

## **Impact of Governance Indicators on FDI Net Inflows: Empirical Evidence from Sri Lanka**

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### **Introduction**

The inflows of Foreign Direct Investment (FDI) are extremely crucial for the 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 (Athukorala & Karunaratna, 2004; Nurudeen, 2010). Therefore, developing countries are attempting to obtain greater FDI inflows with the intention of strengthening their business and industries. Policies and procedures are revised continually to make it convenient for the investors to make investment in these countries (Zeshan & Talat, 2014). However, while several countries are successful in attracting greater FDI inflows, some have been facing problems in attracting FDI.

Enhancing FDI inflows is a sustainable solution for economic difficulties. FDI is critical for developmental projects, industrial growth, employment generation, technological advancement, enhancing of industrial production, reducing balance of payments deficit, increasing foreign reserves, improving infrastructure, building skilled human resources and eventually realizing economic growth (Zeshan & Talat, 2013). The economic growth of a country is also influenced by the political process including 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 (Zeshan & Talat, 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, et al., 2009). These

indicators are Voice and Accountability, Political Stability and Absence of Violence, Government Effectiveness, Regulatory Quality, Rule of Law and Control of Corruption.

There are several pieces of research that investigate the factors influencing inflows of foreign direct investment. Rusike (2008), in analysing the determinants and trend of inward FDI to South Africa for the period 1975-2005, found exchange rates, openness and financial progress to be key variables in determining FDI inflows in the long-run. Masku and Dlamini (2009) probed locational determining variables of FDI in Switzerland by utilizing cointegration along with ECM techniques during 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 Kahtak (2009) evaluated the influence of political instability and human capital on FDI stock in Pakistan for the period 1971-2005 by utilizing least squares method. The estimated results reveal a positive and significant link between human capital and FDI stock. 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 a positive relationship with FDI inflows in Pakistan.

However, it is difficult to find literature on the relationship between FDI inflows and governance indicators in Sri Lanka. Further, there is a huge debate about the political stability and the governance of the country. Thus, there is a high need to observe whether there is a substantial relationship between FDI inflows and governance indicators of the country.

## Objectives

The key objective of the research is to determine the relationship between FDI inflows and Governance Indicators of Sri Lanka. Secondly, it aims at investigating the influence of governance indicators when determining the FDI inflows in Sri Lanka.

## Methodology

This study is based on the time series secondary data for the period 1996 to 2017 covering 21 years. Data have been collected from the World Bank Development Indicators Database. The research approach adopted is to run a unit root test to check the stationarity of data. It was expected to apply OLS regression model in order to determine the impact of governance indicators including government effectiveness and regulatory quality on inflows of FDI in Sri Lanka. The following regression model was estimated:

$$FDI = \beta_0 + \beta_1 GE + \beta_2 RQ + u$$

Where:

FDI = Net inflows of foreign direct investment in US\$

GE = Government Effectiveness

Estimate gives the country's score on the aggregate indicator, ranging from approximately -2.5 to 2.5.

RQ = Regulatory Quality

## Results and Discussion

According to the descriptive statistics, the mean of the FDI net inflows for the period is 568838702.6 US \$. The mean values of Government Effectiveness and Regulatory Quality remain negative (Table 1). Research employed Augmented Dickey-Fuller test to check the stationarity of data. According to the unit root test, the variables like FDI net inflows, Government Effectiveness and Regulatory Quality are stationary at level. Thus, research applied a OLS regression model on the variables such as FDI net inflows, government effectiveness and regulatory quality. The estimated model is as follows,

$$FDI = \beta_0 + \beta_1 GE + \beta_2 RQ + u$$

$$FDI = 7.32 + 1.30GE - 5.62RQ$$

According to the estimated model the coefficient of government effectiveness is statistically significant. It indicates the positive correlation with the FDI net inflows. Further, it reveals the significant influence of government effectiveness on FDI net inflows. The coefficient of Regulatory Quality is insignificant (Table 2). The value of the Jarque-Bera normality test indicates the normal distribution of the residuals. The VIF value of the model is less than 10, thus the model is free of multicollinearity. The Durbin-Watson statistic reveals the positive autocorrelation of the model (Table 2).

Table 1: Descriptive statistics

|                          | Mean      | St. Deviation |
|--------------------------|-----------|---------------|
| FDI net inflows          | 568838702 | 359669573     |
| Government Effectiveness | -0.1663   | 0.1223        |
| Regulatory Quality       | -0.0947   | 0.1979        |

Table 2: OLS Regression estimates

| Variables     | Coefficient | St. error          | t. statistic | Prob. | VIF  |
|---------------|-------------|--------------------|--------------|-------|------|
| GE            | 1.30        | 6.08               | 2.13         | 0.049 | 1.03 |
| RQ            | -5.62       | 3.76               | -1.50        | 0.154 | 1.03 |
| Constant      | 7.32        | 1.34               | 5.48         | 0.000 |      |
| R-Square      | 0.3371      | Adj.R-square       | 0.2542       |       |      |
| Durbin-Watson | 0.6659      | Jarque-Bera N test | 0.1977       |       |      |
| F-Statistic   | 4.07        | Prob(F-Statistic)  | 0.0373       |       |      |

## Conclusion

The purpose of this study was to determine the relationship of governance indicators with inflows of FDI in Sri Lanka for the period 1996 to 2017. Research concludes that there is a significant influence of government effectiveness on FDI inflows in Sri Lanka. Thus, government effectiveness should be considered in policy formulation for attracting greater inflows of FDI. The influence of regulatory quality on the FDI net inflows is not significant. Based on the findings of this study, the policy makers and regulatory authorities should take some effective measures to improve the condition of government effectiveness 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 government effectiveness, it may not be possible to provide a better business environment and to attract overseas investors.

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