

Institutional Quality and FDI Inflows: A Study of Long and Short-Term Effects in Bangladesh

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Abstract

This study examines the short and long-term effects of institutional quality on foreign direct investment (FDI) in Bangladesh from 1995 to 2020, utilizing the autoregressive distributed lag (ARDL) cointegration approach. The ARDL bound test results confirm a long-term relationship between institutional quality and FDI inflows. Findings indicate that political institutional quality has a significant negative effect on FDI in the long term, while in the short term, it exerts a positive influence. Conversely, economic institutional quality shows a favorable long-term effect on FDI, but its short-term impact is negative. The results highlight the pivotal role of institutional quality in shaping FDI inflows, with trade openness also displaying a strong positive influence in both the short and long run. The study suggests that to enhance economic growth through FDI, Bangladesh should prioritize improving institutional quality. These findings lend robust support to North's (1990) institutional hypothesis, underscoring the importance of institutional frameworks in fostering a favorable environment for FDI.

Keywords: *Institutional quality, Foreign direct investment, ARDL approach, Bangladesh.*

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1. Introduction

Foreign direct investment (FDI) has become a critical avenue for technological transfer and economic growth, serving as a bridge that enables the flow of technology from advanced economies to developing nations. The importance of FDI in stimulating economic development is widely acknowledged, as it not only introduces new technologies but also enhances productivity, promotes employment, and boosts competitiveness in less developed countries (Kinda, 2010; Nunnenkamp & Spatz, 2003). However, for FDI to be effective, the institutional quality of the host country is paramount. Institutions, through their roles in contract enforcement, protection of property rights, and promotion of collective action, create a conducive environment for sustained economic transactions, thereby influencing the stability and attractiveness of FDI (North, 1990; Dixit, 2009).

The relationship between FDI and institutional quality has drawn significant academic interest, especially in light of globalization and trade liberalization policies that have facilitated the expansion of multinational corporations and the global flow of capital (Globerman & Shapiro, 2002). Foundational theories on FDI highlight the multifaceted factors that drive cross-border investments. Dunning's (1977) eclectic paradigm, also known as the OLI model, provides a comprehensive framework by emphasizing three primary determinants of FDI: Ownership advantages (O), Location factors (L), and Internalization incentives (I). According to Dunning and Lundan (2008), favorable OLI conditions create an optimal setting for international production, whereby firms are motivated to invest abroad if the host country provides strategic location advantages, operational efficiencies, and regulatory stability.

Theories predating the OLI model also offer insights into FDI dynamics. The Heckscher-Ohlin model (1933) posits that countries with abundant factor endowments, such as labor and land, have a natural advantage in attracting FDI, as these resources lower production costs for multinational firms. Additionally, Aliber's (1970) currency theory proposes that strong national currencies can attract FDI by offering foreign investors more favorable capital markets. Institutional quality further shapes FDI inflows, as exemplified by North's (1990) institutional theory, which suggests that well-developed institutions reduce transaction costs and increase economic activity. Empirical studies corroborate this, demonstrating that countries with robust legal and regulatory frameworks tend to attract higher levels of FDI (Ahmad & Ahmed, 2014; Mudambi & Navarra, 2002).

In recent years, extensive research has examined the role of institutional quality on FDI, often finding that governance factors such as regulatory quality, control of corruption, and political stability are pivotal in creating a favorable investment climate (Buchanan et al., 2012; Ali et al., 2010). In countries with sound institutions,

foreign investors are reassured by predictable policies and reduced risks, leading to higher investment inflows. However, studies also highlight discrepancies, where democratic institutions or economic freedoms alone do not consistently attract FDI in developing regions, suggesting that the relationship between institutional quality and FDI may be context-dependent (Choi & Samy, 2008; Kariuki, 2015).

This study seeks to contribute to the empirical literature by investigating the impact of institutional quality on FDI inflows in Bangladesh, employing a time-series dataset from 1995 to 2020. Through the autoregressive distributed lag (ARDL) cointegration approach, this research evaluates both short and long-term effects of institutional factors on FDI.

2. Empirical Literature Review

A substantial body of research has established a significant relationship between institutional quality and FDI inflows, underscoring the critical role that political stability, regulatory quality, and property rights protection play in attracting foreign investors. Institutions, by reducing transaction costs and providing a stable environment, make markets more predictable and attractive for foreign investment (North, 1990; Dixit, 2009). This section reviews empirical studies that examine the link between FDI and institutional quality across various regions and contexts.

2.1 Governance Quality and FDI Inflows

Governance quality has consistently been identified as a determinant of FDI, with multiple studies demonstrating that improvements in institutional quality positively impact FDI. For instance, Buchanan, Le, and Rishi (2012) conducted a panel study of 164 countries from 1996 to 2006, concluding that higher institutional quality, including political stability and regulatory quality, is associated with greater FDI inflows. Similarly, Ali, Fiess, and MacDonald (2010) argue that strong institutions are crucial for FDI, as they create an environment conducive to long-term investments by providing transparent and predictable governance.

2.2 Institutional Indices and Regional Studies

Empirical studies have also focused on specific components of institutional quality and their differential impacts on FDI across regions. Yakubu (2020), for example, examined the relationship between governance indicators and FDI in Ghana, finding that indicators such as government stability, law and order, and democratic accountability are significant attractors for foreign investors. This finding aligns with earlier research, which suggests that institutional stability and effective legal frameworks foster investor confidence (Knack & Keefer, 1995). In Sub-Saharan Africa, Ajide, Adeniyi, and Raheem (2014) reported that governance improvements, particularly in reducing corruption and enhancing government effectiveness, have a positive effect on FDI, highlighting the importance of tailored governance reforms in emerging economies.

Peres, Ameer, and Xu (2018) examined institutional quality in both developed and developing countries, finding that while institutional factors like corruption control and law enforcement are critical for FDI in developed nations, regulatory quality and political stability play a more prominent role in attracting FDI to developing economies. This indicates that different regions have varying institutional needs for optimizing FDI inflows.

2.3 The Role of Economic and Political Freedom

The role of economic and political freedoms in influencing FDI has also been widely debated. Studies suggest that while economic freedom (such as business and trade freedom) positively impacts FDI, political freedoms alone may not always yield a favorable environment for foreign investment. Choi and Samy (2008) found a weak correlation between democratic institutions and FDI in developing countries, suggesting that although democracy promotes political stability, other factors—such as economic stability and regulatory efficiency—are more decisive in attracting FDI. Kariuki (2015) further observed that high economic, political, and financial risks negatively affect FDI in African countries, emphasizing the need for stability beyond political freedoms.

Economic freedom has been shown to positively influence FDI in several regional studies. Adegboye et al. (2020) argued that in Sub-Saharan Africa, the quality of institutions significantly affects FDI levels, as economic freedoms reduce regulatory barriers and encourage investment. Similarly, Owusu-Nantwi (2019) found that economic freedoms in South America have a positive relationship with FDI, indicating that foreign investors

favor regions with open economies and minimal restrictions on business activities.

2.4 Discrepancies in Institutional Quality and FDI

While many studies confirm a positive relationship between institutional quality and FDI, some findings suggest mixed or context-dependent results. Ullah and Khan (2017), for example, studied Central Asia and found minimal positive effects of economic freedom on FDI, with governance factors even having a negative impact in the SAARC region. This finding aligns with Wheeler and Mody (1992), who argued that the influence of institutional quality on FDI can vary depending on other factors, such as economic risk and political stability, which may offset the positive effects of governance improvements in certain contexts.

Moreover, research by Choi and Samy (2008) and Kariuki (2015) suggests that high political risk, economic instability, and financial volatility can weaken the positive influence of institutional quality on FDI. These studies highlight that although institutional quality is a strong determinant, external risks and regional challenges can sometimes offset its positive impact, emphasizing the need for comprehensive and region-specific analyses.

The existing empirical literature largely supports the idea that institutional quality is a significant determinant of FDI, particularly in developing countries where foreign investors rely on regulatory stability and governance transparency. However, the diverse results across studies highlight the importance of contextual factors, such as economic risk and regional stability, in moderating the relationship between institutional quality and FDI. In light of these findings, this study focuses on Bangladesh, using a time-series analysis to evaluate the impact of institutional quality on FDI inflows.

3. Methodology

This study utilizes a time-series data set and the autoregressive distributed lag (ARDL) cointegration technique to examine the short and long-term relationships between institutional quality and FDI in Bangladesh. The data spans 1995 to 2020, capturing significant trends in FDI inflows and institutional developments over 26 years.

3.1 Data Sources and Variable Identification

The dependent variable in this analysis is FDI, measured as net inflows relative to GDP, sourced from the World Bank's World Development Indicators (WDI). Independent variables include proxies for both political and economic institutional quality. Political institutional quality is represented by an index (INQ), averaging indicators like Voice and Accountability, Political Stability, Regulatory Quality, Rule of Law, and Government Effectiveness, derived from the World Governance Indicators (WGI). This index aims to encapsulate governance elements that impact political stability and reliability for investors.

In contrast, economic institutional quality is proxied by the Economic Freedom Index (FRE) from The Heritage Foundation. This index incorporates metrics such as Business Freedom, Government Spending, Fiscal Health, and Investment Freedom, providing a comprehensive view of the economic environment. Trade, measured as a percentage of GDP, is also included as a control variable, reflecting the openness of Bangladesh's economy and its relevance to FDI inflows. The variables' descriptions and sources are summarized below in table 1.

Table 1: Description of the Variables

Variable	Description	Sources
FDI	Net inflows of foreign direct investment (as a % of GDP)	World Development Indicator (WDI)
INQ	Average of Voice and Accountability, Political Stability and Absence of Violence, Regulatory Quality, Rule of Law, Government Effectiveness as a proxy of political institutional quality	Worldwide Governance Indicators (WGI)
FRE	Index of economic freedom as a proxy of economic institutional quality	The Heritage Foundation
TR	Trade (% of GDP)	World Development Indicator (WDI)

3.1 Model Specification and ARDL Bound Testing

The empirical model for this study is structured to assess the relationship between FDI, institutional quality (both political and economic), and trade. The general model is specified as:

$$FDI_t = \alpha + \beta_0 INQ_t + \beta_1 FRE_t + \beta_2 TR_t + \mu_t \quad (1)$$

Where FDI , INQ , FRE and, TR are specified in the data and data source section. In equation (1), t shows the sample period. $\beta_0, \beta_1, \beta_2$ are the coefficients and α is the intercept. The term μ_t is error term, which includes the unobservable elements.

3.2 ARDL (autoregressive distributed lag) Bound Test

We employ Pesaran and Shin's ARDL bound testing method to examine the long- and short term relationships between foreign direct investment and institutional quality (1999). Pesaran et al. expand on this method (2001). Pesaran and Shin (1995) and Pesaran et al. (1996) created the ARDL Bound test to examine the cointegration of series with various integration orders, such as $I(0)$ or $I(1)$ or mixed order $I(0)$ and $I(1)$. The following equation serves as the foundation for the ARDL Bound test method used in this study to examine the long-run and short-run relationships among the variables

$$\Delta FDI_t = \alpha + \sum_{i=1}^n \beta_i \Delta FDI_{t-i} + \sum_{i=1}^n \omega_i \Delta INQ_{t-i} + \sum_{i=1}^n \varphi_i \Delta FRE_{t-i} + \sum_{i=1}^n \gamma_i \Delta TR_{t-i} + \rho_0 FDI_{t-1} + \rho_1 INQ_{t-1} + \rho_2 FRE_{t-1} + \rho_3 TR_{t-1} + \varepsilon_t \quad (2)$$

Where α is the drift component or intercept, ε_t is the error term, n is the lag length, and Δ is the first difference operators. ρ_0, ρ_1, ρ_2 , and ρ_3 are representing the long-run coefficients, whereas $\beta_i, \omega_i, \varphi_i$, and γ_i are the short-run coefficients. To investigate the long-run association among institutional quality, FDI, and trade, this study uses ARDL- bound F-statistics. The F-statistics is performed on the joint null hypothesis. The null hypothesis of the non-existence of a long-run relationship against the alternative hypothesis is given as follows.

$$H_0: \rho_0 - \rho_1 - \rho_2 - \rho_3 = 0 \text{ (The long run relationship does not exist)}$$

$$H_A: \rho_0 \neq \rho_1 \neq \rho_2 \neq \rho_3 \neq 0 \text{ (The long run relationship exists)}$$

The two critical limits $I(0)$ and $I(1)$ created by Pesaran et al. are used in ARDL bound testing to compare the value of F statistics (2001). The lower constraint $I(0)$ shows no cointegration between the underlying variables. The underlying variables must be cointegrated according to upper bound $I(1)$. The outcome is unclear if the value of F statistics falls between $I(0)$ and $I(1)$. Let us say the results of the bound test demonstrate that the variables are cointegrated. By reparametrizing equation (2) into the Error Correction Model (ECM), which captures both short-run and long-run dynamics, we may estimate the short-run and long-run parameters. The error correction model of equation (2)'s ARDL version is written below.

$$\Delta FDI_t = \alpha + \sum_{i=1}^n \beta_i \Delta FDI_{t-i} + \sum_{i=1}^n \omega_i \Delta INQ_{t-i} + \sum_{i=1}^n \varphi_i \Delta FRE_{t-i} + \sum_{i=1}^n \gamma_i \Delta TR_{t-i} + \theta ECM_{t-1} + \varepsilon_t \quad (3)$$

Where θ is the speed of adjustment parameter and ECM_{t-1} denotes the error correction term lagged by one period.

4. Empirical result

4.1 Descriptive Statistics and Correlation Analysis

Table 2 presents descriptive statistics for the variables in this study, spanning 26 observations (1995–2020). The mean FDI inflow relative to GDP is 10.46, with a standard deviation of 5.16, indicating some volatility over the years. Economic freedom (FRE) exhibits the highest average score of 51.05, reflecting moderate economic liberalization in Bangladesh, while trade (TR) holds a mean value of 35.71, signifying an open economy.

Table 2: Descriptive Statistics

Variable	Observation	Mean	Std. Dev.	Min	Max
<i>FDI</i>	26	10.462	5.163	1	18
<i>INQ</i>	26	11.192	6.759	1	23
<i>FRE</i>	26	51.05	3.606	40.9	56.4
<i>TR</i>	26	35.707	6.914	26.076	48.111

Correlation analysis in Table 3 shows the relationships between FDI, political institutional quality (INQ), economic freedom (FRE), and trade. Notably, FDI has a moderate negative correlation with political institutional quality (-0.399) but a positive correlation with trade (0.132). These correlations suggest that while economic liberalization encourages FDI, political institutional factors might create challenges that deter investment in the long term.

Table 3: Correlation Matrix

Variables	FDI	INQ	FRE	TR
FDI	1.000			
INQ	-0.399	1.000		
FRE	-0.127	0.613	1.000	
TR	0.132	0.427	0.201	1.000

4.2 Unit Root Test

To identify the unit root problem, we utilize the augmented dickey-fuller (ADF) and Phillips-perron (PP) tests. Table 4 represents the unit root results. The results from both ADF and PP tests suggest that the foreign direct investment, economic freedom index, political-institutional quality, and trade are stationary at 1% and 5% significance. Hence, all variables are integrated in the order I (0), which supports the ARDL cointegration technique.

Table 4: Augmented Dickey–Fuller and Phillips–Perron Tests

Variables	Augmented Dickey–fuller test (ADF)		Phillips–Perron test (PP)	
	t-statistics	Integration Order	t-statistics	Integration Order
FDI	-2.433***	I (0)	-2.463***	I (0)
FRE	-1.307***	I (0)	-3.530***	I (0)
INQ	-1.032***	I (0)	-1.340***	I (0)
TR	-1.805***	I (0)	-1.717**	I (0)

Note: *** and ** indicates 1% and 5% significance levels respectively. Optimum lag length is chosen by the Akaike Information Criterion (AIC).

4.3 ARDL Bound Test

This study uses the ARDL- bounds approach to identify the long-run relationship between FDI and other independent variables. The results of the bounds-testing method are shown in Table 5. It states that the estimated F-statistics value (34.958) is greater than the upper critical bound I (1) at 1%, 5%, and 10% significance levels. Therefore, it rejects the null hypothesis of no cointegration and accepts the alternative hypothesis of cointegration. The alternative hypothesis implies the existence of a long-run relationship among the variables. The long-run relationship is estimated by selecting ARDL (4, 3, 4, 4) based on AIC. This result supports the hypothesis that institutional quality and FDI are interrelated in the long term, aligning with previous studies that emphasize the role of stable institutions in sustaining FDI inflows (e.g., Yakubu, 2020; Adegboye et al., 2020).

Table 5: Bounds Test for Cointegration Relationship

Critical value bounds of the F-statistics				
Test statistics	Value	Level (%)	Lower I (0)	Upper I (1)
F – Statistics	34.598***	1	4.29	5.61
k	3	5	3.23	4.35
		10	2.72	3.77

Note: *** indicates 1% significance levels and 'k' denotes the number of parameters.

5. Result and Discussion

Table 6 reports the long-term impacts of institutional quality and trade on FDI inflows. Long-run estimations show a weak but significant negative relationship between political institutional quality and FDI inflows. This outcome is consistent with Li, Q., and Resnick, A.'s research (2003). On the other hand, FDI inflows and economic institutional quality have a significant positive association. In other words, substantial effects of strong economic institutions (tax burden, business freedom, monetary independence, government spending, etc.) on FDI inflows to Bangladesh. These results confirm that FDI inflows are significantly influenced by macroeconomic conditions and institutions of high institutional quality (Kaushal, L. A. (2021).

Table 6: Estimated long-run coefficient using ARDL approach

ARDL (4, 3, 4, 4) Selected based on AIC			Dependent Variable=FDI	
Variable	Coefficient	Standard error	t-statistic	Prob. Value
INQ	-1.4729	0.1029	-14.31	0.001***
FRE	3.1494	0.2729	11.54	0.001***
TR	0.9311	0.1011	9.21	0.003***

Note: *** and ** indicates 1% and 5% significance levels respectively. Optimum lag length is chosen by the Akaike Information Criterion (AIC).

The findings support North's institutional theory from 1990, which emphasizes the vital connection between institutional quality and FDI inflows. Additionally, the outcome is in line with earlier empirical findings (Masron, T. A., & Abdullah, H. (2010); Peres, M., Ameer, W.& Xu, H. (2018). Trade and FDI inflows have a positive correlation. The outcome shows that a 1 percent increase in trade will, over time, enhance Bangladesh's volume of FDI inflows by 0.93 percent. This is the case in line with Owusu-Nantwi, V. (2018).

In Table 7, the short-run dynamic coefficients and the estimated error correction model results are shown. From the findings, the error-correction term (ECM_{t-1}) coefficient is negative (-2.1301) and statistically significant at a 1 percent level. The result confirmed the established long-run relationship between FDI and the independent variables. There are some dissimilarities in the short-run and long-run. For instance, political institutions have a significant positive impact on FDI in the short run, but the effect is negative in the long run in the case of Bangladesh. Moreover, economic institutions have a significant negative influence on FDI inflows in the short-run and vice-versa in the long run.

Table 7: Estimated Short-run Coefficient Using ARDL Approach

ARDL (4, 3, 4, 4) Selected based on AIC			Dependent variable=FDI	
Variable	Coefficient	Standard error	t- statistics	Prob. Value
ΔFDI_{t-1}	1.4034	0.2909	4.82	0.017**
ΔFDI_{t-2}	0.5179	0.2236	2.32	0.103
ΔFDI_{t-3}	0.9404	0.1375	6.84	0.006***
ΔINQ	2.4773	0.3364	7.36	0.005***
ΔINQ_{t-1}	1.3902	0.1667	8.34	0.004***
ΔINQ_{t-2}	1.0772	0.1268	8.50	0.003***
ΔFRE	-7.6859	0.9976	-7.70	0.005***
ΔFRE_{t-1}	-4.2642	0.6284	-6.79	0.007***
ΔFRE_{t-2}	-4.4112	0.6013	-7.34	0.005***
ΔFRE_{t-3}	-0.8914	0.1993	-4.47	0.021**
ΔTR	-0.3593	0.1282	-2.80	0.068*
ΔTR_{t-1}	-1.0264	0.1451	-7.07	0.006***
ΔTR_{t-2}	-0.3225	0.1833	1.76	0.177
ΔTR_{t-3}	-1.1096	0.2079	-5.34	0.013**
ΔECM_{t-1}	-2.1301	0.3092	-6.89	0.006***
$R^2 = 0.9930$				
Adjusted $R^2 = 0.9513$				

Note: *** and ** indicates 1% and 5% significance levels respectively. Optimum lag length is chosen by the Akaike Information Criterion (AIC).

6. Conclusion

This study contributes to the ongoing discourse on the nexus between institutional quality and FDI, focusing on Bangladesh from 1995 to 2020. Using the autoregressive distributed lag (ARDL) cointegration approach, the research has illuminated the distinct roles of political and economic institutional quality in shaping FDI inflows. The findings reveal that, while both political and economic institutional qualities are essential, their impacts on FDI vary across short- and long-term horizons, highlighting the nuanced dynamics of institutional influence.

The long-term analysis demonstrates that political institutional quality has a negative effect on FDI inflows, suggesting that stringent political oversight may deter sustained foreign investment by creating an environment perceived as less predictable by investors. This aligns with prior studies (e.g., Li & Resnick, 2003; Mudambi & Navarra, 2002) that argue for a careful balance in political regulation to avoid deterring investment due to perceived instability or regulatory burden. Conversely, economic institutional quality, proxied by the Economic Freedom Index, has a significant positive influence on FDI, affirming that liberalized economic policies are crucial for attracting and maintaining FDI. This finding reinforces the theoretical perspectives of North (1990) and empirical insights from Masron and Abdullah (2010), who argue that economic liberalization creates a favorable business climate for multinational enterprises.

In addition to institutional quality, trade openness has emerged as a consistent positive influence on FDI, both in the short and long terms. This suggests that an open economy with liberal trade policies enhances investor confidence by promoting cross-border trade, thus aligning with findings by Buchanan et al. (2012) and Ajide et al. (2014), who advocate for trade liberalization as a key enabler of FDI inflows. For Bangladesh, these insights emphasize the importance of sustaining open trade policies as part of its broader strategy for economic integration and FDI attraction.

The results of this study offer several practical implications for policymakers in Bangladesh. First, there is a need to streamline political institutions to balance stability with flexibility, ensuring that regulatory frameworks provide predictability without excessive constraints. An environment with transparent and efficient governance

can help mitigate long-term investment risks, thus encouraging foreign investors to view Bangladesh as a stable and attractive destination.

Second, the positive impact of economic institutional quality on FDI underscores the importance of continued economic liberalization. Policymakers should prioritize reforms that enhance business freedom, reduce bureaucratic red tape, and ensure regulatory transparency. Incremental implementation of economic reforms may help mitigate short-term disruptions to businesses, allowing both domestic and foreign firms to adjust gradually without incurring substantial costs.

Third, the study highlights trade openness as a critical factor in sustaining FDI. To capitalize on this, Bangladesh should maintain its trade liberalization efforts, pursuing policies that encourage export diversification and strengthen trade partnerships. Such efforts would not only bolster FDI but also foster economic resilience by reducing dependency on any single market or sector.

This study provides a foundation for further exploration of the relationship between institutional quality and FDI in emerging economies, yet several avenues for future research remain. First, examining sector-specific FDI flows could yield insights into how different industries respond to institutional quality variations. Given that institutional requirements may differ for manufacturing, services, and technology sectors, a disaggregated analysis could offer more targeted policy recommendations.

Additionally, future studies could extend the analysis by incorporating qualitative measures of investor perceptions, such as survey-based assessments of political and economic stability. Such data could provide a more nuanced understanding of how institutional quality impacts investor confidence, complementing the quantitative findings.

Lastly, cross-country comparisons among South Asian nations could provide valuable insights into regional institutional dynamics. By comparing Bangladesh with neighboring economies like India, Pakistan, and Sri Lanka, researchers could identify institutional best practices that attract FDI and promote regional economic integration.

In conclusion, this study reaffirms the critical role of institutional quality in attracting FDI to Bangladesh, highlighting the complex interplay between political stability, economic freedom, and trade openness. As Bangladesh aspires to strengthen its position in the global economy, a strategic focus on improving institutional quality and sustaining trade openness will be essential. By adopting a balanced approach to governance and economic liberalization, Bangladesh can foster an environment conducive to long-term foreign investment, driving sustained economic growth and development

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