Chapter 1.
Public Governance as a Key Determinant of FDI : *A Comparative Analysis of Sub-Saharan Africa and South-East Asia Host Countries*

Rodolphe Desbordes, Céline Azémar
and Jean-Louis Mucchielli *
TEAM, Université Paris I-Panthéon-Sorbonne

1. Introduction

The World Bank (2000), in its report on « Quality of Growth », emphasises the importance of public governance as the keystone of a country's development. Studies examining determinants of foreign direct investment (FDI) are also increasingly taking account of such fundamentals as institutional and political factors. Thus, rule of law, bureaucratic corruption, educational attainment or quality

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* This article is a short version of Desbordes *et al.* (2004). Corresponding author. E-mail address: rodolphe.desbordes@univ-paris1.fr. University of Paris I, Panthéon-Sorbonne. Maison des Sciences Economiques, 106-112, Bd. de l'Hôpital, 75647 Paris cedex 13, France. E-mail addresses: celine.azemar@malix.univ-paris1.fr and jlmuc@univ-paris1.fr

of physical infrastructure are now included in econometric analyses next to more common variables such as market size, labour costs or trade openness. In other words, good governance appears to be a key condition for attracting FDI. For instance, Lehmann (1999), shows that a country like India could increase its share of US affiliates' physical investment by 50% if it were to eliminate all political uncertainty.

For a developing country, the stakes for improving its public governance are high. Beyond an increase in its growth rate, a favourable business climate is likely to attract more FDI and enhance their alleged spillovers. More FDI means more financial resources for the host country, whereas it is likely that the technological intensity of these investments and the transfer of foreign know-how to domestic firms will largely depend on the quality of public governance.

This article has three goals. First, to clarify why public governance is likely to influence FDI inflows. Second, to propose a new evaluation of public governance through the construction of quantitative, relatively objective, easily replicable and sample-specific indicators. The public governance of two geographic zones will be assessed through this method: Sub-Saharan Africa (SSA) and South-East Asia (SEA). As shown in table 1.1, the former attracts much less FDI than the latter. Third, to test econometrically whether public governance explains the diverging abilities of SSA and SEA to attract FDI.

The paper is constructed as follows : section 2 examines the theory behind the potential influence of public governance on foreign direct investment and compares the governance conditions in SEA and SSA, through the use of self-made public governance indicators. Section 3 tests econometrically which governance

Table 1.1

Distribution of FDI flows throughout the world, 1980-2001

	Inward FDI (%)	
	1980	*2001*
Developed countries	**84.3**	**68.4**
Western Europe	39	45.7
North America	41	20.7
Other developed countries	4.3	2
Developing countries	**15.6**	**27.9**
Africa	1	2.3
Sub-Saharan Africa	0.4	1.6
Latin America and the Caribbean	13.6	11.6
Asia-Pacific	0.9	13.9
South, East and South- East Asia	6.5	12.8
Central and Eastern Europe	**0.1**	**3.7**

Source: UNCTAD World Investment Report 2002 and UNCTAD FDI/TNC database: http://stats.unctad.org/fdi/

indicators have an influence on foreign direct investment flows and how well public governance explains the diverging attractiveness of SEA and SSA. Section 4 concludes.

2. Theory of Public Governance : Impact on Foreign Direct Investment

2.1 Public governance: definition, impact on foreign direct investment and statistical evaluation

Kaufmann *et al.* (1999) define public governance as « the traditions and institutions by which authority in a country is exercised » (p.1). Five dimensions of government performance can be outlined :

a) Freedom and political stability

b) Provision of public goods

c) Macroeoconomic policy

d) Property rights and contract enforcement

e) Corporate governance.

Each can help create a satisfactory business climate for foreign investors, as follows :

a) Freedom and political stability

Political freedom corresponds to the right of citizens to choose, monitor and replace the people in power. Freedom of expression, assembly, association (including business activity), religion and oppression can be classified under the heading of civil liberties. Nevertheless, freedom does not necessarily imply political stability, which can be defined as frequent regular or irregular changes in the government in power, through peaceful or violent means and by the existence of checks and balances constraining the Executive.

Political instability in countries is likely to deter FDI inflows because the legal environment is unpredictable. As the future is uncertain, firms may prefer to wait for new information. Moreover, democratic countries stand a better chance of attracting FDI because this political system tends to favour a more stable and transparent business climate in the long run (Rivera-Batiz, 2001 ; Rodrik, 1999) and because multinational companies are increasingly reluctant to invest in a repressive regime, so as to preserve their brand name and image (Letnes, 2002).

b) Provision of public goods

As La Porta *et al.* (1999) point out, government plays a large role in delivering health, education, infrastructure, particularly when the use of these goods cannot be confined to certain individuals. The efficiency of its interventionism depends largely on its bureaucracy, which can be seen as another public good (La Porta *et al.*, 1999 ; Rauch and Evans, 2000). Health and education enhance a worker's productivity and therefore lower the efficiency wage rate, *i.e.* the absolute wage rate deflated by the productivity of labour force. A positive link might therefore arise between the location of multinational firms attempting to take advantage of international differences in factor prices, and these public goods. Carr *et al.* (2002) offer two other explanations. First of all, it is likely that the setting-up of a foreign plant will require a certain amount of skilled labour. Furthermore, human capital should be correlated with other FDI determinants, such as physical and institutional infrastructure.

Pro-business measures, including reductions in bureaucratic « red tape » and corruption, are seen as increasing determinants of foreign direct investment flows (Mallampally and Sauvant, 1999). Conversely, burdensome and lengthy administrative procedures required to establish and operate a business are likely to discourage FDI. Likewise, there may well be a strong correlation between administrative costs and bureaucratic corruption, since public officials may impose these excessive regulations on multinational companies to extract rents from them. Indeed, as explained by Wei and Wu (2001), « the need for international investors to pay bribery and deal with extortion by corrupt bureaucrats tends to increase with the frequency and the extent of their interactions with local bureaucrats » (p5). Foreign investors are therefore confronted with an additional tax, whose rate is uncertain (Wei, 1997).

c) Macroeoconomic policy

The goal of a macroeconomic policy is to maintain the internal and external balance of the macroeconomic system (Krugman and Obstfeld, 2001) . The internal equilibrium refers to the full use of the factors of production and to price stability. The external equilibrium implies that the trade balance is high enough to allow the country to pay back its foreign debts.

FDI is unlikely to flow to economically unstable countries as they do not offer a stable and predictable business environment and because the deterioration of internal and external macroeconomic indicators, *i.e.* inflation and trade balance, may engender higher taxes and capital controls as well as the increased use of import barriers, probably reducing the expected profitability of a foreign investment.

d) Security of property rights and contract enforcement

North (1990) defines property rights as « the rights individuals appropriate over their own labour and the goods and services they possess. Appropriation is a function of legal rules, organizational forms, enforcement, and norms of behaviour — that is, the institutional framework » (p.33). The creation, protection and enforcement of property rights are particularly important because without them the scope for market transactions is limited (World Bank, 2002). North (1990) and more recently Clague *et al.* (1999) have emphasised the need for third-party enforcement when transactions are not simultaneous. Because the market has clear limits when it comes to enforcing contracts, this role is devolved upon the government, notably through its judiciary system. However, this authority also possesses the power to expropriate agents.

Foreign investors demand protection of their property rights, especially when their ownership advantage lies in their technological level. Otherwise, they are denied the return on their investment, which means that without this profit incentive, they will not be inclined to take a risk and invest in the potential host country (Drabek and Payne, 1999). Furthermore, whenever their property rights are threatened and their contracts violated, multinational companies must be able to quickly settle their disputes through the legal system.

e) Corporate governance

Corporate governance relates to the regulatory settings for a firm's decision-making. For the OECD (1999), good corporate governance implies (1) the protection of shareholders'rights ; (2)

equitable treatment of shareholders, including minority and foreign shareholders ; (3) recognition of the stakeholders'rights ; (4) timely and accurate disclosure on all material matters regarding the corporation ; (5) a responsible board that is fully informed and accountable to the company and shareholders. Corporate governance can be associated with public governance as it is the government's duty to ensure that the proper rules have been enacted and that they are adequately enforced by independent authorities.

FDI is likely to be drawn towards countries offering a strong corporate governance framework for at least two reasons. First, weak corporate governance may fuel economic instability (Acemoglu and Johnson, 2002). Second, FDI is increasingly taking the form of cross-border mergers and acquisitions (M&As) [4], and it can therefore be expected that the quality of corporate governance plays a role in the acquisition decisions of multinational companies.

2.2. A review of indicators of public governance and institutional quality

Most studies on the performance of public governance use subjective indexes which are based on polls of experts (Business International, International Country Risk Guide, Business Envi-

4. Indeed, according to UNCTAD (1999) " available information suggests that cross-border M&A activity has accounted for between one-half and two-thirds of world FDI flows in the 1990. The figure is higher for developed than for developing countries, but the difference is principally due to the smaller role of M&As in China. If China is excluded, the share of M&A in cumulative FDI in 1992–1997 turns out to be 72 per cent, up from 22 per cent during 1988–1991. […] Thus, the recent boom in FDI flows to developing economies has, with the exception of China, consisted predominantly of M&A, largely in the services sector " (p 118). In these countries, this phenomenon has been largely driven by privatisation programmes, such as in Latin America (*ibid.*., p118). In 2002, privatisations still accounted for 60% of the value of M&As (World Bank, 2003, p.86).

ronmental Risk Intelligence, Freedom House) or cross-country survey of firms (World Development Report, 1997). Some disadvantages with using this type of indicators can be pointed out. Most of them are obviously not freely available and logically select the countries in which foreign investors are most interested. The accuracy of a country's rating depends on the knowledge of the expert(s) assessing it. Moreover, evaluators may be influenced by a country's recent economic performance when they evaluate its institutional efficiency. Indeed, Chong and Calderon (2000) found a two-way causality between institutional quality (BERI or ICRG indexes) and growth rate. Finally, commercial country risk indexes tend to assess developed and developing countries and therefore contrast the latter with the former; as mentioned by Morisset (2001), African countries tend to be concentrated at the bottom of commercial rankings.

2.3 A comparative numerical analysis of public governance in South-East Asia and Sub-Saharan Africa

2.3.1. Methodology and data used to measure governance aspects

In order to create indexes measuring the different dimensions of public governance, principal component analysis will be used. This is a statistical technique for data reduction as the objective is to find the unit-length linear combinations of the variables with the greatest variance. This method should help by creating weighted indexes that are not biased by the researcher's subjective choices. Furthermore, given the presence of multicollinearity, it makes sense to form a composite index. Finally, the ranking that will be generated in this way will have the advantage of being specific to the sample used ; African and Asian countries will be compared to each other, on the basis of available statistical information.

Four dimensions of public governance will be evaluated with a principal component analysis : [5]

a) Political, civic and economic freedom

b) Public goods

c) Macroeconomic policies

d) Socio-political instability.

The variables, described below, were chosen on the basis of their relevance and spatial/temporal availability (table 1.2). As is well-known, statistics on developing countries, especially African nations, are scarce.

Two periods are observed: 1976-1985 and 1986-1995 [6]. The calculations have been made with the two time spans included, in order to be able to track the evolution of public governance conditions. Each index has been rescaled from zero to ten. A public global governance index has been computed such as :

Public Governance Index = (Freedom Index + Macroeconomic Policies Index + Public Goods Index) – Socio-political Instability Index

2.3.2. Numerical confirmation of a global better public governance climate in South-East Asia compared to Sub-Saharan Africa

The data and methodology used in this paper confirm that the quality of the institutions in SEA is much higher than in SSA (table 1.3). SEA has fared better than SSA in terms of macroeconomic

5. Only the first principal component is used.

6. As institutions tend to be very stable over time, it would therefore be meaningless to observe the evolution of governance conditions over a short time period

Table 1.2

Description of the variables used to measure different governance dimensions

Variable	Description and explanation of choice	Source
Freedom		
Democracy	Democracy score.	Polity IV: *http://www.cidcm.umd.edu/inscr/polity/*
Contract Intensive Money (CIM)	Ratio of non-currency money to total money supply (M_2-Currency/ M_2). If citizens of a particular country believe that there is sufficient third-party enforcement, they are more likely to allow other parties to hold their money in exchange for some compensation, and CIM is correspondingly higher.	Clague *et al.* (1999) and data compiled by R. Bittick: *http://somc.csudh.edu/fa01_pub504/CIM%20data.xls*
Political constraint index	Measures the degree of constraints on policy change (checks and balances) with the assumption that on average, the benefits of constraints on executive discretion outweigh the costs of lost flexibility. This index can be seen as an indicator of credible political commitment.	Henisz (2000): *http://www-management.wharton.upenn.edu/henisz/POLCON/*
Political rights	Meaningful election of chief authority; meaningful election of legislature; fair campaigning; fair reflection of voter preferences; multiple political parties; no military control; decentralised political power; informal consensus; significant opposition vote; recent shift in power through elections; no denial of self-determination of major groups.	Freedom House: *http://www.freedomhouse.org*
Civil rights	No censorship; open public discussion; freedom of assembly; freedom of political organisation; guaranteed socio-economic rights; no gross inequality; no government indifference; no political terrorism; rule of law in political cases; freedom of religion; free trade unions; freedom of business; guaranteed personal rights; freedom of private organisations.	*Ibid.*
Public goods		
Number of telephone lines per 1000 people	According to Easterly and Levine (1997) and Collier and Gunning (1999), while telecommunications is the only widely available infrastructure variable, it is likely that different kinds of infrastructure are highly correlated.	*World Development Indicators (2000) CD-ROM*
Life expectancy at birth	Life expectancy at birth indicates the number of years a new-born infant would live if prevailing patterns of mortality at the time of its birth were to stay the same throughout its life. It can be seen as an indicator of the quality of the health system.	*Ibid.*
Gross secondary enrolment ratio	Ratio of total enrolment, regardless of age, to the population of the age group that officially corresponds to the level of secondary education. Secondary education completes the provision of basic education that began at the primary level, and aims at laying the foundations for lifelong learning and human development. This ratio is therefore a measure of participation in education and should be correlated with the availability of skilled labour.	*Ibid.*

Macroeconomic policies		
Trade openness	Sum of exports and imports divided by GDP. A measure of trade liberalisation. Islam and Montenegro (2002) have shown that openness is positively associated with institutional quality : (1) international pressures and influences work to improve institutional quality; (2) openness tends to reduce rent-seeking and corruption behaviours due to higher competition; (3) better institutions are sought to manage the risk that comes from trading with unknown partners.	*Ibid.*
Export growth	Indicator of dynamic international competitiveness. For Berthélemy and Démurger (2000, pp. 149), "promotion of exports is likely to improve factor productivity through exploitation of economies of scale and improved use of production capacity".	*Ibid.*
Black market premium for foreign exchange	Parallel exchange rate/official exchange rate-1)*100. Indicator of the level of distortions in the economy, macroeconomic imbalances and corruption as exchange controls provide opportunities for corruption (Van Rijckeghem and Wedern 1997; Rodriguez and Rodrik, 1999). For Singapore, it has been assumed that the black market premium is null.	Compiled by the Global Development Network Growth Database (2002): *http://www.worldbank.org/research/growth/GDNdata.htm*
Total debt service	Debt service on long-term debt, short-term debt and repayments to the IMF as a percentage of exports of goods and services. Indicator of macroeconomic mismanagement and potential risk of capital flow restrictions.	World Development Indicators (2000) CD-ROM.

Socio-political instability		
Assassinations	The number of politically motivated murders or attempted murders of high government officials or politicians.	Arthur S. Banks Cross National Time-Series Data Archive (1999). Compiled by the Global Development Network Growth Database (2002).
General strikes	The number of strike of 1,000 or more industrial or service workers that involve more than one employer and that are aimed at national government policies or authority.	*Ibid.*
Guerrilla warfare	The number of armed activities, acts of sabotage, or bombings carried out by independent bands of citizens or irregular forces and aimed at the overthrow of the present regime.	*Ibid.*
Major government crises	The number of rapidly developing situations that threaten to bring the downfall of the present regime - excluding situations of revolt aimed at such overthrow.	*Ibid.*
Revolutions	The number of illegal or forced changes in the top governmental elite, any attempts at such change, or successful or unsuccessful armed rebellions whose aim is independence from the central government.	*Ibid.*
Civil war	An armed conflict is classified as a civil war if it satisfies the following criteria: (a) the war has caused more than one thousand battle deaths; (b) the war represented a challenge to the sovereignty of an internationally recognised State; (c) the war occurred within the recognised boundary of that State; (d) the war involved the State as one of the principal combatants; (e) the rebels were able to mount an organised military opposition to the State and to inflict significant casualties on the State.	Sambanis (2000): *http://econ.worldbank.org/files/13218_PartitionData.zip*

Table 1.3

Indicators of public governance dimensions for a pooled SEA and SSA sample

Index	Freedom		Public Goods	
Period	1976-85	1986-95	1976-85	1986-95
Country				
Benin	0.73	4.90	1.26	1.47
Botswana	9.42	**10.00**	2.41	3.26
Burundi	0.66	1.21	0.50	0.32
Cameroon	1.59	2.26	1.49	2.16
Central Africa	0.00	1.99	0.86	0.91
Chad	0.54	0.52	0.22	0.68
China	1.55	0.99	4.18	4.61
Congo	0.69	3.26	3.69	3.05
Côte d'Ivoire	1.84	2.07	1.39	1.57
Gabon	1.38	2.97	2.14	2.90
Gambia	6.97	6.37	0.43	1.55
Ghana	2.66	2.23	2.59	2.92
Indonesia	2.45	2.23	2.40	3.71
Kenya	2.89	2.45	1.95	2.30
Madagascar	1.92	4.70	1.93	1.65
Malawi	1.03	2.40	0.37	0.57
Malaysia	7.75	6.98	4.64	6.11
Mali	0.00	3.71	0.33	0.52
Mauritania	1.13	1.11	0.86	1.41
Mauritius	8.53	9.40	4.41	5.50
Niger	0.75	3.26	0.16	0.49
Nigeria	4.79	2.11	1.31	1.77
Philippines	2.99	8.13	4.37	5.19
Rwanda	1.32	1.48	0.49	0.11
Senegal	4.12	4.45	0.79	1.38
Sierra Leone	2.60	1.40	0.00	0.13
Singapore	3.58	4.15	7.56	9.99
South Korea	2.77	7.76	6.36	**10.00**
Thailand	5.88	7.75	3.20	4.14
Togo	0.90	2.25	1.74	1.68
Uganda	2.32	2.29	0.82	0.85
Zambia	2.36	4.29	1.45	1.58
Zimbabwe	4.68	3.11	2.05	3.15
SSA	2.53	3.32	1.37	1.69
SEA	3.85	5.43	4.67	6.25

Macroeconomic Policies		Socio-political instability		Global index of Public Governance		
1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	Variation
5.17	4.30	0.00	0.56	7.16	10.11	41.20
6.64	5.59	0.00	0.00	18.47	18.85	2.06
3.88	2.89	0.17	2.83	4.87	1.59	-67.26
5.49	3.17	0.17	0.56	8.40	7.03	-16.26
4.48	4.83	1.58	0.37	3.76	7.36	96.07
5.17	4.96	4.46	5.17	1.47	0.99	-32.83
4.80	4.70	0.76	0.58	9.77	9.72	-0.56
5.16	3.74	0.76	0.50	8.78	9.55	8.71
3.90	3.25	0.00	0.37	7.13	6.52	-8.49
4.83	5.16	0.00	0.22	8.35	10.81	29.48
5.34	4.81	0.47	0.00	12.27	12.73	3.72
0.00	3.36	1.03	0.00	4.22	8.51	101.59
3.76	3.53	2.02	1.75	6.59	7.72	17.28
3.55	3.43	0.76	1.34	7.63	6.84	-10.39
2.97	3.09	0.17	1.77	6.65	7.67	15.36
3.51	3.27	0.00	0.00	4.91	6.24	27.09
5.49	6.43	1.61	1.16	16.27	18.36	12.82
5.10	4.56	0.52	1.44	4.91	7.35	49.80
4.53	3.51	1.55	0.00	4.97	6.03	21.23
5.28	5.96	0.16	0.37	18.06	20.49	13.45
3.35	3.36	0.35	0.63	3.91	6.48	65.68
3.63	3.86	2.10	1.77	7.63	5.97	-21.81
3.59	4.26	5.90	**10.00**	5.05	7.58	50.18
5.42	2.90	0.17	2.52	7.06	1.97	-72.11
4.45	4.03	0.00	0.00	9.36	9.86	5.34
2.35	4.21	0.31	1.46	4.64	4.28	-7.64
8.73	**10.00**	0.00	0.00	**19.87**	**24.14**	21.49
5.06	5.30	0.99	0.37	13.20	22.69	71.94
4.53	5.52	5.95	2.11	7.66	15.30	99.75
5.10	4.53	0.00	1.99	7.74	6.47	-16.44
1.82	1.38	4.23	2.62	0.73	1.90	159.67
3.11	1.81	0.17	0.22	6.75	7.46	10.62
4.02	3.82	4.76	0.00	5.99	10.08	68.35
4.16	3.84	0.92	1.03	7.15	7.81	9.33
5.14	5.68	2.46	2.28	11.20	15.07	34.58

policies, provision of public goods, political, civil and economic freedom. However, this region has also undergone higher socio-political instability, which has frequently been a prelude to democratic reforms. Conversely, political stability in Sub-Saharan Africa should be viewed by and large through the joint prisms of repression and immobility (Goldsmith, 1998).

While SEA countries are well-ranked, some SSA nations, such as Botswana, Mauritius and to a lesser extent Gambia or Benin, follow them closely. Moreover, SEA region hosts some « lame ducks », such as Indonesia or Philippines, which have not done much better, in terms of public governance, than the average African country.

Although no generalisation should be made without caution, globally, the public governance conditions of these two regions are opposite. This paper will now attempt to determine whether they have an influence on foreign direct investment flows and how well public governance explains the diverging attractiveness of SEA and SSA.

3. Econometric study on the impact of public governance on foreign direct investment in Sub-Saharan Africa and South-East Asia

It has been shown that, in theory, diverging governance conditions should explain why SEA has attracted much more FDI than SSA. For the sample used in this study, the difference in the weighted average share of FDI in GDP between SEA and SSA is 1.68%, over the 1976-1995 period (table 1.4 [7]).

7. Weighted averages, according to the share of the host country in regional output.

Table 1.4

Differences in the quality of the public governance between SEA and SSA

Index	*Freedom*		*Macroeconomic policies*		*Public goods*		*Socio-Political Instability*		*Global index of governance*			*Average share of FDI in GDP*		
Period	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	1976-85	1986-95	Variation(%)	1976-85	1986-95	Average
Zone														
SSA	3	3.08	3.89	3.69	1.53	1.99	1.16	1	7.26	7.77	7.02	0.98	0.67	0.825
SEA	2.97	4.47	4.82	5.11	4.65	6.33	1.95	1.28	10.49	14.63	39.57	1.76	3.25	2.505
Average differences between SSA and SEA	0.68		1.175		3.73		0.535		5.045			1.68		

Numerous studies have demonstrated that each dimension of public governance has a positive impact on FDI (table 1.5). In order to test whether the public indicators constructed in this paper help to explain the diverging abilities of SEA and SSA in terms of attracting FDI, a panel data model is used. The sample includes 33 countries in all - 26 SSA countries and 7 SEA countries (table 1.3). Two periods are observed: 1976-1985 and 1986-1995. As is standard in the literature, the dependent variable is the ratio of net FDI flows to GDP (Asiedu, 2002). The explanatory variables are the governance indicators, given in table 1.2 No other independent variables are included as the governance measures should proxy for most of the determinants of FDI found significant in previous works (Wheeler and Mody, 1992; Singh and Jun, 1995; Chunlai, 1997). Nor is the output growth rate taken directly into account, since numerous studies have shown a clear link between economic growth and good public governance (Aaron, 1999 ; Dethier, 1999).

Concerning the estimated specification, the Breuch-Pagan lagrangian multiplier test suggests that the random effect model is more appropriate that a pooled model. Moreover, the Hausman test indicates that the former should be preferred to the fixed effects model. Accordingly, the equation to be estimated is :

$$(\text{FDI/GDP})^{i}_{t} = \alpha^{i} + \beta(\text{Public Governance Indicator})^{i}_{t} + \varepsilon^{i}_{t}.$$

As illustrated by regression (1), the global public governance index is a strong determinant of FDI (table 1.6). This positive link appears to be driven by the macroeconomic policies index and the public goods index [(3,4,6,7)] ; other indicators are not significant [(2,5,6)]. These results are in line with other studies such as Wheeler and Mody (1992), Singh and Jun (1995), Chunlai (1997), Lehmann (1999), Asiedu (2001) or Carr *et al.* (2002) [7]. Thus, international investors, when they make their location decisions, seem to favour countries with (a) sustainable and outward-oriented market policies, and (b) a high provision of public goods. These factors of attractiveness have certainly mattered for different reasons in SSA and SEA. In Africa, during this period, most FDI inflows were resource-seeking and therefore raw materials had to be easily and cheaply exported; a high-quality infrastructure and an open trade

7. These results are robust to the inclusion of a dummy for exporters of natural resources (50 % or more of total exports).

Table 1.5

A selected survey of the impact of public governance on FDI

Impact of public governance on FDI	Impact	Authors
Freedom and political stability		
Social unrest and political uncertainty	-	Frey and Schneider (1985), Singh and Jun (1995), Lehmann (1999).
Democracy	+	Harms and Ursprung (2001) and Busse (2003).
Public goods		
Human capital and physical infrastructure	+	Wheeler and Mody (1992), Carr *et al*. (2002)
Bureaucratic corruption	-	Wei (2000), Wei and Wu (2001), Aizemann and Spiegel (2002),
Administrative procedures	-	Morriset and Neso (2002)
Macroeconomic policies		
Inflation, overvalued currency	-	Schneider and Frey (1985), Ahn *et al*. (1998)
Stable nominal/real exchange rate	+	Bénassy-Quéré *et al*. (1999), Aizenmann and Marion (2001).
Trade openness	+	Singh and Jun (1995), Chunlai (1997), Gastanaga *et al.* (1998), Lehmann (1999).
Property rights and contract enforcement		
Rule of law	+	Singh and Jun (1995), Lehmann (1999), Li and Resnick (2001) or Carr *et al.* (2002)
Intellectual property rights	+	Maskus (1998)
Corporate governance		
High governance standards	+	Survey of McKinsey (2002)

policy diminish transport costs. In Asia, FDI were more concentrated in the manufacturing sector. Owing to their openness, the low cost of a relatively skilled labour force and their proximity with Japan, these countries have indeed played an active part in the vertical integration of multinational enterprises [9].

On the other hand, the freedom index and the socio-political instability index are not significant. In SSA, it is likely that the return to investment was high enough to compensate for the lack of freedom and the political risk (Asiedu, 2002). Moreover, as argued by Busse (2003), « the firms in the extractive industries depended to a large extent on good relations with the government of the host country. To secure their investment and (later on) profits, the MNEs had to protect and keep access to the natural resource. In a similar fashion, host country governments depended in some cases on the flow of foreign exchange from the MNE investment in their country. Since both sides thus had an interest in physically protecting the investment, connections between MNEs and the host government could have been expected to be close and the MNEs might have supported repressive regimes ». In SEA, although authoritarian regimes were common at the end of the seventies, political leaders used as legitimising devices, « a commitment to sharing growth and the development of secure political foundation for granting economic rights to economic agents in the private sector » (Park, 2001, p.10). Furthermore, it is likely that multinational companies have viewed the political instability that has preceded the advent of democracy in certain SEA countries as temporary and not threatening for their investment.

9. In 1988, 52% of FDI stock in Africa was in the primary sector and 21% in the manufacturing sector. In Asia, the percentages were 14% and 43%, respectively (UNCTAD, 2001).

Based on regression (7) and table 1.4, it is possible to calculate the impact of diverging public governance conditions on the difference between FDI's average shares of GDP in SEA and SSA, over the 1976-1995 period (table 1.7). Thus, the quality of public governance accounts for 90% of this difference !

Table 1.6
Public Governance as a determinant of FDI in SEA and SSA

	Dependent variable: share of FDI into GDP in SEA and SSA						
Explanatory variables/Rregressions	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	-.39 (.42)	.90** (.41)	.15 (.35)	-2.11*** (.57)	1.32*** (.33)	-1.83*** (.62)	-1.98*** (.56)
Global Index	.18*** (.04)						
Freedom Index		.08 (.09)				-.04 (.08)	
Public Goods Index			.44*** (.10)			.24** (0.11)	.21** (0.10)
Macroeconomic Policies Index				.77*** (.12)		.61*** (0.14)	.62*** (0.14)
Socio-political Instability Index					-.11 (.12)	-.03 (0.10)	
R?	0.32	0.05	0.28	0.45	0.01	0.49	0.49
Number of Observations	66	66	66	66	66	66	66
Number of countries	33	33	33	33	33	33	33
Hausman test (>chi2)	0.31	0.13	0.78	0.13	0.94	0.85	0.58

Standard deviations are in parenthesis and ***, **, and * denote significance at 0.01, 0.05 and 0.10 levels, respectively.

Table 1.7
Public governance as an explanation of the difference in FDI share between SEA and SSA

	Public Goods Index	*Macroeoconomic Policies Index*
Average differences between SEA and SSA	3.73	1.175
Coefficients given by (7)	.21	.62
Impact on average share of FDI/GDP	0.78	0.73
% of the difference in average FDI shares between SEA and SSA	Predicted difference by diverging governance conditions/ Real difference in average FDI share = (0.78+0.73) /1.68= **90%**	

4.Conclusion

By comparing Sub-Saharan African and South-East Asian host countries, this paper has demonstrated that public governance is a strong determinant of FDI inflows. First, various public governance indicators have been constructed which show that overall, SEA countries possess much better institutions that SSA countries. Second, it has been econometrically shown that FDI flows to countries that carry out sustainable and outward-oriented macroeconomic policies and deliver a high provision of public goods, such as a reliable physical infrastructure. The estimation results suggest that diverging public governance conditions account for 90% of the difference between FDI's average shares of GDP in SEA and SSA, over the 1976-1995 period.

The constructed indicators have been quite useful for several reasons. First of all, they offer a new analytical way of gathering and summarising usual and new determinants of foreign direct investment in the five dimensions of public governance. Next, they have been based on relatively quantitative and objective data, making them easily replicable. Finally, they are specific to the sample used, thereby allowing detailed comparisons between SSA and SEA countries. They are a huge improvement on country-risk commercial indicators, which tend to be too subjective, unclear from a methodological point of view, do not rate all countries and give broad scores which are not always sufficiently dispersed to distinguish the business climate of two different countries.

To sum up, this paper suggests that countries wishing to attract these capital flows and benefit from their alleged positive effects in terms of productivity and growth [10], must earmark a larger share of their resources to strengthening their institutions.

10. Surveys on the impact of FDI on the host country economy can be found for instance in Hanson (2000) or Lipsey (2002). On the basis of case studies, Moran (1998) also suggests that the magnitude of the spillovers depends on the host investment climate.

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