Asia Proceedings of Social Sciences (APSS)
www.readersinsight.net/APSS

AIC 2018: EMERGING ISSUES IN ECONOMICS AND FINANCE

Effect of Economic Institutions on Foreign Direct Investment: Case of Latin American and Caribbean Countries

Qurat ul Ain*

PhD scholar School of Public Finance and Taxation
South Western University of Finance and Economics, China
& Lecturer Management Sciences COMSATS University,Wah Campus,
Pakistan

Tahir Yousaf

PhD scholar School of Business Aministration
Sichuan University, China
& Lecturer University of Lahore Sargodha Campus,
Pakistan

Yasmeen Akhtar

PhD scholar Management Sciences
COMSATS University, Islamabad, Pakistan
& Lecturer University of Sargodha,Sargodha,
Pakistan

***Corrosponding author's** *Email: quratulain_ad36@yahoo.com*

Peer-review under responsibility of 4th Asia International Conference 2018 editorial board (http://www.utm.my/asia/our-team/)
© 2018 Published by Readers Insight Publisher,
lat 306 Savoy Residencia, Block 3 F11/1,44000 Islamabad. Pakistan,
info@readersinsight.net
This is an open access article under the CC BY-NC-ND license (http://creativecommons.org/licenses/by-nc-nd/4.0/).

Copyright © 2018 Authors. This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

Asia Proceedings of Social Sciences (APSS)
www.readersinsight.net/APSS

Research Highlights

This study focuses on examining the effect of Economic Institutions on Foreign Direct Investment (FDI) inflows in 24 developing Latin American and Caribbean (LAC) countries. This study used panel data over the period 1995 to 2015 , for its emerical investigation, by using a fixed-effects model as suggested by Hausman after controlling for heteroscedasticity. The empirical finding suggests that the counties can attract more FDI if they enhance their economic institutions despite deficiencies in market size, trade openness and high level of human capital. However the development level seems to have an equal importance as that of economic institutions and is significant at all levels in LAC. The study also shows significant relation with controlling variables namely GDP per Capita and human capital.

Research Objectives

Economic institutions are one of the important factors sought by the foreign investors while investing abroad. The host government needs to promote sound policies and regulations for foreign investors as well as quality of property rights and contract enforcement. Sound and easy policies and regulations and better contract enforcement increase the confidence of investors to invest their capital. Multinational Enterprises (hereafter MNE's) in order to effectively utilize their investment try to find the location which provides best institutional and economic facilities in exception of few MNEs that are in search of resources and labor in developing countries (Dunning, 1998). The purpose of this study is to analyze the effect of economic institutions on FDI inflows in Latin American and Caribbean countries. Developing countries of Latin American and Caribbean countries were chosen because of the record level of FDI received by this region in the last few years in spite of the financial crises worldwide and decreased FDI up to 15% worldwide during the same period.And the study further need to investigate the role that is being palyed by economic instituitions in attracting FDI in LAC countries during this time period.

Copyright © 2018 Authors. This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

Asia Proceedings of Social Sciences (APSS)
www.readersinsight.net/APSS

Methodology

The paper have used panel data taking from 24 LAC developing countries over the period of 1995-2015 to see the effect of economic institutions in FDI inflows. The data were obtained from the World Bank, UNCTAD, (Kaufmann, 2010) and from Educational attainment of total population 1950-2010 (Barro & Wha, 2013).
In order to investigate the role the economic institution played in attracting FDI into a region, the following functional from of the model of the order given below can be used (Mengistu and Adhikary (2011), (Gani, 2007) and (Buchanan, Le, & Rishi, 2012a).

$$FDI_{jt}=f(Mark\ size, Develop\ \ level, Openess, Human\ capital, Econ.Institutions) \quad (1)$$

Where

FDI is taken as dependent variable and is taken as a log of FDI stock (proxy for FDI). Controlling variables are taken from literature where different variables are used to see the effect of these traditional variables on FDI inflows. . Economic institutions are taken as an independent variable along with controlling variables to see their effect on FDI inflows and to answer the question under investigation. Variables from the governance are used as a proxy for economic institutions. In model j represents cross section i.e. j=1, 2 …N; where N shows a number of countries, and t represent time period i.e. t=1, 2………T; where T shows time period varies from 1995s to 2015.

Results

Regulatory quality and Voice and Accountability are used as proxy for economic institutions in the Model. The result clearly shows that regulatory quality is positively and significantly related to FDI inflows and this relationship is statistically significant at 1% level of significance .Moreover Voice and Accountability is added in the model to further see the effect of economic institutions on FDI inflows in LAC countries .The results shows that Voice and Accountabilty is significat at 5 %. The model shows that with adding the RQ (proxy for economic institutions) , the controlling variable i.e. market size loses its importance however the GDPpc and secondary education along with better economic will provide better environment for investors or helps in increasing FDI inflows. (Daude & Stein, 2007) and (Gani, 2007) in their work also show the positive and significant relation of Regulatory Quality with FDI inflows.The result shows that high development level, more openness, adequate human capital and

Copyright © 2018 Authors. This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

Asia Proceedings of Social Sciences (APSS)
www.readersinsight.net/APSS

better economic institutions will increase the FDI inflows in the selected range of countries. Moreover the result shows that in presence of all of the above factors market size loses its importance for the attraction of FDI inflows. (Gani, 2007), (Mengistu & Adhikary, 2011) and (Daude & Stein, 2007) in their studies show insignificant relation of Voice and Accountability with FDI.

The results are logical because the explanatory power of R^2 is fairly high, there is no serious multicollinearity problem as most of the coefficients are statistically significant and F-ratio further reveals that all regressor jointly influence the response variable during the period under the study. To control for the problem of heteroscedasticity we use robust option in the model. Hausman test shows the p-value of 0.334 i.e. we are unable to reject H_0 and accept alternate H_1, So the (Hausman, 1978) test suggests the use of random effect over fixed effect for the analysis

Findings

The paper shows the role that the economic institutions play in attracting FDI. The sample consists of 24 developing Latin American and Caribbean countries from 1995-2015. Economic institutions play an important role in attracting FDI and its role is consistent under different controlling variables. So we can say that economic institution is the robust determinant of FDI. As compared to other variables used in the model like market size, human capital and trade economic institutions appear to have greater impact on FDI. However development level seems to be equally important as that of economic institutions and it is significant at all steps of regression in the model or we can say that in the presence of high development level an economic institution enhances its role in attracting FDI. So we can say that economic institution is an important factor consider by the foreign investors while investing abroad.

References

Barro, R. J., & Wha, J. (2015). A new data set of educational attainment in the world , 1950 – 2015 ☆. *Journal of Development Economics*, *104*, 184–198. https://doi.org/10.1016/j.jdeveco.2012.10.001

Buchanan, B. G., Le, Q. V., & Rishi, M. (2012a). Foreign direct investment and institutional quality: Some empirical evidence. *International Review of Financial Analysis*,

Copyright © 2018 Authors. This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.

Asia Proceedings of Social Sciences (APSS)

www.readersinsight.net/APSS

21(24), 81–89. https://doi.org/10.1016/j.irfa.2011.10.001

Buchanan, B. G., Le, Q. V, & Rishi, M. (2012b). International Review of Financial Analysis Foreign direct investment and institutional quality : Some empirical evidence. *International Review of Financial Analysis*, *21*(24), 81–89. https://doi.org/10.1016/j.irfa.2011.10.001

Daude, C., & Stein, E. (2007). the Quality of Institutions and Foreign Direct Investment. *Economics & Politics*, *19*(3), 317–344. https://doi.org/10.1111/j.1468-0343.2007.00318.x

Dunning, J. H. (1998). Location and the Multinational Enterprise: A Neglected Factor?, *1*, 45–66.

Gani, A. (2007). Governance and foreign direct investment links: evidence from panel data estimations. *Applied Economics Letters*, *14*(10), 753–756. https://doi.org/10.1080/13504850600592598

Hausman, J. A. (1978). Specification Tests in Econometrics. *Econometrica*, *46*(6), 1251–1271.

Kaufmann, D. (2015). The Worldwide Governance Indicators : Methodology and Analytical Issues.

Mengistu, A. A., & Adhikary, B. K. (2011). Does good governance matter for FDI inflows? Evidence from Asian economies. *Asia Pacific Business Review*, *17*(3), 281–299. https://doi.org/10.1080/13602381003755765.

Copyright © 2018 Authors. This is an open access article distributed under the Creative Commons Attribution License, which permits unrestricted use, distribution, and reproduction in any medium, provided the original work is properly cited.