THE ROLE OF GOOD GOVERNANCE ON INSTITUTIONAL QUALITY AS A FDI MOTIVATOR IN THE MALAYSIAN CASE

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ABSTRACT

Malaysia, as well as other developing countries has been the recipients of FDI and (foreign direct investments) over the past few decades. These investments have proven to be a source of economic growth for the host countries. However, in recent years, there seem to be a strong competition among developing countries to attract FDI as the importance of FDI in developing the host country through increased employment and resource usage hence GDP growth cannot be overlooked. This article examines the role of institutional fitness in FDI considerations. The World Governance Indicator (WGI) which includes voice and accountability, political stability, absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption as the main issues of governance. We will examine these indicators for Malaysia over a period of 1996-2012 and predict the path for Malaysia as a FDI destination for the coming years. If indeed these indicators are of importance, for FDI consideration as proclaimed in FDI literature, then is Malaysia having the advantage compare to its neighbors like Singapore, Indonesia and Thailand? In order to ensure these indicators are encouraging signals, good governance is a necessary condition

Keywords: Governance, FDI, Institutional Quality, Foreign Direct Investment,World Governance Indicators (WGI).

INTRODUCTION

FDI has become a Big Word in economic development literature and global economics as it has proven to have enhanced growth and development in many countries as well as transformed many economies for the better. This is undeniable as many studies have been undertaken to look at the benefits of FDI to both host country and donor country, which to a large extent has proven support for the benefits of FDI as a catalyst to growth and development in capital scarce, resource-rich host country and capital-rich, resource-poor donor country. Hence, FDI can be regarded as a mechanism that redistributes factors of production in a way that leads to appositive sum game, bringing benefits to all stake-holders involved.

Henceforth, it is worthy to note that FDI brings along with it many benefits to the host country such as increased employment, technology and education transfer, higher GDP and many other development prospects which would otherwise be difficult to achieve if the economy is solely dependent on domestic funds, both the government and private. So, FDI is therefore a vital injection for a growing economy.

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As such, as the beneficial effects of FDI become more and more recognized and accepted, many countries especially in the developing clusters try to capture as much of FDI in a competitive environment to stay attractive and relevant to donor countries.

Although, proper empirical studies on FDI as an agent of technology transfer is still lacking, there has been there has been enough recognition of FDI as an agent of both technology transfer and economic transformation in many studies, for example Lloyd (1996).On FDI being a catalyst of economic transformation, there is enough evidence s witnessed by the transformation of countries like Singapore, Hong Kong, South Korea, Taiwan which are the offspring of FDI from the western countries, thereby creating the first tier of newly industrialized countries (NIE).

Due to the transformative and positive impact of FDI on host countries, it is only logical that Less Developed Countries (LDCs) brace to improve their macroeconomic and institutional outlook to attract FDI in the midst of a very competitive environment of survival of the fittest.

REVIEW OF FDI IMPORTANCE

Dunning (1993) provides four reasons for FDI motives rather than exporting or licensing arrangements that being, access to resources and markets, efficiency gains and acquisition of assets.

The importance of FDI in developing regions cannot be overlooked as these economies often lack the funds and technology to undertake investment projects which are crucial in the creating job opportunities, technology transfers and on a bigger scope an improvement in economic growth and development.

Lloyd (1996) categorizes FDI roles into two main areas – an agent for technology and an agent for economic transformation.

The FDI outflows from Japan starting from the 1960’s to countries like Singapore, Hong Kong, South Korea and Taiwan has seen the making of these countries to be categories as NIE (Newly Industrialized Economies) as it is currently known. It is further than the FDI inflows into these four parts NIES can be transformed into high performing industries through technological advancements Aminian, Fung and Lin (2007).

Kojima (1973) explains the role of FDI in economic transformation of the host country using a model of ‘flying geese’.

As these countries advanced, then they eventually will lose the comparative advantage, hence FDI outflows from the more developed countries will seek to invest in lesser developed countries like Malaysia, Thailand and credit the Second tier NIEs.

Sumner (2005) asserts that the impact of FDI on host country will differ depending on the attributes and functions of the FDI inflows. Raw-material seeking FDI may create export expansions but little effect on domestic employment compared market-seeking FDI which is expected to bring better employment, technology for the host country.

It has been evidenced by empirical findings that FDI supports growth of the host country; however, certain country conditions lead to a better inflow of investment.

REVIEW OF INSTITUTIONAL FACTORS IMPACTING FDI MOVEMENTS

Dunning (2002) argued that institutional factors such as good governance and economic freedom are becoming increasingly important determinants of foreign direct investment (FDI) as the motives of multinational companies (MNCs) have shifted from market- and resource-seeking to efficiency-seeking implying that traditional determinantsof FDI such as natural resources, low labor costs and good infrastructure are now becoming relatively less important while less traditional determinants such as governance and economic freedomare becoming more important However, investigation between FDI and institutional factors are limited in literature except for corruption. We will examine some of the main macroeconomic and institutional determinants of FDI which is discussed from the review of past studies. Among the role of institutions which are considered important determinant for FDI inflows include effectiveness of property rights, economic freedom, and regulatory system (i.e. tax system, corruption, transparency etc.) bureaucracy framework.

Rodrik(1999) explained that the declining trend in FDI after 1975 can be explained by weak institutions of conflict management. Daniele and Murani (2006) identified three potential channels through which institutions affect FDI inflows.

Firstly, the presence of good institutions tends to improve factor productivity and thus stimulates investments whether domestic or foreign. Quality institutions lead to lower transactions costs related to investments. This refers to corruption –related costs. Thirdly, with good institution (i.e. proper property rights enforcement effective legal systems) give more security to MNC, eliminating the presence of sunk cost which is often associated with FDI's.

Many recent studies on FDI-institutions relationships have surfaced, discussing the importance of quality institutions on FDI inflows. Knack and Keefer (1995) discusses the components of institutional quality namely, the property and contract rights which focuses on right of expropriation and rule of law.

Clarke (2001) however focuses on role of institutions in technological deepening. The findings of Clarke (2001) suggest that institutional quality has a positive correlation with FDI.

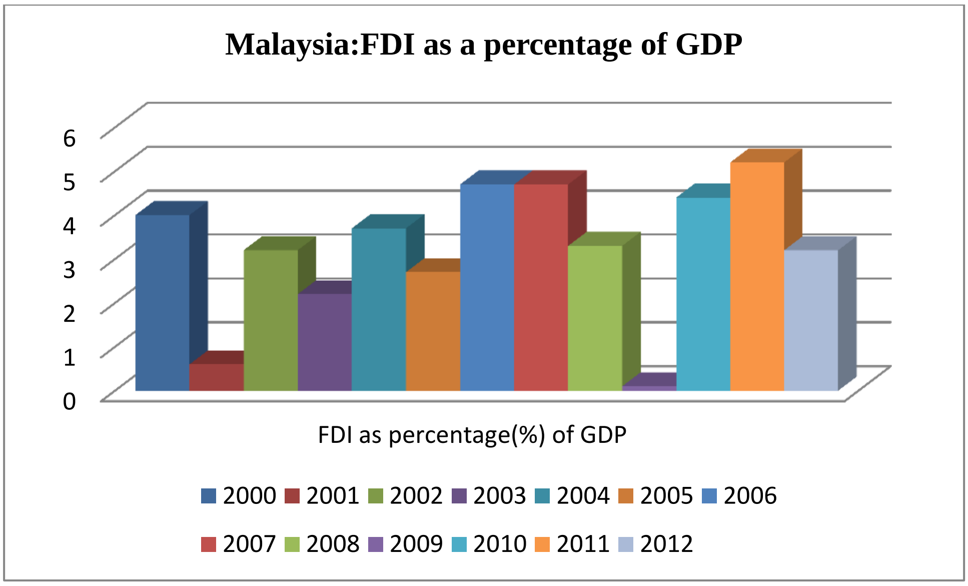
Kose et.al (2006), asserts that growth and stability benefits of financial globalization can be realized through abroad set of positive factors in the host country such as well-developed financial market, efficient institutions, better governance and macroeconomic disciple.

FDI IN MALAYSIA

UNCTAD reports that Malaysia's FDI grew by an impressive 22.2% (RM13.6 b) in 2013 compares to RM 10 b in 2012. Despite this impressive growth, Malaysia is lagging behind its neighbors in terms of total FDI receipts, putting Malaysia only in the fourth spot among ASEAN countries like Singapore, Indonesia and Thailand.Malaysian Investment Development Authority (MIDA) claims that the outlook for FDI in Malaysia is on the positive trend shown by leading indicators.

The data and the graph below shows that Malaysia has been receiving substantial FDI inflows for the past 13 years constituting between 2% TO 5% OF ITS GDP with the exception for 2001 and 2009, where the FDI as a percentage of GDP did not make even 1%.However, will Malaysia continue to an attractive FDI destination with the increasing FDI competition. We will examine the prospects of Malaysia in maintaining its FDI from the governance of its Institutional indicators.

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
FDI as percentage(%) of GDP	4.0	0.6	3.2	2.2	3.7	2.7	4.7	4.7	3.3	0.1	4.4	5.2	3.2



THE ROLE OF GOVERNANCEIN FDI DETERMINATION

The World Bank has defined governance as a mode of power exercise in the management of social and economic resources of country. UNTAD defines governance as the manner in which the main actors of society, governments, businesses and civil society work together to make society better.

The World Bank group has introduced the world governance indicators (WGI)[2] which comprises of 6 main pillars of governance which will be discussed as follows:

1. *Voice and Accountability (VA)*
This upholds the principles of democratic principles, which emphasizes the right of the citizens involved in decision making and the government's responsibility and accountability to the government. It includes issues such as freedom of media, freedom to assemble, freedom to fair and clean election for selecting the government and the freedom of expression without fear or favor.

[2]The Worldwide Governance Indicators (WGI) are a research dataset summarizing the views on the quality of governance provided by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries. These data are gathered from a number of survey institutes, think tanks, non-governmental organizations, international organizations, and private sector firms. The WGI do not reflect the official views of the World Bank, its Executive Directors, or the countries they represent. The WGI are not used by the World Bank Group to allocate resources.

2.*Political Stability and Absence of Violence (PSAV)*

This refers to the number of years a government remain in office as well as the ease of power change without any undue struggle and violence;it also reflects that unlikelihood that the government will be overthrown by unconstitutional means or politically motivated or terrorism.

3. *Government Effectiveness (GE)*

Refers to the quality of public service provision, the quality of bureaucracy, the competence of civil servants, the independence of civil service from political pressures and the credibility of the government's commitment to policy implementation

4 .*Rule of law (ROL)*

This comprises several indicators measuring the extent to which, agents have confidence in and abide by the rules of society which includes perceptions of incidence of crime , effectiveness and predictability of the judiciary and enforceability of contracts.

It can also be described as the degree to which citizens and administration of a country is willing and able to accept established institutions to make and abide by the laws.

5. *Regulatory Quality (RQ)*

This refers to the perception that the elected government is capable to formulate and implement sound policies and regulation that permit and promote private sector development.

6. Control of corruption (COC)

Corruption can be referred to the extent to which public power is exploited for personal gains as well as "captive" of state by elites and private interest

Corruption affects the financial and economic efficiency and deters FDI inflows. According to (Davidson,1980), firms prefer to operate in a lesser corrupt environment. Likewise, other studies also show negative relationships between FDI and corruption Tanzi and Davoordi(1997).

This article examines the six pillars as advocated in the WGI for Singapore, Malaysia, Indonesia and Brunei for the period of 2000 to 2013 using the data from the World Bank Database for World Governance Index.

Table 1: Voice and Accountability

Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	0.77	-0.92	-0.92	-0.86	-0.87	-1.08	-1.04	-0.98	-0.75	-0.65	-0.60	-0.50	-0.50
Indonesia	-0.44	-0.39	-0.38	-0.29	-0.16	-0.14	-0.07	-0.06	-0.03	-0.07	-0.04	0.04	0.00
Malaysia	-0.33	-0.48	-0.52	-0.25	-0.19	-0.50	-0.51	-0.55	-0.49	-0.48	0.04	-0.33	-0.32
Singapore	0.18	0.05	-0.16	-0.01	0.01	-0.37	-0.36	-0.32	-0.24	-0.20	-0.07	0.08	0.06

As seen from the chart for VA, all the four countries seem to reflect badly on this index, showing that there is much suppression in freedom to voice and question on issues that affect general public. In this case, it can be seen that Brunei has the lowest score even falling below Indonesia.

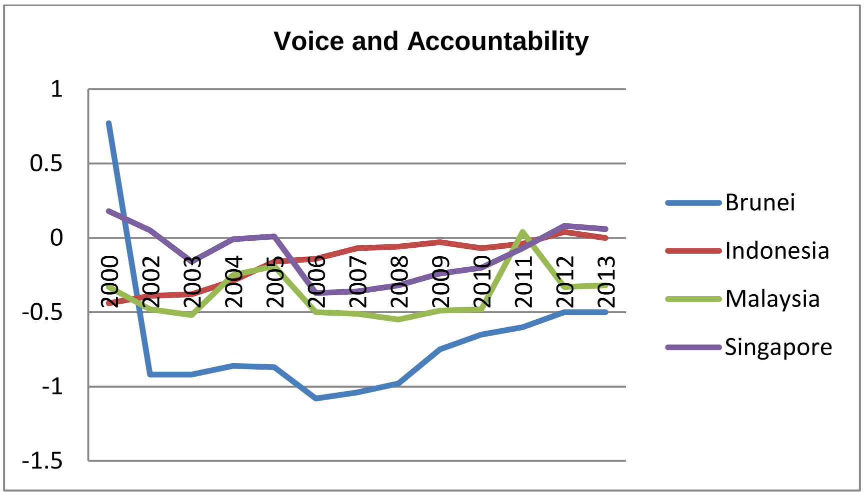
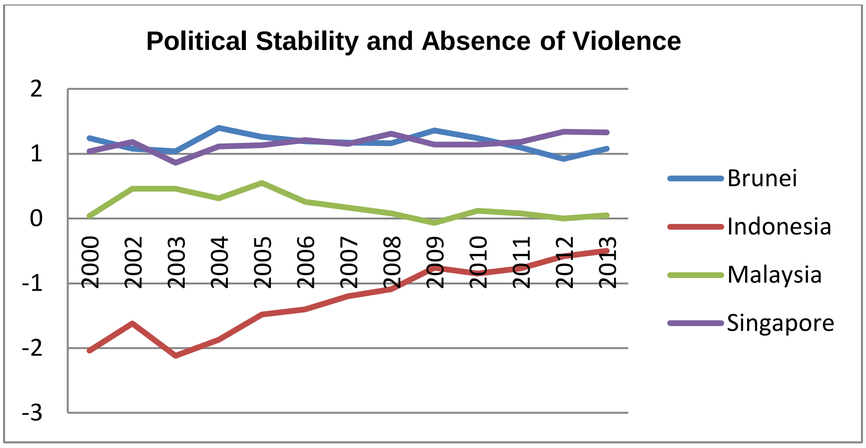


Table 2: Political Stability and Absence of Violence

Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	1.24	1.08	1.04	1.40	1.26	1.19	1.17	1.16	1.36	1.24	1.10	0.92	1.08
Indonesia	-2.04	-1.62	-2.12	-1.87	- 1.48	-1.40	-1.20	-1.09	- 0.76	-0.85	-0.77	-0.58	- 0.50
Malaysia	0.04	0.46	0.46	0.31	0.55	0.26	0.17	0.08	- 0.07	0.12	0.08	0.00	0.05
Singapore	1.04	1.18	0.86	1.11	1.13	1.21	1.15	1.31	1.14	1.14	1.18	1.34	1.33

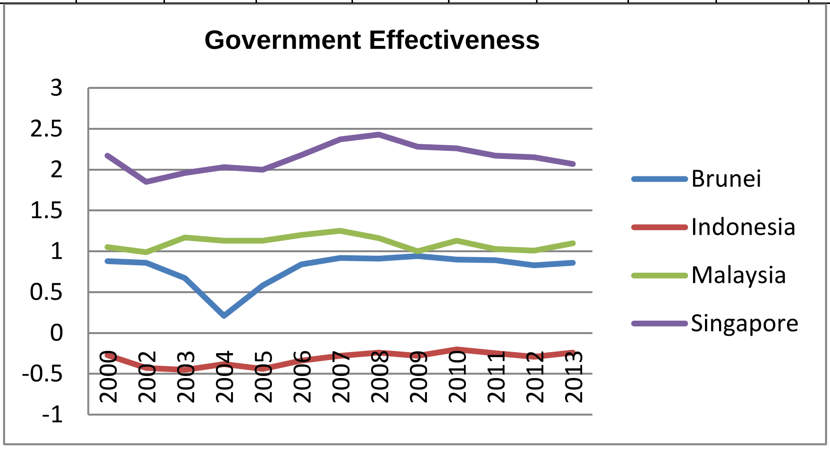


From the graph above it can be noted that Malaysia falls behind Singapore and Brunei .Political re-silence in these two countries may be attributed to their political systems where one is a republic and the other a Kingdom respectively.

Table 3: Government Effectiveness

Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	0.88	0.86	0.67	0.21	0.58	0.84	0.92	0.91	0.94	0.90	0.89	0.83	0.86
Indonesia	- 0.27	-0.43	-0.45	-0.38	- 0.44	-0.34	- 0.28	-0.24	- 0.28	-0.20	-0.25	-0.29	-0.24

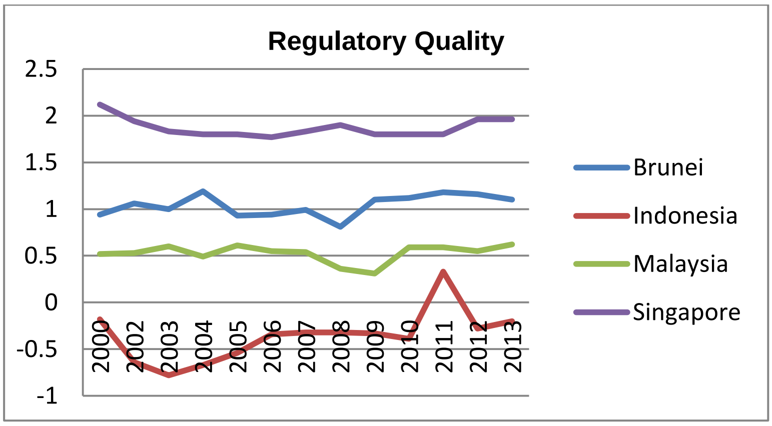
Malaysia	1.05	0.99	1.17	1.13	1.13	1.20	1.25	1.16	1.00	1.13	1.03	1.01	1.10
Singapore	2.17	1.85	1.96	2.03	2.00	2.18	2.37	2.43	2.28	2.26	2.17	2.15	2.07



In this aspect, Malaysia comes in second after Singapore, which reflects very strong public administration for which the Singapore government should be emulated. A strong government and public administration is definitely a good environment for business investment.

Table 4: Regulatory Quality

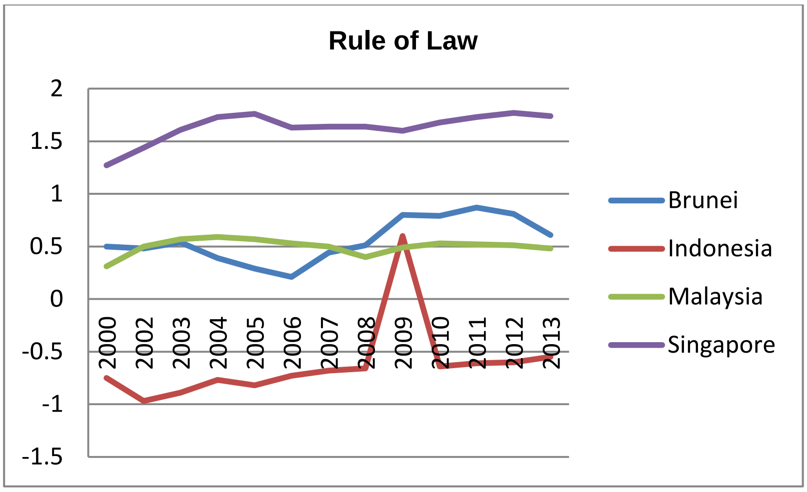
Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	0.94	1.06	1.00	1.19	0.93	0.94	0.99	0.81	1.10	1.12	1.18	1.16	1.10
Indonesia	-0.18	-0.64	-0.78	-0.67	-0.54	-0.34	-0.32	-0.32	-0.33	-0.39	0.33	-0.28	-0.20
Malaysia	0.52	0.53	0.60	0.49	0.61	0.55	0.54	0.36	0.31	0.59	0.59	0.55	0.62
Singapore	2.12	1.94	1.83	1.80	1.80	1.77	1.83	1.90	1.80	1.80	1.80	1.96	1.96



In this aspect, Malaysia comes in third after Brunei and Singapore .Regulatory functions are as important as policy formulating. If the regulatory systems are strong and consistent, then there will smooth functioning of government machinery and less wastage of funds.

Table 5: Rule of Law

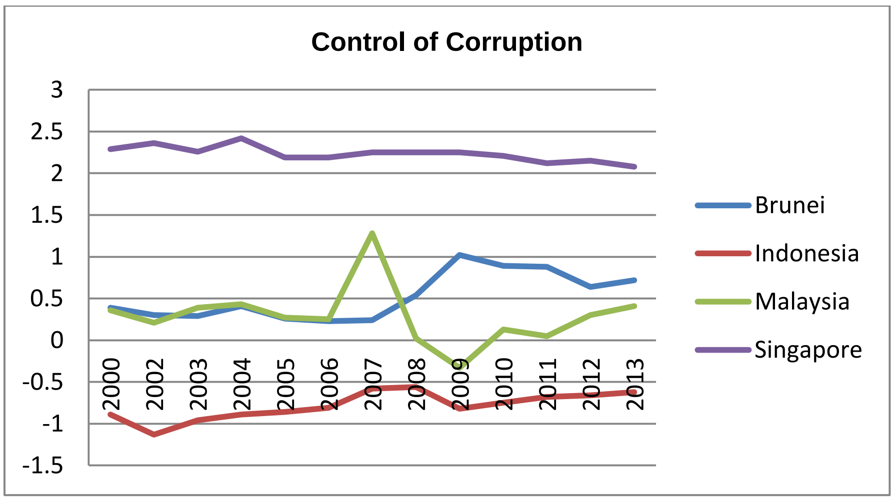
Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	0.50	0.48	0.54	0.39	0.29	0.21	0.44	0.51	0.80	0.79	0.87	0.81	0.61
Indonesia	-0.75	-0.97	-0.89	-0.77	-0.82	-0.73	-0.68	-0.66	0.60	-0.64	-0.61	-0.60	-0.55
Malaysia	0.31	0.50	0.57	0.59	0.57	0.53	0.50	0.40	0.49	0.53	0.52	0.51	0.48
Singapore	1.27	1.44	1.61	1.73	1.76	1.63	1.64	1.64	1.60	1.68	1.73	1.77	1.74



There is much improvement needed in this aspect with respect to Malaysia. There is need for an independent judiciary from the state control. Singapore on the other hand, heads the others in this aspect.

Table 6: Control of Corruption

Country/Year	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Brunei	0.39	0.30	0.29	0.41	0.26	0.23	0.24	0.54	1.02	0.89	0.88	0.64	0.72
Indonesia	-0.89	-1.13	-0.96	-0.89	-0.86	-0.81	-0.58	-0.56	-0.82	-0.75	-0.68	-0.66	-0.62
Malaysia	0.36	0.21	0.39	0.43	0.27	0.25	1.28	0.02	-0.33	0.13	0.05	0.30	0.41
Singapore	2.29	2.36	2.26	2.42	2.19	2.19	2.25	2.25	2.25	2.21	2.12	2.15	2.08



While Singapore again takes the lead in corruption control, Malaysia on the other hand comes in third after Singapore and Brunei, reflecting a very lax regulatory quality and the lack of determination to combat this evil.

All data used in this article sourced from the World Bank

CONCLUDING REMARKS

Based on the 'flying geese' model of Kojima, as countries transform from FDI inflows they will lose their competitive advantage and their macroeconomic variables will no longer seem attractive to pull in FDI. Hence, these countries have to look for alternative methods to remain attractive as FDI destinations. Institutional quality has been much regarded as an important factor in FDI decisions. The findings in this paper see Malaysia as an attractive destination for FDI. Malaysia is in the transition to the second-tier NIE, hence it has to benchmark with Singapore to remain fit for FDIs. However, there is a need for improvement in many of the indicators especially corruption control. If corruption is well under control, then to achieve strength in all the other indicators will be much easier. Governance of corruption control is more of self-governance among elected representatives who will put the interest of the public above their own self-interest. With the will to serve the people better, the country will reach greater heights and allow more freedom of expression and will be more accountable and transparent to gain the confidence of the citizens and the world at large.

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