become a crucial component across various disciplines (Shah, 2011a; 2017b). Consequently, trade and business, particularly FDI, have integrated GG, making its importance increasingly evident (Shah & Faiz, 2015). This literature review aims to ascertain the previously mentioned claim about the significance of GG for FDI in light of the empirical literature. According to UNCTAD (1996), incentives are crucial when competing globally to attract MNCs. Fazio and Talamo (2008) state that FDI is a global phenomenon, with countries, regardless of their geographical location and developmental stage, aspiring to be part of the FDI race. Therefore, several governments have developed various incentives to attract investors. These incentives include fiscal benefits, commercial gains, and the right to engage in monopolistic practices. With increasing globalization, various economic opportunities have been created for enterprises, but it has also heightened the necessity for better governance in host countries. The authors further state that social structure and governance play a more important role in attracting FDI than financial benefits, such as lower production costs. Consequently, with the growth of global trade, it is becoming crucial to survive in this globalized world. Many countries have embraced various policy changes to facilitate and encourage FDI.

Studies Related to Developed Countries

Mody and Srinivasan (1998), studying US and Japanese FDI, showed that Japan favored states encouraging trade openness more than US MNCs. Allessandrini and Resmini (1999) examined FDI in Europe and the Mediterranean region from 1900 to 1997 and found that trade openness adversely affected FDI inflows, while market size was insignificant. Lucke, Karmann, and Eichler (2013) investigated Japanese FDI into 59 developed and emerging host countries, revealing that Japanese investors are attracted to

developed economies with open markets and lax regulations. Emerging nations prove to be more attractive when they have enhanced governance policies, such as greater transparency, effective governance, and superior regulatory quality. However, political stability seemed to be important to a lesser degree, especially in developed countries. Surprisingly, the findings revealed that a high level of corruption seems to attract more Japanese FDI; this does not imply support for corrupt regimes, but indicates that in the presence of overburdening and strict regulations, government officials share the FDI profits. Mahmood et al. (2019) studied Canada's inward FDI. Canada is a developed country and was arguably the least affected during the financial and economic troubles of 2008-09, thanks to its excellent governance policies. Their findings confirm the positive relationship between governance and FDI, indicating that improving governance policies is not only beneficial for developing nations but also favorable for developed countries.

Studies Related to Developing Countries

Li and Reuveny (2003) state that voice and accountability (VA) negatively influence FDI. High levels of VA empower an unskilled labor force, which may create challenges for MNCs trying to exploit cheap labor. Similarly, Carkovic and Levine (2005) identified that inward FDI leads to technology transfer in developing regions, suggesting a positive relationship between incoming FDI and economic growth. Li and Resnick (2003) find a negative link between VA and FDI due to the availability of cheap labor, entry deals, low costs, and the suppression of labor forces in regions with weak VA. Ahlquist (2006) found a positive connection between FDI and VA. FDI flows toward democratic states, as they create a more accountable and credible business environment. Moosa and Cardak (2006) consider market size and trade openness to be the most significant drivers of FDI. Nourzad (2008) found a negative relationship between FDI and openness. Fereidouni, Masron, and Amiri (2011), evaluating FDI and VA in the Middle East and North Africa (MENA) region, discovered an insignificant relationship between them. Berden, Bergstand, and Etten (2013) show that VA tends to decrease the import and export of goods, which may negatively impact FDI. Cantah, Wiafe, and Adams (2014) found that trade openness affects FDI negatively.

Shah and Afridi (2015), examining the significance of GG for FDI in SAARC from 2006-2014, showed that market size, political stability, and the quality of regulations exhibited a positive association with FDI, whereas corruption

had a negative one. Khan and Banerji (2016), analyzing the FDI from 63 countries in India for 2010-2013, found that promoting and improving corporate governance codes (including transparency) and aligning them with those of the developed countries (UK/US) were vital for attracting investment from abroad. Sabir, Rafique, and Abbas (2019), considering governance factors and FDI in developed and developing countries, concluded that governance plays a significant role in driving FDI. Their findings further indicate that VA positively influences FDI in developed countries, but it is insignificant in developing countries. Corruption control and political stability also show a positive link with FDI.

Studies Related to Asian Countries

This section includes studies related to both Asian and ASEAN countries, as ASEAN is part of Asia. Sun and Parikh (2001), using GDP growth as a measure of development level, found a significant relationship between it and FDI. Zaman, Shah, Khan, and Ahmad (2012), studying FDI in Pakistan, show that low-quality human capital negatively affects economic growth, whereas trade liberalization, population, government size, inflation, and human capital positively influence the FDI-growth nexus. Masron and Nor (2013) explore the effect of institutional quality (IQ) on FDI in ASEAN nations. They show that, except for regulatory quality, all other indicators had a significant positive impact on FDI. Ahmad and Ahmed (2014) studied the IQ effects on FDI in Pakistan for 1980-2012. Poor governance indicators, such as a high level of corruption, inefficient government, and miserable regulatory quality, seriously deter MNCs. White III, Chizema, Canabal, and Perry (2015) studied Southeast Asian economies and proposed that uncertainty of the legal system and regulatory inferiority have a curvilinear relationship with FDI. This means that FDI will decrease as the legal uncertainty of the law increases until a certain point, after which FDI inflow begins to show a greater surge with increasing legal uncertainty. Enterprises are attracted to highly uncertain legal systems because they offer opportunities to reap greater rewards, use financial leverage, and acquire favorable positions in the market. Xaypanya, Rangkakulnuwat, and Paweenawat (2015), using Dunning's eclectic paradigm, examined FDI determinants in ASEAN from 2000 to 2011. They found that market size and infrastructure play a significant role in attracting FDI, and even with limited trade openness, investors remain willing to invest. Rashid, Looi, and Wong (2017), scrutinizing 15 Asia-Pacific nations from 2000 to 2013, revealed that foreign enterprises prefer large markets with stable

political and economic conditions for their investments. Likewise, Masron (2017) studied how the inward FDI of a host country was affected by the institutional quality (IQ) of its competitor country. He considered ASEAN nations while referencing Chinese IQ for comparison from 1996 to 2013. Results showed that the ASEAN FDI pattern was considerably influenced by the "relative" Chinese IQ. He further stated that if ASEAN nations can improve their governance, it will benefit their economies a world of good, as it will enable them to "escape the middle-income trap" as well.

Importance of Good Governance for FDI

Hausmann (2000) believes that incentives, such as tax, financial, and regulatory stimuli, may lead to less favorable economic conditions for the host economies. In contrast, Shatz (2001) postulates that nations with developed governance and investment environments improve their inward FDI potential. Similarly, Kaufmann and Kraay (2024) and Kaufmann, Kraay, and Mastruzzi (2004) state that governance factors such as lower corruption, transparency, and superior legal regulations pave the way for MNCs' decisions to invest in a particular country. The OECD's (2003) report suggests that governance factors and FDI have a bidirectional bond. At times, transparency leads to FDI growth and, while at other times, FDI can give rise to new and improved transparent practices. Moosa and Cardak (2006) also found political stability to be a significant FDI determinant. On the other hand, corruption and the absence of transparency cause a strong negative effect on FDI (Fazio & Talamo, 2008).

Alguacil, Cuadros and Orts (2011) stressed that if a nation wants to improve FDI inflow, merely enhancing conventional incentives, such as cost reductions and tax incentives, is insufficient; they should also focus on strengthening governance practices and enhancing economic infrastructure. Similarly, Masron (2017) suggested that the conventional incentives employed by host countries add substantial costs and are difficult to maintain in the long run. Thus, relying solely on conventional incentives to attract FDI is not a wise choice; improvements in good governance policies can be extremely beneficial in this regard.

In light of the previously mentioned literature, signalling a positive impact of good governance and FDI on host economies, it is also wise to discuss some of the literature that presents conflicting outcomes. Wheeler and Mody (1992) were unable to find any significant FDI-governance rapport; their results indicated that FDI decisions were largely dominated by classical determinants and agglomeration benefits. Some authors are of the view that FDI negatively

impacts a nation's growth, as this growth is not natural and is induced by foreign intervention, ultimately resulting in sluggish growth (Disney & Amin, 1976). Tekin (2012) argued that FDI positively affects economic growth only if it is assumed that foreign investment does not crowd out domestic investment. Dang and Nguyen (2021) examined FDI into ASEAN-7 from 1996 to 2019 and found, through Pooled-OLS and Feasible Generalized Least Squares (FGLS) for Seemingly Unrelated Regression, that FDI is negatively affected by political stability. Krifa-Schneider, Matei, and Sattar (2022) analyzed FDI into 80 developed and emerging countries, finding that political stability has a significantly negative influence on FDI in emerging economies. Antonietti and Mondolo (2023), studying FDI into 102 developing and emerging states over 25 years, from 1995 to 2019, found that it Granger causes voice and accountability.

To conclude this section and reiterate the importance of good governance for host countries, and specifically for ASEAN, Daude and Stein (2007) state that poor regulations, an unstable political environment, and government inefficiency significantly affect FDI negatively. Kaufmann and Kraay (2024) emphasize the need of enhance good governance (government efficiency, political stability, control of corruption, sound regulation) to attract and sustain FDI. Numerous studies have demonstrated that good governance codes positively and significantly impact FDI and economic growth (Ahmad & Ahmed, 2014; Shah & Afridi, 2015; Saidi, Ochi & Maktouf, 2023; Shah & Tahir, 2024).

Hypothesized Relationship of the Explanatory Variables

In the light of the literature review, the hypothesised relationship of GG with FDI is given below, whereas, for other explanatory variables, it is mentioned in Table 1.

H_0: Good Governance has no effect on inward FDI in ASEAN

H_1: Good Governance has a significant effect on ASEAN inward FDI

Table 1: Hypothesized Relationship of the Explanatory Variables

Variables	Expected Effects
Market size	Positive
Development Level	Positive
Trade Openness	Positive
Human Capital	Positive
Good Governance	Positive

Methodology

This part covers the research methodology employed in this research work. It states the population/sample, conceptual framework, explanation of dependent and independent variables, and mix of tools and techniques used for data collection and analysis (Shah, 2011e).

Population

To explore and examine the impact of good governance on inward FDI of the host countries belonging to the ASEAN region we have taken in account data for 2000-2022 of all the ten member nations of ASEAN which are Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam (ASEAN, 2024). As all ten member nations of ASEAN are considered for this study, the population and sample are the same.

Model Specification

A bivariate analysis would cause omitted variable bias (Shah & Khan, 2017). Therefore, other control variables are added to decrease omission bias and get superior and more reliable results (Appiah, 2018; Shah, 2012a; 2013b; 2017d). The functional form of the FDI good governance rapport is explained through equation 1:

$$FDI_{jt} = f\begin{pmatrix} Market\ Size, Development\ Level, Trade\ Openness, \\ Human\ Capital, Good\ Governance \end{pmatrix}_{jt} \quad (1)$$

Where "j" represents the member countries varying from 1 to 10, and "t" represents the time period 2000-2022, varying from 1 to 23. Annual secondary data is collected mostly from the World Bank (WB), Worldwide Governance Indicators (WGI), World Development Indicators (WDI), and Lee and Lee's

(2024) educational data set. It is analysed using multiple regressions to determine the relationship between the dependent and independent variables.

$$FDI_{jt} = \begin{matrix} \alpha_0 + \beta_1 Market\ Size_{jt} + \beta_2 Development\ Level_{jt} + \beta_3 Trade\ Openness_{jt} \\ + \beta_4 HumanCapital_{jt} + \beta_5 PoliticalStability_{jt}\ or \\ \beta_6 Voice\&Accountability_{jt} or\ \beta_7 Control\ of\ Corruption_{jt} + \mu_{jt} \end{matrix} \quad (2)$$

Where "α" is the intercept, "β_j" stands for the coefficient of the explanatory variables, while "μ" is the error term of the model.

Variable Explanation

Dependent Variable - Foreign Direct Investment (FDI)

When a multinational enterprise enters a foreign market either by acquiring a business as a whole or extending its business activities, it is known as an investment (Shah, 2010). The data for annual net FDI inflows and FDI stock have been collected from the United Nations Conference on Trade and Development (UNCTAD, 2024).

Controlling Variables:

Four control variables: market size, development level, trade openness, and human capital have been selected in order to reduce the chances of omitted variable bias (Shah & Samdani, 2015; Shah & Khan, 2016). These are discussed below.

Market Size

Market size is perhaps one of the foremost FDI determinants that influence an investor's decision (Shah, 2012c). Gross domestic product (GDP) is used as a proxy for market size (Xaypanya et al., 2015). Population is also utilised as a possible proxy for market size (Shah & Azam, 2018). It is expected to have a significant positive effect on FDI in light of extant literature (Moosa & Cardak, 2006; Rashid et al., 2017; Nguyen & Cieślik, 2021).

Development Level

Pulselli et al. (2015) say that gross domestic product per capita (GDP PC) should be adapted using purchasing power parity (PPP) rates, in order to get more reliable comparisons between the development level of countries (Shah, 2016b). For this reason, gross domestic product adjusted for purchasing power parity per capita (GDP PPP PC) is used as a proxy to measure the development level (Shah & Qayyum, 2015). A greater development level is preferred by potential investors (Shah, 2017c; 2018d).

Trade Openness

Exports as a percentage of GDP are used to measure the trade openness of the host countries. Investors prefer to invest in trade-friendly countries compared to isolated economies. FDI flows to countries that allow the import of raw materials and the export of finished goods. A positive relationship is expected (Mody & Srinivasan, 1998; Wang, Yang & Yang, 2023).

Human Capital

To measure human capital, tertiary education enrolment is used as a proxy. The quality of human capital informs investors about the education, competencies, and skill level of available labour in the host country (Shah, 2014a). Skilled and affordable labour is highly preferable in order to ensure a successful investment endeavour in a foreign nation. Human capital is expected to have a positive affiliation with FDI (Ahmed & Kialashaki, 2023; Rehman & Islam, 2023). Tertiary education stats are collected from Lee and Lee's (2024) dataset.

Independent Variable – Good Governance (GG)

Good governance is the main independent variable. It doesn't have a universal definition. The World Bank defines governance as the manner in which power is exercised and how the rules are created and imposed by the concerned authority. Furthermore, it relates GG with factors such as efficient government, rule of law, political stability, superior human rights, and transparency (World Bank, 2017). Whereas, the Office of the High Commissioner for Human Rights (OHCHR) outlines GG as the practices considered essential for growth and advancement. In addition, it describes GG as the procedures through which public concerns, resources, economic goals, and political aims are managed while ensuring transparency, accountability, avoiding corruption, and abiding by the rule of law (OHCHR, 2024). To measure the effect of good governance, the World Governance Indicators (WGI) by Kaufmann and Kraay (2024) are used. Governance indicators consist of six dimensions: voice and accountability, government effectiveness, political stability and absence of violence, the rule of law, regulatory quality, and control of corruption. However, three governance dimensions are chosen as proxies to study the impact of good governance on FDI in the ASEAN region, which are control of corruption, political stability, voice, and accountability. Studies carried out by Brewer, Choi, and Walker (2007) and Shah and Afridi (2015) use three out of six and four out of six dimensions of GG, respectively. Following Kaufmann and Kraay (2024) and Saidi et al.

(2023), we expect a positive and significant relationship of GG with FDI. The conceptual framework is provided as Figure 1.

Control of Corruption

Corruption is interpreted as the extent to which public power is exploited for personal advantage. The presence of corruption can prove to be a deterrent for inward FDI, as evident from the extant empirical literature (Fazio & Talamo, 2008; Ahmad & Ahmed, 2014; Shah, 2018c; Krifa-Schneider et al., 2022).

Conceptual Framework

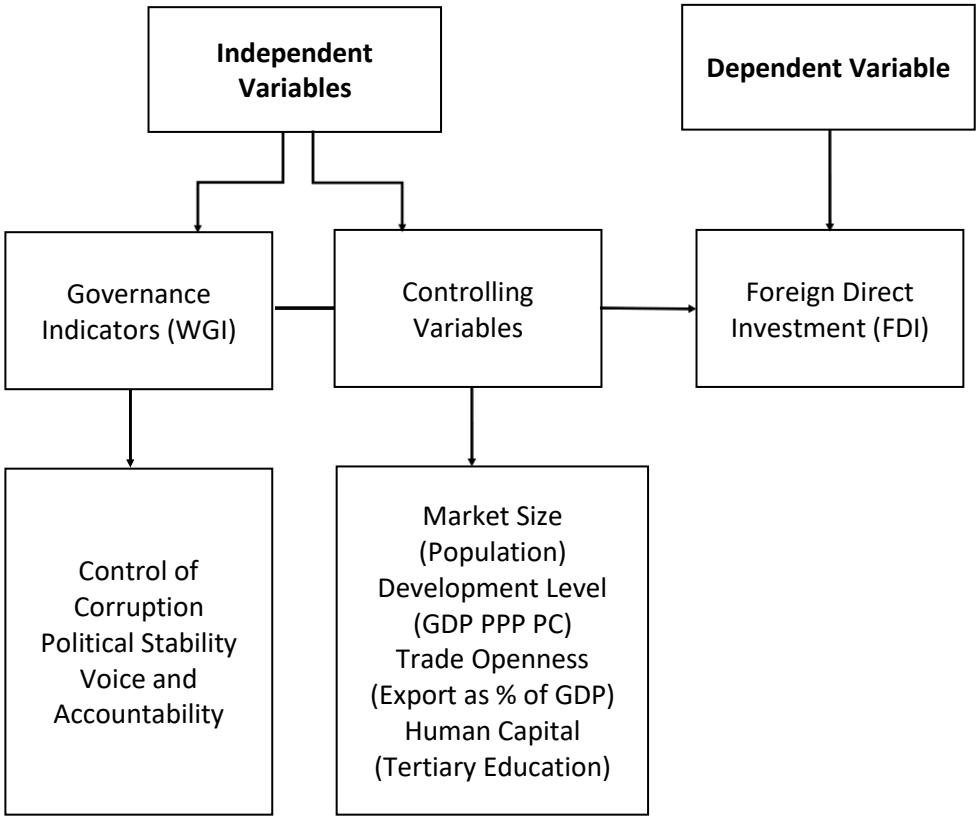

Figure 1 Conceptual Framework

Political Stability

The perception of a government's tendency to collapse due to violent means, such as terrorism, negatively influences potential investors. Foreign investors looking to invest prefer politically stable countries, expecting them to be favorable and supportive of their investments. The lower the political risk, the greater the attraction for foreign investors (Okara, 2023). A positive effect is anticipated, in light of previous studies (Gonchar & Greve, 2022; Moosa & Cardak, 2006; Rashid et al., 2017).

Voice and Accountability

Voice and accountability can be defined as the perceptions of the extent to which citizens perceive their ability to choose their government. This concept also encompasses freedom of speech, freedom of the press, and freedom of association. A negative relationship is anticipated based on the studies discussed in the literature review (Li & Resnick, 2003; Li & Reuveny, 2003; Fereidouni et al., 2011; Berden et al., 2013; Antonietti & Mondolo, 2023).

Estimation Issues

Before running the regressions on the data, it's important to observe the data and look for any outliers, which may cause issues in the reliability of the results. The statistical tests used for this study are given below: STATA 13 is used for running the regressions.

Descriptive Statistics

Table 2 shows the descriptive statistics of the data. It includes the number of observations, mean, standard deviation, minimum, and maximum value for all variables. It demonstrates the absence of outliers in the data; hence, there is no unreliability in the results for this reason.

Table 2 Descriptive Statistics

Variables	Proxies	Obs	Mean	Std.Dev.	Min	Max
FDI	Ln FDI	230	23.7080	1.8390	19.7320	27.8820
Market Size	Ln Pop	230	16.8760	1.8040	12.6270	19.3910
Development	Ln GDP PPP PC	230	9.0897	1.2709	6.8817	11.3668
Trade Openness	Ln Exports	230	3.7910	1.1470	0.0950	5.4480
Human Capital	Ln Tert Edu	230	1.7190	0.6900	0.2070	3.9730
Good	CoC	230	-0.2810	0.9990	-1.7000	2.3000
Governance	VA	230	-0.7240	0.7030	-2.2000	0.5000
	PS	230	-0.1800	0.9550	-2.1000	1.6000

Multicollinearity

Multicollinearity refers to the extent to which independent variables are correlated with one another. When problematic multicollinearity exists among them, it can complicate the results of the study being conducted (Shah & Khan, 2018). In the presence of multicollinearity, the outcomes of regression become unreliable, and the significance tests of regression coefficients may be flawed (Shah, 2013a). For this reason, it is crucial to check the data for the presence of multicollinearity before proceeding with regression analysis.

Correlation Matrix

To check for any potential extreme multicollinearity in the data, correlation coefficients for the variables were calculated using STATA 13 in the form of a correlation matrix (Shah, 2016c). The presence of extreme collinearity can lead to biased outcomes. Wooldridge (2015) states that if the correlation coefficient exceeds 0.90, it's an indication of problematic multicollinearity. However, all of the correlation coefficients are below 0.90, suggesting an absence of extreme multicollinearity.

Table 3 Correlation Matrix

No	Variable Name	Proxy Used	1	2	3	4	5	6	7	8
1	Foreign Direct Investment	Ln FDI	1.00							
2	Market Size	Ln Pop	0.37	1.00						
3	Development Level	Ln GDP PPP PC	0.46	-0.56	1.00					
4	Trade Openness	Ln Exports	0.41	-0.28	0.57	1.00				
5	Human Capital	Ln Tert Edu	0.67	-0.20	0.72	0.34	1.00			
6	Good Governance	CoC	0.54	-0.46	0.85	0.68	0.75	1.00		
7		VA	0.52	0.12	0.46	0.55	0.39	0.53	1.00	
8		PS	0.14	-0.70	0.68	0.58	0.40	0.72	0.11	1.00

Variance Inflation Factor (VIF)

Variance inflation factor, or simply VIF, is another means to check for multicollinearity. According to Asteriou and Hall (2021), if the VIF value is above 10, then this signals the presence of problematic multicollinearity, which will lead to biased regression coefficients. However, if the values are

below 10, then multicollinearity is non-problematic. As visible from Table 4, VIF for all variables are below 10. The mean VIF is also well below 10 at 4.17, which indicates that this data doesn't suffer from multicollinearity.

Table 4 Variance Inflation Factor

Variable	VIF	1/VIF
Control of Corruption	7.83	0.127778
Ln GDP PPP PC	5.53	0.180789
Political Stability	4.04	0.247523
Ln Tertiary Education	3.65	0.274035
Ln Population	2.90	0.344366
Voice and Accountability	2.67	0.374885
Ln Exports as % of GDP	2.57	0.388624
Mean VIF	**4.17**	

Heteroscedasticity

Regression analysis operates under the assumption that the error terms of a regression model are uniform across all values of the dependent variable, a condition known as homoscedasticity. In this scenario, the regression model can reliably predict the dependent variable across all values (both high and low) of the dependent variable. However, when the error terms are not uniform, this condition is referred to as heteroscedasticity (Shah, 2012b). This leads to unreliable regression models because of the model's inability to predict the dependent variable consistently across all values (high and low values) of the dependent variable, ultimately rendering the outcomes unreliable.

The test used for checking for heteroscedasticity is the Breusch-Pagan / Cook-Weisberg test. The null hypothesis of this test is that the variance of the error term is the same for all variables. If the resulting p-value of this test is below 0.05, then the null hypothesis can be rejected, which will mean heteroscedasticity is present. A list of models and their corresponding heteroscedasticity test results is presented in Table 5. In all the models, p-values are less than 0.05, which rejects the null hypothesis, meaning the presence of heteroscedasticity. In models where heteroscedasticity is present, robust standard errors should be used to control for this problem.

Table 5 Test for Heteroscedasticity

No.	Model Tested	P-Value
1	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \mu_{jt}$	0.0001
2	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \mu_{jt}$	0.0000
3	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \beta_3(Ln\ Exports)_{jt} + \mu_{jt}$	0.0000
4	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \beta_3(Ln\ Exports)_{jt} + \beta_4(Ln\ Tert\ Edu)_{jt} + \mu_{jt}$	0.0116
5	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \beta_3(Ln\ Exports)_{jt} + \beta_4(Ln\ Tert\ Edu)_{jt} + \beta_5(CoC)_{jt} + \mu_{jt}$	0.0000
6	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \beta_3(Ln\ Exports)_{jt} + \beta_4(Ln\ Tert\ Edu)_{jt} + \beta_5(CoC)_{jt} + \beta_6(VA)_{jt} + \mu_{jt}$	0.0000
7	$\alpha_0 + \beta_1(Ln\ Pop)_{jt} + \beta_2(Ln\ GDP\ PPP\ PC)_{jt} + \beta_3(Ln\ Exports)_{jt} + \beta_4(Ln\ Tert\ Edu)_{jt} + \beta_5(CoC)_{jt} + \beta_6(VA)_{jt} + \beta_7(PS)_{jt} + \mu_{jt}$	0.0000

Data Specifications

Pooled Ordinary Least Squares (POLS) Method

This is the first model applied to the collected data to use as a base for comparisons with other panel-based models. Multiple regressions are run using Ordinary Least Squares (OLS) on pooled data. Pooled data doesn't account for variations in time and treats the data as having similar characteristics throughout all time periods. In other words, heterogeneity and individuality, which may exist in the different countries of ASEAN, are missing from the data. Due to this reason, pooled OLS model results are skewed and fail to provide the real picture (Gujarati & Porter, 2017).

Panel Data Techniques

Panel data techniques are appropriate for data having both time-series and cross-sectional characteristics. This research aims to study the good governance-FDI Nexus in ten ASEAN member states over a time period of 23 years. The collected data have the two mentioned characteristics; consequently, panel data techniques should be employed. Panel data techniques are appropriate for data having both time-series and cross-sectional characteristics. This research aims to study the good governance-FDI Nexus in ten ASEAN member states over a time period of 23 years. The collected

data have the two mentioned characteristics; consequently, panel data techniques should be employed.

According to Baltagi (2021), there are various benefits of using panel data. The heterogeneous properties of individual nations are able to measure effects that are not possible in pure time series or pure cross-sectional data. There is more variation in the data, which reduces the collinearity among the variables. Panel data techniques also reduce or even eliminate the aggregation effects among nations, providing more reliable and unbiased results. The two main types of panel data techniques are fixed effects and random effects.

Fixed Effects Model (FE)

In the fixed effects model, the independent variables are assumed to have a fixed (non-random) nature, meaning the characteristics don't change over time. However, there is a chance that the change may be caused by some exogenous effect. In this model, the intercept may vary across individuals (nations), but the intercept doesn't change over time. Also, omitted variable bias can be controlled in this model, while it's difficult to do in OLS models.

Random Effects Model (RE)

In the random effects model, the independent variables are assumed to have a random nature, and it is assumed that all errors are accounted for in the model, and exogenous effects do not exist (Shah & Khan, 2019). In this model, the individuals (nations) have a common average intercept value.

Specification Diagnostic Tests

These tests are used to identify the most suitable estimation technique for this study. As the nature of the data is panel data, some tests are needed to check which types of panel data techniques are more appropriate for this data set. The result of these specification tests is mentioned in Table 6.

Table 6 Specification Test

Test	To Select Between	Null Hypothesis	P-Value	Results
Fischer-Test	Pooled OLS & Fixed Effects	Pooled OLS is Better	0.0000	Use Fixed Effects
Breusch-Pagan Langrage Multiplier Test	Pooled OLS & Random Effects	Pooled OLS is Better	0.0000	Use Random Effects
Hausman Specification Test	Fixed Effects & Random Effects	Random Effects is Better	0.0000	Use Fixed Effects

Fischer Test

This test is used to decide between pooled OLS and fixed effects model. The null hypothesis for this test is that pooled OLS is appropriate, whereas the alternative hypothesis is that fixed effects is apt (Shah & Ali, 2016). As mentioned in the specification test table, for this test, the p-value was statistically significant. Therefore, we can reject the null hypothesis, meaning that the fixed effect model is applicable.

Breusch-Pagan Langrage Multiplier Test

To select between the pooled OLS and the random effects model, this test is used. The null hypothesis for this test is that pooled OLS is suitable, while the alternative hypothesis is that the random effects model is a better fit (Shah & Sikander, 2025). As evident from the specification test table, the p-value was statistically significant; therefore, we can reject the null hypothesis, meaning that the random effects model is applicable.

Hausman Test

This is a commonly used test to identify the precise panel data model between fixed effects and random effects models. This test was developed by Hausman in 1978. The null hypothesis is that both random and fixed effects models are appropriate, while the alternative hypothesis is that the fixed effects model is more suitable. If the p-value is statistically significant, then the fixed effects model should be used; otherwise, the random effects model can also be

applied. As shown in Table 6, the p-value was statistically significant; therefore, we can reject the null hypothesis, meaning that the fixed effects model should be applied.

Findings and Analysis

The purpose of this study is to examine the effect of GG on FDI in the member nations of ASEAN. The results of the regression analysis, using a fixed effects panel data technique, are shown in Table 7. A total of seven models were constructed, and their results are mentioned in the table. The R-squared values range from 13.58% to 58.91% across models 1 to 7.

The first one shows FDI regressed on market size alone. The highly significant coefficient illustrates that an increase in market size would lead to an increase in FDI activity. In model 2, the development level (GDP PPP PC) is introduced to the previous model. The addition of the new variable noticeably increased the R-square from 13.58 % to 28.19%. The coefficient of development level is also highly significant and positively influences FDI. Model 3 introduces trade openness (exports as a percentage of GDP) to Model 2. It is found to be insignificant with a coefficient of -0.1062. Market size and development level still remain highly significant and positively linked with FDI. The R-square slightly increased from 28.19% to 29.83%. It seems that FDI in ASEAN is primarily market-seeking horizontal FDI. Though insignificant, it signals that investors seek closed markets in ASEAN. The introduction of human capital (tertiary education) in model 4 is found to be significant. The coefficient value of 0.6824 indicates that an increase in human capital will cause an increase in FDI activity. Market size remained significant with the largest coefficient. However, its coefficient decreased from 3.9203 to 2.6901, perhaps due to the inclusion of human capital and its noticeable influence over FDI. The R-square value increased from 29.83% to 43.56%. It shows that multinationals sought high-skilled labour, probably producing high-end tech-specific products.

Control of corruption is added in Model 5. The coefficient is significant at a 1% significance level and positively associated with FDI. The coefficient value of 0.5551 means that enhanced corruption control leads to an increase in FDI activity. Trade openness also became significant (significant at 5% significance level), however, with a coefficient value of -0.1234, which indicated that an increase in trade openness would lead to a decrease in FDI activity. The rest of the variables exhibited a similar pattern to that of the previous model. The R-square increased from 43.56% to 53.89%. In model 6, voice and accountability are introduced and are found to be highly significant

at 1% but negatively related to FDI. The coefficient value indicates that a one-unit increase in voice and accountability would lead to a decrease in FDI activity by 0.5124 units. The coefficient value of control of corruption almost doubled to 1.0526, with the introduction of voice and accountability. It indicates that the presence of voice and accountability increases the influence of control of corruption on FDI. The rest of the variables displayed a similar pattern to that of the previous model. The R-square increased from 53.89% to 59.00%. The final model introduces political stability to model 6. The coefficient of political stability is 0.0111, which is found to be insignificant, meaning it has no effect on FDI in ASEAN. The rest of the variables displayed a similar pattern to that of the previous model. The R-square slightly decreased from 59.00% to 58.91%, which indicates that 58.91% of the variation in FDI is explained by market size, development level, trade openness, human capital, and good governance.

Variable-Wise Discussion

Market size was found to be positive and highly significant in all models, with the largest coefficient. This indicates that foreign investors favour big markets while deciding to invest in a host country. This is highly confirmatory of the literature review, as various studies have shown the positive effect of market size on FDI (Mahmood et al. 2019; Moosa & Cardak, 2006; Rashid et al. 2017; Shah & Sikander, 2025). This indicates the possible presence of horizontal FDI, which is generally market-seeking and mostly carried out in mature markets.

Development level is statistically significant and positive in all models. The significance level and the direction of the relationship are as expected from literature and theory (Shah & Tahir, 2024; Sun & Parikh, 2001). This indicates that MNCs prefer host countries with enhanced development levels, as the economic growth of the host nation also positively affects the living standards, infrastructure, and labour skills. This is also affirmed by the fact that out of ten ASEAN countries, the biggest FDI recipient last year was Singapore, the most developed of the member nations.

Likewise, human capital was found to be significant in all models after its inclusion in model four. This indicates that the quality of the labour force is a primary concern for MNCs considering investment in ASEAN. These outcomes are also in line with the findings of the study conducted by Zaman et al. (2012) and Guechheang and Moolio (2013).

Trade openness is found to be significant, but with a negative sign. It is in contrast to the majority of literature, which states that a reduction in trade

barriers positively affects FDI, as it enhances the overall commercial and business environment (Mahmood et al. 2019; Mody & Srinivasan, 1998; Rashid et al. 2017). However, this negative relationship between openness and FDI is also reported by other studies conducted by Allessandrini and Resmini (1999), Nourzad (2008) and Cantah et al. (2014). The negative relationship suggests that MNCs operating in ASEAN are making horizontal FDI and are focused on capturing new markets (also indicated by the large market size coefficient value) rather than focusing on (re)exports.

Control of corruption is highly statistically significant and has a positive effect on FDI in all the models, which is as hypothesised in the literature review. It has the third-largest coefficient in Model 7, indicating the importance of corruption control in attracting FDI. It shows that foreign investors prefer countries with no or a negligible level of corruption. Regions with high corruption levels will generally be less likely to attract investors from abroad, as the business environment in corrupt regimes presents an inherent financial risk. Therefore, a high level of corruption will be a barrier for the MNCs looking to invest in a certain host economy in ASEAN. This result is also supported by the findings by Ahmad and Ahmed (2014), Fazio and Talamo (2008), Kaufmann and Kraay (2024), Masron and Nor (2013), Sabir et al. (2019), Shah and Afridi (2015) and Shah (2018c).

Voice and accountability are statistically significant; however, it is found to be negatively linked with FDI. The findings of past research are inconclusive when it comes to voice and accountability, as in some cases, it exhibits a positive bond, while in others, it's negatively associated with FDI. For example, Lucke et al. (2013) say that the presence of corruption may create extra benefits (bribery and profit sharing) for government officials and MNCs, which leads to a positive connection with FDI.

Table 6 Regression Results

Variables	Proxy	1	2	3	4	5	6	7
Market Size	Ln Population	7.2541*** (0.9695)	4.1416*** (0.8878)	3.9203*** (0.9607)	2.6901** (1.1169)	2.6838** (1.0782)	2.7216** (0.8579)	2.7250** (0.8632)
Development Level	Ln GDP PPP PC		1.3452*** (0.3611)	1.4618*** (0.4339)	1.2728** (0.4178)	1.3418*** (0.4102)	1.3273*** (0.3383)	1.3207*** (0.3490)
Trade Openness	Ln Exports as a % of GDP			-0.1062 (0.1159)	-0.1234 (0.1107)	-0.2407** (0.0775)	-0.2262* (0.1027)	-0.2224** (0.0910)
Human Capital	Ln Tertiary Education				0.6824* (0.3206)	0.6304* (0.3317)	0.5341** (0.2064)	0.5338** (0.2108)
Good Governance	Control of Corruption					0.5551*** (0.1702)	1.0526*** (0.2569)	1.0496*** (0.2418)
	Voice and Accountability						-0.5124*** (0.1413)	-0.5202*** (0.1489)
	Political Stability							0.0111 (0.1126)
R-Square		13.58 %	28.19%	29.83%	43.56%	53.89%	59.00%	58.91%
No. of Observations		230	230	230	230	230	230	230

*Note: Coefficient values are rounded off to four decimal places. Robust standard errors are mentioned in parenthesis. ***, **, * show significance at 1%, 5%, and 10%, respectively. Ln is used for natural logarithm*

VA represents the power of people to select their government; however, in the absence of VA, this can lead to corrupt governments focused on accumulating wealth for a select few. For this reason, the presence of voice and accountability may be seen as a hindrance for some MNCs, particularly those seeking tax havens and tax evasion. In contrast, lower voice and accountability—characterized by lax reporting practices, opportunities for tax fraud, exploitation of cheap labor, and oppression of labor unions—might be viewed as favorable conditions by some foreign investors, especially in developing countries where voice and accountability practices are weaker. Consequently, this may explain why VA shows a negative relationship with FDI in ASEAN. This finding also resonates with the conclusions of Li and Resnick (2003), Li and Reuveny (2003), and Berden et al. (2013).

Results for political stability are insignificant but positively associated with FDI. Aside from the significance level, the direction of the relationship aligns with expectations from the literature review (Daude & Stein, 2007; Kaufmann & Kraay, 2024; Rashid et al,. 2017; Sabir et al., 2019). This relationship may be insignificant because other variables with large coefficients, such as control of corruption, market size, and development level, overpower the model, and hence, make the effect of political stability insignificant.

Recommendations

Even though voice and accountability were found to have an inverse effect on FDI, this phenomenon may indicate that a lack of VA yields promising results in the form of an immediate boost in FDI. However, in the long run, this could create serious issues for the economic and financial stability of ASEAN member states, such as tax fraud, loan defaults, and increased levels of corruption. Given the high volume of FDI share in developing countries, this may even disrupt the global financial system and lead to another financial crisis, similar to the downturns of 1997 and 2008-09. In some cases where the VA is absent, MNCs can also coerce the labor force and suppress local citizens for their own advantage. Therefore, to avoid such catastrophes, ASEAN policymakers should consider this and actively work to enhance their VA standings by tightening the reporting standards for MNCs, ensuring transparent asset declarations, amplifying the voice of the labor force, promoting freedom of speech and free media, and curbing corrupt practices such as bribery and tax fraud. In the long run, this will certainly foster an investment-friendly and sustainable business environment.

ASEAN should also focus on improving the quality of its human capital. As one of the fastest-growing regions in internet and mobile phone users, this has led to the rapid spread of the digital economy in ASEAN. Many companies, such as Facebook, Yahoo, and Amazon.com, are focusing on ASEAN to take advantage of these opportunities. However, since these MNCs require highly skilled workers because of the nature of their products and services, ASEAN will need to continue providing them with a highly skilled labor force to remain attractive to these enterprises and capture new prospects. As reported in the ASEAN Investment Report (AIR) 2018 (ASEAN Secretariat, 2018), Australia and the Netherlands have shown extraordinary interest in future projects in ASEAN. One of the main reasons could be the quality of human capital in the region and improving it will certainly create further opportunities for inward FDI from other economies as well. Hence, enhancing and improving human capital is another way to increase FDI flows to the region.

Control of corruption was the third most significant and positive influencer of FDI in model 7, alongside political stability, which, although statistically insignificant, had a positive coefficient associated with it. Therefore, improving governance is an exceptional way to increase FDI, as relying solely on classical factors is insufficient for attracting FDI. There is a reason these are considered conventional factors; most nations have employed them to sway FDI in their favor. These factors are arguably easier to achieve compared to governance factors, which require changes at the foundational level of the overall system. However, once improvements are made in governance, these factors not only become favorable for foreign investments but also enhance the business environment for local companies. Consequently, it is expected that they will have some complementary effects as well.

Conclusion

The focus of this research study was to examine the effect of good governance on foreign direct investment in all ten member states of the Association of Southeast Asian Nations (ASEAN), namely Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Vietnam, for the period from 2000 to 2022. The data were analyzed using fixed-effect panel data techniques in STATA 13. The empirical findings of this research study showed that market size (population), development level (GDP PPP PC), and human capital (tertiary education) exhibited a positive influence on FDI. These findings align with the previous literature, indicating that conventional/classical factors are dominant in affecting FDI. However, trade

openness (exports as a percentage of GDP) displayed a negative effect on FDI in ASEAN.

Control of corruption is found to be highly significant and positively related to FDI, implying that economies with corrupt regimes struggle to attract foreign investors. However, with appropriate laws and policies in place, when corruption is kept in check, the host country becomes favorable for investment from abroad. Political stability did not show any significant influence on inward FDI, indicating that political stability does not play a major role in affecting FDI in ASEAN. Voice and accountability demonstrated a significant negative influence on ASEAN inward FDI, which aligns with previous studies. The voice of labor unions and the power of people to have a say in government can sometimes obstruct the path of MNCs, especially those looking to exploit corrupt practices to take advantage of certain resources, such as cheap labor, lax reporting systems, weak property rights, or tax evasion opportunities. For this reason, having a weak voice and accountability may be perceived as favorable by foreign investors.

To conclude this research study, good governance is a significant factor when it comes to MNCs' FDI decisions, especially in ASEAN. Therefore, policymakers of ASEAN specifically and other developing nations in general should include GG in their future policies and development plans in order to attract FDI and, as a result, develop their economy.

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