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The Effect of Government Quality on Foreign Investment: Empirical Study on ASEAN Developing Countries

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Abstract

Introduction: Many ASEAN nations face governance challenges and high corruption, especially Cambodia, Myanmar, and Laos, categorizing most as developing countries. Foreign capital inflows are essential for economic growth, requiring governments to create favorable investment climates. While good governance can attract foreign direct investment (FDI), this relationship is inconsistent. This study aims to determine how government quality affects foreign investment (Foreign Direct Investment). **Research Methods:** In this study, secondary data is used using quantitative methods. Developing countries in ASEAN are used as samples in this study. **Results:** This study provides results that political stability and legal regulations have a significant positive impact on Foreign Direct Investment, while corruption control, government effectiveness, and voting rights and accountability hurt FDI. **Conclusion:** The study has three fundamental implications: it enhances understanding of government quality's impact on foreign investment in developing ASEAN countries, serves as a reference for further research, and offers insights for policymakers to improve regulations and investment climates.

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INTRODUCTION

ASEAN (Association of Southeast Asian Nations) was declared in Bangkok in 1967. which is an organization consisting of several countries in Southeast Asia. ASEAN member countries currently number 10, namely Thailand, Indonesia, Vietnam, Malaysia, the Philippines, Laos, Myanmar, and Cambodia. The country that is included in the category of developed countries in ASEAN is only Singapore. Based on the classification of developed and developing countries, Brunei Darussalam can be categorized as a developed country. However, Brunei Darussalam does not participate in the membership of the International Monetary Fund (IMF) so it is not included in the list of developed countries (International Monetary Fund, 2008).

The history of most ASEAN countries is similar. Because most ASEAN countries were once colonies, some of them had difficulty in implementing their new countries when they first became independent. For most ASEAN countries, high levels of corruption are common. According to the Political and Economic Risk Consultancy in 2018, Cambodia is the most corrupt ASEAN member country, followed by Myanmar, Laos, Vietnam, Thailand, the Philippines, Indonesia, Malaysia, Brunei Darussalam, and Singapore. This is in line with the 2009-2018 investigation conducted by Transparency International and the World Bank which found that several ASEAN countries ranked higher among the most corrupt countries. Therefore, the majority of countries in ASEAN are categorized as developing countries except Singapore and Brunei Darussalam. The high per capita income of Brunei Darussalam and Singapore makes these two countries categorized as developed countries (Sari, 2018).

This condition indicates that most ASEAN member countries are still experiencing many problems in terms of governance. Inefficient bureaucracy or government is considered a barrier to economic activity and grease money or bribes can fix "circumvent" or failure (Meon & Sekkat, 2010). According to Rothstein and Teorell (2005), good governance must be able to provide appropriate policies to achieve economic welfare. A strong government is needed to create prosperity for the community, because with the following it can influence international and regional markets.

However, to achieve the welfare of a nation cannot be separated from the way in which developing countries manage their economic affairs. The country needs a certain amount of capital to carry out these tasks, which will be used to support the country's household to achieve its goals. Alfaro. Kalemli-Ozcan, and Volosovych (2007) emphasized that capital flows are very important for the running of a country. Now. sources of income to run economic operations are not limited to domestic sources. In fact, foreign funding sources are very important to advance the economic progress of a country. Foreign investment is a term used when funds or budgets come from abroad and are used for domestic economic operations.

FDI has a role in encouraging the entry of new technologies and the exchange of managerial skills between countries that are cooperating. FDI is categorized as important because it can enrich the country concerned by bringing capital flows into the country (Bosworth

& Collins, 1999). Currently, countries cannot only rely on domestic funding in the form of taxes or debt. One variable that can help the government in terms of funding is FDI.

The strategy implemented by the government in attracting foreign capital is certainly through the systems and policies that are formed. Alfaro, et al (2007) explained that the flow of foreign capital in a country can increase when a country has a conducive investment climate. Therefore, the role of the government in creating a conducive investment environment is very important in increasing the interest of foreign investors. The important role of the government in attracting foreign capital is through the policies and systems that are formed. With this role, it is hoped that a conducive investment climate will be successfully created by the government so that it can increase the flow of foreign capital entering a country (Alfaro et al., 2007). In order to achieve this goal, countries in ASEAN cooperate in the economic sector in order to improve a competitive economic climate, so that FDI in each ASEAN member country can also increase (Delfiyanti, 2017). One way is to reduce tariffs or other policies that can increase foreign investment and trade in countries in ASEAN in the free trade market.

Olayiwola and Busari (2008) stated that good government quality can reduce the volatility of foreign capital coming in and out of a country. Volatility itself is a statistical measure of the variation in the value of an instrument (Butler, 1999). In other words, volatility can be said to be the speed at which foreign capital inflows or outflows increase or decrease. In order to improve the country's economy, a country can increase capital inflows through appropriate policies. (Bosworth & Collins 1999). According to Kaufmann, Kraay and Mastruzzi (2010). The right policy is a policy that is able to provide conductivity for the investment climate so that it attracts foreign direct investment. This conducive situation can be realized in the form of intervention in the form of the manifestation of good government governance so that it can provide stability in the political and economic fields (Amelia & Sukadana, 2019). The World Governance Indicators (WGI) provided by the World Bank measure good governance using 6 indicators, namely corruption control, government effectiveness, political stability, rule of law, regulatory quality, and voting rights and accountability.

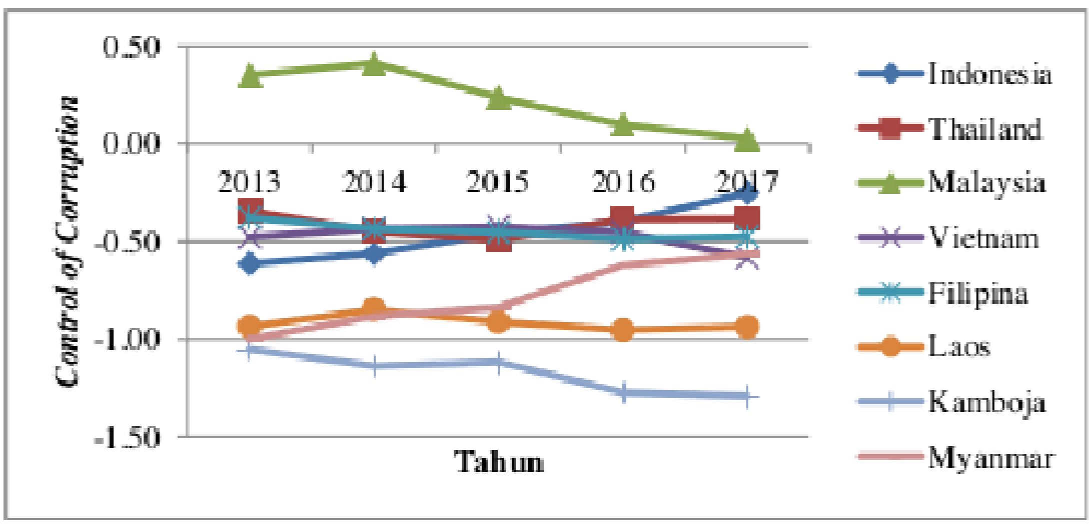
The values of the 6 indicators of governance quality and foreign capital flows entering several ASEAN member countries have a direction of volatility that is not in line. Improved governance quality is not always followed by an increase in foreign investment incoming, and vice versa. This condition becomes a gap phenomenon in this study. In several previous studies it was found that economic openness is expected to increase FDI. When the government implements economic openness, it should be accompanied by creating a conducive investment climate and good policy making. The research was conducted by Bosworth and Collins (1999); Ahmed, Arezki and Funke (2005); Lothian (2006); Honig (2006); Ralhan (2006): Olayiwola and Busari (2008); Alfaro, Kalemi-Ozcan and Volosovych (2007); and Mody and Murshid (2004).

Altinkemer's research (1995) has a different opinion. Initially, government policy caused FDI to enter quickly, but then it caused a deficit in the current account so that capital flows out and even devaluation. According to Olayiwola and Busari (2008), of the overall indicators of the quality of government variables used as a measure of government policy, only 3 indicators were found to have a significant positive influence on FDI entry, namely government effectiveness, political stability, and regulatory quality. Meon and Sekkat (2010) explained that economic openness and local political conditions in a country do not affect the flow of capital inflow.

Economic liberalization has a greater impact on FDI inflows than local government policies (Bute & Milner 2008). To encourage economic growth, the role of capital inflows is very important. The economy of the recipient country will shift significantly if capital flows stop. Therefore, ASEAN countries can use the characteristics of government quality to encourage FDI inflows to take advantage of the opportunities of open economies between countries.

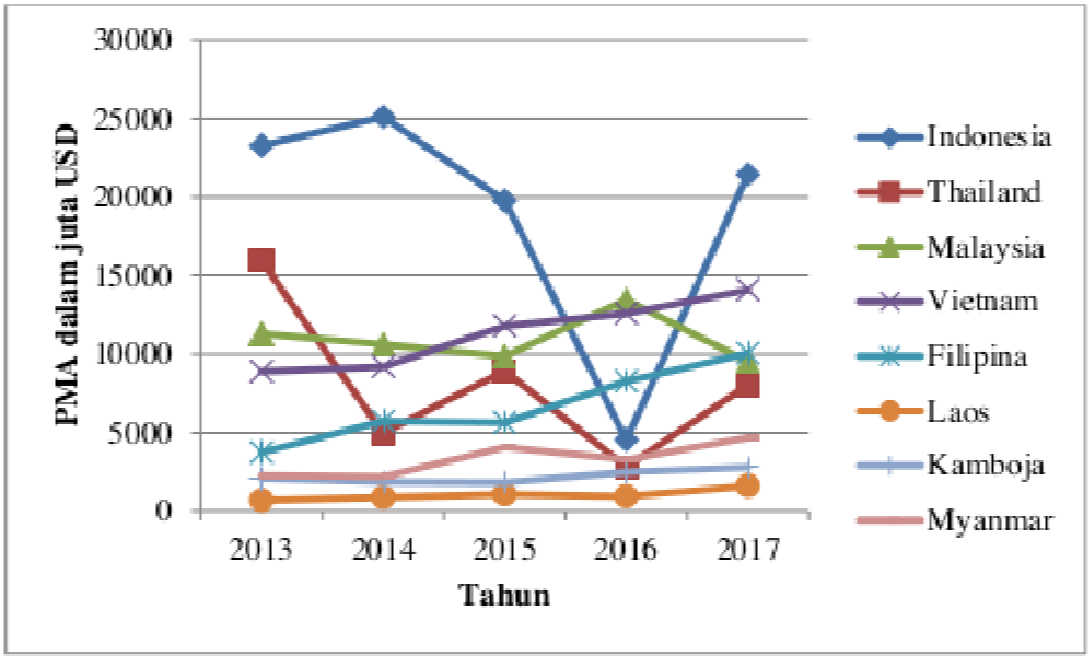
From this background, good governance quality can increase the value of incoming FDI, but sometimes it can actually decrease the value of incoming FDI in ASEAN countries, especially developing countries. Indicators of governance quality and foreign capital flows entering several ASEAN member countries do not go hand in hand. Improved governance quality is not always followed by an increase in incoming foreign investment, and vice versa. The following is an example of data on the level of incoming FDI and corruption control in ASEAN countries in 2013-2017.

Figure 1. Level of FDI inflows in 2013-2017 in milion USD



Source: World Bank (2019)

Figure 2. Control of corruption in developing countries in ASEAN in 2013-2017



Source: Gov Indicator, 2019

In Figures 1 and 2, it is known that there is a gap in several countries for the control of corruption variable indicator, including Thailand and Laos. In 2014-2015, the estimated value of this variable decreased, while the FDI value increased.

The existence of a gap in the phenomenon of ASEAN developing countries and referring to several previous studies, experts argue that research is needed to examine the indicators of governance quality for ASEAN countries, the value of FDI in ASEAN developing countries. The purpose of this study is to analyze whether the quality of government consisting of corruption control, government effectiveness, political stability, rule of law, regulatory quality, and voting rights and accountability, has a positive effect on the level of FDI in ASEAN developing countries in the period 2002-2017. This time span was chosen to obtain empirical evidence that the quality of government positively affects FDI in the period before the trade war between China and the United States which rocked the economy and investment in the world in 2018 (Laksono et al., 2020).

RESEARCH METHOD

Data analysis in this study is quantitative analysis using EViews 7 software. This study uses secondary panel data obtained from the Global Governance Indicators [WGI] project. Estimation of the selection of the appropriate model is carried out with the stages of the Chow test, Hausman test and Lagrange multiplier test. The classical hypothesis tests used to test the data are the variance test, normality test, and multicollinearity test.

The next step is to conduct a significance test based on the previously selected model.

1. Partial test (T-test) aims to determine the influence of 1 independent variable individually to explain the dependent variable (Widarjono, 2013). In this study, the t-table value is 1.645 which is obtained from the product moment table. If the calculated t value> 1-label and the significance value <0.05, then the independent variable is said to have a substantial influence on its dependent variable.
2. Simultaneous test (F-test) aims to measure whether all independent variables in the model simultaneously have an influence on the dependent variable (Widarjono 2013). In this study, the value of the F-table is 2.29 which is obtained from the F-distribution Table (Anova). If the F-count value> F-label and the significance value <0.05, then the independent variables simultaneously have a substantial influence on the dependent variable.
3. The determination coefficient test (R^2) aims to measure the suitability of a regression equation model of more than 2 variables. The Derksar R^2 value is between $0 < R^2 < 1$, the greater the R^2 value (approaching 100%), the better the regression model. An R^2 value of 0 means that the variation of the dependent variable cannot be explained by the independent variable (Wicianono 2013).

RESULT AND DISCUSSION

Description of Research Object

The object of this study is 8 ASEAN members, namely Indonesia, Thailand, Malaysia, Vietnam, Philippines, Laos, Cambodia, and Myanmar. These countries were selected based on the conditions of the country which are currently in the developing stage. According to the Political and Economic Risk Consultancy in 2018, Cambodia followed by other countries namely Myanmar, Laos, Vietnam, Thailand, Philippines, Indonesia, Malaysia have high levels of corruption in ASEAN. The FDI conditions of these countries are very diverse. Cambodia is the country with the highest corruption in ASEAN but has high FDI. On the other hand. Myanmar has the second highest level of corruption after Cambodia, but FDI in Myanmar can be said to be very low (Kurniasih, 2020). The observation years used in this study were from 2002-2017. This year was taken to see the effect of government quality on FDI before the trade war between the United States and China in 2018. Secondary data obtained showed the amount of FDI entering and the value of government quality. Because it fluctuates from year to year, there is a trend of changes in the value and nominal FDI. The fluctuation in the value of government quality is between -2.5 to +2.5. Meanwhile, the nominal FDI entering is the actual amount of FDI entering in US Dollars.

Panel Data Model Estimation Results

The researcher eliminated one variable in the study because it found high multicollinearity symptoms, precisely in the variable of regulatory quality. Thus, the test results in this study only use five variables, namely corruption control, government effectiveness, political stability, rule of law, and voting rights and accountability. The following are the results of the analysis of the correct panel data model estimation:

1. The Chow test shows the F-test probability value of 0.0000 < 0.05. so that HO is rejected, then the right model is the fixed effect model.
2. The Hausman test shows a chi-square value (Prob>chi2) of 0.0000 <0.05, so HO is rejected, so the appropriate model is the fixed effect model.

The fixed effect model is known to be the appropriate model to use so that no Lagrange Multiplier test is required.

Classical Assumption Test Results

1. Multicollinearity test
   Based on the multicollinearity test, the variables of political stability, legal flow, and voting rights and accountability have VIF values <10 and tolerance values >0.1, which means that there are no symptoms of multicollinearity. However, for the control variables of corruption and government effectiveness, they have VIF values >10 and tolerance values <0.1, which means that there are symptoms of multicollinearity for these variables. Based on Gujarati and Porter (2012 414), multicollinearity is ignored because it still produces a BLUE estimator so that the assumption of no correlation between independent variables is not required.
2. Heteroscedasticity test
   The heteroscedasticity test shows a Prob>chi2 value greater than 0.05, which means that the independent variable shows no heteroscedasticity problem.

Hypothesis Test Result

1. Partial Test (T-test)

Table 1. Regression result with the fixed effect model approach

Variable	Coefficient	T-statistic	p-value (prob)	Information
Constant	22,24179	58,99	0,000	
KK	-0,41017	-0,45	0,651	Not Significant
EP	0,3888513	0,48	0,635	Not Significant
SP	0,794086	2,28	0,006	Significant Positive
AH	3,454288	4,54	0,000	Significant Positive
HA	-1.24596	-2,33	0,022	Significant Negative

Source: Secondary Data (Processed)

Based on the T-test, the variables Political Stability (SP) and Rule of Law (AH) have a substantial positive influence on FDI. The right to vote (HA) has a substantial negative influence on FDI, but the other two variables, namely corruption control (KK) and government effectiveness (EP) do not have a significant influence on FDI.

2. Simultan Test (F-Test)

Table 2. Result of simultaneous test (F-test)

Model	F-statistic	Prob>F	Information
Fixed effect model	15,55	0,000	Significant

Source: Secondary Data (Processed)

The results of the F test show that the independent variables simultaneously affect the dependent variable. Table 2 shows that the F-statistic value (F-count) > F-label, which is 15.55 > 2.29 (2.29 is obtained from the F-distribution Table or Anova) and the substantial value <0.05, is 0.000 <0.05. Thus, that corruption control, government effectiveness, political stability, rule of law, and voting rights and accountability, together have a positive and significant influence on FDI.

Multiple Determination Coefficient (R^2)

Table 3. Result of the multiple determination coefficient (R^2)

Model	R^2 Value
Fixed effect model	0,2187

Source: Secondary Data (Processed)

From Table 3, it can be seen that the R^2 value is 0.2187. This shows that FDI is influenced by all indicators of government quality used by 21.87% while the remaining 78.13% is influenced by other factors outside the indicators of government quality used in this study.

The influence of corruption control on Foreign Direct Investment (FDI)

According to Meon and Weill (2008) inefficient and ineffective government can be a major obstacle to a country's economic activities, including investment, but corruption or grease money can combat these obstacles and become a solution. One hypothesis, namely an efficient grease hypothesis, explains that corruption can be an accelerator that makes bureaucratic acceleration inefficient and ineffective. The study shows that corruption has little impact on economic activity in countries with poor institutional quality.

In general, many people argue that corruption tends to have a negative effect on a country's economic activity. This can be seen in countries with high levels of corruption or rent seeking and tends to slow down investment and economic growth. Corruption causes additional costs that can slow down or even complicate economic activities, resulting in increased costs that must be borne by investors and reducing interest in making investments. In addition, corrupt practices in providing capital to facilitate transactions can prevent investors from pending transactions. For investors, this unfinished business is a burden, both in terms of trading opportunities, interest costs, and other expenses. This makes this corrupt practice able to help increase investor business if the country has very poor bureaucratic regulations and corruption control. The impact of this violation can motivate government employees to try harder. Being bribed for their services will encourage government employees who were previously ineffective in running their daily business to become more productive. Every country may experience this situation.

Corruption does not necessarily worsen economic activity and is not widespread. As is the case in several developing ASEAN countries, the economy continued to grow despite rampant corruption in all developing ASEAN countries, except Singapore and Brunei Darussalam because these countries are classified as developed countries and have low levels of corruption. It should be noted that this rapid change did not lead to increased energy capacity or actual economic progress, but rather to widespread exploitation and destruction of natural resources, and increased government and private sector external debt. Therefore, reducing corruption in a country has little impact on the volume of FDI entering the country or on economic activity.

The influence of government effectiveness on Foreign Direct Investment (FDI)

The results of Mean and Weill's (2008) research show that less effective governance Ineffective and inefficient can be a major obstacle to an activity economy, including investment activities. However, bribery activities or bribery or the existence of grease money can be a solution to overcome these obstacles. The results of this study are also consistent with the results of other studies and can be explained using the following rationalization. Theoretically, a professional government will facilitate the investment process in a country, which can increase the amount of FDI in the country. However, investors consider various aspects before making investment decisions. In making investment selections, foreign investors do not necessarily prioritize a good governance system. This is the result of an efficient grease hypothesis. According to this hypothesis, corruption is a catalyst for the growth of ineffective bureaucracy.

According to the idea presented above, investors may not always consider effective governance when deciding where to invest their money. As a result, the level of FDI entering a country is not positively affected by government effectiveness. On the contrary, the existence of an ineffective government actually provides opportunities for investors to commit fraud, such as bribery or corruption, in order to increase business profits, and is expected to overcome the problem of ineffective and inefficient bureaucracy.

The influence of political stability on foreign direct investment (FDI)

Huyen (2015) conducted a study by collecting 41 questionnaires to foreign companies in Thanh Hoo, Vietnam. The results showed that one of the factors of political stability has a positive effect on the value of incoming FDI. Political factors are important factors for foreign investors to make investment decisions. Foreign investors only invest their capital when they know that a country has a stable political environment and safe capital movement. Political stability is reflected in several aspects such as government commitment in various matters related to investment capital ownership, policy making, and development orientation.

The same thing was also found by Olayiwala and Busari (2008) that good political stability in a country can increase the value of FDI entering the country. Aisen and Veiga (2011 in Yustika 2013) said that political stability is considered to be able to create significant economic growth. However, on the contrary, political instability can cause a country's productivity to worsen and suppress the accumulation of physical and human capital.

The results of this study can be explained by the following rationalization. In general, many companies want to invest their capital in countries that have stable economic conditions and have small political risks, with this small political risk many political costs can be avoided by foreign investors. Of course, it can provide benefits for foreign investors if they invest their money, thus the value of Foreign Investment entering the country will increase.

The influence of legal regulations on Foreign Direct Investment (FDI)

Boetike and Subrick (2003) said that laws that are well implemented in a country will make foreign investors interested in investing their capital, so that the value of incoming FDI will increase and the economy will become more advanced. The same view is held by Rothstein and Tearell (2005) who argue that the application of sound legal principles will provide a sense of trust and certainty for investors. The results of Honig's (2006) research also show that the legal system and strength will cause institutions to function well, so that foreign investors are interested and feel safe to invest. Avianti (2010) found that good legal implementation in a country will provide a sense of security for investors to invest so that the value of incoming FDI will increase. Huyen (2015) explains that foreign investors will only invest their capital in countries that have safe legal policies in terms of capital movement.

Property rights are one component of the rule of law. Property rights, according to Furuboin and Richter (2000 in Yustiko 2013), are the rights to a secure income stream. This situation can arise if other parties are concerned about certain circumstances to protect that benefit. According to Yustika (2013), property rights require individual control over assets, giving the owner the right to use or transfer his property. Assets in this situation can be in the form of knowledge or skills.

Because ownership rights are not guaranteed, either in the form of products or patents, many foreign investors in developing countries have fled or withdrawn their investments. When a new industry emerges, for example the electronics industry, software, cassettes, and other new industrial commodities like this, it is always followed by the emergence of counterfeit goods on the market at much lower prices. The lack of motivation for foreign producers or investors to develop new goods causes the economy to stagnate. It can even cause foreign investors to move to other countries that have legal certainty, so that the country left by the foreign investor becomes less productive and the economy becomes sluggish (Yustika, 2013). This shows that foreign investors are more interested in investing in countries that guarantee ownership rights for them, in the sense of having good legal regulations.

Legal regulations that have a positive influence on the continued inflow of foreign direct investment prove that the government, which is the party that makes and implements the laws of a country, has succeeded in carrying out its duties, especially in implementing definite and clear laws. This will attract foreign investors because the implementation of certain laws makes investment safer considering how simple it is to do. According to foreign investors, legal ambiguity has a very high cost and is considered a cost. Therefore, a strong legal system will increase the value of FDI entering a country.

The influence of voting rights and accountability on Foreign Direct Investment (FDI)

Koonam hypothesis is rejected, based on the results of previous hypothesis testing which show that voting rights and accountability have a negative impact on FDI. This shows that the higher the level of political freedom and accountability of a country or the higher rights of association and speech, the easier access to information in the country can make the government side with local entrepreneurs who are threatened by the arrival of foreign investors and this condition makes it difficult for foreign investors to invest, so that the flow of FDI continues to decline. The results of this study are consistent with the research conducted by Brooks, Fan and Sumulong (2003) and Avianti (2010).

Brooks. Fan and Sumulong (2003) explained that the right to speak and good accountability are related to the freedom of citizens to participate and propose their voices in the economic activities of a country. Local entrepreneurs will convey their concerns to the government if they feel threatened by the presence of international investors. To limit the entry of foreign investors, the government will strengthen the law. This happened when Finland, Brazil, Hong Kong, Japan and North Korea replaced Singapore, Malaysia, Thailand and Indonesia as popular investment destinations in the 2000s.

According to Avianti (2010), the level of FDI in a country will actually decrease as a result of strong accountability standards and freedom of speech. To minimize free market competition, the government prioritizes the interests and opinions of local entrepreneurs who reject the entry of foreign companies into the same industry. As a result, the lower the FDI entering the country, the more responsible the government is to local businesses.

The results of this study are also in line with the following rationalization. A country that has high freedom of speech and association and ease of access to information can change the dynamics of a country quickly. The large number of citizens who hold demonstrations is one example of high freedom of speech. This can make the condition of a country tend to be unstable and will have an impact on economic activity. This condition is considered less profitable for foreign investors to invest in the country, so that the value of incoming FDI will tend to decrease.

Indicators of governance quality (simultaneously) have a positive effect on Foreign Direct Investment (FDI)

FDI is simultaneously affected by government effectiveness, in accordance with the findings of the simultaneous hypothesis test in the previous section. This shows that the quality of a country's government affects the attractiveness of foreign investors to invest their assets, thereby increasing the value of FDI entering the country. The findings of this test are consistent with research by Rajan, Rongala, and Ghosh (2008) and Alfaro. Kalemi-Ozcan, and Volosovych from 2007,

Alfaro. Kalemli-Ozcan, and Velosovych (2007) assert that a country's governance affects the flow of money into the country. Evidence for this can be seen in the infrastructure that supports economic activities or in the policies of government agencies. The government is a key element in attracting investment to a country, according to Rajon, Rongalo, and Ghosh (2008). High FDI values indicate that the government has implemented the best economic support policies.

The results of this study are also in line with the following rationalization. A country's economic activities can be facilitated by good infrastructure, which can also boost production. Because they are the parties authorized to create informal norms and also institutions that determine the structure of the economy, government institutions play an important role in society. Because investment decisions are influenced by the quality of government organizations, it can be said that a weak government system will affect investment and result in unpredictable economic activities. This will hinder the entry of foreign capital into the country. On the other hand, with an effective and high-quality government system, the nation's economic activities will maintain legal certainty and stable stability in various matters, thus attracting foreign investors to invest and increasing the number of FDI entering.

CONCLUSION

The study conducted in 8 developing ASEAN countries from 2002 to 2017 aims to provide empirical evidence that effective governance positively influences foreign direct investment (FDI). Five key conclusions can be drawn from the findings.

1. Effective corruption control does not significantly impact incoming FDI and is not a primary concern for investors. Instead, they prioritize stable factors like political stability and law enforcement, as ineffective bureaucracy can be mitigated through bribery.
2. Government effectiveness does not significantly influence incoming FDI. Corruption can foster inefficient bureaucracy, prompting investors to favor countries with ineffective

governments where bribery is easier, thus enhancing profits by addressing bureaucratic challenges.

3. Greater political stability in a country correlates with higher incoming FDI, as foreign investors prefer stable environments that ensure safe capital movement and minimize political risks.
4. A stronger rule of law leads to higher incoming FDI, as effective law enforcement and the protection of ownership rights provide investors with security and certainty, enhancing their investment value.
5. Greater freedom of speech and accountability can decrease incoming FDI, as these conditions may lead governments to favor local entrepreneurs, making it harder for foreign investors and reducing FDI flow.

This study faced high multicollinearity with one variable, leading to its removal. Future research should consider variables unrelated to the six World Governance Indicators, like infrastructure.. The observation period was from 2002 to 2017, limited by data availability, though it could ideally extend to 2018. The study has three key implications: it enhances understanding of government quality's impact on foreign investment in developing ASEAN countries, serves as a reference for further research, and offers insights for policymakers to improve regulations and investment climates.

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