



GOVERNANCE INDICATORS AND FDI NET INFLOWS: WITH EMPIRICAL EVIDENCE FROM SRI LANKA

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ABSTRACT

Foreign Direct Investment (FDI) is considered as a key determinant of the economic growth of developing countries. Effectiveness and efficiency of governance and the regulatory bodies play a vital role when attracting FDI to developing economies. World Bank governance indicators measure the quality of the governance of world economies. This study attempts to identify the influence of government indicators on foreign direct investment (FDI) net inflows in Sri Lanka. Research is based on the time series secondary data for the time spanning from 1996 to 2017 covering 21 years. The data were extracted from the World Bank Development Indicators Database. The operational methodology adopted is a multiple regression model on variables such as FDI net inflows, Voice and Accountability, Political Stability and absence of Violence, Government Effectiveness, Regulatory Quality and Control of Corruptions. The findings of the study reveal the positive correlation between the FDI net inflows and variables such as voice and accountability, political stability, government effectiveness, control of corruption in Sri Lanka. Further, research discovers that the highest positively influential variable on FDI inflows in Sri Lanka is the Government Effectiveness. Moreover, research recommends policy makers and regulatory authorities to take effective measures to improve the condition of government indicators in Sri Lanka.

KEY WORDS: *Foreign Direct Investment, Governance Indicators, Net Inflows*

INTRODUCTION

The inflows of Foreign Direct Investment (FDI) are extremely crucial for economic growth of developing countries. FDI provides investment capital for developing countries along with employment opportunities, management skills and updated technology which eventually leads the developing countries towards economic growth (Nurudeen, 2010). Therefore, developing countries are attempting for obtaining greater FDI inflows with the intention of strengthening their business and industries. Alternatively, policies and procedures are revised continually for making it convenient for the investors to make investment in these countries (Anwar & Afza, Impact of Governance Indicators on FDI Inflows: Empirical Evidence from Pakistan, 2014). However, several countries are successful in attracting greater FDI inflows while some have been facing problems in attracting FDI.

Sri Lanka needs FDI inflows for its economic growth because of the gap in its savings and investments. Moreover, Sri Lanka faces serious difficulties when continuing its economic activities as a result of the strong less internal economic capacity. Enhancing FDI inflows is a sustainable solution for

this since foreign direct investment is critical for the developmental projects, industrial growth, raise employment level, technological advancement, enhancing industrial production, reducing balance of payments deficit, increasing foreign reserves, better infrastructure, skilled human resources and eventually realizing economic growth (Anwar & Afza, 2013)

The economic growth of a country is also influenced by the government selection process, monitoring and replacement of the governments; governmental ability to implement and formulate policies and procedures; respect of their people and position of institutions which administer social and economic interaction (Anwar & Afza, 2014). There are six dimensions of governance mechanisms which may be useful to evaluate the governance level for the countries, identified as governance indicators (Kaufman, Kraay, & Mastruzzi, 2009). These indicators are Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption.

Governance consists of the traditions and institutions by which authority in a country is



exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the governments to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them. Voice and Accountability captures perceptions of the extent to which a country's citizens can participate in selecting their government, as well as freedom of expression, freedom of association, and a free media. Political Stability and Absence of Violence captures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically motivated violence and terrorism. Government Effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. Regulatory Quality concerns perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Rule of Law concerns perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Control of Corruption captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

There are several researches that investigate the factors influencing inflows of foreign direct investment. Rusike (2008) analysed the determinants and trend of inward FDI to South Africa for the period of 1975-2005. He pointed that exchange rates, openness and financial progress were key variables to determine the FDI inflows in long-run (Rusike, 2008). Masku and Dlamini (2009) probed locational determining variables of FDI in Switzerland by utilizing cointegration along with ECM techniques over period of 1980-2001. The variables tested were market size, openness of economy, infrastructure, domestic market attractiveness, external economic stability and internal economic stability. Research reveals that external economic stability, internal economic stability, infrastructure and economy's openness had positive correlation whereas home market size and domestic market attractiveness had negative correlation with FDI stock (Masku & Dlamini, 2009). Azam and Kahttak (2009) evaluated the influence of political instability and human capital on FDI stock in Pakistan for the period 1971-2005 by utilizing least square method. The estimated results reveal a positive and significant link between

human capital and FDI stock, while the correlation between political instability and FDI was positive but significantly insignificant (Azam & Kahttak, 2011). Anwar and Afza (2014) attempted to determine the relationship of governance indicators including voice and accountability, political stability, government effectiveness, regulatory quality, control of corruption and governance index with inflows of foreign direct investment in Pakistan for the period of 1996 to 2010 through applying ARMA and Ordinary Least Squares regression techniques. The results of the study have shown that governance indicators have positive relationship with FDI inflows in Pakistan (Anwar & Afza, Impact of Governance Indicators on FDI Inflows: Empirical Evidence from Pakistan, 2014).

RESEARCH PROBLEM

Several researches have studied about the relationship between FDI inflows and political stability in many countries. But it is difficult to find out the literature that reveals the relationship between FDI inflows and governance indicators in Sri Lanka. According to newly released economic data, Sri Lanka has attracted foreign direct investments (FDI) amounting to US \$ 1,685 million in 2014 – a 21 percent increase from 2013, but below the US \$ 2 billion target set by the government. Sri Lanka consistently failed to reach FDI targets in recent years although the overall FDI trend remains positive (Hettiarachchi, 2019). Further, there is a huge debate about the political stability and the governance of the country. Thus, it is highly needed to observe whether there is a considerable relationship between FDI inflows and governance indicators of the country.

OBJECTIVES OF THE RESEARCH

The key objective of the research is to determine the relationship between FDI inflows and Governance Indicators of Sri Lanka. Further, Research aims to identify the solutions to improve FDI inflows in Sri Lanka.

METHODOLOGY

This study is based on the time series secondary data for the time spanning from 1996 to 2017 covering 21 years. Data have been collected from the World Bank Development Indicators Database. According to Koutsoyiannis (1977), the first and most significant footstep the econometrician has to take in attempting the study of any relationship between variables is to explain this relationship in mathematical form that is to specify the model with which the economic phenomenon will be explored empirically (Koutsoyiannis, 1977). OLS regression model has been applied in order to determine the impact of governance indicators including voice and accountability, political stability and absence of



violence, government effectiveness, regulatory quality and control of corruptions on inflows of FDI in Sri Lanka. As a justification for this method, Maddala (1977) identified that ordinary least square is more robust against specification errors than many of simultaneous equation methods and also that prediction from equation estimated by ordinary least squares often compare favourably with those

$$\ln FDI = \beta_0 + \beta_1 VA + \beta_2 PV + \beta_3 GE + \beta_4 RQ + \beta_5 CC + \beta_6 RL + \epsilon_t$$

Where:

LnFDI	=	Inflows of foreign direct investment in US\$
VA	=	Voice and Accountability
PV	=	Political Stability and Absence of Violence
GE	=	Government Effectiveness
RQ	=	Regulatory Quality
CC	=	Control of Corruption
RL	=	Rule of Law

RESULTS AND DISCUSSION

Research employed several diagnostic tests to check for the presence of multicollinearity, autocorrelation and the normal distribution of the residuals. Residuals of the dependent variable shows a normal distribution. Tolerance and VIF values have been used to check the multicollinearity of the model. If the tolerance is lower than to 0.1 and VIF is greater than to 10, the model would be consisted with multicollinearity. Collinearity statistics proved that the model is settled out from multicollinearity (Table 1). Further, the Durbin-Watson value indicates the autocorrelation in the data set. Durbin-Watson statistic always has a value between zero and 4.0. A value of 2.0 means there is no autocorrelation detected in the sample. Values from zero to 2.0 indicate positive autocorrelation and values from 2.0 to 4.0 indicate negative autocorrelation. Model Summery reveals that Durbin-Watson value of the model is 1.587 (Table1). Hence, there is weak positive autocorrelation. Yet it is too close to value 2.0, thus any adjustment to the data set has not been done.

The estimated model is as follows:

$$\ln FDI = 21.160 + 1.22VA + 0.369PV + 1.795GE - 1.533RQ + 0.657CC - 3.077RL$$

The estimated model discovers that the variables such as Voice and Accountability, Political Stability and absence of Violence, Government Effectiveness and Control of Corruption positively correlate with the FDI inflows in Sri Lanka. Yet, the Regulatory Quality and Rule of Law show a negative correlation with the FDI inflows in Sri Lanka. When all the other

obtained from equations estimated by the simultaneous equation method (Maddala, 1977). Among the other reasons is the simplicity of its conceptual procedure in conjunction with optimal properties of the estimates obtained. The following regression model has been estimated:

factors are constant, the increase of government effectiveness by one unit will influence to increase the FDI inflows by 1.795 units of US \$ millions. Further, the Adjusted R-square value of 0.677 indicates that the explanatory variables used in multiple regression model have described approximately 67 percent of the variation taking place in FDI inflows in Sri Lanka.

CONCLUSION

The purpose of this study is to determine the relationship of governance indicators including voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, control of corruption and rule of law with inflows of FDI in Sri Lanka for the period of 1996 to 2017. The results of the study show that variables such as Voice and Accountability, Political Stability and absence of Violence, Government Effectiveness and Control of Corruption positively correlate with the FDI inflows in Sri Lanka. Moreover, the highest positively influential variable among that is government effectiveness. Thus, these factors should be considered in policy formulation for attracting greater inflows of FDI. Based on the findings of this study, the policy makers and regulatory authorities should take some effective measures to improve the condition of governance indicators in order to strengthen the confidence of domestic and foreign investors and to increase inflows of foreign direct investment in Sri Lanka since without improving governance indicators, it may not be possible to provide a better business environment and to attract overseas investors.



Table 1: OLS Regression Estimates

Dependent Variable: LnFDI Method: Ordinary Least Squares Included Observations: 19 after adjustments						
Variables	Coefficient	St. Error	t.Statistic	Prob.	Tolerance	VIF
VA	1.220	1.434	0.851	0.412	.116	8.589
PV	0.369	0.259	1.425	0.180	.365	2.743
GE	1.795	1.142	1.572	0.142	.490	2.042
RQ	-1.533	0.641	-2.391	0.034	.594	1.683
CC	0.657	1.424	0.461	0.653	.384	2.605
RL	-3.077	1.736	-1.772	0.102	.123	8.161
Constant	21.60	0.807	26.206	.000		
R-Square	0.784	Adjusted R-square	0.677			
Durbin-Watson	1.587					
F-Statistic	7.280					
Prob(F-Statistic)	0.002					

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