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THE EFFECT OF GOVERNMENT QUALITY ON FOREIGN DIRECT INVESTMENT IN ASEAN PLUS THREE

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Abstract
This study aims to determine the effect of government quality on Foreign Direct Investment (FDI) in ASEAN Plus Three. Recent empirical studies have shown that FDI is expected to be strongly associated with good governance conditions in the host country. The research method used in this study is a quantitative approach. To accomplish this study, we used a panel data set of 13 countries in ASEAN Plus Three regions from 1996 to 2022. This analysis was conducted using a random effects model (REM). Our findings can be summarized: Government Effectiveness and the Rule of Law positively impact FDI in the ASEAN Plus Three Countries. Moreover, Political Stability, Voice, and Accountability have a negative impact on FDI. However, Regulatory Quality and Control of Corruption could be more significant in attracting FDI inflows.
Keywords: ASEAN Plus Three, Foreign Direct Investment, Government Quality.

INTRODUCTION

The Asian Financial Crisis (AFC) of 1997-1998 was a turning point for East Asian regionalism as a response to global dependence on the United States. The Growth of East Asian regionalism occurred due to economic interdependence and interconnectedness. Thus, the Association of South-East Asian Nations (ASEAN) Plus Three (APT) cooperated at the sidelines of the 2nd informal ASEAN Summit in Malaysia in December 1997. The AFC was the primary catalyst for forming ASEAN Plus Three (APT), as every country in the region was negatively affected by the crisis to varying degrees (Hew, 2006).

In 1997, The Asian financial crisis generated an urgent need for institutionalized cooperation and intense economic integration beyond the geographical differences between Northeast and Southeast Asia (EASG, 2002). APT cooperation is thus considered more attractive as a necessary mechanism to manage global power and influence, as well as the interdependence of developing countries on each other (Low, 2003). APT cooperation paves the way for ASEAN countries to build economic ties with developed countries, such as Japan and South Korea, as well as the dynamic Chinese market as a way to overcome the crisis.

ASEAN is the third-largest economy in Asia and the fifth-largest in the world. It is one of the largest emerging markets globally and has a sizable consumption. Due to its large market size and intense regional integration, ASEAN emerging economies remain the top destination for Foreign Direct Investment (FDI) after China.

ASEAN countries are crucial for China, Japan, and Korea in overcoming problems caused by weak domestic demand and overcapacity in production. In addition, the Southeast Asian region is serving as a transit trade corridor connecting the West and the Plus Three countries. This trend can be associated with production relocation and supply chain shifts to Southeast Asia. However, ASEAN member states are stepping up protectionism and deglobalization as their trading conditions are focused increasingly on China. The aim is to attract foreign investment, develop domestic industries, and upgrade global value chains (Li, 2024).

ASEAN member countries are still adapting to the global market and seeking the right balance between protectionism and liberalization. So, to overcome this, ASEAN trade is based on three principles: increasing dependence on China, the proliferation of its Free Trade Areas (FTAs), and enhanced economic nationalism and protectionism. Despite the ongoing uncertainty in the global economy, ASEAN reports continued growth. The industrial sector is expanding rapidly, regional integration is deepening, there is a growing number of middle-income consumers, and there is consistent policy encouragement from governments, making it increasingly difficult for investors to ignore the ASEAN market (Association of Southeast Asian Nations, 2023).

A country can recover from a crisis driven by several factors, one of which is increased foreign investment inflows. The formation of APT cooperation is the best vehicle for developing strategies to promote global economic recovery, one of which is with foreign direct investment (FDI). Figure 1 shows that the formation of APT cooperation encouraged the recovery of FDI flows in APT countries after five years in 2003, after the AFC.

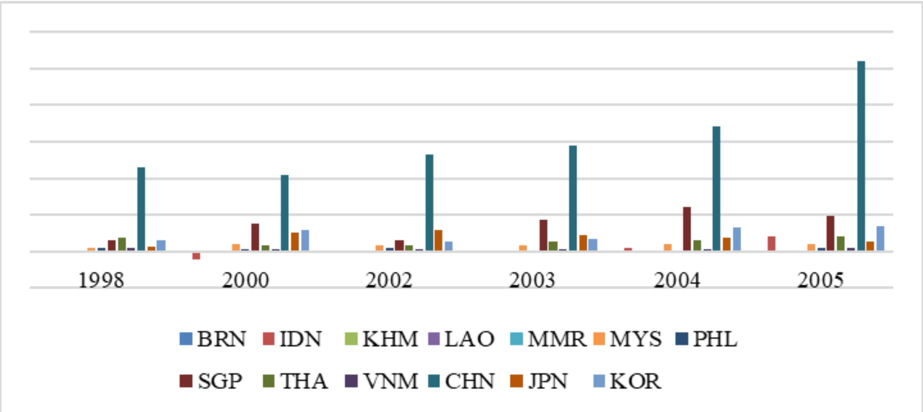

Figure 1. Foreign Direct Investment (FDI) inflows 1998-2005.

Source: Data Processed by the Author.

FDI is an essential channel of inflows to facilitate the transfer of technology between countries, is involved in promoting international trade through foreign market access, and can be a means of driving a country's economic development through the assistance of human resource development. Despite challenges due to uncertainty in the global economy, FDI inflows from the plus three countries to ASEAN member states reached US$ 32 billion in 2019, as shown in Table 2.

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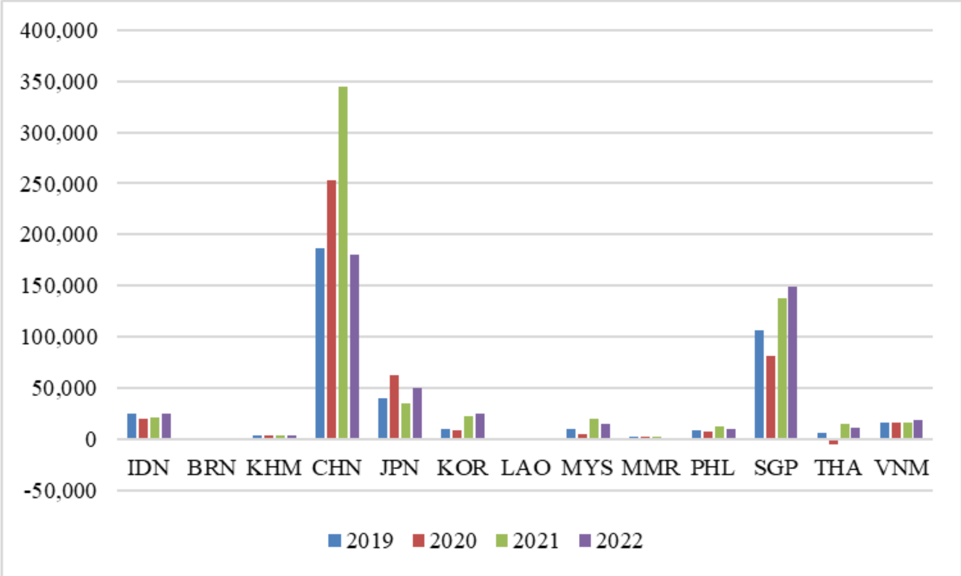

Figure 2. Foreign Direct Investment (FDI) inflows 2019-2022.

Source: Data Processed by the Author.

APT cooperation is a grouping of heterogeneous countries. There is significant diversity in the political, economic, and social systems. However, the region is developing into a crucial mechanism for strengthening and deepening regional cooperation, particularly in the economic, social, and political spheres (Teeramungcalanon, Chiu, & Kim, 2020).

The high trade flows and capital mobility in the region in a period of globalization become a risk for foreign investors if the quality and institutional structure of APT countries is weak (Angkinand Prabha & Chiu, 2012). Countries with a risk-free environment and good-quality institutions will attract foreign investors to engage in cross-border transactions (North, 1990). The transparency of government through good governance, such as effectiveness, rule of law, lack of corruption, voice, and participation, can encourage growth, including foreign investment (North *et al.*, 2008). Countries with a legal system that provides certainty regarding operating protection will attract FDI (White III, 2015).

The link between good governance and FDI inflows has received attention from various scholars for several purposes, i.e., FDI is sensitive to country-specific political risks, FDI is elastic to investment transaction costs, FDI is affected by investors' trust and confidence (Mengistu & Adhikary, 2011). Zidi (2016) studied governance and foreign direct investment and stated that governance had positively impacted FDI inflows in MENA countries. In addition, Hussain & Malik (2011) suggested that governance indicators increase FDI inflows in developing countries.

FDI flows can be increased through government policies that provide incentives such as reduced tariffs and tax concessions to investors. Multinational companies always seek to invest where the institutional environment is favorable. Meanwhile, investors prefer to invest in countries with a transparent institutional framework characterized by coherent politics (Buchanan, Le, & Rishi, 2012).

The World Bank identifies governance into six dimensions identified by Kaufmann as World Governance Indicators (WGI), namely 1) voice and Accountability, 2) the rule of law, 3) political stability, 4) regulatory quality, 5) government effectiveness, and 6) control of corruption (Kaufmann *et al.*, 2005).

LITERATURE REVIEW

Foreign Direct Investment

Foreign direct investment (FDI) is a crucial element in international economic integration that can create stable and sustainable economic relationships between countries. FDI is the process by which residents of one country, which is considered the home country where the investing firm is located, acquire ownership of assets to control the production, distribution, and other activities of a firm in another country, which is considered the host country where the investing firm is located (Moosa, 2002).

FDI before 1960 was categorized as portfolio investment because it involved only the international transfer of capital (Kindleberger, 1969). The increasing role of multinational firms in the causes and consequences of FDI was explored in a separate area of investigation first developed by Hymer, Kindleberger, Alber, Vernon, and others (Rayome & Baker, 1995). This area of inquiry is essential because it explains the activities of multinational companies that enjoy and prefer one country for business activities.

The theories developed aim to explain the determinants of success of some countries that are more successful in FDI than others. On the other hand, some theories aimed to explain outward FDI reasons multinational firms prefer to invest abroad rather than in the home country and inward FDI to see the tendency and ability of a country to attract investors. Several theoretical works found several factors to be a consideration for investors making foreign investment decisions, such as Heckscher-Ohlin trade theory, Vernon's product life cycle theory, North theory, and most importantly, Dunning's eclectic paradigm theory (Saha *et al.*, 2022).

Government Quality

The quality of government can be seen from the six indicators of Worldwide Governance Indicators (WGI), a series of governance-related indicators provided by the World Bank since 1996. The World Bank identifies governance into six dimensions identified by Kaufmann as World Governance Indicators (WGI), namely 1) voice and Accountability, 2) the rule of law, 3) political stability, 4) regulatory quality, 5) government effectiveness, and 6) control of corruption.

Kaufmann et al. (2005) define the first indicator, voice and Accountability (VA), as the perception that measures the extent to which people can participate in electing the government, have freedom of association, freedom of expression, and freedom granted to the media. Second, the

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indicator of political stability and absence of violence (PS) measures the perception of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including political violence and terrorism. Third, the government effectiveness indicator (GE) measures the quality of public services, the quality of the civil service and its degree of independence from political pressure, the quality of policy formulation and implementation, and the credibility of the government's commitment to those policies. Fourth, the Regulatory Quality (RQ) indicator measures the government's perceived ability to formulate and implement sound policies and regulations that enable and promote private sector development. Fifth, the Rule of Law (RL) indicator measures perceptions of the degree to which government officials, institutions, and other agents comply with applicable laws and the extent to which they believe that rules are followed. Sixth, corruption control (CC) indicates the extent to which public power is exercised for private gain, including petty and grand forms of corruption and capture of the state by elites and vested interests.

METHOD

This study examines the effect of government quality on FDI in ASEAN Plus Three. The type of data used in this study is secondary data from World Bank Worldwide Governance Indicators developed by Kaufmann *et al.* (1999). The secondary data used is a combined panel data of time series from 1996 to 2022 and cross section from 13 countries in ASEAN Plus Three regions: Indonesia, Malaysia, Singapore, Philippines, Cambodia, Myanmar, Brunei Darussalam, Thailand, Vietnam, Laos, Jepang, Korea Selatan, dan Cina. This research uses the Random Effects Model (REM), and the data is processed using Eviews 12 software.

RESULTS AND DISCUSSION

REM has the advantage of eliminating heteroscedasticity. Sometimes, classical assumptions are not tested because the main focus is on analyzing random effects and variability between cross-sectional units. The Random Effect Model (REM) aims to estimate interrelated disturbance variables between time and individuals. Each company's error term captures the intercept differences between individuals. This method is known as Generalized Least Squares (GLS).

According to Gujarati (2004), the GLS method is OLS applied to a transformation model that satisfies classical assumptions. The GLS method takes into account explicitly and can produce the Best Linear Unbiased Estimator (BLUE). So, the researchers in this study chose not to conduct a classical assumption test, in line with the research of Anggraini & Zulkifli (2021) and Saputra & Zulkifli (2022), who used panel data regression analysis without using the classical assumption test. Baltagi (2021) often illustrates the use of REM in research without constantly testing classical assumptions.

Regression analysis is conducted to understand the impact of good governance on the inflow of

FDI based on the six independent variables: Control of Corruption (CC), Government Effectiveness (GE), Political Stability and Absence of Violence/Terrorism (PV), Regulatory Quality (RQ), Rule of Law (RL), and Voice and Accountability (VA). The regression model tested in the study is as follows in Table 1.

Table 1. Variable Summary

Dependent Variable: Foreign Direct Investment
Y = FDI (Foreign Direct Investment)
Dependent Variables: Six Governance Indicators of World Bank
X_1 = VA (Voice and Accountability)
X_2 = PS (Political Stability and Absence of Violence/Terrorism)
X_3 = GE (Government Effectiveness)
X_4 = RQ (Regulatory Quality)
X_5 = RL (Rule of Law)
X_6 = CC (Control of Corruption)
Constant:
C = Constant

The random effects model's result, test t–t-statistic, is used to investigate the hypothesis, as shown in Table 2.

Table 2. Regression Coefficients

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	2.76E+09	1.39E+10	0.199283	0.8422
X1	-1.62E+10	7.85E+09	-2.064088	0.0399
X2	-1.07E+10	4.95E+09	-2.158016	0.0317
X3	3.32E+10	9.05E+09	3.663051	0.0003
X4	3.13E+09	8.22E+09	0.381526	0.7031
X5	3.97E+10	1.20E+10	3.316721	0.0010
X6	-2.07E+10	1.09E+10	-1.907391	0.0574

The study reveals that Voice and Accountability significantly negatively impact FDI. Public opinion hinders investment activities in line with the *Social License to Operate* (SLO) theory, which states that public perception and social approval are necessary for a company to be accepted and approved for its operational activities. Without public support, forms of foreign direct investment, such as establishing foreign companies in the host country, will face significant obstacles in protests, strict regulations, or even the revocation of operational licenses.

The findings of this study are not in line with the research conducted by Guerin & Manzocchi (2009), Jadhav (2012), and Teeramungcalanon *et al.* (2020), which shows that voice and

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Accountability are significantly positive towards FDI. Rodrik, Subramanian, and Trebbi (2004) state that good institutions, including freedom of expression, are more important than policy or geography in FDI activities. Research by Ismail & Zubair (2018) also shows that votes and Accountability significantly impact FDI attractiveness. Voice and Accountability will dramatically increase due to the development of the internet and information communication technology such as social media, which encourages information transparency and freedom of expression.

However, this research aligns with the conditions in ASEAN *Plus Three* countries. Only three countries adhere to a democratic system in their government, showing freedom of speech, information disclosure, and transparency. Other countries need more vital voices and Accountability, meaning limited public freedom of speech, limited access to information, and transparency. Despite the weak voice and Accountability, foreign direct investment continues to enter these countries. The data shows that when the voice and Accountability are close to -2.5, it will encourage foreign direct investment inflows because the APT area has dynamic international market conditions and access to raw material resources. Thus, investors adhere to the philosophy of *greed*, which is good and driven by profit acquisition and wealth optimization by excessive risk-taking, ignoring social and environmental consequences.

Then, the APT area, which includes the Asia-Pacific region, has the concept of economic growth that refers to the theory of *the flying gees*e, proving that industrialization and economic growth are at different stages. Each country focuses on sectors that are based on its comparative advantages. Hence, interaction activities also drive the driving factors for foreign direct investment to transfer their comparative advantages to the destination country. The novelty of this research is supported by research. Alesina *et al.* (2003) show that in countries with many ethnic divisions, freedom of expression will cause social and political conflicts, thus hindering the inflow of foreign investment.

Political stability is one of the main factors considered by foreign investors. Political instability can increase investors' risks, including policy changes, expropriation, and social unrest, which will discourage foreign direct investment (Henisz, 2000). Excessive political stability, especially in highly controlled authoritarian regimes, can discourage foreign direct investment due to inflexible policies and the potential for sudden changes in policy without warning (Busse & Hefeker, 2007).

This study's results align with a study conducted by Alesina (1996), which found that political instability, as measured by the frequency of government changes and the level of political violence, significantly negatively impacts foreign direct investment. However, highly authoritarian political stability can also reduce investment attractiveness due to rigid and unpredictable policies. In addition, Nizam (2018) supports that political stability hurts foreign direct investment because stable political conditions will hinder policy innovation, making it unattractive to investors looking for a dynamic and innovative environment. Sigh and Jun (1995) have consistent findings that political risk is not significant to the entry of foreign direct investment. Political instability leaves public officials and investors with a short-term focus and, at the same time, will sacrifice legality and work for personal gain (Shahbaz & Rahman, 2010).

Government effectiveness is the capacity and ability of the state to implement effective policies (Lederman *et al.*, 2005). Therefore, when government effectiveness exists, the state will be able to provide quality public services, run an effective bureaucracy, make civil services independent of political pressure, and gain public trust in the credibility and commitment of the government to implementing sound policies (Oster, 2009). Government effectiveness is classified as a substance of efficiency and transparency. When a country is more efficient, the effectiveness of its government will be related to costs. The more efficient the state, the more the expenses incurred in implementing a policy will be reduced.

North's theory supports these findings that an adequate state reducing transaction costs by providing precise mechanisms for contract enforcement and dispute resolution will minimize risk and uncertainty for economic actors, including foreign investors. North's theory also highlights the provision of appropriate incentives for individuals and companies to invest in physical and human capital and innovate. In addition, this research is in line with the electoral paradigm, which says that in determining whether to invest in the host country, the advantages of the location are considered, including low costs and the existence of incentive policies.

The results of this study are in line with the research of Ismail & Zubair (2018) that government effectiveness is the capacity and ability of the state to implement effective policies and build adequate governance infrastructure and that government effectiveness plays a significant role in contributing to the influx of foreign investment by attracting foreign companies to the host country. The Busse and Hefeker study (2007) also found that efficient government effectiveness and sound institutions are more attractive to foreign investors because they reduce uncertainty and risk. In addition, Dunning and Lundan (2008) emphasized the importance of an effective institutional environment, including government effectiveness, in influencing investment decisions by multinational corporations. Rodrik (2008) also argues that government effectiveness plays a significant role in contributing to the influx of foreign investment by attracting foreign companies to the host country. Then Adhikary (2011) stated that most empirical studies agreed that the indicator of governance effectiveness is a determining factor in economic development through the entry of foreign direct investment.

The quality or excellence of a country's regulatory system depends on the extent to which regulations are made and the level at which people accept them. The government is responsible for ensuring that quality regulations exist and that the economy operates within those regulations to encourage economic development and attract foreign investment (Lee & Tan, 2006). The research results by Dunning and Lundan (2008) show that large companies have the resources and experience to manage regulatory risks. Hence, the quality of regulation in the host country needs to improve

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investment decision-making. In addition, the findings of Sabit *et al.* (2019) state that the quality of regulation does not affect foreign direct investment in developing countries.

The quality of regulation does not affect foreign direct investment, supported by the theory of dependence on other factors with the concept that foreign investment decisions depend on a variety of specific situational factors, such as market size and natural resources, political stability, and political risks, and specific industrial sectors. This theoretical concept is in line with the findings of Sabit *et al.* (2019) that regulatory quality can play a positive and significant role in attracting foreign direct investment in developed countries, meaning that it implies that developed countries have adopted market-friendly policies that attract investment.

Shivute (2009) defines the rule of law as a fundamental value symbolizing that government and state authorities can only be legally exercised within the appropriate legal parameters and established procedures. Shivute (2009) further states that power can only be given to the people by adopting the rule of law and promoting and practicing good governance. The rule of law is an essential component of good governance indicators that positively facilitate the inflow of foreign direct investment into the host economy.

It reveals that countries with effective and transparent legal systems increase domestic investment and attract foreign investors for long-term investments. In addition, instituting effective legal rules also significantly protects intellectual property and individual rights to promote innovation and invention. The results align with Jadhav's (2012) and Nunenkamp and Spatz's (2004) findings, which show that solid legal protection in a country attracts foreign direct investment positively. The level of FDI inflows into a country is highly dependent on the ethical behavior, honesty, and integrity of government officials of the host country, promising political and administrative behavior in respecting laws, procedures, and rules (Shivute, 2008).

This study's results align with North's theory, which emphasizes the role of institutions such as laws, regulatory frameworks, and governance structures in shaping economic behavior and outcomes. Investment activities are related to ownership rights, so a country with effective laws protecting ownership rights will make investors feel safe because the risk of expropriation and uncertainty is reduced (Acemoglu *et al.* 2001). Consistent enforcement of laws and contracts will help companies face fewer obstacles in doing business, which increases a country's attractiveness for foreign investment (Heniz, 2000).

Corruption, on the other hand, hinders financial progress. Corruption is often associated with institutional weakness and is cited as an essential factor affecting FDI flows (Gossel, 2018). However, corruption can be a barrier that increases the cost of multinational corporations and deters investors (Ofori *et al.*, 2023). It is broken by the findings of Dunning (1993) and Mudambi (2002) that multinational companies can plan strategies that adapt to the environment of the destination country with a high level of corruption and continue to operate effectively without being affected by conditions with high levels of corruption. It is also supported by the findings of Hakkal (2008) and Heinisz (2000), who argue that the effects of corruption are asymmetrical so that in some cases, corruption does not affect the investment decisions of companies that have a strategy to deal with an environment with high levels of corruption and can use corruption as a mechanism to reduce risks in countries with weak legal systems.

According to Transparency International (2023), several findings illustrate that many countries still need to make more efforts to eradicate corruption in the public sector. It is confirmed by the average global corruption perception index, which has remained unchanged since 2022. It does not affect foreign direct investment because the application of the concept of *greed is good*, where it is encouraged by the acquisition of profits and optimizing wealth by taking excessive risks and ignoring social and environmental consequences.

CONCLUSION

This research examined government quality's effect on FDI in ASEAN Plus Three from 1996 to 2022. Therefore, the thirteen countries, namely, China, Japan, Korea, Brunei Darussalam, Camboja, Indonesia, Thailand, Singapore, Myanmar, Malaysia, Laos, Vietnam, and the Philippines, were examined using the World Bank’s six governance indicators to identify their impact on the inflow of FDI. Based on the findings, the study has arrived at the following conclusions:

The two governance indicators, political stability, voice, and Accountability, have a statistically negative and significant impact on FDI. Freedom of expression is restricted, and political violence occurs among APT countries. However, this encourages the entry of foreign investment because the APT country area is located in an area close to raw material sources, the breadth of new markets, and there are incentives for investors.

The two governance indicators, Government effectiveness and Rule of Law have a statistically significant impact on FDI, indicating that these indicators are essential for increasing FDI in the economies of the APT countries. Similarly, the World Bank’s WGI percentages and indices for these two indicators are significantly low, showing that the poor overall FDI inflow into the countries is due to these two factors. Some past research on governance further agrees that adequate and robust government is a crucial factor influencing economic growth.

On the other hand, this study's statistical results reveal that regulatory quality and control of corruption do not significantly influence the inflow of FDI. Furthermore, the WGI discussed in this study indicates that these factors may positively influence the inflow of FDI into the APT countries.

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