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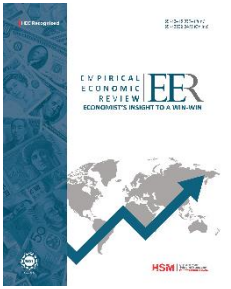

Title:	**Impact of Political and Economic Institutions on FDI Inflows: Evidence from South Asian countries**
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Impact of Political and Economic Institutions on FDI Inflows: Evidence from South Asian Countries

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Abstract

The current study examines the effects of political and economic institutions on the FDI inflows for the selected 4 South Asian countries including Pakistan, India, Bangladesh and Sri Lanka. For this, Panel data is employed for the period 1984--2020. Panel unit root test, Pedroni Cointegration test, Dynamic OLS (DOLS), and Panel Error Correction Model (PECM) methods have been used to extract the results. The empirical findings revealed the significant and positive effect of economic institutions on the inward FDI of South Asian countries. However, political institutions are found to be insignificant for inward FDI. The outcomes of the VECM and the panel cointegration approach confirmed the presence of a cointegrated relationship among the variables. The short-run effects are found to be insignificant. Therefore, Policymakers should make certain policies by taking into account the heterogeneity between economic and political institutions. They need to pay attention to the steps through which the institutions can be made stronger and more effective so that they can make the environment more favorable to attract the maximum number of FDI projects into a specific region.

***Keywords**:* economic institutions, political institutions, foreign direct investment, South Asia

Introduction

Foreign direct investment help in securing foreign exchange and also the employment opportunities in host country (Bevan et al., 2004). Developed nations, attract Foreign Direct Investment (FDI) inflows more as compared to developing countries. This is because they are equipped with well-developed infrastructure along with strong political institutions that ensure foreign investors the security of their investments thus by ensuring more

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profit. Indeed, good infrastructure in the host country is beneficial to transport the manufactured products more efficiently all over the country (Economou, 2019).

Moreover, institutions can also be very helpful in setting up the production facilities by minimizing a lot of documentation work required before starting a business in the host country, consequently providing an economic freedom. However, if the institutions are good enough then they will create ease for the foreign investors and facilitate them to start their businesses. The institutional theory suggests that the firms find it more comfortable to conduct their business in the countries where normative forces are active such as privatization and economic treaties in contrast to the regulatory imposition (Trevino et al., 2008; Francis et al., 2009).

A large body of research has analyzed the effects of institutional quality on inward (Foreign Direct investment) FDI. There remain diverging views regarding the institutional environment's impacts on inward FDI. Most of the results indicate that there is a positive and significant impact of the institutional environment of the host country on the FDI inflows (Cicatiello et al., 2021). A country with a high level of corruption, reduced economic freedom, and weak property rights is unable to attract FDI inflows. Indeed, to give a boost to FDI flows into the country, there must be good institutions that provide ease and freedom for outside businesses to operate their business activities in host country without any fear of losing their investment (Shah & Afridi, 2015).

Foreign Direct Investment (FDI) fills the gap between the capital savers and the capital borrowers in order to run economic system smoothly. FDI flows are considered one of the most important determinants of economic growth because through FDI inflows, the latest technology comes into the host country which in return enhances domestic living standards (Kasasbeh et al., 2018). Initially, since 1990 developed and emerging countries attract more and more FDI into their boundaries by providing tax incentives to foreign investors. Foreign investors analyze acutely the institutional quality before investing in the country because it maximizes their profitability and minimize their costs (van Wyk & Lal, 2008). This can only be possible if the host country possesses strong political institutions that can protect the

rights of the foreign. Institutional reforms have become the major agenda of almost all developing nations because to be in the global competition a country must have a strong institutional framework with which it can get the maximum amount of FDI inflows.

This study explores the role of political and economic institutions in economic development mainly by analyzing their effect on the inward FDI in South Asian countries including Pakistan, India, Bangladesh, Sri Lanka. Furthermore, developing nations are facing the issue of low FDI inflows and the reason behind this low number of FDI projects is the poor institutional framework. So, according to the recent studies, it is suggested that to achieve economic growth, developed and developing countries need to shift their focus on institutional building rather than anything else, as institutions are the key players in the country's economic development. South Asian countries have not prioritized institutional building in the past which is why these countries have been left behind by the western world. Therefore South Asian nations have also started working on their institutions to get more FDI inflows. This study also focuses on the question of whether the political and/or economic institutions have any effect on the inward FDI of the South Asian region or not?

For investigating the research questions, the current study employs Dynamic Ordinary Least Squares (DOLS) methodology. Although, in the literature, there are different methodologies used like OLS, GMM, and ARDL etc. The reason for using the DOLS method is that firstly, we want to estimate long-run effects and secondly, it also takes into account the problems related to endogeneity. Therefore, we consider the methodology to be superior to the ones stated above

This paper is structured as follows: Section 2 discusses the review of literature. Section 3 presents the model, methodology, and data analysis. Section 4 reports the results and discussion, and section 5 concludes this research.

Review of Literature

Indeed, foreign investment plays an important role in the growth of the economy. Therefore, the countries (especially developing countries) struggle to attract FDI inflows. Nevertheless, the potential investors seek

favorable conditions which can be beneficial for the FDI projects which they are going to bring into the host country. For that matter, institutions play an important role as they create an environment that is favorable for foreign investors (Medvedev, 2012). Therefore, this has become a policy question and recently researchers have taken interest in examining the impact of institutional quality on FDI inflows.

Both political and economic institutions are relevant for attracting FDI. The FDI inflows and economic freedom are complementary because free markets encourage optimal factor allocation that increases productivity and therefore, the profitability of the investment increases (Caetano & Caleiro, 2009). They further argued that FDI involves significant sunk costs and that's why investments become very sensitive to the degree of stability and security offered by the legal protection system of intellectual property rights. Therefore, the South-Asian countries need to create a friendly and free business environment in order to attract FDI inflows (Bissoon, 2012). Hence, sound economic policies related to ensuring the liberalization of investments play an important role in attracting inward FDI (Drabek & Payne, 2001). The economic reforms by the governments such as minimal government regulations, reduced ownership of industries by the state as well as continued support of private sector do have an important role in boosting FDI inflows (Biglaiser & Staats, 2010). The production process of numerous goods in today's world is quite complex and countries have developed their own production networks. There is a spatial distribution of labour and the businesses need to access specialized labour to produce in a certain country (for cost savings) and trade the intermediate goods to the other country for further processing. Additionally, the potential investing businesses seek the freedom of trade in the host countries (McKeown, 1999). Moreover, the tax burden is also a determining factor to invest in a certain country (Bajpai & Sachs, 2000).

Pournarakis and Varsakelis (2004) employed OLS methodology and found that geography and institutions have a positive and significant impact on the inward FDI in the transition economies of the European Union. On the basis of their results, they suggested that these countries need to make

certain reforms in their institutions in order to secure more FDI projects. Another study of 64 emerging economies by Wernick and Haar (2009) confirms, using OLS methodology, a positive relationship between FDI inflows and the quality of institutions in the host country. Ali Fiess and MacDonald (2010) and Fiodendji and Evlo (2015) used panel data of 69 countries for the years 1981-2005 and 30 SSA countries for the period 1984-2007 respectively and applied random effects model to explore how institutions play a significant role in boosting inward FDI and found that institutions have a long-lasting and significant impact on the FDI. The importance of institutions in attracting FDI is confirmed in the ASEAN region (Masron & Abdullah, 2010), for Organization for Economic Cooperation and Development (OECD) countries (Kuncic & Jaklic, 2014) by using the OLS methodology, and Arab countries (Aziz, 2018) by following the econometric approach of GMM.

In contrast with the above economic explanations for attracting FDI, there are political factors that may play a role. These include risk considerations and regime type by the investors. However, there is a debate about the impact of regime type on FDI. This is to analyze whether the country is an active democracy or autocracy. Li and Resnick (2003) suggested that democratic institutions in the host country reduce political risks for businesses that express their interest to invest. Therefore, there are less chances of policy reversal in democracies (Harms & Ursprung, 2002), and it is difficult to renege on commitments where democratic structures are present. However, some scholars asserted that political risk is important in the determination of investments but regime type is not in the eyes of investor. The institutional factors and their contribution along with the political risk on the FDI inflows of Sub-Saharan African (SSA) region are examined by Cleeve (2012) who used OLS methodology. The results show that institutional factors and political risk have a significant impact. Using GMM methodology, Gammoudi and Cherif (2015) concluded that the institutions not only have a direct impact but they do also facilitate the effects of other important determinants of FDI such as capital openness. The results of Bitar et al. (2020) indicated that political risk factors are important determinants in boosting FDI inflows whereas the infrastructure and trade openness does not affect FDI in Lebanon. Rafat and Farahani (2019) applied

Two stage least square(2SLS) methodology in order to account for endogeneity and find that external conflict, ethnic tensions, and socioeconomic conditions deter FDI inflows in Iran.

Daniele and Marani (2011) investigated the impact of the socio-institutional environment on the growth of FDI at regional level of 103 Italian provinces. Weighted Least Square (WLS) method is used and their results indicated that there is no relation between crime and the growth of FDI as these crimes of robbery and theft are not related to the firms in which the foreign investors invest. Furthermore, these crimes normally occur in the less developed regions of the country and foreign investors invest in the developed areas of the host countries as they need proper infrastructure and strong property rights which they can get in the developed areas of the host country. Also, these crimes of robbery and theft have nothing to do with property rights so they cannot affect the inward FDI of the country. The host country with a good record of property rights protection, rule of law, and less corruption is an ideal place for foreign investors to invest (Dogru, 2012). Nations which possess powerful institutions are more likely to attract most of the foreign investment than the countries with weaker institutions. Kersan et al. (2013) and Tintin (2013) examined the institutional capacity in boosting FDI inflows in South-East European (SEE) and Eastern and Central European (ECE) countries respectively and showed that corruption, privatization, and trade development have a significant impact on FDI inflows. Therefore, countries with a high standard of institutions are more capable to attract foreign investors (Kurul, 2016; Sabir et al., 2019), For this they both used the GMM approach to attain results.

In the case of Pakistan, Asif and Majid (2018) investigated the effects of institutional standards along with macroeconomic indicators on the inward FDI using ARDL method. They found that the institutional standard has a positive and crucial effect on the inward FDI in the long run as well as in the short run. Peres et al. (2018) showed that FDI and institutions have a positive and significant relationship with FDI. Papageorgiadis et al. (2019) investigated the impact of the institutional framework which is responsible for the control of intellectual property rights for the inward FDI. The results

show that if a country has strong property rights institutions it can attract more FDI. If a country is good in all other aspects but lacks the institutions that are responsible for the protection of property rights then foreign investors would not prefer to invest in that country. Contrary to the above arguments and outcomes of the authors discussed so far, the study by Bhasin and Garg (2020) shows the negative effects of rule of law on the FDI into the emerging host country. The study took into account country heterogeneity by employing panel data with fixed effects. For this purpose, twenty-three emerging economies for the time period 2006-2015 were studied. The assertion here is that foreign investors can take full advantage of the weak laws and norms of these emerging countries. However, regulatory efficiency does have a positive effect on inward FDI.

The institutional theory suggests that the firms do operate better in the countries where normative pillars are in places such as privatization and economic treaties in contrast to the regulatory or coercive forces (Trevino et al., 2008; Francis et al., 2009). To sum up the above-mentioned literature regarding the impact of institutions on the FDI inflows, it can be concluded in a way that the institutions are the key determinants of FDI inflows. Low levels of corruption and strong property rights are the necessary components on which each country pays attention to attract FDI. However, there are diverging views regarding their impact on FDI. Indeed, sometimes foreign investors also try to exploit the situation in a country endowed with bad institutions. In addition, another thing to be noticed is that the heterogeneous effects of political and economic institutions in attracting FDI are relatively scant in the literature. There is a need to disentangle their effects on FDI.

Methodology

In order to analyze the impact of political and economic institutions on inward FDI for the selected 4 South Asian countries including Pakistan, India, Bangladesh, Sri Lanka, panel data has been collected from the most reliable sources. The sample comprises of 4 South Asian countries, for which the data is available, over the period 1984-2020. The natural logarithm of all the variables has been taken except for Economic Freedom.

Foreign direct investment (FDI) inflows (% of GDP), trade (% of GDP), inflation (annual % age), GDP per capita (GDPPC in current US dollars) and fixed telephone subscriptions (FixedTel) (per hundred people) have been taken from the World Bank and World Development Indicators (WDI). Economic freedom of the World (EFW) has been taken from the Fraser Institute. EFW is the degree to which a country's policies and institutions facilitate economic freedom. The index is composed of comprehensive measures related to the secure protection of private properties, the legal and regulatory system, and a stable trade environment. International country risk guide (ICRG) data has been taken from the political risk services (PRS) group. This measure depicts the country's overall political risk. It is based on 12 risk components that include the stability of the government, internal and external conflict to the nation, socioeconomic conditions, bureaucratic quality, and democratic accountability, etc. Property rights and civil liberties (PRCL) data has been taken from the Freedom house. The coding has been reversed by taking minimum value for bad institutions and maximum value for good institution. Heritage data has been taken from The Heritage Foundation. The heritage index refers to government integrity, property rights, and freedom related to business, labor, trade, monetary, and financial.

The econometric examination starts with cross-sectional dependence (CD) test in order to confirm it. This is done to apply the appropriate unit root test. The test was developed by Pesaran (2004). This test provides consistent estimation when time period is long and cross sections are small which is the case in our data. The statistics of the test follow the normal distribution (N(0,1)). It is calculated as follows:

We take up to four lags to test the presence of cross-section dependence. In the next step, unit root testing is done to examine the stationarity of all variables. The two types of unit root tests are employed. These tests are the Augmented Dickey and Fuller (ADF) test and the Phillips and Perron (PP) test. The third step is to run the Pedroni Cointegration Test which is necessary to check the Cointegration among the variables. After estimating the Pedroni Cointegration test, the fourth step is to estimate the results and examine the long-run effects of independent variables. Ordinary least

square (OLS) method could not be used as it is not that accurate in terms of results so for that purpose, we have used the Dynamic Ordinary Least Square (DOLS) method which is widely used to estimate the effect of some independent variables on a dependent variable, when the variables are non-stationary but co-integrated. The regression equation for the impact of political and economic institutions on inward FDI is as follows;

$$lnFDI_{it} = \beta_{it} + \beta_1 lnICRG_{it} + \beta_2 lnPRCL_{it} + \beta_3 EFW_{it} + \beta_4 lnHeritage_{it} + \beta_5 lnTrade_{it} + \beta_6 Inflation_{it} + \beta_7 lnGDPPC_{it} + \beta_8 FixedTel_{it} + \varepsilon_{it} \quad (1)$$

Cointegration cannot find out the causality direction. The Granger causality test can examine the connection and direction of causality between variables. Therefore, likewise the last step, Granger causality is established through Panel Error Correction Model (PECM) model. Therefore, short-run estimates are established through PECM model by Pesaran et al. (1999). The current analysis was conducted using PECM causality is performed in order to estimate the direction of causality of variables.

Results and Discussion

This section summarizes the results of our investigation which is further divided into five sub-sections. Table 1 presents the outcome of cross-section dependency.

Table 1

Cross-Section Dependence (CD) Test Results – Pesaran (2004)

Variables	Lags			
	1	2	3	4
FDI	6.19***[0.000]	6.147***[0.000]	6.127***[0.000]	5.995***[0.000]
ICRG	4.769***[0.000]	4.709***[0.000]	4.643***[0.000]	4.572***[0.000]
PRCL	-2.644***[0.008]	2.661***[0.008]	2.590**[0.010]	2.604***[0.009]
Heritage	6.697***[0.000]	6.611***[0.000]	6.530***[0.000]	6.535***[0.000]

EFW	13.297***[0.000]	13.160***[0.000]	12.944***[0.000]	12.721***[0.000]
Trade	-0.444 [0.042]	-0.398 [0.039]	-0.297 [0.026]	-0.298 [0.047]
GDPPC	14.371***[0.000]	14.200***[0.000]	13.997***[0.000]	13.784***[0.000]
FixedTel	10.574***[0.000]	10.841***[0.000]	11.118***[0.000]	11.094***[0.000]
Inflation	3.504***[0.000]	3.579***[0.000]	3.294***[0.000]	3.504***[0.000]

The Cross-sectional Dependence test statistics follow normal distribution N (0,1). P-values in brackets. *** represents p<0.01, ** show p<0.05.

The results of CD tests are presented in table 1. The results significantly rejected the null hypothesis of cross-sectional independence for all variables except trade. Therefore, it is established that the selected panel of South Asian countries including Pakistan, India, Bangladesh and Sri Lanka have been analyzed in our study are cross-sectionally dependent except trade. In the presence of cross-sectional dependence, the second-generation unit root tests should be conducted developed by Pesaran (2007). For trade variable, that is cross-sectionally independent, we employed two tests i.e., Augmented Dickey Fuller test as well as Phillips Perron test.

Table 2

Cross-Sectionally Dependent Panel Unit Root Test Results – CIPS Pesaran (2007)

VARIABLES	LEVEL		FIRST DIFFERENCE	
	Constant	Constant and Trend	Constant	Constant and Trend
FDI	-4.208***	-4.273***	-6.088***	-6.237***
ICRG	-2.341**	-2.296	-3.373***	-3.313***
PRCL	-1.986	-1.990	-5.917***	-5.938***
Heritage	-4.216***	-3.049***	-4.290***	-5.377***
EFW	-1.099	-1.549	-4.188***	-4.515***
GDPPC	-1.684	-1.526	-5.360***	-5.851***

FixedTel	0.491	0.312	-4.120***	-4.488***
Inflation	-4.073***	-4.352***	-6.190***	-6.420***
Panel Unit Root Test Results – Augmented Dicky Fuller				
Trade	-0.495	-1.250	12.116***	11.498***
Panel Unit Root Test Results – Phillips Perron				
Trade	-0.817	-1.279	26.264***	23.119***

All variables are logged except EFW. *** and * show the stationarity at 1 % and 10% respectively.

As a second step, we verified whether the variables are stationary or not. In order to achieve this objective, the panel unit root tests are applied to each variable. Therefore, table 2 presents the panel unit root test results using CIPS methodology. The stationarity has been tested at a level and first difference including constant as well as constant and trend. The test results show that most of the variables are non-stationary at level, however, all are stationary at first difference. Furthermore, for trade variable data was cross-sectionally independent therefore for this purpose we used Augmented Dickey Fuller and Phillips Perron tests. The trade variable was insignificant at level in both tests, however, it is stationary at first difference. Therefore, the null hypothesis of non-stationarity has been rejected for all the variables at the first difference and we can proceed to the next step for testing cointegration. The cointegration test results are provided in table 3.

Table 3

Pedroni Cointegration Test Results (Panel)

	Panel v	Panel q	Panel PP	Panel ADF	Group q	Group PP	Group ADF
Model 1	-0.404	-0.802	-5.678***	-5.331***	-0.203	-5.954***	-5.626***
	(0.343)	(0.211)	(0.000)	(0.000)	(0.419)	(0.000)	(0.000)
Model 2	0.092	-1.619*	-6.451***	-4.828***	-1.024	-6.865***	-5.219***
	(0.463)	(0.053)	(0.000)	(0.000)	(0.153)	(0.000)	(0.000)

Model 3	-0.339	-1.679**	-7.595***	-4.094***	-1.067	-7.995***	-5.21***
	(0.367)	(0.047)	(0.000)	(0.000)	(0.143)	(0.000)	(0.000)
Model 4	-0.177	-1.053	-6.189***	-5.441***	-0.467	-6.609***	-6.195***
	(0.429)	(0.146)	(0.000)	(0.000)	(0.320)	(0.000)	(0.000)

P-values in parenthesis. All variables are logged except Economic Freedom (EFW).
***, **, * significant at 1 %, 5% and 10% respectively.

The Pedroni Panel Cointegration test was conducted to verify the long-run relationship between variables in question in our four models. Overall, at least 4 out of 7 statistics confirm cointegration for all models where null hypothesis of no cointegration is rejected. Model 3 confirms the significance of 5 statistics out of 7. This confirms the existence of long-run cointegration of variables in our 4 models.

After the Pedroni Cointegration test, the next task was to estimate Dynamic Ordinary Least Square (DOLS) in order to test the impact of institutions on FDI inflows. The DOLS regression results are mentioned in Table 4.

Table 4

Results of Dynamic Ordinary Least Square (DOLS)

VARIABLES	Political Institutions		Economic Institutions	
	(1)	(2)	(3)	(4)
GDPPC	0.992***	0.927***	0.253	0.946***
	(0.194)	(0.186)	(0.172)	(0.210)
Inflation	-0.017	-0.025	0.149*	0.006
	(0.097)	(0.093)	(0.082)	(0.105)
Trade	1.117***	1.147***	0.752**	0.973***

	(0.319)	(0.308)	(0.295)	(0.350)
FixedTel	-0.069**	-0.062**	-0.045**	-0.065**
	(0.028)	(0.027)	(0.022)	(0.031)
ICRG	-0.001			
	(0.088)			
PRCL		0.150		
		(0.252)		
EFW			1.013***	
			(0.185)	
Heritage				0.281***
				(0.093)
Observations	132	132	132	132
Number of	4	4	4	4

Standard errors are in parenthesis. All variables are logged except economic freedom. ***, ** significant at 1% and 5% level respectively.

The results show a negative, however, insignificant impact on FDI inflows in South Asian countries for the political institution of ICRG. The PRCL has a positive but also insignificant impact on FDI inflows. This shows that both political institutions do not significantly attract FDI inflows for South Asian countries however, this contrasts with the results of Cleeve (2012). Our dataset is based on selected South Asian countries whereas Cleeve's (2012) study was on the countries of Sub-Saharan Africa (SSA) region. Interestingly This is why, the economic institutions exhibit a positive and significant impact on the FDI inflows in South Asian countries. A 1 unit increase in economic freedom of the world (EFW) induces FDI inflows by 1.013 units. In elasticity terms, a 10% improvement in economic freedom increases FDI inflows by 27.5%. Also, another index of economic freedom, heritage, increases FDI up to 2.8% if it is enhanced by 10% for South Asian economies.

These results shed light on the supremacy of economic institutions over political institutions in attracting FDI. The economic institutions are the key determinant of the FDI inflows rather than political institutions. Foreign investors only think about property rights and economic freedom before investing in the host country. Economic institutions are the well-established arrangements and structures which are part of the culture and society. The

results are in line with Gammoudi and Cherif (2015), and Papageorgiadis et al. (2019) where they found the strong effects of property rights for inward FDI inflows.

The results suggest that these are the considerations by the foreign investor before investing in the host country. The political matters can be resolved with the passage of time but what matters the most is the economic side as public opinion, level of liberty, and cultural aspects cannot be changed easily. Therefore, these results have an important implications for the theory of institutions on FDI. Indeed, economic institutions are more effective in attracting FDI than the political and coercive checks. Thus, liberalization incentives are better than restrictive ones.

The control variable of income growth significantly attracts FDI inflows. This goes in line with the previous literature where the effects of income per capita are significant. Models 1,2, and 4 confirm this observation. However, inflation is insignificant in attracting FDI inflows. The variable of trade flows is found to be strongly significant in boosting FDI inflows in South Asian countries. The positive results show that trade is complementary to FDI. Thus, no tariff jumping effect is found. The fixed telephone subscriptions are found to be significant but negative in inducing FDI. As nowadays most of the official contact is being done through the use of new technologies embedded in mobile phones such as WhatsApp. Therefore, the fixed telephone lines may become obsolete and most of the business communications are done through the internet and mobile phones.

The final step of our empirical analysis was to capture the long-run as well as short-run Granger causality of the models estimated through DOLS. For this purpose, the Vector Error Correction Models (VECM) was applied. The results are presented in Table 5.

Table 5
VECM test results based on Granger Causality

	Short Run						Long Run
Model 1	ΔFDI	ΔICRG	ΔTrade	ΔInflation	ΔGDPPC	ΔFixedTel	ECT (-1)
ΔFDI	*NA*	-0.645	-0.504	0.282	0.368	0.245	-0.672***
		(1.162)	(1.301)	(0.181)	(0.884)	(0.254)	(0.183)
ΔICRG	-0.167	*NA*	0.003	0.085	-2.167	0.111	-0.343**
	(0.172)		(0.193)	(0.079)	(2.087)	(0.079)	(0.155)
ΔTrade	0.019**	0.008	*NA*	-0.013	-0.123	0.013	-0.298
	(0.008)	(0.039)		(0.035)	(0.086)	(0.027)	(0.219)
ΔInflation	0.053	0.254	0.375	*NA*	0.929	-0.127	-0.561***
	(0.080)	(0.287)	(0.289)		(0.884)	(0.132)	(0.172)
ΔGDPPC	-0.016	-0.031	0.024	0.004	*NA*	-0.028***	-0.034
	(0.013)	(0.062)	(0.088)	(0.012)		(0.010)	(0.036)
ΔFixedTel	-0.049	0.003	-0.448	0.038	1.175	*NA*	-0.068
	(0.085)	(0.114)	(0.761)	(0.149)	(1.024)		(0.114)

Model 2	ΔFDI	ΔPRCL	ΔTrade	ΔInflation	ΔGDPPC	ΔFixedTel	ECT (-1)
ΔFDI	*NA*	2.720**	0.174	0.334	1.457	0.528	-0.639***
		(1.059)	(0.684)	(0.232)	(1.689)	(0.506)	(0.166)
ΔPRCL	0.038**	*NA*	-0.136***	-0.046	-0.055	-0.098	-0.236
	(0.016)		(0.032)	(0.034)	(0.299)	(0.101)	(0.159)
ΔTrade	0.001	-0.149**	*NA*	0.024	-0.073	0.002	-0.138***
	(0.009)	(0.069)		(0.017)	(0.117)	(0.011)	(0.046)
ΔInflation	0.048	0.896***	0.364	*NA*	0.616	-0.289	-0.579***
	(0.085)	(0.322)	(0.455)		(0.879)	(0.237)	(0.186)
ΔGDPPC	-0.007	0.074	-0.097	0.009	*NA*	0.006	-0.031**
	(0.007)	(0.052)	(0.067)	(0.013)		(0.008)	(0.015)
ΔFixedTel	0.006	-1.284**	-0.550	0.032	1.315	*NA*	-0.019
	(0.087)	(0.570)	(0.748)	(0.145)	(0.967)		(0.115)

Model 3	ΔFDI	ΔEFW	ΔTrade	ΔInflation	ΔGDPPC	ΔFixedTel	ECT (-1)
ΔFDI	*NA*	0.179	-0.689	0.179	1.182	0.153	-0.725***
		(0.366)	(1.347)	(0.177)	(1.071)	(0.273)	(0.181)
ΔEFW	-0.019*	*NA*	0.275***	-0.065***	-0.006	0.053*	-0.114
	(0.011)		(0.102)	(0.011)	(0.157)	(0.030)	(0.090)
ΔTrade	0.051***	0.069	*NA*	-0.007	-0.265***	-0.025	-0.195
	(0.015)	(0.045)		(0.032)	(0.099)	(0.048)	(0.147)
ΔInflation	0.012	-1.144***	0.653**	*NA*	1.046	-0.018	-0.566***
	(0.068)	(0.267)	(0.303)		(1.065)	(0.151)	(0.150)
ΔGDPPC	-0.009	-0.036***	0.001	-0.008	*NA*	-0.061**	-0.117
	(0.015)	(0.014)	(.072)	(0.015)		(0.029)	(0.076)
ΔFixedTel	-0.144**	-0.623	0.889	-0.032	0.549	*NA*	-0.033
	(0.069)	(1.127)	(0.916)	(0.073)	(1.008)		(0.024)

Model 4	ΔFDI	ΔHeritage	ΔTrade	ΔInflation	ΔGDPPC	ΔFixedTel	ECT (-1)
ΔFDI	*NA*	0.047	0.337	0.190	1.396	0.256	-0.662***
		(0.594)	(0.534)	(0.143)	(1.391)	(0.214)	(0.155)
ΔHeritage	-0.054	*NA*	0.736	0.035	1.542	0.135	-0.248***
	(0.065)		(0.749)	(0.035)	(1.507)	(0.116)	(0.079)
ΔTrade	0.011*	0.029	*NA*	0.017	-0.125	-0.006	-0.269**
	(0.001)	(0.260)		(0.013)	(0.136)	(0.049)	(0.114)
ΔInflation	0.027	1.883	0.404	*NA*	0.800	-0.148	-0.560***
	(0.079)	(1.491)	(0.443)		(0.976)	(0.158)	(0.174)
ΔGDPPC	-0.025	0.144	-0.026	0.003	*NA*	-0.064**	-0.070***
	(0.018)	(0.198)	(0.076)	(0.019)		(0.029)	(0.023)
ΔFixedTel	-0.060	-0.002	-0.445	0.043	1.129	*NA*	-0.069
	(0.093)	(0.147)	(0.776)	(0.148)	(0.979)		(0.114)

Standard Errors are reported in parentheses for short-run and long-run changes in the independent variables. ECT is the estimate for error correction. *** significant at 1% level, ** significant at 5% level and * significant at 10% level.

The results exhibit long-run causality between the institutions (and other determinants of FDI) and FDI inflows suggesting convergence of FDI inflows in response to institutional developments. These results are robust to the different institutional indicators used in the analysis. Furthermore, the results show a bi-directional causality for one political institution (i.e., ICRG) and one economic institution (i.e., Heritage Index of Economic Freedom). The unidirectional long-run causality exists between FDI inflows and PRCL as well as Economic Freedom (EFW). However, institutional enhancements do not have a significant impact in the short run.

Conclusion

This study analyzed the impact of political and economic institutions separately on inward FDI in selected South Asian countries including Pakistan, India, Bangladesh, Sri Lanka. Panel data of four countries of South Asia was taken for the period 1984 - 2020. In order to obtain empirical findings, the panel Unit Root test, Pedroni Cointegration test, Dynamic OLS, and VECM were employed.

The results showed that, in the South Asian region, political institutions have an insignificant impact on inward FDI. However, there is a positive and significant impact of economic institutions on inward FDI in this region. VECM results confirm long-run causality between FDI inflows, ICRG, PRCL, economic freedom, heritage, trade, inflation, GDP per capita, and fixed telephone subscriptions in the South Asian region.

Recommendations

This research reinforces the importance of institutions in attracting FDI into the country. The policymakers of the host country should make certain reforms in economic institutions that would facilitate the foreign investors. Corruption and lack of protection for property rights are the majror concerns for South Asian countries, since these two factors act as deterrents for foreign investors. Additionally, this study sheds light on those economic institutions which need immediate attention as compared to political institutions because more time is required to strengthen them. Therefore, economic institutions should be fully functional as they establish an overall

favorable environment for foreign investors to set up their production facilities in the host country.

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