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Research Article

Dominating Factors of Foreign Direct Investment in Emerging Economies: Evidence from Dynamic Panel Estimation

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Abstract

This study examines the impact of governance quality, the corporate tax rate, and exchange rate volatility on foreign direct investment (FDI) inflows in 16 emerging countries over the period 2003–2017. Considering the persistence of potential endogeneity issues, the study employs the system generalized method of moments (GMM), a dynamic panel data model, to estimate the variables of interest. The results provide evidence that governance quality positively and significantly affects FDI inflows, whereas the corporate tax rate has a negative effect. No significant relationship is found between FDI inflows and exchange rate volatility. From a policy and strategic perspective, the study suggests that emerging economies should reconsider their tax imposition mechanisms to reduce the burden of corporate taxation. Simultaneously, greater emphasis should be placed on maintaining strong governance performance to ensure a favorable business environment. Overall, the study highlights the importance of creating a business-friendly institutional environment to attract foreign investment.

I. INTRODUCTION

With the emergence of economic and political reforms driven by globalization, cross-border inflows and outflows of capital have increased dramatically through foreign direct investment (FDI). This macroeconomic variable helps boost capital accumulation, increase employment opportunities, facilitate the transfer of technological skills, and enhance countries' productivity (Kilicarslan, 2018). FDI is a well-known phenomenon worldwide, especially as the global economy undergoes a phase of economic globalization, and it is considered an engine of economic development, particularly in developing and emerging economies (Sokang, 2018). Therefore, FDI has become a key policy target in both developed and developing countries because of its growth-stimulating effects. Emerging market economies, characterized by high industrial competitiveness and consumer market diversity, depend heavily on foreign investment as an important source of capital due to insufficient domestic capital and investment (Bundesbank, 2003; Ioana-Cristina & Gheorghe, 2014; Masron & Abdullah, 2010; OECD, 2017). Following the global financial crisis, FDI flows to emerging and developing economies increased rapidly. In 2010, FDI inflows to these regions exceeded those of developed economies (Kudina & Pitelis, 2014). However, more recently, emerging countries have been facing significant institutional challenges (Deng & Zhang, 2018; Nguyen *et al.,* 2018). Many key institutional elements in these countries remain underdeveloped and vulnerable compared to those in developed economies (Uddin *et al.,* 2019). Political unrest, corruption, poor regulatory quality, political pressure, and weak law enforcement have further exacerbated these conditions (Masron & Nor, 2013; Nguyen *et al.,* 2018).

In addition, macroeconomic instability-particularly exchange rate volatility-has become a serious concern (Khosa *et al.,* 2015; Yousaf *et al.,* 2013). Problems in

corporate tax policy formulation have increasingly imposed a burden on businesses and foreign investors. Together, these factors have reduced the attractiveness of emerging economies to foreign investors, raising concerns about the recent decline in FDI inflows in these regions. For decades, researchers in trade and international business have shown strong interest in identifying the factors that affect a country's level of FDI attractiveness (Bailey, 2018). Extensive research has been conducted on the relationship between FDI and economic variables (Deng & Zhang, 2018; Khosa *et al.,* 2015; Nguyen *et al.,* 2018), policy variables (Ghazal & Zulkhibri, 2015; Sambharya & Rasheed, 2015; Wisniewski & Pathan, 2014), and institutional variables (Bilgili *et al.,* 2012). More recently, FDI flows in emerging markets have drawn increased attention, with researchers attempting to identify the determinants of inward foreign direct investment (IFDI) in these regions (Angelo *et al.,* 2010; Castro *et al.,* 2013; Kudina & Pitelis, 2014; Lien & Filatotchev, 2015; Panigrahi & Panda, 2012; Parashar, 2015; Quader, 2009; Torrisi *et al.,* 2007; Zhang, 2011).

Variables such as gross domestic product (GDP), capital formation, external debt, market size, balance of trade, tax rates, geographical conditions, labor costs, employment rates, exchange rates, trade openness, government subsidies, tax incentives, investors' opportunity costs, inflation, consumer sales, trade liberalization, historical FDI flows, and policy changes have been identified as crucial determinants of FDI (Angelo *et al.,* 2010; Castro *et al.,* 2013; Panigrahi & Panda, 2012; Parashar, 2015; Quader, 2009; Torrisi *et al.,* 2007; Zhang, 2011).

However, much of the existing literature has not adequately addressed the recent trends in FDI in emerging economies, particularly the causes of volatility and the recent downturn in FDI inflows. No consistent empirical work has yet investigated the recent decline in FDI in emerging market economies. This gap in the literature motivates the present study.This research contributes to the existing literature in two key ways. First, it analyzes the trend of FDI inflows and identifies the declining FDI attractiveness of emerging economies. Second, it investigates the dominant factors influencing FDI attractiveness by examining the relationships between FDI and governance quality, corporate tax rates, and exchange rate volatility. To the best of our knowledge, no prior study has simultaneously considered these three factors within a single empirical framework. By incorporating all three variables into the model at the same time, this study identifies their relative importance in determining FDI inflows, thereby contributing to the existing literature.

II. TREND OF FDI IN EMERGING ECONOMIES

Since the mid-nineteenth century, both inward and outward FDI flows have increased globally. FDI inflows to developing and emerging nations have also risen during this period (Uddin *et al.,* 2019). However, due to various economic and political constraints, capital inflows to these regions did not reach their full potential and, at times, declined sharply. Fortunately, this adverse situation did not persist for long. Around 1991, both FDI and portfolio investment increased substantially following economic and political reforms. This trend continued for an extended period; however, during the global financial crisis, FDI experienced a sharp decline worldwide, particularly in emerging market economies (Arbatli, 2011).

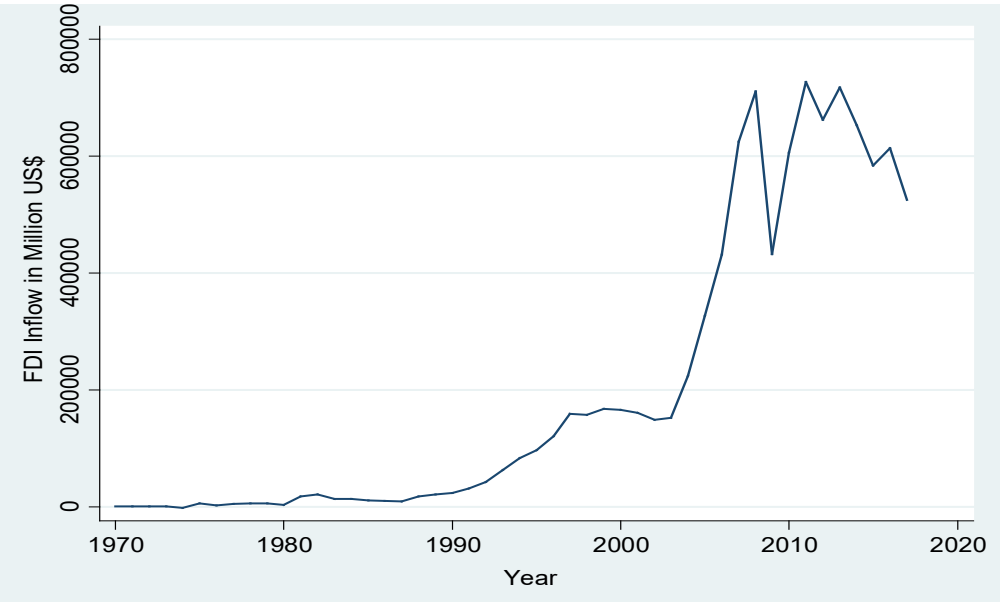


Fig.1 Trend of FDI Flows to Emerging Countries

Figure 1 presents a graphical representation of FDI inflows alongside empirical evidence. Since 1970, FDI flows to emerging economies were relatively stable; however, around 1990, FDI inflows began to rise and increased rapidly around 2005. Following the global financial crisis, FDI experienced a sharp decline as the global economy entered a period of turmoil. In 2008, FDI inflows to emerging economies amounted to USD 559,223.40 million, which decreased by nearly 42% in the following year. As the financial crisis negatively affected international trade and business activities, FDI inflows into emerging economies were also adversely impacted.

This downturn was temporary, as FDI inflows increased by nearly 52% in the subsequent year. In 2011, FDI reached its peak at USD 608,949.80 million. However, a major concern is the recent decline in FDI inflows. Since 2011, FDI inflows have continued to decrease. Risk factors associated with FDI inflows are largely responsible for this downward trend.

III. LITERATURE SURVEY

A. Do Governance Quality, Corporate Taxation, and Exchange Rate Volatility Matter for FDI? Empirical and Theoretical Evidence

Empirical evidence suggests that a strong relationship exists between governance quality and FDI inflows (Bailey, 2018; Buchanan *et al.,* 2012; Cole *et al.,* 2009; Daude & Stein, 2007; Gani, 2007). The quality of accountability and public voice, the effectiveness of laws and regulations, government effectiveness, and the ability to resist political unrest are considered key elements of governance that significantly influence FDI location choices (Gangi & Abdulrazak, 2012; Saidi *et al.,* 2013). The extent to which developing and underdeveloped countries can attract FDI largely depends on their governance quality (Kurul & Yalta, 2017; Masron & Abdullah, 2010; Shah *et al.,* 2016).

Poor governance quality increases investment risk and creates a negative impression among foreign investors, as it is associated with political uncertainty, weak government leadership, ineffective institutions, and the inability to implement policies effectively (Basson, 2015). Good institutional quality serves as an FDI-attracting factor, whereas poor institutional quality deters foreign investment. Early studies on FDI and corporate tax rates assert that a strong relationship exists between corporate taxation and foreign investment. Specifically, FDI is inversely associated with corporate taxation (Cela, 2017; San *et al.,* 2012).

According to traditional tax competition theory, in a liberalized economy with perfect capital mobility, corporate tax rates should be low because taxation directly affects firms' cost structures and profitability (Quere *et al.,* 2005). Corporate taxes impose a cost burden on investors and directly influence their investment decisions. Similar to corporate taxation, exchange rate volatility has been found to be inversely related to a country's FDI attractiveness (Alagidede & Ibrahim, 2017; Asmah & Andoh, 2013; Sharifi-Renani & Mirfatah, 2012; Silvia & Loan, 2017). Exchange rate volatility affects the expected returns on foreign investment and increases investment uncertainty (Kilicarslan, 2018). While currency depreciation may attract FDI, excessive exchange rate volatility increases risk and discourages foreign investment (Muhammed *et al.,* 2018). Long-run exchange rate volatility has a stronger effect on FDI inflows; however, volatility can also negatively affect FDI in the short run. The institutional theory proposed by North (1990) supports the relationship between governance quality and FDI.

The theory posits that good governance enhances economic performance by minimizing transaction, production, and distribution costs. Strong institutions reduce the cost of doing business, whereas weak governance generates risks and uncertainties that discourage foreign investment. As poor governance is associated with high economic costs, countries with weak governance performance tend to be less attractive to foreign investors, resulting in declining FDI inflows. Similarly, the eclectic paradigm proposed by Dunning (1998) supports the FDI–governance relationship through location advantages.

The theory emphasizes that ownership, location, and internalization advantages enable multinational corporations (MNCs) to invest abroad (Bellak & Leibrecht, 2009). Governance quality in host countries influences location-specific advantages related to business profitability. Consequently, countries with strong governance characteristics are more attractive to foreign investors. The eclectic paradigm also supports the proposition that corporate taxation influences FDI. However, Tobin's Q theory of investment provides a more direct theoretical framework for analyzing the relationship between FDI and corporate taxation (Mudenda, 2015).

According to this theory, firms are discouraged from investing when costs exceed expected benefits. Since corporate taxation directly affects firms' cost structures and profit margins, higher tax rates reduce investment incentives, making regions with high corporate taxes less attractive to foreign investors. Kilicarslan (2018) and Silvia and Loan (2017) argue that the hysteresis theory of investment delay supports the impact of exchange rate volatility on FDI inflows. This theory suggests that investment decisions are influenced by risk factors and uncertainties that increase sunk costs. Rational investors are therefore reluctant to invest in economically uncertain environments. Exchange rate volatility heightens investment risk and creates negative perceptions among investors (Kilicarslan, 2018). Additionally, Asmah and Andoh (2013) note that risk-averse firms are less inclined to invest in unstable economic environments. Consequently, countries experiencing high exchange rate volatility tend to lose their attractiveness for FDI.

IV. METHODOLOGICAL ISSUES

A. Data and Sample

The final sample consists of data from 16 emerging countries covering the period 2003–2017. The selection of this time frame is justified by the nature and trend of FDI inflows in these countries. FDI data were obtained from the World Development Indicators (WDI, 2019) database. Although the OECD publishes detailed data with time and sectoral dimensions, data for all variables of interest could not be obtained from this source because information for all sample countries was not available. As quarterly data were unavailable, annual data were used. The natural logarithm of FDI was employed as the dependent variable.

Following previous studies (Buchanan *et al.,* 2012; Daude & Stein, 2007; Globerman & Shapiro, 2003; Kurul & Yalta, 2017), this empirical analysis uses governance indicators from the Worldwide Governance Indicators (WGI) database developed by Kaufmann *et al.,* (2010). These governance indicators are constructed based on information collected from cross-country surveys (Daude & Stein, 2007). The WGI database includes six dimensions of governance: Voice and Accountability (VA), which reflects citizens' perceptions of their ability to participate in government selection and to exercise freedom of expression; Political Stability and Absence of Violence (PS), which measures perceptions of the likelihood of political instability and politically motivated violence;

Government Effectiveness (GE), which captures perceptions of the quality of public services, civil service independence from political pressures, policy formulation and implementation, and government credibility; Regulatory Quality (RQ), which reflects the government's ability to formulate and implement sound policies that promote private sector development and a favorable business environment; Rule of Law (RL), which measures perceptions of the extent to which agents have confidence in and abide by societal rules, including contract enforcement, property rights, the quality of courts and police, and the incidence of violence; and Control of Corruption (CC), which captures perceptions of the extent to which public power is exercised for private gain, including elite capture of the state.

All governance indicators are expressed as index values ranging from −2.5 to +2.5, where higher values indicate stronger governance performance and lower values indicate weaker governance performance. Although the Corruption Perceptions Index (CPI) is an important governance indicator, it is not included in this study because its scale ranges from 0 to 100, making it difficult to combine with the WGI indicators.

Nominal exchange rate data were collected from the WDI database on an annual basis. As this study calculates real exchange rate volatility, consumer price index (CPI) data required to compute the real exchange rate were also obtained from the WDI database. Corporate tax rate data were collected from the OECD and KPMG databases. Since OECD data were not available for all sample countries, corporate tax rate data for the Philippines and Ukraine were obtained from KPMG. This study uses statutory corporate tax rates rather than effective corporate tax rates, as statutory rates provide greater consistency and comparability across countries.

Although governance quality, corporate tax rates, and exchange rate volatility are the main explanatory variables in this study, several control variables were included based on a review of the existing literature. These control variables include GDP growth, trade openness, inflation, infrastructure, the real exchange rate, and labor force participation. Data on GDP growth, exports, and imports-used to calculate trade openness-were obtained from the WDI database. Inflation is represented by the consumer price index, as it provides more reliable results. While real exchange rate volatility is an explanatory variable, the real exchange rate itself is included as a separate control variable. Infrastructure is proxied by mobile phone subscriptions per 100 people, following Mengistu and Adhikary (2011). Data for all control variables were obtained from the World Development Indicators database and are measured annually over the period 2003–2017.

B. Variable Construction

1. Trade Openness: Trade openness represents the ratio of a country's participation in the world market to its GDP. The author calculated this using the following equation:

$$\frac{Export + Import}{Gross\ Domestic\ Product}$$

2. Real Exchange Rate: To ensure reliability and consistency, this study estimates volatility in the real exchange rate. The equation for this is as follows:

$$RER = \frac{Nominal\ exchange\ rate \times Price\ level\ in\ foreign\ country}{Price\ level\ in\ domestic\ country}$$

In the equation, the nominal exchange rate represents the units of local currency per U.S. dollar. This study uses the Consumer Price Index (CPI) of the respective country to represent the domestic price level. The CPI of the United States is used to represent the foreign price level.

3. Real Exchange Rate Volatility: In this research, the author uses the Generalized Autoregressive Conditional Heteroskedasticity (GARCH) model proposed by Bollerslev (1986) to estimate real exchange rate volatility, following Asmah and Andoh (2013), Dal Bianco and Loan (2017), Del Bo (2009), and Kilicarslan (2018). Both the GARCH model and the moving-average standard deviation are widely used methods for measuring volatility. However, the justification for using the GARCH model is that it explicitly accounts for the presence of heteroskedasticity in the variable of interest.

This model is based on the assumption that the variance of the disturbance term is not constant over time (Dal Bianco & Loan, 2017). The GARCH model is an extension of the Autoregressive Conditional Heteroskedasticity (ARCH) model proposed by Engle (1982).

The simplest specification of the GARCH model, known as GARCH (1,1), can be expressed by the following equation.

$$y_t = x_t\beta + \epsilon_t$$

$$\sigma_t^2 = \delta + \alpha\gamma_{t-1}^2 + \beta\sigma_{t-1}^2 + \epsilon_t$$

The GARCH model can be expressed based on the two equations above. The first equation is referred to as the mean equation, while the second is called the variance equation, which captures volatility. The first equation is not the focus of this research; the second equation is the primary equation to be estimated. Here, δ is the constant, and α and β are the coefficients. γ_{t-1}^2represents the squared value of the mean from the previous period and is called the ARCH term. σ_{t-1}^2represents the variance of the previous period and is called the GARCH term. The conditional variance σ_t^2depends on the mean δ, the ARCH term, and the GARCH term. In the GARCH (1,1) model, the first "1" indicates the variance lag, and the second "1" indicates the error term lag. The sum of the coefficients (α + β) is used to predict real exchange rate volatility. After estimating the variance equation, the conditional variance is generated, which represents the real exchange rate volatility and is subsequently used to estimate the main regression model.

4. Governance Quality: Following the research of Globerman and Shapiro (2003) and Buchanan et al. (2012), Principal Component Analysis (PCA) was used to calculate a governance quality index representing overall governance quality. Consistent with previous studies, six governance indicators described above were used to construct a composite index. Although some studies have used these indicators separately in their estimation models, in this research, they were not used individually. The reason is that using these indicators separately could lead to multicollinearity, which would compromise the validity of the estimation results (Buchanan *et al.,* 2012; Globerman & Shapiro, 2003), as the indicators are highly correlated with one another (see Appendix 2). All six indicators are expressed on an index scale ranging from −2.5 to +2.5. Based on these indicators, a composite index was constructed. PCA was employed to obtain an efficient index value. Following Buchanan et al., (2012) and Globerman and Shapiro (2003), the first principal component was extracted, as it provides the most efficient representation of governance quality. This new composite index is referred to as the governance quality index in this study.

C. Empirical Strategy

1. Panel Data Unit Root Test: Panel unit root tests were used in this study to examine the stationarity of the panel data. Using non-stationary data in panel analysis can lead to inefficient results. Therefore, prior to estimating the regression model, modern econometric methodology recommends testing for stationarity to ensure the validity of the research findings. As this study uses short-panel data, the Levin et al., (2002) panel unit root test was employed. This test is based on the Augmented Dickey-Fuller procedure, as described below:

$$\Delta y_{it} = \rho_i y_{i,t-1} + \sum_{L=1}^{\rho i} \vartheta_{i,L}\,\Delta y_{it-L} + \alpha_{mi} d_{mt} + \epsilon_{it}$$

Here, d_{mt}represents the stochastic component. $\rho_i = 0$indicates that $y$contains a unit root for a specific i. If $\rho_i < 0$, it indicates that $y$does not contain a unit root and that the process is stationary. This test evaluates the null hypothesis that a unit root exists in the panel data against the alternative hypothesis that the data are stationary at level. The procedure involves estimating two regressions. First, $\Delta y_{it}$is regressed on $y_{i,t-1}$and $d_{mt}$to obtain the mean value of the current-period error term. Next, $y_{i,t-1}$is regressed on $\Delta y_{it-L}$and $d_{mt}$to obtain the value of the lag-period error term. A necessary condition for this test is that $\sqrt{N_T}/T \to 0$, where $N_T$indicates that the cross-sectional dimension $N$is a monotonic function of the time-series dimension T.

2. Dynamic Panel Data Model: This research employs a dynamic panel data model to estimate the relationship between FDI and the other variables of interest. The baseline model is as follows:

$$FDI_{it} = \beta FDI_{i,t-1} + x_{it}'\alpha + u_{it}$$

In this model, FDI_{it}denotes FDI in the current period, which is the dependent variable. $FDI_{i,t-1}$represents the lagged value of FDI, indicating FDI in the previous period. The parameter βrepresents the coefficient of the lagged dependent variable. x_{it}'denotes the vector of independent variables, which includes governance quality, corporate tax rate, exchange rate volatility, GDP growth, trade openness, infrastructure, inflation rate, labor force, and real exchange rate. The parameter αrepresents the vector of coefficients of the independent variables. Here, u_{it}denotes the error term, which is composed of a time-invariant effect (ϵ_i) and a stochastic disturbance term (v_{it}). Thus, the error term can be expressed as:

$$u_{it} = \varepsilon_i + v_{it}$$

As a dynamic panel data model, this study employs the system Generalized Method of Moments (GMM) proposed by Arellano and Bover (1995) and Blundell and Bond (1998). The primary motivation for this approach is to enhance the validity of the research findings. The advantage of using a dynamic panel data model over a static model is that it generates a more robust analysis, thereby increasing the reliability of the results. Estimating FDI using a general panel data model can be problematic and may produce inefficient results in the presence of endogeneity. However, GMM is an efficient estimator in such cases. By using the

lagged dependent variable as an explanatory variable and the lagged values of the independent variables as instrumental variables, GMM addresses the problem of endogeneity. Both first-difference GMM and system GMM can be used to estimate dynamic panel data models, as indicated in the literature. However, due to certain limitations of the first-difference GMM proposed by Arellano and Bond (1991), this study employs the system GMM. The system GMM estimator accounts for unobserved country-specific effects and addresses potential omitted variable bias. For all of these reasons, system GMM is employed as the dynamic panel data model to estimate FDI using the variables of interest.

3. Estimation Technique: The efficiency of GMM estimation depends on two conditions. The first is the validity of the additional instruments, and the second is the absence of second-order autocorrelation in the disturbance term. To assess these conditions, this study uses the Sargan test to ensure the reliability and validity of the additional instruments. The Arellano-Bond autocorrelation test is employed to check for second-order autocorrelation in the disturbance term. In the Sargan test, the null hypothesis is that the over-identification restrictions are valid. Rejection of the null hypothesis indicates that the model may need to be reconsidered; therefore, acceptance of the null hypothesis is preferred. In the Arellano-Bond autocorrelation test, the null hypothesis is the absence of second-order autocorrelation. Autocorrelation in the first-order process (AR1) is not problematic, but autocorrelation in the second-order process (AR2) would render the estimated results inefficient. For both tests, acceptance of the null hypothesis supports the validity of the research findings. These identification and autocorrelation tests are conducted as post-estimation diagnostic checks to ensure the rigor of the results.

V. RESULTS

A. Analysis on Governance Indicators in Emerging Economies

In Table I, the author reports the average governance indicators in emerging countries. The results show that these countries perform well in terms of voice and accountability, government effectiveness, and regulatory quality. However, the negative scores for political stability, rule of law, and control of corruption provide evidence of weak governance in these areas.

TABLE I QUALITY OF GOVERNANCE INDICATORS IN EMERGING ECONOMIES

Year	VA	PS	GE	RQ	RL	CC
2003	0.175	-0.275	0.216	0.283	-0.014	-0.051
2004	0.164	-0.416	0.155	0.254	-0.036	-0.090
2005	0.177	-0.295	0.151	0.285	-0.041	-0.074
2006	0.075	-0.328	0.148	0.284	-0.052	-0.081
2007	0.094	-0.330	0.199	0.297	-0.074	-0.113
2008	0.099	-0.360	0.184	0.288	-0.067	-0.122
2009	0.104	-0.417	0.161	0.279	-0.038	-0.168
2010	0.100	-0.363	0.194	0.290	-0.017	-0.150
Average (2003-2010)	0.124	-0.348	0.176	0.283	-0.042	-0.106
2011	0.089	-0.343	0.195	0.300	-0.015	-0.137
2012	0.068	-0.361	0.199	0.313	-0.039	-0.137
2013	0.051	-0.400	0.233	0.310	-0.021	-0.133
2014	0.040	-0.409	0.265	0.298	0.013	-0.178
2015	0.023	-0.442	0.234	0.258	-0.026	-0.188
2016	-0.004	-0.500	0.185	0.248	-0.033	-0.158
2017	-0.020	-0.442	0.179	0.235	-0.058	-0.210
Average (2011-2017)	0.035	-0.414	0.213	0.280	-0.026	-0.163
Average (2003-2017)	0.082	-0.379	0.193	0.281	-0.035	-0.133

Source: Author's compilation based on WGI (2018)

For the period 2003–2017, the average scores of voice and accountability, government effectiveness, and regulatory quality are 0.082, 0.193, and 0.281, respectively, whereas the scores for political stability, rule of law, and control of corruption are −0.379, −0.035, and −0.133, respectively. This analysis indicates that, although the first three factors contribute positively, emerging economies face significant challenges regarding political instability and violence.

To analyze the indicators over time, the research period was divided into 2003–2010 and 2011–2017. The results show that, except for government effectiveness and rule of law, all

other governance indicators have deteriorated. During 2003–2010, the average scores of voice and accountability, political stability, regulatory quality, and control of corruption were 0.124, −0.348, 0.283, and −0.106, respectively, which decreased to 0.035, −0.414, 0.280, and −0.106, respectively, in 2011–2017. As a result, overall governance quality has declined in the more recent period, as shown in Appendix 3. In 2013, the average index value was approximately 0.150, decreasing to about −0.150 in 2017. Since 2013, overall governance quality has gradually fallen. The downward trend indicates that emerging countries have recently experienced poor governance performance. These results provide strong evidence questioning the ability of emerging countries to maintain a consistent governance system.

B. Result of Summary Statistics

The summary statistics presented in Table II, based on 240 observations, reveal that the mean FDI inflow is approximately 26,899 million US$, with a standard deviation of 47,896.84. This indicates an unequal distribution of FDI in emerging economies, as a few countries attract a disproportionately large share. The average corporate tax rate is about 26%, suggesting that, more or less, the governments of emerging countries impose relatively high taxes on corporate profits. However, the standard deviation indicates considerable variation in corporate tax rates across countries. Emerging economies face significant challenges related to high exchange rate volatility, as reflected in the summary statistics. The average real exchange rate volatility in these countries is 23,988.07. The average governance quality index is below zero, pointing to relatively low government performance in emerging countries.

This does not imply, however, that governance is poor in all emerging economies. The standard deviation of governance quality is 1, indicating variation in government performance across countries. This result is consistent with the findings of Buchanan *et al.* (2012) and Globerman and Shapiro (2003). Among the control variables, the average trade openness of emerging countries is 0.74, indicating that, on average, 74% of these countries' GDP is linked to international trade. Although the average GDP growth rate is relatively high, at nearly 4%, the standard deviation shows that economic performance is uneven across countries. The average labor force is 104.62 million, with a high standard deviation of 204.99 million, indicating substantial differences in country-specific labor force sizes.

This disparity reflects population size rather than a country-specific issue. Average infrastructure, measured by mobile phone subscriptions per 100 people, is nearly 94%, suggesting widespread access to mobile communication and relatively good infrastructure. The average inflation rate is 5.20%, with a standard deviation of over 4%. Although inflation is not extremely high, relative to GDP growth, this rate is concerning, as average GDP growth is approximately 4%, while inflation exceeds 5%. Additionally, there is considerable variation in currency valuation across these countries.

TABLE II RESULT OF SUMMARY STATISTICS

Variables	Unit of Measurement	Observation	Mean	Standard Deviation
FDI Inflow	Million US$	240	26855.96	47896.84
Corporate Tax Rate	(%)	240	26.175	7.445
Real Exchange Rate Volatility	conditional variance	240	23988.07	78475.47
Governance Quality	Index	240	-3.05e-09	1.000
Trade Openness	(%)	240	0.735	0.409
GDP Growth	(%)	240	4.289	3.740
Labor Force	Million People	240	104.62	204.99
Infrastructure	Number	240	93.508	38.617
Inflation	(%)	240	5.201	4.797
Real Exchange Rate	Local currency per 1 unit US$	240	64.044	141.706

Source: Author's compilation based on WDI (2019); WGI (2018), OECD (2019) and KPMG (2019)

C. Result of GARCH Estimation

The results of the GARCH estimation are reported in Table 3. Before estimating the GARCH effect, the stationarity of the variable was checked, as GARCH cannot be estimated with non-stationary data. Table 4 presents the results of the unit root test, which show that the real exchange rate data are stationary at the level. Consequently, the GARCH model was estimated using level data. In the GARCH estimation model, the primary focus is on interpreting the variance equation to estimate exchange rate volatility. However, in both the mean and variance equations, the constant is significant at the 1% level. The constant in the mean equation represents the average real exchange rate. The significant and positive value of the ARCH parameter indicates that information from the previous period's real exchange rate has a significant positive effect on current-period real exchange rate volatility. Although the ARCH effect is significant, the GARCH effect is not, indicating that previous-day volatility does not have a significant influence on current-period volatility.

TABLE III RESULT OF GARCH ESTIMATION

Parameters	Coefficient	P Value	Standard Error
Mean Equation			
Constant	3.192912***	0.000	.0503699
Variance Equation			
ARCH (1)	1.017856***	0.000	.0946394
GARCH (1)	-5.80e-06	0.724	.0000165
Constant	.0677841***	0.002	.021954

Source: Author's compilation based on data of WDI (2019)
Note: Here (***) indicates significance at 1% level

In the variance equation, the mean is significant at the 1% level, with a coefficient value of 0.067, indicating that the conditional variance is accurately specified. The sum of the coefficients of the GARCH and ARCH terms exceeds 1, which indicates the persistence of volatility over the study period. As no exogenous variables were included in this model, no post-estimation tests were conducted to assess the robustness of the GARCH results. After estimating the variance equation, the conditional variance of the real exchange rate was generated, which is referred to here as real exchange rate volatility. This data was subsequently used in the model estimation.

D. Result of Unit Root Test

Table IV presents the results of the stationarity test. The results indicate that all variables are stationary at the level. For all variables, the null hypothesis of a unit root is rejected, and the alternative hypothesis of stationarity is accepted at the 1% significance level, except for the real exchange rate, which is significant at the 5% level. Since the data are stationary at the level, the variables are used directly in the model to estimate the dependent variable. As all variables are stationary at the level, testing for cointegration is neither possible nor required.

TABLE IV RESULT OF PANEL DATA UNIT ROOT TEST

Variable	Levin, Lin and Chu Test		
	Statistic	P Value	Decision
Ln (FDI)	-4.516***	0.000	I(0)
Corporate tax rate	-2.353***	0.009	I(0)
Governance Quality	-4.135***	0.000	I(0)
Real Exchange Rate Volatility	-1686.71***	0.000	I(0)
Inflation	-7.599***	0.000	I(0)
Infrastructure (Number of Mobile Subscriptions per 100 People)	-2.484***	0.007	I(0)
Ln (Labor Force)	-4.058***	0.000	I(0)
Real Exchange Rate	-2.178**	0.014	I(0)
Trade Openness	-4.299***	0.000	I(0)
GDP Growth	-10.572***	0.000	I(0)

Source: Author's compilation based on WGI (2018); OECD (2019); KPMG (2019) and WDI (2019)
Note: *** and ** indicates significant at level 1% and 5% respectively. I(0) indicate stationary at level.
For this root test the H_1: Panel is stationary at level

.E. Estimation Result

Table V reports the results of the Arellano-Bover and Blundell-Bond system dynamic panel data regression model. Model 1 presents the regression results between FDI and its main explanatory variables: governance quality, corporate tax rate, and real exchange rate volatility. However, the diagnostic test results indicate that Model 1 cannot be reliably estimated because the over-identification restrictions are not valid, as indicated by the Sargan test. Therefore, several control variables were added to the regression model, and the results are reported in Model 2. The Sargan test results for Model 2 support the validity of the over-identification restrictions, indicating no issues with the instrumental variables. The p-value of the AR test suggests no serial correlation. Thus, there is no endogeneity problem, and the coefficient estimates are efficient.

The results support a positive impact of previous-year FDI on the current-year FDI of countries. A 1% increase in previous-year FDI leads to a 0.271% increase in current-period FDI, which is significant at the 1% level. This finding indicates that the amount of foreign investment emerging countries receive depends on their existing stock of FDI. This result is logical because foreign investors are often reluctant to invest in entirely new regions and typically prefer to expand their previous investments. A positive relationship between governance quality and FDI

was also observed. A one-standard-deviation increase in governance quality increases FDI by a factor of 1.54, and this result is significant at the 1% level. Countries with strong governance attract more FDI because foreign investors prefer destinations with robust institutional systems. Good governance reduces costs by mitigating risks associated with poor governance and ensures a business-friendly environment for foreign investors. Conversely, countries with weak institutions are less attractive, leading to lower FDI inflows. The corporate tax rate has a negative impact on FDI inflows in emerging countries. The results indicate that a 1% increase in the corporate tax rate reduces FDI inflows by 0.043%, which is significant at the 10% level. Since corporate taxation directly affects business costs, foreign investors are less willing to invest in countries with higher tax rates and prefer locations with lower taxes. Consequently, countries with higher corporate taxes lose FDI attractiveness. Similarly, exchange rate volatility was found to have a negative effect on FDI inflows, although the result is not statistically significant.

TABLE V RESULT OF ARELLANO BOVER AND BLUNDELL BOND SYSTEM GMM ESTIMATION
DEPENDENT VARIABLE: LN (FDI)

Variables	Model 1	Model 2
lnFDI(t-1)	0.929*** (0.032)	0.271*** (.061)
Governance Quality	0.377* (0.212)	(0.434)*** (0.155)
Corporate Tax Rate	0.068** (0.029)	-0.043* (0.025)
Real Exchange Rate Volatility	8.01e-07 (3.80e-06)	-2.88e-06 (4.07e-06)
GDP Growth	-	0.063*** (0.017)
Inflation	-	0.036*** (0.013)
Infrastructure	-	0.007*** (0.002)
ln (Labor Force)	-	0.931*** (0.093)
Real Exchange Rate	-	0.005 (0.004)
Trade Openness	-	1.143*** (0.381)
Sargan Test	(0.024)	(0.192)
Arellano-Bond Autocorrelation Test	-	-
Order 1 Order 2	(0.022) (0.120)	(0.009) (0.455)

Source: Author's own compilation based on WGI (2018); OECD (2019); KPMG (2019) and WDI (2019)

Note: ***; *** indicates that significant at 1%, 5% and 10% level significantly. Standard errors are in the parentheses.

For Sargan test and the Arellano-Bond Autocorrelation test, P values are in the parenthesis. Let us analyze the impact of other determinants on FDI that have been considered as control variables in this research. GDP growth has a positive impact on FDI inflows in emerging market economies. Based on the regression results, a 1% increase in GDP growth leads to a 0.063% increase in FDI, which is significant at the 1% level. High economic growth ensures a large market size, making foreign investors more interested in investing there.

This analysis also indicates a positive relationship between FDI and the inflation rate, although this result is surprising, as no previous research supports this relationship. Nonetheless, this study finds that the inflation rate has a positive impact on FDI inflows. Infrastructure was also found to be a positive indicator of FDI. The results show that if mobile phone subscriptions per 100 people increase by one, FDI inflows will increase by 0.7%. Greater access to mobile phones indicates enhanced connectivity and faster information transfer, which helps to enlarge the market size. At every stage of business-such as purchasing raw materials, production, and distribution of goods and services-a well-planned telecommunication system and a large market size are highly beneficial. This attracts investors and motivates them to invest. Similar to GDP growth and infrastructure, labor force has a positive and significant impact on FDI. The availability of labor is associated with lower labor costs, making countries with abundant labor, such as China, highly attractive to foreign investors. This factor has been identified in previous literature as crucial for FDI inflows in emerging and developing nations. Likewise, trade openness is a positive and significant indicator of FDI. The positive coefficient indicates that countries more open to international trade can attract higher levels of FDI. Foreign investors are well informed about the degree of openness of the host country

and prefer to invest in economies that offer a favorable international business environment. This study finds no significant relationship between the real exchange rate and FDI. The author conducted a Sargan test of over-identification restrictions and an AR test of serial correlation to assess the validity and efficiency of the results. The p-value of the Sargan test is 0.192, indicating that the over-identification restrictions are valid. The p-value of the second-order AR test is 0.455, indicating no serial correlation in the second-order disturbance term. Both diagnostic tests support the validity of the statistical results and provide strong evidence regarding the efficiency and reliability of the model, ensuring its suitability for policy recommendations.

VI. DISCUSSION

This study has found that governance quality and corporate tax rate are key components affecting emerging countries' FDI attractiveness. At the beginning of this research, the author analyzed the trend of FDI inflows in these countries and found that the FDI curve is downward-sloping. That is, emerging countries are losing their FDI attractiveness in the recent period. Identifying the factors mainly responsible for this situation is the research problem addressed in this study. Our empirical estimation reveals that governance quality positively and significantly affects countries' FDI inflows. This finding aligns with previous research (Buchanan *et al.,* 2012; Daude & Stein, 2007; Kurul & Yalta, 2017; Masron & Abdullah, 2010; Mengistu & Adhikary, 2011). Among all governance indicators, Kurul and Yalta (2017) found that voice and accountability, control of corruption, and government effectiveness are the most influential in determining FDI. The stronger a country is in terms of governance indicators, the higher its potential to attract FDI. Research conducted by Mengistu and Adhikary (2011) and Uddin *et al.* (2019) indicates that no single component of governance is sufficient; rather, the development and presence of all governance components are required to stimulate FDI inflows. However, Daude and Stein (2007) argued that not all governance indicators are equally important in determining MNCs' FDI decisions. They noted that commitment gaps, bureaucratic pressures, excessive regulatory burdens, and unpredictable government policies negatively affect parent-country FDI decisions. From the analysis of governance indicators, this study finds that political instability, corruption, and poor implementation of the rule of law are the factors that undermine governance performance in emerging economies and discourage foreign investors. Poor governance functions as a cost and creates barriers to FDI.

This research suggests that countries that can control political unrest and violence, ensure political stability, enforce the rule of law, maintain government effectiveness, and control corruption are likely to attract substantial foreign investment.

The situation is similar for corporate tax. Our empirical results indicate that corporate tax negatively affects FDI attractiveness in emerging economies, consistent with the findings of Bellak and Leibrecht (2009), Boly *et al*. (2019), and San *et al.* (2012). Countries that levy high taxes on corporate profits lose FDI attractiveness, while countries with lower corporate taxes are more appealing to foreign investors. However, no significant impact of exchange rate volatility on FDI inflows was found in this region.

Governance quality and corporate tax rate are not the only factors contributing to FDI inflows in emerging countries. Other factors, including GDP growth, infrastructure, labor force, inflation, and trade openness, are also significant and positive determinants of FDI. The availability of labor indicates location advantages and makes host countries more attractive to foreign investors. Consequently, countries with abundant and affordable labor can attract more FDI.

This research reveals that GDP growth is conducive to FDI inflows. Countries that generate notable economic growth while ensuring a favorable business environment are more likely to perform well in attracting FDI. Similarly, infrastructure has a positive effect on FDI inflows. Development, especially in telecommunication infrastructure, reflects a country's economic development. Improved infrastructure enhances productivity and efficiency across stages of production, distribution, and services, making countries more attractive to investors. These implications align with the findings of Mengistu and Adhikary (2011). Additionally, a country's ability to attract FDI depends on its openness to trade. Trade openness is found to be a significant positive determinant of FDI, consistent with the research of Donghui *et al.* (2018) and Uddin *et al.* (2019). Greater openness facilitates economic integration and reduces transaction costs, creating a favorable environment for international business. Foreign investors prefer countries with open economies, as supported by Goh and Tham (2013) in their study on Malaysia. The positive relationship between FDI and inflation is less straightforward. To the best of our knowledge, few studies have found inflation to be a positive determinant of FDI. Samal (2018) reported a negative relationship, while Omankhanlen (2011) and Alshamsi and Azam (2015) found no significant relationship.

In conclusion, the research question-"Which factors are mainly responsible for the recent falling trend of FDI in emerging countries?"-suggests that poor governance quality and high corporate tax rates are likely responsible for decreasing foreign investment. This study recommends that emerging countries focus on ensuring quality governance and reducing corporate tax burdens. At the same time, they should sustain economic growth, develop infrastructure, provide an available labor force, and facilitate international trade to enhance their FDI attractiveness.

VII. CONCLUSION

FDI is critically linked with globalization and is globally recognized as a driver of economic growth and development. This research attempts to analyze the key drivers of FDI inflows in emerging economies for the period 2003–2017. It contributes to the literature by employing the System GMM as a dynamic panel model, analyzing recent FDI trends in emerging economies, and including three explanatory variables in the same model-likely the first such attempt in this field. Principal Component Analysis (PCA) was used to calculate the governance quality index from six governance components in the WDI, and the GARCH model was employed to estimate exchange rate volatility. Finally, System GMM was applied to estimate the model and identify the determinants of FDI in emerging nations.

Motivated by the need to identify the key factors behind the decline of FDI in emerging economies, this research finds that governance quality positively affects host countries' FDI attractiveness and encourages foreign investment. In contrast, corporate taxation-particularly high tax rates on corporate profit-acts as a burden and negatively affects FDI inflows. The study also finds that emerging countries face significant challenges related to political instability, poor implementation of the rule of law, and high levels of corruption. The findings suggest that proper implementation of law, effective control of corruption, and reforming rules and regulations can increase FDI attractiveness in emerging economies. Furthermore, easing bureaucratic procedures for business operations, reorganizing political systems, controlling political unrest, and developing judicial institutions are crucial to enhancing governance performance. Reforming corporate taxation policies and reducing corporate tax rates is also necessary to attract foreign investment. This study concludes that countries that reveal weaknesses in governance-caused by corruption, political unrest, and bureaucratic inefficiencies-should reform their political systems and enforce the rule of law. At the same time, they should ensure a favorable business environment by reducing corporate taxation and maintaining macroeconomic stability.

TABLE VI LIST OF COUNTRIES

Country of Origin	Country Name	Code
Asia	China	CHN
	India	IND
	Malaysia	MYS
	Philippines	PHL
	Thailand	THA
	Turkey	TUR
Europe	Hungary	HUN
	Poland	POL
	Russia	RUS
	Ukraine	UKR
	Romania	ROU
South America	Brazil	BRA
	Chile	CHL
	Peru	PER
North America	Mexico	MEX
Africa	South Africa	ZAF

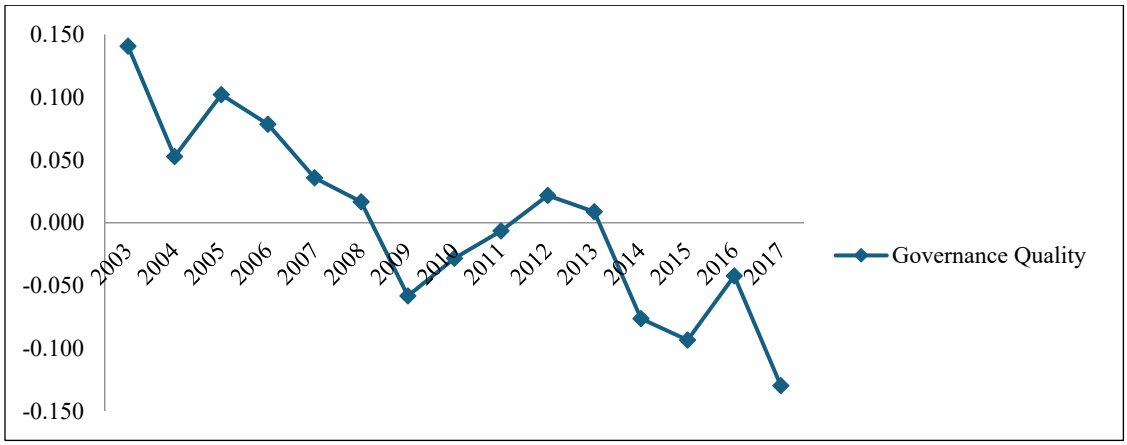
Source: Author's compilation based on IMF (2018)

Note: All the country codes are set by the Word Bank. Russia is located in Both Asia and Europe Continent. Though 75% geographical part of this country is located in Asia but 75% of its total population lives in Europe. As a why Russia has been considered here as an European country

TABLE VII CORRELATIONS OF GOVERNANCE INDICATORS

Variable	VA	PS	GE	RQ	RL	CC
VA	1.0000					
PS	0.5114	1.0000				
GE	0.3215	0.5538	1.0000			
RQ	0.6219	0.7052	0.7793	1.0000		
RL	0.6253	0.6981	0.8482	0.8485	1.0000	
CC	0.6321	0.6833	0.8221	0.8940	0.9239	1.0000

Source: Author's compilation based on WGI (2018)



Source: Author's compilation based on WGI (2018)

Fig.2 Trend of Governance Quality in Emerging Economies

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