UAEU College of Business and Economics

Faculty Research in Practice

Institutional Groupings and FDI Flows in MENA Countries

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Abstract

This research examines the influence of institutional groupings on FDI flows to 17 MENA region countries. Principal component analysis (PCA) is used to extract institutional components from ICRG's political risk indicators for the period 1984-2011. Institutions are clustered into three groups: stability and order, quality of public administration, and the presence of democratic system. Feasible generalized least squares (FGLS) estimates show that stability and order has a positive influence, while the quality of public administration has a surprisingly negative influence. The presence of a democratic system has a positive but statistically insignificant influence.

The influence of institutions on capital flows has been examined in the extant literature. A number of studies have examined the role of institutions and risk in attracting capital flows. For example, Papaioannou (2009) examines the role of institutions in driving capital flows and finds that imperfect legal and judicial institutions deter banking flows, while Daude and Fratzscher (2008) find earlier that the quality of institutions matters most for portfolio investment and least for FDI.

In the capital flows literature, institutions were treated individually, and ignored the

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correlation between institutions and their possible groupings into broad institutional functions. This research uses principal component analysis (PCA) to extract institutional groupings for 17 Middle East and North Africa (MENA) countries using ICRG's political risk indicators for the period 1984-2011. MENA countries include Algeria, Bahrain, Egypt, Iran, Iraq, Jordan, Kuwait, Lebanon, Libya, Morocco, Oman, Qatar, Saudi Arabia, Syria, Tunisia, UAE, and Yemen.

Institutions, as measured by ICRG political risk indicators, include bureaucracy quality, corruption, democratic accountability, ethnic tensions, external conflicts, government stability, internal conflicts, investment profile, law and order, military in politics, and religion in politics. Bureaucracy quality assesses the strength to govern without severe changes in policy and/or interruptions in the provision of public services. Corruption assesses the degree of corruption within the political system. Democratic accountability measures the responsiveness of government to its people. Ethnic tensions measure the degree of racial, national, and linguistic tensions. External conflict measures the risks of wars and cross-border conflicts. Government stability measures the government power to undertake its announced economic and political programs and remain in office. Internal conflict measures political violence. Investment profile assesses investment risk factors, such as the extent of contract expropriation and the degree to which investors repatriate earned profit. Law and order measures the degree of strength, independence, and unbiasedness of the legal system and people's observance of law. Military in politics assesses the degree of interference and involvement of the military establishment in politics. Religion in politics measures the domination of a single religious group and its intent, attempts and/or success to replace civil laws by religious law and exclude other religions from the social and/or political process. A high score on each of these indicators reflects a better performance.

The results of PCA show institutions clustering into three groups: stability and order, quality of public administration, and the presence of democratic system. PCA reports the clustering of internal conflict, government stability, ethnic tensions, law and order, external conflicts, investment profile and religion in politics into one group. Corruption, bureaucracy quality, and military in politics cluster into a second group. Democratic accountability cluster into a third group. We then use these groupings to explain aggregate FDI flows to the region.

To explain FDI flows we use Dunning's (1981) location advantage hypothesis. According to this hypothesis the multinational firm is attracted to the host country by the available location advantages, such as large domestic or regional market size and potential, developed infrastructure, openness to trade and capital flows, developed financial markets, and friendly business environment. To this list of variables, we add institutional groupings, which is the focus of this research.

FGLS estimation results show that stability and order has a positive though statistically significant influence on FDI flows. As mentioned above, this group comprise internal conflict, government stability, ethnic tensions, law and order, external conflicts, investment profile and religion in politics.

The quality of public administration, which includes corruption, bureaucracy quality and military in politics, exerts a statistically significant, negative influence on FDI flows. Although this negative result seems surprising, a similar result was obtained by Helmy (2013) in examining the relation between corruption and FDI in the MENA region. This negative relationship sheds light on the perception about the association between the greasing/greased hand and FDI flows. The democratic system group shows a positive but statistically insignificant influence on FDI flows.

Clustering institutions into groups building on the correlation between them can be particularly useful in institutional reforms. Rather than reforming individual institutions MENA governments can embark on reforms of institutional group together. We address this issue in a separate research.

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