Bangladesh Journal of MIS
2024, Vol.10, No.02
https://doi.org/10.61606/BJMIS.V10N2.A8
ISSN:2073-9737 (Print), 2410-7077 (Online)
OPEN ACCESS

Institutional Quality and Foreign Direct Investment in Bangladesh: An Empirical Analysis

Aditi Shams[1]
Ashis Talukder[2]

ABSTRACT

The purpose of this paper is to examine the institutional quality and foreign direct investment inflow of Bangladesh. This study focuses particularly on the legal and political institutions to examine the relationship between legal governance, political stability, and voice and accountability in relation to FDI inflow in Bangladesh over the period from 1996 to 2023. The OLS regression is employed for analysing the impact of institutional quality and FDI inflow. Firstly, Principal Component Analysis (PCA) is employed to tackle the dimensionality of institutional quality indicators. Secondly, two principal components, indicating legal institutions and control, and political institutions, are employed to analyse the relationship between different dimensions of institutional quality and FDI. Consistent with institutional theory and transaction cost theory of FDI, the findings suggest that legal governance has a strong positive impact on FDI inflows in Bangladesh. Stronger rule of law and control of corruption attract higher FDI inflows. Interestingly, political stability showed a significant negative correlation with FDI inflow over the study period. This indicates that political stability not accompanied by stronger institutional governance may negatively impact inward FDI. The results highlight the critical role of different dimensions of institutional quality in attracting FDI inflows in an emerging country context. Policymakers should focus on strengthening governance structures, particularly in the areas of corruption control and rule of law enforcement, to foster FDI inflows in emerging countries like Bangladesh. Bangladesh.

KEYWORDS: FDI Inflow, Institutional Quality, Developing Countries, Government of Bangladesh.

[1] Department of International Business, University of Dhaka, Dhaka- 1000, Bangladesh. Email: aditishams@du.ac.bd
[2] Department of Management Information Systems (MIS), University of Dhaka, Dhaka-1000, Bangladesh. (CORRESPONDING AUTHOR) ashis@du.ac.bd

ARTICLE HISTORY: *Received:* **31 Dec 2024;** *Revised:* **18 Jun 2025;** *Accepted:* **20 Jun 2025;** *Published:* **30 June 2025**

1. Introduction

> *"FDI brings investment, jobs, increased exports, supply chain spillovers, new technologies and business practices to countries."* — World Bank Group, Global Investment Competitiveness Report 2017/2018.

Foreign Direct Investment (FDI) is recognized as a critical driver of economic development in emerging countries. FDI brings capital inflows, accelerates economic growth, creates jobs in the domestic market, facilitates the transfer of advanced technology, innovation, and expertise, and provides access to the international market. It also supports the host government in building national infrastructure conducive to attracting and sustaining FDI. Chakrabarti (2001) attributed FDI as a viable alternative source of capital market for developing countries.

According to the UN Trade and Development (UNCTAD), the global FDI inflow reached the highest peak of $ 1.76 trillion in the year 2015 (Figure 1). The FDI trend from 1990 to 2021 exhibits that FDI inflows have not observed stable growth. Major global shocks have a significant impact on cross-border FDI flows. Figure 1 illustrates that the global financial crises in 2002 and 2008 have shaken investors' confidence and disrupted the upward trend in FDI. The COVID-19 pandemic, followed by economic disruption, has been the most significant hit, and the world's FDI inflows fell by 42% in 2020. FDI trends in the developed economies and developing economies highlight that the vulnerability in the world economies affects both developing and developed economies but not in the same magnitude. FDI trends following the pandemic reveal a more resilient picture of developing economies as FDI inflow destinations compared to developed economies.

In an effort to find the causes of these unsteady FDI, existing literature has emphasized the association between institutional environment and FDI (Bevan, Estrin, & Meyer, 2004; Buchanan et al., 2012; Peres, Ameer, and Xu, 2018). North (1990) defines institutions as a set of formal and informal rules and regulations that shape economic activities. Broadly defined, institutions include rules of law, regulatory framework, property rights protection, political stability, and the quality of governance. North (1990) emphasizes the significance of the institutional environment in promoting investment and economic development within a country. Bevan, Estrin, and Meyer (2004) emphasize that investors are increasingly considering institutional quality when determining in which country to invest. Peres et al. (2018) document that institutional quality and governance significantly affect FDI. Poor institutions cause increased uncertainty and deter FDI, whereas strong institutions attract FDI (Ali, Fliess, & MacDonald, 2010; Buchanan et al., 2012). Investors seek institutional environments where contractual obligations are enforced, corruption is minimized, and policy predictability is high. While a considerable body of literature has explored the relationship between institutions and FDI in global or cross-country contexts, less attention has been given to country-specific analyses, especially in the context of developing nations with complex institutional landscapes.

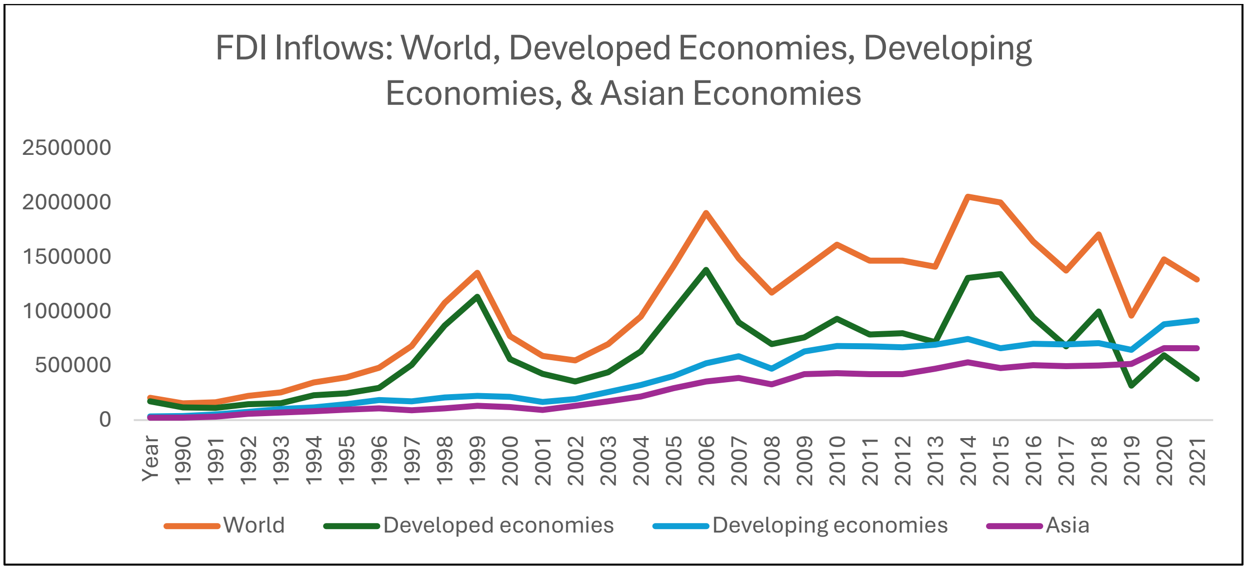

Figure 1: FDI Inflows: World, Developed Economies, Developing Economies, & Asian Economies. Source: UN Trade and Development

Bangladesh, as one of South Asia's fastest-growing economies, presents a compelling case for such an investigation. According to Statistica Bangladesh's GDP growth rate was 7.88% in 2019, one of the highest among the South-Asian nations. Over 65% of the population is under 35, making Bangladesh a suitable location for young, cost-competitive labor sources ready to be utilized in the manufacturing and service sectors. An expanding middle class, around 22% of the 170 million population, also drives domestic consumption. However, again, the geo-strategic position of Bangladesh, being close to significant markets such as the Asian giants China, India, and ASEAN nations, also interests investors. Additionally, the untapped Bay of Bengal holds significant potential for foreign direct investment. Despite persistent economic growth, a favorable domestic market, low labor costs, geographic position, and untapped resources, Bangladesh has been underperforming in attracting FDI compared to its regional counterparts (Figure 2). This paradox raises important questions about the role of institutional factors in pulling FDI.

Since the 1990s, an extensive body of literature has examined the relationship between institutional determinants and FDI. However, there is a dearth of knowledge on the association of institutional determinants and FDI in Bangladesh. This study aims to fill the gap by allowing in-depth analysis for a more nuanced understanding of how specific institutions – the rule of law, control of corruption, governance, regulatory quality, and political stability impact foreign direct investment inflows.

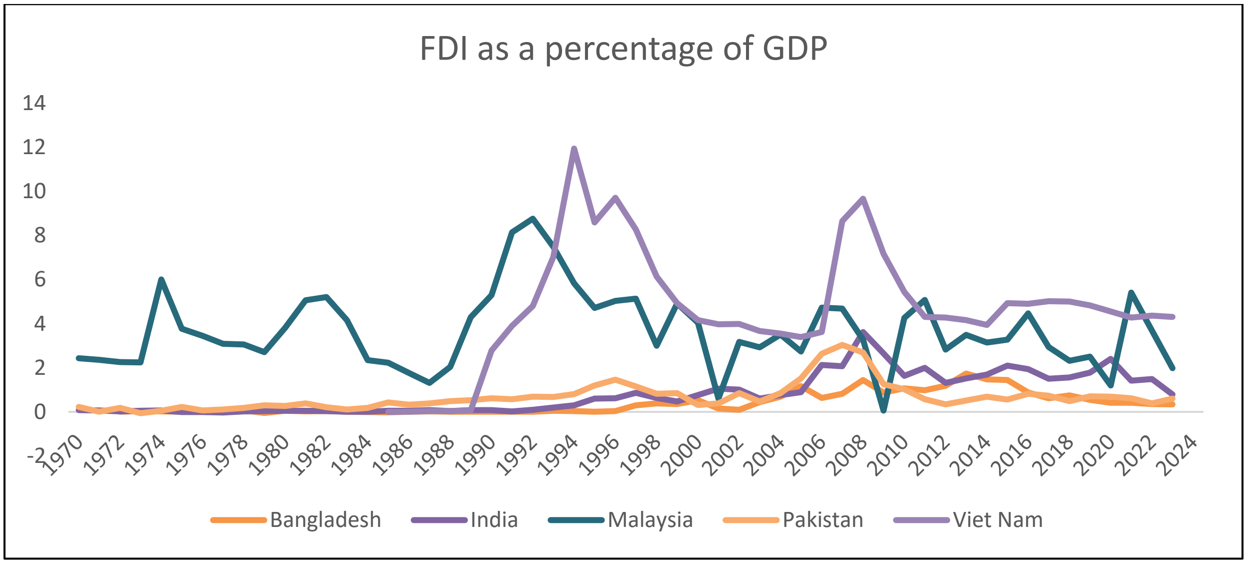

Figure 2: FDI as a % of GDP of selected countries. Source: World Bank (2024)

This study makes a significant contribution to the existing literature in multiple ways. Firstly, current studies have mainly employed cross-country FDI analysis, which often fails to detangle differences in legal systems, cultures, and institutional environments of individual countries. Secondly, current studies on institutional determinants have utilized the World Governance Index (WGI) measures as a means of idiosyncratic weighting of several institutions or categories of institutions (Dang, 2013). Critics of aggregate measures (Dang, 2013; Jellema & Roland, 2009) argue that these are likely to be biased and may not result in a reliable synthetic measure of institutions. Therefore, the findings of this paper are expected to complement the current studies by investigating the relationship between institutions and foreign direct investment within a single-country case context. Historically, in Bangladesh, institutional quality and political stability have not aligned. This study employs Principal Component Analysis (PCA) to group the WGI indicators, measuring institutional strength, political stability, and governance. This methodology enabled us to separately examine the relationships between institutional strength, political stability, and governance, and FDI. This institutional focus of the study offers valuable insights for academics and policymakers seeking to improve the investment climate in Bangladesh.

2. Theoretical Framework and Literature Review

The comparative advantage theory, proposed by Ricardo (1817), asserts that international capital flows or transactions are more likely to occur between countries that offer lower production costs. The general theory of cost-benefit analysis and financial management also asserts that rational investors will invest in countries where the return on investment exceeds the cost of doing business. Transaction cost theory, as proposed by Williamson (1975), and modern property rights theory, as developed by Demsetz (1967), suggest that FDI inflows tend to be higher in countries with better protection of property rights and lower transaction costs. The eclectic theory, proposed by Dunning (1993), notes that international capital flows across countries can be explained by three major components: ownership advantage (O), location factor (L), and internalization (I). However, Ullah (2017) argues that increased globalization, competition, and geopolitical risks have called into question the applicability of ownership advantage (O) and location factor (L). Ullah (2017) asserts that institutional quality must be examined to understand the complex country-specific or region-specific dynamics that attract greater FDI to one nation over others.

The institutional theory posits that formal and informal rules of the game significantly shape economic behavior and organizational outcomes (North, 1990). Broadly defined, institutions encompass the rule of law, protection of property rights, political institutions, regulatory quality, and the quality of governance. According to North (1990), effective institutions enable businesses to reduce transaction costs, as well as manufacturing, operational, and production costs, thereby increasing profitability. Acemoglu et al. (2005) argue that the protection of property rights and the rule of law enhance the allocation of resources, potentially leading to higher economic growth and attracting more investors. In a poorly constructed institutional environment, property rights remain unprotected, contract enforcement becomes challenging, and higher risk premiums result in sluggish economic activity. International investors thus prefer better institutional quality to enhance FDI utilization (North, 1990; Acemoglu et al., 2005). Kobeissi (2005) studied the macroeconomic variables, legal systems, and governance in relation to FDI in 12 Middle East countries for the period 1990-2001 and found that legal systems and governance are positively related to FDI. Rammal & Zurbrügg (2006) studied five ASEAN nations during the period from 1996 to 2002 and found that declining regulatory quality has deteriorated the intra-ASEAN FDI flow. Contractor, Dangol, and Raghunath (2021) examine the association between a country's regulatory quality and FDI in 120 emerging countries over 12 years and find that regulatory quality has a strong influence on the FDI decision. Mirkovikj, Gkasis, and Golitsis (2024) also find that stronger regulatory quality increases FDI even in small economies like North Macedonia. The existing literature suggests that bribes may be treated as an additional cost, increasing the level of uncertainty surrounding the return on investment (Hanousek, Shamsur, Svejnar, & Tresl, 2021; Nguyen, Doan, & Bui, 2021). Jadhav (2012) explores the role of economic, institutional, and political factors in attracting FDI in BRICKS countries for the period from 2000 to 2009 and finds that the rule of law and corruption have a significant impact on inward FDI.

Political governance refers to the rules of the game that determine the institutional characteristics of a political regime (Filippaios, Annan-Diab, Hermidas, & Theodoraki, 2019). Political governance may reflect the quality of public institutions. From an international business (IB) perspective, the political-institutional environment, or political governance, plays a crucial role in MNEs' investment decisions. Ursprung and Harms (2001) examine the relationship between the democratic form of political institutions and FDI inflows in 62 developing and transitional economies, finding that MNEs tend to invest in countries with participatory democratic institutions. Busse and Hefeker (2007) investigated the relationship between political rights and FDI using data from 83 developing countries between 1983 and 2003, and found a positive and statistically significant correlation. They find that government political stability and accountability have a high impact on FDI inflows. Jensen (2003) explores the political condition and FDI inflows in 114 countries and finds that democratic countries attract higher levels of FDI inflows. Busse and Hefeker (2007) examine the relationships between political risks, institutions, and FDI in 83 developing countries from 1984 to 2003, finding that government stability, law and order, and the quality of bureaucracy are significant determinants of FDI flows. Conversely, another set of literature documented that autocratic countries may encourage FDI flow from other autocratic countries (Filippaios et al., 2019). Autocratic countries with FDI-friendly regulations can encourage FDI inflows. Moon (2019) empirically examines 86 authoritarian countries from 1970 to 2008 and finds a positive association between autocratic authority and FDI flows. Autocratic political institutions with a stable legislature increase transparency and act as veto players, thereby enhancing policy stability and reducing transaction costs. This leads to a higher FDI inflow.

3. Methodology

Foreign direct investors tend to prefer investing in countries that have well-established legal and political institutions in place. The present study encompasses two categories of determinants: institutional quality and economic indicators of the FDI flow. Equation (1) represents the baseline FDI model:

$$FDI_t = \propto + \beta_1 IQ_t + \beta_2 EI_t + \mu \quad \ldots \quad (1)$$

Here, FDI_t Stands for FDI inflows expressed as a log of aggregate FDI inflow, IQ is the institutional quality proxied by six indicators- government effectiveness, voice & accountability, rule of law, control of corruption, political stability, and regulatory quality estimated by Kaufmann, Kraay, and Mastruzzi (2010), retrieved from the Worldwide Governance Indicators (WGI), and EI represents the economic controls used extensively by extant literature (Busse & Hefeker, 2007; Mengistu & Adhikary, 2011; Ullah & Khan, 2017; Nguyen, Doan, & Bui, 2021; Raza et al., 2021).

The empirical analysis utilizes six dimensions of governance – voice and accountability (VA), rule of law (RL), control of corruption (CC), political stability (PS), and regulatory quality (RQ)- to measure legal and political institutions (Kaufmann et al., 2010). GE measures the freedom and quality of civil services and governments in formulating and implementing policies. Rammal and Zurbruegg (2006) find that government ineffectiveness in enforcing investment regulations hurts FDI in ASEAN countries. The VA captures the ability of people to participate in selecting their government, along with freedom of expression and freedom of the media. The seminal paper by North and Weingast (1989) proposed that political institutions characterized by checks and balances enable governments to avoid opportunistic behavior toward investors. Salsavage (2002) extended that hypothesis and rigorously tested the relationship between checks and balances and FDI inflows globally. He concluded that higher checks and balances lead to increased private investments globally. Harms and Ursprung (2002) add to the previous findings, finding that democratic political institutions prevailing in the host country attract multinational corporations to invest. Mengistu and Adhikary (2011) also documented that ASEAN countries with higher scores on voice and accountability attract more FDI inflows. RL captures the perception and confidence of agents in the protection of property rights and the enforcement of laws. A higher score represents a stronger rule of law prevailing in society. Buchanan et al. (2012) find that a weak rule of law discourages FDI flows. The PS indicator measures "Political stability and Absence of Violence/Terrorism". It captures the perception of the likelihood and threats of politically-motivated violence. A higher score on PS indicates confidence in the continuity of government institutions (Busse & Hefeker, 2007; Raza et al., 2019; Ullah & Khan, 2017). The CC measures the extent to which public power is exercised for private gain. It encompasses both petty and grand forms of corruption, including the unlawful actions of public servants, bribes, and illegal disbursements to public authorities by influential individuals. The extant literature utilizes the 'control of corruption' measure developed by the WGI to measure corruption (Baklouti & Boujelbene, 2021; Jadhav, 2012; Raza et al., 2019; Ullah & Khan, 2017). The existing literature suggests that bribes may be treated as an additional cost, increasing the level of uncertainty surrounding the return on investment (Hanousek, Shamsur, Svejnar, & Tresl, 2021; Nguyen, Doan, & Bui, 2021). RQ measures the government's ability to formulate sound policies and regulations that promote private investment and economic growth (Kaufmann et al., 2010). The World Bank highlights the importance of sound regulatory quality, which represents transparency and encourages stakeholder participation (Kaufmann et al., 2010). Contractor, Nuruzzaman, Dangol, and Raghunath (2021) examine the association of a country's regulatory quality and FDI in emerging countries and found that regulatory quality strongly influences the FDI decision. Rammal and Zurbrügg (2006) also found that intra-ASEAN FDI flows have deteriorated due to declining regulatory quality. Stronger regulatory quality in the host country decreases transaction costs and promotes FDI flow. Mirkovikj, Gkasis, and Golitsis (2024) also find that stronger regulatory quality increases FDI even in small economies like North Macedonia.

Table 1: Correlation Analysis of Institutional Quality Indicators

Variables	GE	VA	RL	CC	PS	RQ
GE	1					
VA	0.629***	1				
PS	0.716***	0.615	1			
CC	0.372*	0.1370	0.475*	1		
RL	0.012	-0.408*	-0148	0.475*	1	
RQ	0.091	0.059	0.498*	0.388*	0.089	1

Notes: GE, government effectiveness; VA, voice & accountability; RL, regulatory quality; CC, control of corruption; PS, political stability & absence of violence; RQ, regulatory quality. *** Significant at 1 percent level. * Significant at 10 percent level.

This study employs ordinary least squares (OLS) regression analysis for empirical analysis. However, before the use of OLS, this study constructs two indices —governance index and political institutions — by applying the principal component analysis (PCA) method. The unbundling of institutions allows us to examine the different dimensions of institutional quality and FDI inflow. However, again, it addresses the potential multicollinearity among the explanatory variables (Ullah & Khan, 2017). Buchanan et al. (2012) reported that the institutional quality determinants are highly correlated with each other. Table 1 presents the results of the correlation analysis.

Here, PCA enables the transformation of correlated variables into a set of uncorrelated components, known as principal components (PCA). Following the PCA methodology described by Globerman and Shapiro (2002), two principal components are extracted using the eigenvalue method. The components having the least eigenvalues are ignored because they explain a lesser number of variables in the composite index (Ullah & Khan, 2017). In this study, the first two principal components are PC1, named 'legal institutions and control', and PC2, named 'political institutions'—Table 2 and Table 3 present the Eigenvalues and variances, and PCA loadings, respectively.

Table 2: Eigenvalue and Principal Component Analysis

Component	Eigenvalue	% Variance	Cumulative %
Comp1	2.45	0.41	0.41
Comp 2	1.97	0.33	0.74
Comp 3	0.82	0.14	0.88
Comp 4	0.42	0.07	0.95
Comp 5	0.22	0.04	0.99
Comp 6	0.08	0.15	1.00
Note: Two components were retained based on the eigenvalue>1 criterion (Globerman & Shapiro, 2002)			

Therefore, the OLS time series data consists of two dimensions of institutional quality. Equation (2) represents the FDI model used in this paper:

$$FDI_t = \propto + \beta_1 PC1_t + \beta_2 PC2_t + \beta_3 inflation_t + \beta_4 tradeopen_t + \beta_5 growth_t + \mu \quad \ldots \; (2)$$

Here, FDI_t Stands for FDI inflows expressed as a log of aggregate FDI inflows. PC1 is the governance index, which includes 'control of corruption' and 'rule of law'. *PC2* is the composite index representing political stability and regulatory quality. In equation (2), inflation, tradeopen, and growth are control variables. Inflation refers to the country's inflation rate. Trade openness measures how much a country's economy is engaged in international trade. Kyrkilis and Pantelidis (2003) argue that the level of trade openness in the economy has a significant impact on FDI flows. The GDP growth rate serves as a proxy for the economic development of the reported country, as the existing literature suggests a strong association between economic development and FDI (Moon, 2019). The existing literature suggests that rapid GDP growth signals a thriving economy with significant market potential and indicates potential economic stability, which may attract long-term capital flows.

Table 3: Principal Components for Institutional Quality Indicators

Variable	PC1	PC2
Government Effectiveness (GE)	0.56	0.19
Voice & Accountability (VA)	0.54	-0.05
Political Stability (PS)	0.57	-0.06
Regulatory Quality (RQ)	-0.08	0.56
Control of Corruption (CC)	0.19	0.55
Rule of Law (RL)	-0.17	0.59

This study utilizes a time series data set of Bangladesh spanning the period from 1996 to 2023. The log of net FDI inflows is used as the dependent variable, and the data on this variable are taken from the World Development Indicators. The data on institutional quality indicators, RL, CC, PS, and RQ, are retrieved from the Worldwide Governance Indicators database. The following data on GDP growth rate, inflation, and trade openness from previous literature were gathered from the World Development Indicators and the UNCTAD dataset (United Nations Conference on Trade and Development).

4. Results and Discussion

Numerous studies have conducted empirical analyses of the institutional determinants of FDI flows at different periods and in various economic regions (Mengistu & Adhikary, 2011; Buchanan et al., 2012; Busse & Hefeker, 2005; Ullah & Khan, 2017). However, the evidence reports mixed results. Ullah and Khan (2017) argue that the difference in results may be due to the effect of region-specific institutional factors in attracting FDI flows. Therefore, the present study took a single-country context to examine the relationship between different dimensions of institutional quality and FDI inflow in Bangladesh. Table 4 reports the descriptive statistics.

Table 4 presents the descriptive statistics, which report the pattern of variability in FDI inflows (expressed in $ million), governance performance (both legal and political institutional quality), and economic conditions during the study period in Bangladesh. Overall, the FDI inflow, political and legal institutions, and economic performance indicators show wide variance. FDI inflow in Bangladesh shows high volatility, ranging from only 284 million dollars (approx.) in the year 2004 to crossing 3.5 billion dollars in the year 2019 (before the COVID-19 pandemic) (Figure 1). This high level of volatility suggests that FDI flow is sensitive to the changing institutional context of the country over the period.

Table 4: Descriptive Statistics

Variable	Mean	Std. Dev.	Min	Max
FDI Inflow ($ million)	1402.69	1060.85	284.16	3888.99
FDI inflow (Log)	6.95	0.79	5.64	8.26
Government Effectiveness	24.88	3.95	18	37
Voice & Accountability	33.33	6.34	26.57	50
Rule of Law	23.82	5.12	14.43	33.49
Control of Corruption	14.12	7.38	0.53	28.88
Political Stability	13.74	6.62	4.37	33.51
Regulatory Quality	17.93	2.57	12.44	22.75
GDP growth (%)	5.89	1.11	3.45	7.88
Inflation	6.5	2.1	2.01	11.4
Trade Openness	0.34	0.07	0.26	0.48

This study used log-transformed FDI in the model to account for the variance. Government effectiveness score has shown moderate fluctuations over the study period suggesting consistent public service effectiveness. Voice & accountability also show moderate levels of fluctuations signalling poor improvements in public and media freedom. Rule of law score ranges from 23.82 to

33.49 over the 25 years. This represents moderate variation in rule of law quality over the sample period. Control of corruption followed by the political stability indicator shows the highest level of variance. Control of corruption indicators shows significant corruption issues grasping the country. Poor control of corruption may increase the transaction costs of business and deter FDI. Political stability also remains a grey area for Bangladesh. Interesting variations are observed within the 25 years. Bangladesh's political governance characterized by frequent political strikes, unrest, or uprising political tensions between political and opposition parties may have caused these variations over time. Interestingly, the economic growth indicator (GDP growth) shows robust economic performance. Bangladesh's economy grew on an average of 5.89 percent within 1996 to 2023; which depicts huge potential for foreign investors. The trade openness indicator also shows a sufficiently open economy to attract FDI. Despite occasional spikes the inflation indicator also reports stability. In conclusion, the descriptive statistics indicate that a volatile institutional environment is associated with highly sensitive FDI flow in Bangladesh.

Table 5: Correlation matrix

Predictor	FDI (log)	PC1	PC2	Inflation	Trade Openness	GDP Growth
FDI (log)	1					
PC1	-0.405*	1				
PC2	0.681**	-0.0	1			
Inflation	0.177	-0.2	0.309	1		
Trade Openness	0.163	-0.27	0.308	0.431	1	
GDP Growth	0.585**	-0.37	0.365	0.292	0.386*	1
Note: PC1, political institutions; PC2, legal institutions & control, ** Significant at 1 percent level; * Significant at 10 percent level.						

Table 5 reports the correlation matrix estimates of FDI inflow (log-transformed), political institutions (PC1), legal institutions and control (PC2), and economic indicators. This provides key insights regarding the association of FDI inflow and various institutional and economic predictors. Overall, the matrix suggests that institutional quality has a strong influence on the FDI inflow of Bangladesh. PC1 (political institutions) coefficient (-0.405*) suggests a strong statistically significant negative correlation with FDI inflow in Bangladesh. This is counterintuitive to the conventional expectations that stronger political institutions will likely lead to higher FDI inflow (North, 1990). Here the negative relationship between political institutions and FDI inflow must be explained through contextualized country-specific reality. Political institutions of Bangladesh measured through voice & accountability, political stability, and government effectiveness developed by WGI show moderate variability through the sample period. However, this measure does not account for the political unrest, political strikes, and political tensions surrounding the electoral process that characterizes Bangladesh's political environment. Thus, stable political institutions may lead to institutional voids that deter FDI inflow (Khanna & Palepu, 2010). According to the institutional void theory, in weak political institutional settings, such as in Bangladesh, foreign investors might rely on personal ties, networks, and informal facilitators, or develop an informal system that fuels capital flows (Khanna & Palepu, 2010). If political institutions strengthen in the short run these benefits might disappear causing distress in capital flow. Yet again, as Moon (2019) argues, foreign investors might prefer political institutions in an authoritarian setting conventionally defined by less freedom of speech, less freedom of media, or a less participatory governmental system, if they get a favorable business environment and regulations.

Table 6: Regression results predicting FDI inflows

Dependent variable: FDI						
Predictor	**Coefficient**	**SE**	**t**	**p**	**95% CI lower**	**95% CI Upper**
PC1	-0.202**	0.07	-2.83	0.011	-0.35	-0.05
PC2	0.395**	0.07	5.58	0.000	0.24	0.54
Inflation	-0.058	0.05	-1.03	0.315	-0.17	0.05
Trade Openness	-2.64	1.55	-1.70	0.105	-5.91	0.61
GDP Growth	0.188	0.12	1.49	0.154	-0.07	0.45
Constant_	7.21	0.88	8.17	0.000	5.36	9.05
R^2	0.7431					
Adjusted R^2	0.7123					
Root MSE	0.449					
No. of Obs.	25					
Note: PC1, political institutions; PC2, legal institutions & control, ** Significant at 1 percent level; * Significant at 10 percent level.						

The legal institutional indicator (PC2) suggests a significant positive relationship between legal institutions & control and FDI inflow in Bangladesh. This supports the general notion that stronger legal institutions (e.g. rule of law, regulatory quality, and control of corruption) attract foreign investors. Moon (2019) finds that stronger property rights even under authoritarian governmental settings promote foreign direct investment. Contractor et al. (2021) and Rammal & Zurbruegg (2006) also find that stronger regulatory quality and rule of law increase transparency, and enforcement, decrease transaction costs of doing business in foreign countries, and enable FDI inflow. Economic performance indicator (GDP growth) shows a moderately significant association with FDI, which supports the notion that the economic development of the host country creates opportunities for international investors.

Table 6 reports the robust OLS regression estimates of equation (2) explaining the role of legal and political institutions in the FDI inflow of Bangladesh. As mentioned in the methodology section (4.1), we performed a PCA analysis and based on the standard procedure constructed two dimensions of institutional quality- PC1 represents political institutional determinants and PC2, composite index for legal institutional determinants.

Table 7: Variance Inflation Factors (VIF)

Variable	VIF
PC1	1.26
PC2	1.30
Inflation	1.31
Trade Openness	1.40
Growth Rate	1.42
Mean VIF	1.34

In overall, the regression model reveals a strong fit (R^2) explaining 74.31 percent of the variance in the FDI inflows with an F-statistic of 13.27 (significant). The adjusted R^2 is 0.71, indicating that the model explains 71 percent of the variation in net FDI inflows. Robust standard errors are used to account for potential heteroscedasticity. Table 7 shows clearly that the model is not affected by multicollinearity, as indicated by Variance Inflation Factors (VIF) less close to 1. It is clear from Table 6 that political institutions and legal institutions are major determinants of FDI inflow in Bangladesh.

Table 6 regression results show that political institutions (PC1) have a statistically significant relationship with the FDI of Bangladesh. Holding other factors constant, a 1 unit increase in political institutions score is associated with a 0.20 percentage point decrease in FDI inflows. The negative relationship between political institutions and FDI inflow implies that stronger political governance does not attract foreign direct investment in the weak institutional environment of Bangladesh. Generally, political institutions measured through political stability, government effectiveness, and voice & accountability will imply that an increase in the political governance score denotes stronger participatory government settings that increase international capital flow (Mengistu & Adhikary, 2011). However, counterintuitively, our result suggests that less participatory governance characterized by less freedom of speech and freedom of media, attracts FDI in emerging markets like Bangladesh. This result supports the empirical evidence of Jadhav (2012) on the relationship of voice and accountability in BRICS countries. Jadhav (2012) also found that voice and accountability has significant negative association with inward FDI in BRICKS countries. Institutional void theory suggests that in weak institutional settings, foreign investors may establish informal links, systems, networks, and lobbying groups that may facilitate foreign capital flow in the short run (Khanna & Palepu, 2010). Again, an increase in political risks increases the perceived risk premium which may attract foreign investors. Bangladesh's political settings have been marked by frequent volatility, weak accountability, hartals, strikes, and political unrest in the mask of democracy. Investors might feel discouraged from investing in weak political institutions unless the institutional checks and balances are strong (North & Weingast, 1989). India can be another example of the world's largest democracy with regular elections and political stability, nonetheless underperforming in FDI inflows relative to the potential.

Concerning the impact of legal institutions and control on FDI inflow the regression coefficient corresponding to legal institutions and control (β = +395) suggests a statistically significant positive relationship between legal institutions and FDI inflow in Bangladesh. A 1-unit increase in legal institutions and control leads to a 0.395 increase in FDI inflow. The positive relationship between legal institutions and FDI inflow implies that the higher the rule of law, regulatory quality, and control of corruption mechanism in place, the higher the FDI inflow. Several empirical studies have found a positive relationship between legal institutions and FDI (Gloderman & Shapiro, 2002; Mengistu & Adhikary, 2011; Ullah & Khan, 2017). Globerman and Shapiro (2002) found that the rule of law and control of corruption are critical determinants of FDI. Mengistu and Adhikary (2011) found that FDI is sensitive to the rule of law and control of corruption. They find evidence from fifteen Asian countries that a higher rule of law indicates a higher quality of contract enforcement as well as an impartial and transparent legal system that encourages FDI. Habib and Zurawicki (2002) examine the impact of corruption on FDI and provide evidence that foreign investors avoid investment in countries with high corruption. This aligns with the institutional theory that stronger legal institutions along with effective control of corruption increase investors' confidence in the protection of property rights, the ability of regulators to enact rules and regulations, contract enforcement, reduce transaction costs, and increase predictability of return, which leads to increased international capital flow (North, 1990; Habib & Zurawicki, 2002). In the case of Bangladesh, the digitalization of the Bangladesh Investment Development Authority (BIDA), investment-friendly regulations enacted in Export Processing Zones (EPZ) and Special Economic Zones (SEZ) may have contributed to enhanced investors' confidence and positively powered the FDI inflow at times.

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Besides the legal and political institutional indicators, FDI is also affected by market and economic determinants (Mengistu & Adhikery, 2011; Ullah & Khan, 2017). Table 6 reports that economic determinants do not show any statistically significant relationship with FDI. Several studies found a positive association between economic development and FDI (Mengistu & Adhikery, 2011; Ullah & Khan, 2017; Vagadia & Solanki, 2014)). However, this study does not find any statistically significant relationship between economic development and foreign investment. GDP growth here has a positive but statistically insignificant relationship with FDI (β= 0.188, p = 0.154). This suggests that although economic growth encourages foreign investment, it's not a stand-alone determinant of FDI, and institutional determinants explain the FDI variability. Inflation also does not have a statistically significant direct effect on FDI (β= -2.64, p = 0.105). Trade openness captures the degree of trade liberalization of a country. Theoretically, the trade openness of the host country is presumed to stimulate FDI inflow. However, this study does not find a significant relationship between trade openness and FDI. In the context of Bangladesh, structural barriers, port inefficiencies, insufficient roads and logistics, and infrastructural inefficiency can be some of the reasons for this outcome.

5. Conclusion

Foreign direct investment plays a critical role in the economic development of a country. The economic geography of Bangladesh posits huge potential for foreign direct investment in the country. 170 million population, low-cost skilled labor, 37 million middle-income residents with rising purchasing power, postulates a vast domestic market and geo-strategic location conducive for foreign investment. However, since the birth of Bangladesh, foreign direct investment has portrayed high variability. From 300 million dollar FDI inflow to 4 billion in 27 years span unfolds stories of risks and uncertainties.

Existing literature emphasizes the critical role of institutions in explaining the FDI inflow in developed, developing, and emerging countries. However, individual countries have unique institutional settings that have been overlooked in most of the cross-country, cross-regional, and global empirical studies. To address the gap, this study explores the role of legal and political institutions in unveiling the FDI variability in the single-country context of Bangladesh. First, this study used PCA analysis to reduce the dimensionality of institutional variables into two principal components- i) legal institutions and control and ii) political institutions. Next, robust regression analysis is performed to examine the relationship of institutional determinants- both legal and political and FDI inflow from the years 1996 to 2013.

The findings suggest that the institutional determinants explain the FDI variance than economic indicators. Legal institutions and control – rule of law, regulatory quality, and control of corruption emerge as the most robust and positive predictor of FDI inflow. This underscores the importance of transparency of rules and regulations, protection of property rights, and enforcement in promoting foreign investment in emerging markets. While the political governance paper suggests that participatory government increases foreign investors' confidence, reduces transaction costs, and encourages capital investment, our findings suggest that steps towards political stability, and greater voice & accountability may intersect with other institutional environment and deter foreign investment in emerging countries like Bangladesh. In the case of Bangladesh increased political openness increases the vulnerability to political unrest, hartals, and strikes which may discourage foreign investment in the short run. Historical experience of Bangladesh's political regime may disrupt foreign investors and postpone their investment plans.

Overall, findings suggest that the institutional quality of a country is a crucial determinant of FDI inflow. Particularly, legal institutions and political institutions along with stricter control of corruption explain the FDI inflow. This carries interesting theoretical and policy implications for emerging countries like Bangladesh. Our result reaffirms the notion of institutional theory that posits that institutions set the rules of the game. Stronger rules of law, regulatory predictability and enforcement, and anti-corruption measures reduce transaction costs, and uncertainties, and improve FDI. In contrast to the traditional political institutional theory which assumes that greater political openness and public participation increase transparency leading to a conducive investment environment, this study finds that political institutions promoting a participatory governmental system, free speech, and media deters FDI. In the context of the fragile democracy of Bangladesh, political openness creates political tensions and conflicts in the short run which heightens investors' risk perceptions and defers FDI. These results contest the traditional theoretical models and underline the need for contextualized narratives explaining underlying determinants.

To attract FDI inflow in Bangladesh, policymakers may focus on strengthening the rule of law, regulatory quality, and anti-corruption efforts. Property rights protection and transparency through consistent policy application can signal the government's long-term commitment to sustainable

FDI. In addition, policymakers need careful reforms toward democratic practices that translate into institutional safeguards. Reforms in political institutions must prioritize sustainable political stability instead of abrupt disruptions that could deter capital investment. This paper complements the studies on institutional quality and FDI on emerging economies. Though the results indicate important insights into the legal and political institutional features, the Bangladeshi experience may not necessarily imply that institutional quality have the same impact on FDI across region. Moreover, this study only took the legal and political institutional dimensions under considerations. Future research can explore other emerging economies with weak institutional settings to assess the interplay of institutional dynamics.

Funding

This research received no external funding.

Conflicts of Interest

The authors declare no conflict of interest.

Citation

Shams, A., & Talukder, A. (2024). Institutional quality and foreign direct investment in Bangladesh: An empirical analysis. *Bangladesh Journal of MIS, 10*(2), 153–173. https://doi.org/10.61606/BJMIS.V10N2.A8

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