Significance of Good Governance for FDI Inflows in SAARC Countries

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Abstract

This paper studies the importance of good governance for FDI inflows in SAARC member countries for the time period of nine years, i.e. from 2006 to 2014. The worldwide governance indicators of Kaufmann, Kraay, and Zoido-Lobatón (1999) are used to investigate the impact of good governance on FDI inflows. Through random effects panel estimation technique, the results show that political stability and regulatory quality significantly and positively affect inward FDI. On the contrary, prevalence of corruption discourages multinationals to invest in SAARC countries. Moreover, conventional FDI location determinants like market size and development level continue to exert their positive influence. However, openness of the host economy and human capital, though equally important, are insignificant in terms of their possible sway on FDI inflows. The key finding is that good governance has significant impact on inward FDI in the SAARC region.

Keywords: Good governance, SAARC developing countries, FDI, panel data
JEL Classification: C330, C550, F210, F550 and F680

1. Introduction

Developing countries generally fall short of generating enough resources for the economic progress and well-being of their people (Burdekin & Langdana, 2015). Foreign Direct Investments (FDIs) can be one of the possible sources to fulfil this short fall (Shah &Faiz, 2015). Academic research admits that FDIs can make considerable contribution to an economy's expansion by stimulating economic development (Soumaré and Tchana, 2015). In order to attract multinationals, developing countries formulate policy objectives for reforming the investing procedures to develop a superior and profitable business friendly setup which draws the attention of foreign investors (Almond, Ferner & Tregaskis, 2015). In this scenario, the current study strives to investigate the significance of good governance practices in five host SAARC nations, namely, Bangladesh, India, Nepal, Pakistan and Sri Lanka, for overseas investors (Subasat & Bellos, 2013).

World Development Report (2005) defined good governance as a business supporting environment that offers growth prospects and incentives for micro businesses

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and multinational firms to make effective investments, generate employment and accelerate economic growth. It has been specified by Rodrik (2012) that good governance always concentrates on the improvement of organizations and institutions. Therefore, friendly business and investment governing policy mechanism improve the current state of various macro variables, for instance trade regulations, bribery, courts of law, legal framework, labour conventions, electricity, transportation, telecommunications, etc., the characteristics fundamentally sought by multinationals (White, Chizema, Canabal, & Perry, 2015).

The flow of capital or assets from an investor's home country into a foreign country in the form of acquisition or merger with an organization is known as foreign direct investment. UNCTAD (2002) characterized FDI as a venture including an enduring relationship reflecting continual benefits and control by a foreign citizen into a business in an economy other than that of the citizen's. Similarly, World Bank (1992) characterised FDI as investment created in order to obtain an enduring management benefits (typically at least 10 % of stock) in a venture working in a state outside the investor's country.

FDI is usually expected to be strongly associated with democratic governance, political stability, sound macroeconomic conditions and business friendly commercial environment of the host country (Bitzenis and Žugić, 2016). Investment enabling legal framework and property rights security also help in reducing overseas investors' scepticism regarding investments in the host nation (Shah, 2013a).

The term governance is described by the Asian Development Bank (1999) as the way in which power is practiced in the administration of a nation's social and budgetary assets for advancement. The idea of governance is allied with the management of development process in both public and private segments. Asian Development Bank (1999) described four essential components of good governance as accountability, participation, prediction and transparency.

United Nations Development Programme (UNDP) identifies governance from the perspective of human development. It characterises governance in a broader way as compared to the World Bank or Asian Development Bank. UNDP (1997) defined it as the involvement/participation of political, business and authoritative power in the management of national issues at various levels. It involves system, procedures, and societies, through which residents and groups clearly express their interests, practice their legitimate rights, meet their commitments and negotiate their differences. Governance is one of the key subjects regularly discussed in the International Monetary Fund (IMF, 2002). In its 1996 Partnership for Sustainable Global Growth declaration, IMF recognized good governance as a structure incorporating rule of law, enhancing

productivity, ensuring accountability of public office holders in general, and handling bribery in particular (IMF, 1996). These are the fundamental components of a system in which both local and foreign businesses can flourish.

FDIs in South Asia were comparatively low due to the member countries' reluctance to embrace free trade and investment policies (Shah, 2011b). However, they have seen a surge since early 1990s as a result of measures adopted by the member states for engaging foreign investors (Shah, 2011e).

A bulk of FDIs is received by India, while countries like Maldives, Nepal, Afghanistan and Bhutan lag behind (Ekanayake & Perera, 2015). In 1990 41.2% of total SAARC FDIs flew into India. It grew up to 74.11% in 2004 and increased to 84.49% in 2013. Pakistan, in 1990, received 48.34%, while Sri Lanka 7.47%. However, by 2013, both countries' share plunged to a mere 11.05% and 1.52%, respectively (Gugler, 2015).

Total FDIs in SAARC were $2.03 billion in 2000, which is 3.13% of Asia and just 0.24% of the aggregate global foreign investment of $1,271 billion. In 2013, SAARC's stake, in terms of FDI, in Asia and Worldwide was 7.92% and 2.89%, respectively. Among developing countries, SAARC share of inward FDI in 1990 was 1.63% which increased to 7.86% in 2013 (UNCTAD, 2013).

The main focus of earlier researches was mostly on classical FDI determinants such as host market size, human capital, as well as macroeconomic indicators such as GNP, GDP, trade, balance of payments, employment level, inflation, government's fiscal and monetary policy etc. (Shah, 2012c). Inquiry into governance and its impact on FDI was mostly ignored by academics (Claessens & Yurtoglu, 2013). The foremost reason for this was the non-availability of data on governance variables. However, the worldwide governance indicators, introduced by Kaufmann, Kraay, and Zoido-Lobatón (1999), enabled the academics to explore governance's impact on FDIs. The current study also uses Kaufmann et al.'s (1999) governance indicators along with conventional determinants of FDIs in order to empirically investigate the association between the variable of interest, i.e. governance, and FDIs in SAARC countries.

Though, sufficient literature is available on governance and FDIs, there is still a dearth of research exploring the same phenomenon in the SAARC region. This study attempts to fill this gap. This study will help future investors in their investment related decision making. It will also add to the current pool of knowledge regarding good governance and FDIs as well as the policies set by SAARC governments for overseas investors' facilitation. Moreover, the empirical results will provide practical insights into the positive and negative influences of governance variables on FDIs in South

Asian countries. It will also help readers to acquire knowledge about governance and FDIs in general and provide them with empirical evidence apropos their association within SAARC countries. It can also set the foundations for further research on the same topic in several other geographic regions and different time periods with different control variables.

The findings of this study are applicable to South Asian Countries only for the time period of nine years, i.e. from 2006 to 2014 and shall not be generalised to the rest of the world unless the region or group of countries have similar socioeconomic and political standings.

Rest of the paper is organized as follows. Literature on governance and other FDI determinants are reviewed in Section 2 followed by the research hypotheses and theoretical framework. Methodology, variables explanation and model specification are given in Section 3. Estimation issues, analysis of data and interpretation of results are discussed in Section 4. Section 5 concludes the paper.

2. Literature Review

A number of determinants are identified in the empirical literature that affects inward FDIs. Among them, market size, development level, and human capital are the foremost ones. Globerman and Shapiro (2002) stated that a large market would seek more FDIs due to a number of reasons such as robust client base, possible economic clusters, or because of the expected economies of scale in bigger markets. According to Kristjánsdóttir and Óskarsdóttir (2012), for investors, market size and government efficiency have positive effect on foreign investment decision of multinationals. Development level also plays a vital role in attracting FDIs. Mottaleb (2007) stated that FDIs were attracted to the countries where GDP and GDP growth rate were high as well as where business friendly atmosphere and web facilities were easily accessible.

Wheeler and Mody (1992) and Shah (2011d) acknowledged that human capital presence is an essential pre-requisite for FDIs in High-Tec segments. Human capital is measured as either average year of schooling or primary, secondary or tertiary attainment levels. Moreover, Miyamoto (2008), Shah (2009), and Shah (2014b) show that for attracting FDI, at least primary education should be the minimum level of education required after mid-80s.

Yu and Walsh (2010) evaluated FDIs in a sample of 27 developed and developing countries for the period 1985-2008 in the primary, secondary, and tertiary sector. The findings revealed that macroeconomic factors such as inflation, work adaptability, legal framework effectiveness, education, exchange rate, trade, GDP etc. play a vital role for FDI inflows in manufacturing and service sectors. Balasubramanyam (2002) and Shah

(2014a) considered infrastructure as another key FDI determinant. The negative association between FDI inflows and inflation, i.e. macroeconomic instability, is evident from Asiedu (2006) and Shah (2013b). Furthermore, Nunnenkamp (2002), analysing 28 developing nations from 1987 to 2000 found that FDIs are positively correlated with per capita GNP, factor costs, and years of education. According to Margalioth (2003) and Blonigen (2005), FDI inflows can be increased through tax incentives.

Mansfield (1995) demonstrated that intellectual property rights (IPRs) are important for entrepreneurs of pharmaceutical sector. Maskus (2000) said that FDIs can be enhanced through strong IPR promulgation with the help of a supportive legal and regulatory framework. Smarzynska (2002) and Shah (2012a) considered it as one of the most important factors for attracting investments and found a significant positive effect of IPRs on FDIs. Biglaiser and Staats (2010), reviewing U.S joint ventures in Latin America, attested that by strengthening their property rights, rule of law, and legal courts, these countries witnessed increase in inward FDIs. Hewko (2003) asserted that an investor from a country with a corrupt government is indifferent towards the host country's weak legal system in comparison to the investor from a legally resilient state. On the contrary, Peters (2002) found overseas investors to be neutral to the quality of the host country's legal system.

Busse (2003), Jensen (2003), Li and Resnick (2003), and Pierpont (2007) conducted research on FDIs and democratic governance and concluded that countries where democracy prevails draw more foreign investments. Furthermore, Porta, Lopez-De-Silanes, Shleifer and Vishny (1997) and Shah (2010) claimed that countries which fail to ensure investor security witness a loss of FDIs.

Meon and Sekkat (2007) examined FDIs and governance relationship by utilizing Kaufmann et al.'s (1999) governance indicators in 96 countries. It was found that FDIs and institutional governance are positively related. Globerman and Shapiro (2002) also used the same governance indicators for 144 countries from 1994-1997 to analyse the influence of good governance on U.S FDIs. Their results showed that U.S investors consider the existence of sound governance setup as one of the most important requisites of FDIs. Governance-FDI nexus in Ethiopia was explored by Daddi (2013) through interviewing 150 experts selected from 12 institutions. It was found empirically that the three parameters for governance, i.e. efficiency, accountability, and decency of public office holders have a significant positive effect on FDIs.

Busse and Hefeker (2007) analysed political risk, institutions, and FDI relationship for 83 developing countries from 1984-2003. It was found that government stability, reduced corruption and domestic conflicts, sound law and order situation, democracy, accountability and lower bureaucratic mingling positively influenced FDIs. Wei and

Shleifer (2000) and Habib and Zurawicki (2002) found that political stability has positive influence on FDIs. Shah and Faiz (2015) found that countries plagued with terrorism and a high political risk deter FDIs.

Seim (2010) found in his study that improved regulatory quality positively influences inward FDIs. Bissoon (2011) analysed the impact of institutional quality on FDIs by using data for 45 developing countries from Africa, Asia and Latin American. The results showed that stable and strong regulatory laws, low corruption in institutions, and political stability enhance inward FDIs in these countries. Daude and Stein (2007) using 34 source countries and 152 host economies found that regulatory quality and government effectiveness play a vital role in affecting FDIs. Other variables such as corruption, rule of law, political stability and voice and accountability had no significant impact on FDIs. Bénassy-Qu'éré, Coupet, and Mayer (2007) investigating institutional determinants of FDIs from 1985-2000 concluded that low corruption, efficient bureaucracy, vibrant courts, access to information, and a developed banking sector are essential factors for FDI inflows. According to Brada, Drabek, and Perez (2012), excessive corruption could ruin the volume of incoming FDIs. Voyer and Beamish (2004), studying how the level of corruption affects Japanese FDIs in 59 developed and developing countries, found that corruption and FDIs were negatively related. Similarly, Shah (2011b) shows that corruption, absence of government effectiveness, and rule of law have negative influence, while political stability and regulatory quality have a positive significant impact on inward FDIs. Therefore, we postulate that good governance shall exert a significant positive effect on inward FDIs in SAARC countries.

On the basis of above literatures following hypotheses are developed to achieve the research objectives of the study.

H_0: Governance indicators have no impact on inward FDIs in SAARC countries.

H_1: Governance indicators have significant impact on inward FDIs in SAARC countries.

The theoretical framework outlining the relationship between the dependent and all the independent variables is given as Figure 1.
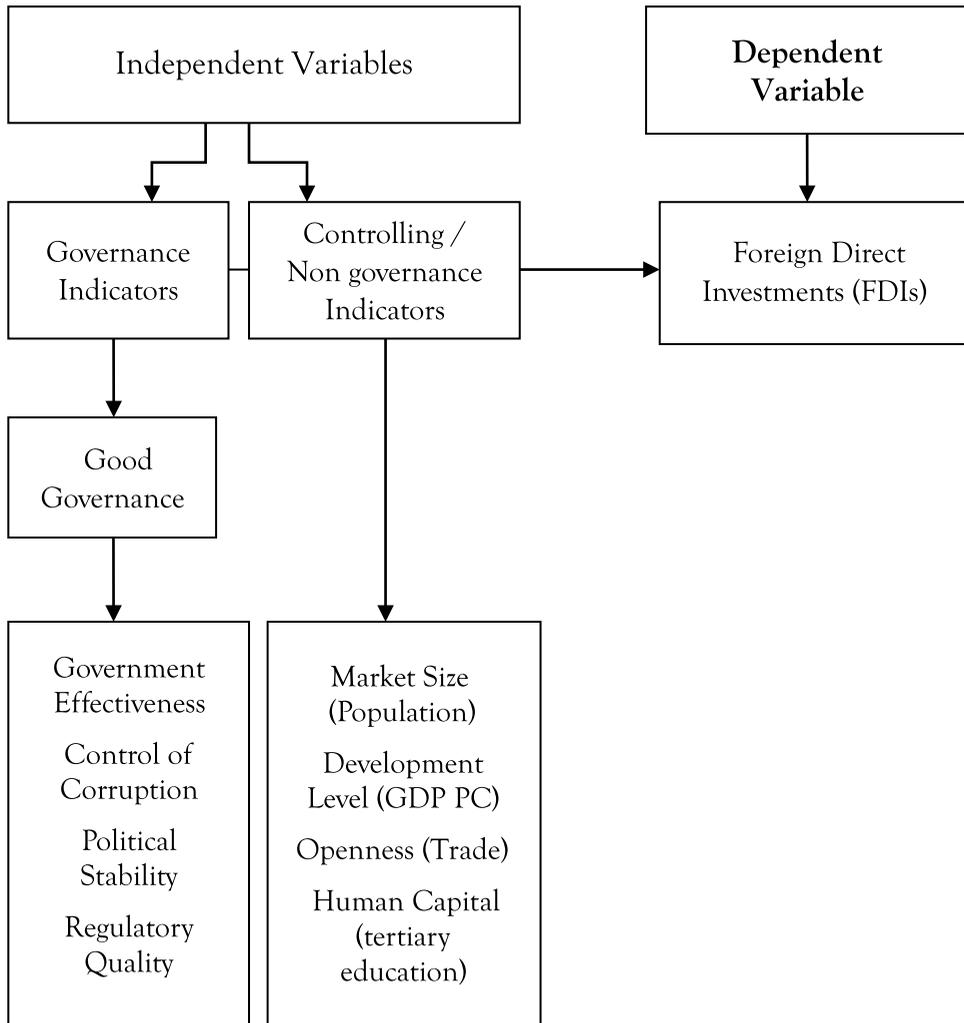
Figure 1: Schematic Representation of the Model

3. Methodology

In this section, methodology of the paper is presented. This includes variables' explanation, sampling design, data collection, and model specification.

3.1. Variables' Explanation

3.1.1   *Dependent variable: Foreign Direct Investments*

When multinationals enter a foreign market either by acquiring a firm or broadening the existing business activities in the host country, it is called foreign direct

investment (FDI). The data for annual net FDI inflows is taken from World Bank, World Development Indicators (WB, WDI) for five SAARC countries to gauge the influence of good governance on inward FDIs.

3.1.2. Independent / Controlling Variables

Eight independent variables are considered for this study. The four non-governance control variables are market size, development level, openness, and human capital; while the governance indicators include political stability, regulatory quality, control of corruption, and government effectiveness. Nineteen proxies were initially selected for independent variables. However, based on their association and significance, only eight proxies were incorporated in the model which is explained below in detail. The omitted proxies are GDP (gross domestic product), primary education, secondary education, average years of schooling, life expectancy, voice and accountability, rule of law, government size, government enterprise investment, legal system, property rights, and inflation.

3.1.3 Market Size

Among all the determinants of FDIs, market size is considered as the most crucial factor for attracting MNCs (Wheeler & Mody, 1992; Kok & Ersoy, 2009). Market size has a positive significant relationship with FDI inflows. Aggregate population is taken from WB, WDI as a proxy for market size for each SAARC member. Market seeking FDIs target large markets for introducing their products due to high expected demand and possible economies of scale and availability of skilled labour (Shah, 2011f).

3.1.4. Development Level

Development level, proxied by GDPPC in current US dollars, signifies peoples' living standard as well as the extent of economic progress of a country. It is the second most important determinant of FDIs (Shah, 2012b). The data is collected from WB, WDI. GDPPC seems more useful while making comparison of one country with another. Higher GDPPC means higher living standard of a country's citizens and a sign of substantial economic growth. Foreign investors prefer those countries where average income and standard of living is high because people have superior buying power. According to Schneider and Frey (1985) and Shah (2011a), there is a significant positive association between FDIs and per capita GDP.

3.1.5. Openness

The degree to which a country is linked with outside world and allows the import of raw material and export of finished products is important for multinationals

(Shah, 2015). Trade as a percentage of GDP is used as a proxy for openness of the host nation. It is taken from WB, WDI. Previous studies like Edwards (1992), Gastanaga, Nugent and Pashamova (1998), Goldar and Banga (2007), and Shah and Samdani (2015) have shown positive effect of trade liberalisation on FDIs. Trade openness in vertical FDIs positively affects FDIs as trade barriers and tariffs are not there to hinder MNCs' activities. However, in market seeking horizontal FDIs, a negative or altogether insignificant association is expected.

3.1.6. *Human Capital*

Like other factors, human capital is also an essential determinant of FDIs. It is measured through level of education, capabilities, and aptitude of labour force. Both health and education are important for the capacity building of a country's skilled, qualified and efficient pool of labour. Researches by Schneider and Frey (1985), Loree and Guisinger (1995), Khan (2007) and Shah (2011c) have stated that a positive relation exists between human capital and inward FDIs. Generally, countries with abundant cheap and skilled human capital draw more FDIs, especially in labour intensive industries. Tertiary education from Barro and Lee's (2013) education data set is used as a proxy for human capital in the current study.

3.2. Independent Variable - Good Governance

The key independent variable of this study is good governance. World Bank, Worldwide Governance Indicators (WB, WGI, 2015) project reports aggregate and individual governance indicators for 215 economies over the period 1996–2014 for six dimensions of governance which are: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, control of corruption.

WGIs were developed by Kaufmann et al. (1999) and are therefore known as Kaufmann et al. governance indicators. Good governance is defined by WGI (2015) as the culture and manner by which power is practiced in a nation. It incorporates the method by which governments are chosen, screened, and reinstated. It is the ability of the authorities to successfully develop and enforce sound strategies, and the appreciation by people and state for the organizations that administer monetary and social connections around them. Political stability, regulatory quality, control of corruption, and government effectiveness are selected as proxies for good governance from WBWGI (2015) in order to assess the impact of good governance over inward FDIs in SAARC nations. The value of all governance indicators varies from -2.5 to +2.5. As evident from the literature review, existing researches show that good governance positively affects inward FDIs. Therefore, we also expect a positive association

between the two.

3.2.1. Political Stability

Political stability is interpreted as the extent to which government is stable. It identifies the chances of premature dissolution of the government in office due to political turmoil. Multinationals prefer democratic states with steady and stable business friendly policies, expecting them to be supportive of international investments and businesses. Moreover, MNCs anticipate a lesser risk of expropriation from such states. Therefore, we expect a positive effect of political stability on inward FDIs.

3.2.2. Regulatory Quality

Regulatory quality is the ability of the government through which reliable and consistent regulatory policies are created and implemented. These government regulations help boost both government and private sector development and also give an indication of the degree of market friendliness for overseas investors. If the regulatory quality is high, a positive influence on overseas investments is expected as multinationals seek locations where the regime is market friendly.

3.2.3. Control of Corruption

Control of corruption shows the extent of corruption prevalence in bureaucracy and their ability to get kickbacks through exploitation of their position. As evident from the literature review, multinationals abhor pervasiveness of corruption and bureaucratic red-tapism. Therefore, we expect that corruption control shall positively affect multinationals' investment decisions.

3.2.4. Government Effectiveness

A government is said to be effective if the civilians are provided with best quality services and their lives are free from political pressures. Effective governments can better facilitate multinationals' operations. Constant government policies are preferred by overseas investors because it helps them make appropriate budgetary allocations sans frequent and unexpected repetitions. A stable government guarantees the continuation of policies; therefore, a positive relationship between FDIs and government effectiveness is expected.

The sources, proxies and abbreviations used for all the above mentioned variables are summarised in Table 1.

Table 1: Variables, their proxies and sources

Variables	Proxy	Abbreviation	Sources
Foreign Direct Investment	LNFDI	Ln FDI	WB, WDI
Market Size	Ln population	Ln Pop	WB, WDI
Development Level	Ln GDPPC	Ln GDPPC	WB, WDI
Openness	Ln trade as a % of GDP	Ln Trade	WB, WDI
Human Capital	Ln tertiary education	Ln TrEdu	Barro & Lee Education Dataset
Good Governance*	Political Stability Regulatory Quality Control of Corruption Government Effectiveness	PolStab RegQu CoCr GovEf	World Bank, World-wide Governance Indicators

* The governance variables are taken without log because their values vary between -2.5 to +2.5.

3.3. Sample

The paper studies the importance of good governance for inward foreign direct investments in five SAARC members: Bangladesh, India, Nepal, Pakistan and Sri Lanka, for a period of nine years, i.e. from 2006 to 2014. Afghanistan, Bhutan and Maldives, though SAARC members, were excluded due to non-availability of data for all the variables.

3.4. Data Collection

The data used is secondary in nature and is collected from World Bank, World Development Indicators (WB, WDI) and Barro and Lee's (2013) educational data set. These sources are also given in Table 1.

3.5. Model Specification

The influence of good governance over incoming FDIs can be estimated through the following equation:

$$FDI_{jt} = f\big(Market\ Size, Development\ Level, Openness,\ Human\ Capital, Good\ Governance\big)_{jt} \qquad (1)$$

Where

FDI is the dependent variable, Controlling factors are market size, development level, openness and human capital, Good governance is the major explanatory or

independent variable, "j" varies from 1 to 5 representing the member countries, "t" is for the time period 2006-2014 varying from 1 to 9.

Substituting relevant proxies for the explanatory variables in equation 1 and log linearizing it, we get:

$$LnFDI_{jt} = \alpha_0 + \beta_1 LnPop_{jt} + \beta_2 LnGDPPC_{jt} + \beta_3 LnTrade_{jt} + \beta_4 TrEdu_{jt} + \beta_5 PolStab_{jt} \text{ or}$$
$$\beta_5 RegQ_{jt} \text{ or } \beta_5 CoCr_{jt} \text{ or } \beta_5 GovEf_{jt} + \varepsilon_{jt} \qquad (2)$$

Where Ln is used for natural logarithm, LnFDI is the dependent variable. Proxies for independent / controlling variables' proxies are:

LnPop = Market Size

LnGDPPC = Development Level

LnTrade = Openness

LnTrEdu = Human Capital

Good Governance proxies that are incorporated in the model are:

PolStab = Political Stability

RegQu = Regulatory Quality

CoCr = Control of Corruption

GovEf = Government Effectiveness

α_0 is the intercept and ε_{jt} is the error term.

4. Results and Analysis

Secondary data for five SAARC countries are collected for nine years over the time period of 2006 to 2014. Descriptive statistics for all variables are presented in Table 2. They include total observations available for all the variables along with minimum, maximum, mean, median, and variance values for each of them.

Heteroscedasticity, uncovered by Breusch-Pagan/Cook-Weisberg test, was removed by using the option of robust standard errors. Table 3 shows correlations among all variables of the study. There was no multi-collinearity found among explanatory variables as the VIF values for all variables were found to be less than 10.

To choose an appropriate estimation technique between possible regression

Table 2: Descriptive statistics*

Variables	Proxies	Obs	Min	Max	Mean	Median	Variance
Foreign Direct Investment	Ln FDI	45	-15.7098	24.4938	17.0684	19.9886	103.6926
Market Size	Ln Pop	45	16.7492	20.8979	18.4654	18.7473	2.1624
Development Level	Ln GDP-PC	45	5.4212	7.6083	6.3411	6.2396	0.2915
Openness	Ln Trade	45	3.2819	4.4957	3.8020	3.8115	0.1043
Human Capital	Ln TrEdu	45	0.9001	2.2877	1.4728	1.3687	0.2036
Good Governance	PolStab	45	-2.5826	-0.7668	-1.4842	-1.4529	0.1848
	RegQu	45	-1.0952	0.2477	-0.5014	-0.5006	0.1147
	CoCr	45	-1.4888	-0.1018	-0.6533	-0.6268	0.1427
	GovEf	45	-0.8649	0.3250	-0.4202	-0.4521	0.0727

*Values rounded off to four decimal places

Table 3: Correlation matrix*

No	Variable Name	Proxy used	1	2	3	4	5	6	7	8	9
1	Foreign Direct Investment	Ln FDI	1.00								
2	Market Size	Ln Pop	0.45	1.00							
3	Development Level	Ln GDP-PC	0.53	0.02	1.00						
4	Openness	Ln Trade	-0.14	-0.67	0.45	1.00					
5	Human Capital	Ln TrEdu	0.40	-0.23	0.86	0.49	1.00				
6	Good Governance	PolStab	0.25	0.28	0.09	0.03	0.12	1.00			
7		RegQu	0.07	-0.17	0.51	0.60	0.56	0.12	1.00		
8		CoCr	-0.05	-0.18	0.44	0.54	0.47	0.13	0.87	1.00	
9		GovEf	0.36	0.35	0.63	0.20	0.54	0.42	0.69	0.73	1.00

*Values rounded off to two decimal places

methods, first the F-Test was performed to make a choice between the pooled OLS and fixed effects panel method. The null hypothesis that the pooled OLS model is adequate, can easily be rejected in favour of the fixed effects alternative with the following statistical values $F(4, 32) = 11.6325$ and a probability value of 0.0000. Next, a Breusch-Pagan Langrage Multiplier test was performed to know whether pooled OLS or random effect panel model shall be used. The probability statistic values of 0.0000 once more conveniently reject the null hypothesis that the pooled OLS model is adequate, in favour of the random effects alternative.

Finally, Hausman (1978) specification test was performed to choose the appropriate panel estimation method between the fixed and random effects. The probability value of Hausman test was 0.8560 which showed that we cannot reject the null hypothesis that the results obtained with consistent fixed effects and efficient random effects are identical (Shah, 2012d). The three tests are summarised in Table 4. This permits us to use random effect panel estimation technique. All the empirical estimation and tests are performed by Stata 11.

Table 4: Specification tests

Test	Choose Between	Null Hypothesis	P-Value	Result
F-Test	Panel Fixed Effects & Pooled OLS	Pooled OLS is better	0.0000	Use Fixed Effects
Langrage Multiplier Test	Panel Random Effects & Pooled OLS	Pooled OLS is better	0.0000	Use Random Effects
Hausman Test	Random Effects & Fixed Effects	Fixed & Random Effects Give the same results	0.8560	Can use Random Effects

Table 5 shows regression results of the study based on random effects technique. Column 1 shows that market size is insignificant. However, in the second model (Column 2) when GDPPC proxying development level and purchasing power is added, it turns positive. It shows that multinationals seek bigger markets but the people should also have the ability to buy their end products.

Trade openness and human capital both are insignificant in all the regressions/models. The reason for human capital being insignificant can be that GDPPC not only exhibits development level and purchasing power of the people but also their extent of education. Hence GDPPC being significant may be overwhelming the possible significance of tertiary education used as a proxy for human capital. Though

not reported in Table 5, but if the variables are regressed without the GDPPC proxy for development level, the coefficient for human capital becomes highly significant at five percent level.

For the insignificance of openness, the only plausible explanation is that the nature of FDIs in SAARC region is of market seeking horizontal nature. In horizontal FDIs, trade openness can negatively affect multinational sales in the host market. This may also partly justify the insignificance of human capital because in horizontal FDIs multinationals concentrate on low skilled mass production or essentially, the economies of scale.

Table 5: Regression analysis by random effects panel estimation method

Variable	Proxy Used	1	2	3	4	5	6
Market Size	Ln Pop	3.4156 (2.3372)	3.0216*** (1.0854)	2.1198*** (0.7526)	2.4318** (1.1695)	1.8662* (1.0259)	2.3536*** (0.7866)
Development Level	Ln GDP-PC		7.8817*** (3.2807)	8.8748* (4.8488)	8.1575 (5.5544)	10.2120*** (4.2273)	10.9082*** (3.8186)
Openness	Ln Trade			-6.1412 (7.7931)	-6.1977 (6.4060)	-5.5996 (6.5629)	-5.8690 (5.8247)
Human Capital	Ln TrEdu				4.6226 (5.0004)	3.3678 (3.2439)	3.8902 (2.7551)
Good Governance	PolStab					3.2944*** (1.3003)	4.0635*** (1.6899)
	RegQu					5.3185* (2.9685)	5.7357* (2.9762)
	CoCr					-10.4107*** (2.7499)	-7.7467** (3.8823)
	GovEf						-6.5049 (4.6723)
Number of Observations		45	45	45	45	45	45
R square		20.00%	46.29%	47.50%	49.41%	55.45%	55.77%

Coefficient values rounded off to four decimal places. Robust standard errors are given in parenthesis below the coefficients. ***, **, * show Significance at 1%, 5%, and 10%, respectively

Political stability and regulatory quality (Column 5) both are positively significant, signifying the importance of these two phenomena for the overseas investments. Also, evident form the same model is the strong negatively significant coefficient of prevalence of corruption in the polity and public offices. This clearly manifests that multinationals seek locations where the bureaucracy is efficient, devoid of any red-tape culture, and free of corruption. Though government effectiveness is insignificant in Column 6, yet it can be seen that the coefficient for corruption falls from -10.4107 to -7.7467, clearly indicating that as the government becomes effective the possibility of bribery and coercion or swindling the local as well as the foreign investor decreases. Moreover, the significance of political stability and regulatory quality remains the same with much stronger coefficients with the inclusion of government effectiveness in Column 6.

The positive significance of political stability and regulatory quality along with the negatively significant coefficient for corruption clearly manifests foreign investors' abhorrence for corruption and their desire for good governance.

5. Conclusion

This research is undertaken with the purpose of analysing the impact of good governance on inward FDIs in five SAARC countries over the period of 2006-2014. The sample comprised of five of the total 8 SAARC countries, namely, Bangladesh, India, Nepal, Pakistan and Sri Lanka. The three other SAARC countries, Afghanistan, Bhutan and Maldives were excluded because of the deficiency of complete dataset on important variables. The empirical results showed that market size (population) and development level (GDPPC) are statistically significant and positively affect FDIs, whereas openness, i.e. trade, and human capital, i.e. tertiary education have no significant influence on inward FDIs which means that they are not playing any part in enhancing inward FDI in the SAARC region.

Political stability was statistically positively significant which is in conformity with our earlier expectations, and therefore proves that the better a recipient country's environment is in terms of political stability; higher will be the likelihood of foreign investment in that country. Similarly, regulatory quality exhibited a significant positive influence on inward FDIs, i.e. the stronger the rules and regulatory policies of a country are concerning market facilitation of overseas investors, the better will be the response of multinationals in the form of investments. Corruption displayed a negatively significant relationship with inward FDIs. This highlights the fact that pervasiveness of corruption is loathed by multinationals and they avoid such places where they incur additional costs in the form of corruption.

To sum up the results, good governance is one of the crucial factors which multinationals consider when choosing a foreign site as a possible FDI destination especially in the SAARC countries. Therefore, the policy makers should ensure to include them in the broader mechanism developed to attract overseas investors in SAARC economies in particular and other developing countries in general.

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