

Which institutional qualities matter for FDI? Evidence from a Resource-Dependent Economy

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ABSTRACT

Foreign direct investment (FDI) responds to institutional environments. The specific governance dimensions that attract foreign capital in resource-dependent developing economies remain debated. This study investigates the heterogeneous relationship between six dimensions of institutional quality and FDI inflows in Zambia from 1996 to 2024. Using an autoregressive distributed lag (ARDL) bounds testing framework with finite-sample adjustments, the analysis evaluates an aggregate institutional index against individual governance indicators. The results indicate that aggregate institutional measures provide limited evidence of a systematic relationship with FDI, whereas disaggregated governance indicators reveal substantial heterogeneity. Bureaucratic dimensions such as government effectiveness and regulatory quality present no statistically supported association with FDI. Conversely, macro-institutional safeguards—specifically the rule of law and voice and accountability—exhibit positive and significant correlations with investment inflows. These patterns are consistent with the enclave FDI hypothesis, which posits that multinational corporations in extractive sectors bypass administrative frictions but remain highly sensitive to expropriation risks and regime instability. Methodologically, the study navigates finite-sample constraints through parsimonious modeling and robust pre-estimation unit-root testing. The findings suggest that policy efforts to attract foreign capital in resource-heavy economies may yield better outcomes by prioritizing property rights and political accountability over incremental administrative reforms.

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1. Introduction

The relationship between institutional quality and foreign direct investment (FDI) represents a principal empirical inquiry in development economics. Institutional frameworks determine the property rights, enforcement mechanisms, and policy predictability that foreign investors face (Agyemang et al., 2017). Existing literature frequently aggregates various governance indicators into a single index. This aggregation assumes all dimensions of governance equally incentivize capital deployment. In resource-dependent economies, the mechanisms through which institutions attract capital often deviate from those in diversified economies. Multinational corporations operating in extractive sectors frequently negotiate direct stability agreements with host governments (Oshionebo, 2018). This practice insulates their operations from local administrative friction while leaving them exposed to macroeconomic instability and expropriation risks.

This study examines the specific institutional dimensions that relate to FDI inflows in Zambia, a copper-dependent developing economy. The central research question asks: Do all institutional dimensions equally attract foreign capital, or do investors selectively respond to specific macro-institutional safeguards?

The study makes a conceptual and methodological contribution to the literature. Conceptually, it challenges the value of aggregate institutional indices in enclave economies. By disaggregating the World Bank's Worldwide Governance Indicators (WGI), the analysis investigates whether administrative micro-institutions—such as regulatory quality and government effectiveness—meaningfully dictate capital inflows. The empirical strategy separates these administrative metrics from macro-institutional safeguards to determine which constructs provide the predictability that foreign capital requires.

Methodologically, the study addresses the mathematical constraints inherent in single-country African time-series data. Where previous research often overparameterizes models, this analysis prioritizes strict parsimony. It applies

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the [Kripfganz and Schneider \(2020\)](#) finite-sample critical values within an autoregressive distributed lag (ARDL) bounds testing framework. Comprehensive pre-estimation unit-root testing justifies the ARDL approach over vector error correction models (VECM), which are inadmissible given the integration properties of the data.

The rest of the paper is structured as follows. Section 2 reviews the theoretical and empirical literature to formulate the hypotheses. Section 3 outlines the data and econometric methodology. Section 4 presents the empirical results. Section 5 discusses the findings and policy implications. Section 6 concludes.

2. Literature Review

2.1. Theoretical Framework

The theoretical foundation of this study integrates institutional economics with international business theory. [North \(1990\)](#) conceptualizes institutions as the rules of the game in a society. These rules directly determine transaction costs and the security of property rights. High transaction costs and uncertain contract enforcement act as deterrents to long-term capital commitments. Foreign investors require predictable environments to calculate expected returns.

In parallel, the Ownership-Location-Internalization (OLI) paradigm suggests that a host country's location advantages extend beyond natural resources or market size ([Dunning, 1998](#)). Location advantages explicitly include the predictability of the host country's political and legal environment. When countries present weak institutional frameworks, foreign capital either demands high risk premiums or seeks alternative destinations.

In resource-dependent developing nations, theoretical adaptations point toward an enclave investment model. Extractive industries are capital-intensive and geographically immobile once established. Foreign firms often secure their investments through bespoke state contracts. These agreements bypass ordinary administrative structures. Under these conditions, general regulatory efficiency holds less relevance to foreign capital than the credible commitment to property rights and political continuity. The enclave model implies that foreign investors evaluate institutional quality selectively rather than uniformly. They require safeguards against expropriation and regime collapse but tolerate inefficiencies in daily bureaucratic processes.

2.2. Empirical Review and Hypotheses Development

A substantial body of empirical work examines the relationship between institutions and FDI. Cross-country panel studies generally observe that better governance, corruption control, and political stability correlate with higher FDI inflows across developing samples ([Sabir et al., 2019](#); [Azam et al., 2025](#); [Khan et al., 2024](#)). [Behera et al. \(2020\)](#) evaluate South Asian emerging economies and suggest a long-run relationship between institutional quality and investment. [Bhujabal et al. \(2024\)](#) similarly suggest that a composite institutional index positively associates with FDI in Asian economies. [Peres et al. \(2018\)](#) observe that institutional quality positively relates to FDI in developed nations but yields statistically insignificant associations in developing nations. The authors attribute this divergence to weak underlying economic structures in emerging markets.

The literature establishes that institutions frequently operate as a threshold condition. Investment gains emerge only after a country surpasses a minimum institutional baseline ([Jude and Leveuge, 2017](#); [Kurul, 2017](#)). [Saha et al. \(2022\)](#) report that regulatory quality increases FDI only when host economies exceed specific per capita income thresholds. Governance quality also moderates the effectiveness of other macroeconomic conditions. For example, strong institutions weaken the adverse effects of economic policy uncertainty on FDI inflows ([Akbakay, 2026](#); [Bommadevara and Sakharkar, 2021](#)). [Chen and Jiang \(2023\)](#) suggest that favorable governance environments support FDI growth by interacting positively with trade openness and financial development.

Despite these aggregate findings, the relevance of specific institutional dimensions varies by context. [Akhtaruzzaman et al. \(2017\)](#) demonstrate that expropriation risk—a proxy for the rule of law and political stability—dominates all other institutional dimensions in explaining FDI to developing countries. They estimate up to a 72 percent increase in investment following a one-standard-deviation improvement in expropriation safeguards. [Daude and Stein \(2007\)](#) and [Busse and Hefeker \(2007\)](#) similarly suggest that democratic accountability and government stability reliably correlate with capital inflows, while administrative indicators yield inconsistent estimates. [Musliu et al. \(2026\)](#) observe insignificant coefficients for general institutional indicators in transition economies, while [Cieřlik and Hamza \(2023\)](#) report that regulatory quality is less relevant than political stability in Gulf economies.

These mixed results indicate that evaluating institutions as a single aggregate construct obscures underlying economic realities. In resource-dependent economies, combining micro-administrative and macro-stability indicators

into a single index theoretically averages out distinct investment signals. Table 1 is a literature review matrix summarising the key empirical evidence considered.

Table 1: Summary of literature on institutional quality and FDI inflows

Study	Methodology	Findings	Implications
Jude and Leveuge (2017)	Theoretical arguments plus a panel smooth regression model on a large sample of developing countries.	FDI has a positive effect on growth only beyond a threshold of institutional quality. Some reforms increase the marginal effect of FDI and institutional complementarities add to growth.	Institutional reforms should precede FDI attraction policies to benefit from FDI-led growth. The study suggests institutional quality conditions whether FDI supports growth.
Nguyen and Nguyen (2025)	Difference GMM Arellano-Bond estimators (one-step and two-step) on 37 advanced economies from 2002–2022, examining fiscal policy, institutional quality, and their interaction on FDI inflows.	Fiscal policy and institutional quality reduce FDI inflows, but their interaction increases them. Market size and trade openness boost FDI, while inflation has a negative effect.	Carefully calibrated fiscal policies and institutional reforms are needed to attract more FDI inflows in advanced economies. The study is limited to 37 advanced economies over 2002–2022.
Peres et al. (2018)	Cross-country study comparing developed and developing countries; institutional quality was measured as the sum of control of corruption and rule of law, with common law and lagged independent variables used as instruments.	Institutional quality positively and significantly affected FDI in developed countries; a one standard deviation change in governance affected FDI by 0.2225. The effect was insignificant in developing countries.	Governance indicators are important for attracting FDI inflows, especially in developed countries. The developing-country null effect is attributed to weak institutional structures.
Akbakay (2026)	Dynamic panel analysis of 37 developing countries (2002–2021) using two-step system GMM; robustness checks used OLS and individual WGI components.	Policy uncertainty significantly reduces FDI inflows, while institutional quality weakens this negative effect. Results were confirmed by OLS and analyses using individual WGI components.	The adverse effect of policy uncertainty on FDI depends on host-country institutional strength; stronger institutions make FDI less vulnerable to uncertainty.
Bommadevara and Sakharkar (2021)	Panel study of 22 economies from 2000 to 2019 examining FDI inflows and their determinants.	Institutional quality strongly increased FDI inflows, while higher economic policy uncertainty reduced FDI inflows. Financial openness, exchange rate stability, and financial development were also important positive factors.	Stronger institutions and improved macroeconomic fundamentals can help moderate policy uncertainty and support FDI inflows.

Table 1 – continued from previous page

Study	Methodology	Findings	Implications
Silajdzic and Mehić (2022)	Empirical study of inward FDI flows in South East Europe using a unique OECD dataset of FDI-related institutional indicators and bilateral FDI flows. Analysis uses gravity modelling to assess the impact of investment policy and promotion variables.	Investment policy efforts appear to pay off: FDI regulation, promotion and facilitation, transparency, privatisation policy, and public-private partnership are associated with higher inward FDI flows in SEE. The analysis finds these policy variables help explain cross-country variation in FDI.	FDI policy and institutional reforms matter for attracting FDI in Southeast Europe, and the effect is time-variant and context-dependent. The study highlights the policy value of improving investment frameworks, with a caveat that the institutional effect varies over time and context.
Adegboye et al. (2020)	Pooled data from 30 sub-Saharan African countries, 2000-2018, analyzed with fixed and random effects regression models.	Foreign capital inflow was crucial for economic development in SSA, and institutional quality affected FDI inflows, contributing to underutilization of domestic resources and abnormal domestic sector investment.	Host governments should improve institutional quality to encourage FDI while strengthening domestic investment to reduce dependence on foreign capital. The study implies FDI benefits development when paired with sufficient domestic investment.
Chen and Jiang (2023)	Panel data analysis of 42 G20 countries from 2005 to 2020, examining mediating and moderating effects.	Institutional quality is positively associated with FDI inflows. The effect operates through trade openness, industrial structure optimization, and technological innovation, and is strengthened by financial development and natural resource abundance but weakened by tax level.	Institutional quality helps attract FDI inflows and supports sustainable FDI growth. Policymakers should use favorable institutions, though the abstract does not report specific limitations.
Kayani and Gan (2022)	Comparative panel study of the United States, China, and Singapore for 2002-2019 using governance indicators and baseline bivariate/multivariate fixed-effects regressions. Robustness checks used Prais-Winsten, Driscoll-Kraay, and two-step system GMM estimation.	Governance and foreign direct investment inflows were directly and significantly related. All six governance indicators showed the same direct and significant relationship.	Better governance is associated with higher inward foreign direct investment, and the findings are robust across alternative estimators. The paper recommends actions for investors at individual and country levels.

Table 1 – continued from previous page

Study	Methodology	Findings	Implications
Raza et al. (2021) Raza et al. (2021)	Quantitative study of 25 Asian economies from 2009 to 2019 using two-step system generalized method of moments estimation.	A corruption-free economic environment stimulates FDI, while state fragility discourages FDI. Control of corruption, state fragility, external intervention, and corruption prevalence were analyzed against FDI.	Good governance supports foreign investment and economic progress, and stable economies should provide expertise and investment support to weaker countries. The study implies bilateral cooperation can strengthen economic structure and development.
Ozekhome (2022)	Annual time-series study of Nigeria from 1970 to 2020 using GMM, with FMOLS and DOLS as robustness checks.	Regulatory quality, government effectiveness, and rule of law significantly matter to FDI inflows in Nigeria. Political stability and exchange rate are positive but not significant; ICT is significant, while inflation and control of corruption are negative.	Stronger regulatory and legal frameworks, better government effectiveness, infrastructure investment, and stable political and macroeconomic environments are recommended to promote FDI in Nigeria.
Paul and Jadhav (2020)	Quantitative study using data from 24 emerging markets, drawing on World Bank, Index of Economic Freedom, and UNCTAD sources.	Infrastructure quality, trade costs, effective rule of law, political stability, regulatory quality, and control of corruption were significant determinants of FDI in emerging markets.	Institutional and infrastructure factors play an important role in attracting inward FDI in emerging markets; the study is presented as the first to analyze sectoral institutional determinants of inward FDI in these economies.
Minović et al. (2021)	Panel techniques using unit root tests and causality analysis on Western Balkan countries from 2002–2017.	Control of corruption, political stability, and rule of law were found to cause inflows of FDI. Bidirectional relationships were found between political stability and rule of law, control of corruption and rule of law, and control of corruption and FDI inflow.	Stronger institutional measures are associated with higher inflows of foreign direct investment. The study supports improving institutional quality to attract FDI.
Bissoon (2012)	Empirical analysis of 45 developing countries in Africa, Latin America, and Asia using governance indicators (corruption control, rule of law, political stability, media freedom) and robustness tests under multiple scenarios.	Institutional quality has an enormous impact on inward FDI, and the institutional indicators are complementary, with their combined effect reinforcing FDI inflows.	Better host-country institutions attract more FDI in developing countries; a key limitation is that the abstract does not report effect sizes or estimation details.

Table 1 – continued from previous page

Study	Methodology	Findings	Implications
Akpa et al. (2026)	Secondary data from 44 sub-Saharan African countries, 2000–2020; analyzed with fixed effects and system GMM for robustness.	Institutional quality moderates the FDI–agricultural export link, and threshold levels are reported for government effectiveness (1.000), political governance (0.200), economic governance (0.375), institutional governance (0.444), and general governance (0.500).	Stronger institutional quality is needed for FDI to improve agricultural exports in SSA, and policies should strengthen institutions while preventing FDI mismanagement.
Azam et al. (2025)	Empirical study of inward FDI in nine ASEAN countries using quarterly data from 2002Q1 to 2022Q4. Parameters were estimated with Robust Least Squares, Fully Modified OLS, and Dynamic OLS.	Institutional quality variables and macroeconomic factors were significant determinants of FDI inflows, with most variables significant at the 1% level. Political stability and rule of law had positive effects, while corruption and government effectiveness had significant negative effects.	Policymakers should strengthen governance, reduce corruption, and improve regulatory frameworks to attract FDI. The study implies institutional reforms are needed to enhance legal certainty and administrative efficiency.
Masron and Naseem (2017)	2SLS regression analysis to examine how institutional quality influences foreign direct investment, using institutional quality ratio and gap measures to address endogeneity.	Institutional quality significantly affects foreign direct investment. The institutional quality ratio is statistically significant, but host-country improvements must exceed competing-country changes to attract FDI.	Institutional quality is a necessary but not sufficient condition for attracting FDI. Host-country institutional improvements must be greater than those of the competing country.
Abille and Mumeni (2023)	Step-wise system-GMM estimation of corporate tax, EDB, and EDB-governance interactions on FDI inflows using data from 2015 to 2019 for 50 African countries.	Corporate tax rate and un-interactive EDB had significant negative effects on FDI inflows in Africa in the short and long run. Governance indicators generally complemented EDB with positive effects, but the findings were not generally significant.	Attracting desired FDI in Africa requires strict institutional quality assurance alongside EDB reforms. A key caveat is that the governance-related positive effects were not generally significant.
Sabir et al. (2019)	Panel data on low-, lower-middle-, upper-middle-, and high-income countries from 1996–2016 analyzed using system GMM.	Institutional quality has a positive impact on FDI inflows in all country groups; coefficients are larger in developed than developing countries. GDP per capita, agriculture value-added, and inflation are negative in developed countries, while GDP per capita, trade openness, agriculture value-added, and infrastructure are positive and significant in developing countries.	Institutional quality is a more important determinant of FDI in developed countries than in developing countries.

Table 1 – continued from previous page

Study	Methodology	Findings	Implications
Murtaza et al. (2026)	Panel data analysis of FDI inflows in 41 countries from 1995 to 2024, using a Hausman specification test and a fixed-effects model with clustered robust standard errors.	GPR and inflation negatively affect FDI inflows; Rule of Law is also negatively associated with FDI. Market openness and population size have positive effects, while GDP has a negative impact.	The study concludes that macroeconomic stability, competitiveness, and pro-investment policies are needed to build investment resilience amid geopolitical uncertainty. It suggests some emerging-economy investors may prioritize cost competitiveness over stronger institutions.
Artikov et al. (2026)	Panel data analysis of 12 South and Central Asian economies from 2002 to 2023 using Driscoll–Kraay standard errors, FGLS, and MMQR; a composite institutional quality index was constructed with principal component analysis.	Trade openness, economic growth, and population consistently stimulated FDI inflows, while inflation discouraged them. Stronger rule of law, regulatory quality, and anti-corruption measures temporarily constrained FDI inflows by raising compliance costs and adjustment burdens.	Institutional strengthening is a double-edged process that can build long-term credibility but reduce short-term FDI inflows in transitional economies. The authors recommend balancing reforms with procedural efficiency and investor-friendly implementation.
Daude and Stein (2007)	Bilateral foreign direct investment (FDI) stocks around the world were analyzed to assess institutional determinants of FDI location. The results were checked across different specifications, estimation methods, and institutional variables.	Better institutions had a positive and economically significant effect on FDI. A one standard deviation improvement in host-country regulatory quality increased FDI by around a factor of 2; unpredictability of laws, excessive regulatory burden, government instability, and lack of commitment deterred FDI.	Institutional quality is an important determinant of FDI location, with regulatory quality and policy predictability especially influential. The findings are reported as robust across specifications and over time.
Khan et al. (2024)	Two-step system GMM panel model using global, developed, developing, and Asian country data from 2002 to 2019.	In the global panel, only regulatory quality significantly increases FDI inflow, while other institutional indicators are negative. Effects differ by subgroup: in developed countries, control of corruption and regulatory quality are negative; in developing countries, some indicators attract FDI while others reduce it; in Asian countries, most indicators are positive except control of corruption.	Institutional quality has significant policy implications for FDI inflows, but its effects vary across country groups. A key limitation is that the findings are specific to the countries and period studied.

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Study	Methodology	Findings	Implications
Bénassy-Quéré et al. (2007)	Cross-section estimations on a newly available institutions database for 52 countries, plus panel data estimations using Fraser Institute data. The analysis controls for GDP per capita, endogeneity of institutions, and origin-host institutional similarity.	Bureaucracy, corruption, information, banking sector, and legal institutions all significantly matter for inward FDI independent of GDP per capita. Weak capital concentration and strong employment protection reduce inward FDI, while institutional proximity between origin and host countries also matters.	Improving institutional quality and converging toward source-country institutions may increase FDI in developing countries beyond the effect of higher GDP per capita. The estimated effects are large, but the origin country's institutions have little impact.
Musliu et al. (2026)	Panel data study of 22 Central and South-Eastern European countries, 2007–2023, using dynamic panel estimators (Arellano-Bond difference GMM and Blundell-Bond system GMM). Institutional quality is measured by six Worldwide Governance Indicators and models include key macroeconomic controls.	Institutional quality indicators are generally not statistically significant, except political stability, which is positively associated with FDI inflows. Population size, trade openness, and the lagged dependent variable are robust determinants; inflation is positive in some specifications.	Market size and economic openness matter more for FDI than institutional improvements in Central and South-Eastern Europe. The authors note measurement limitations and structural rigidities may obscure the impact of institutions.
Cieřlik and Hamza (2023)	Empirical study of inward FDI determinants across GCC countries from 2009 to 2017 using a modified knowledge-capital model of the multinational firm.	Government effectiveness, control of corruption, political stability, and rule of law significantly affected FDI, while regulatory quality was less important. FDI was explained by horizontal market-seeking rather than efficiency-seeking vertical motives, and colonial ties, common language, and contiguity were significant.	Institutional quality matters for inward FDI in GCC economies, with horizontal market-seeking motives dominating. The study is limited to GCC countries over 2009–2017.
Okada (2013)	Dynamic panel analysis using system GMM on an unbalanced panel of 112 countries over 1985–2009, with 5-year averages. The study models FDI and PFI inflows against financial openness, institutional quality, their interaction, and controls.	Financial openness and institutional quality were not significant individually, but their interaction was positive and significant for FDI and PFI. Bureaucratic quality and law and order were especially important for FDI, and instrument-validity tests did not reject the models.	Capital inflows benefit more from financial openness when institutional quality is higher, helping explain the Lucas paradox. The main caveats are the short 5-year panel horizon and reliance on the Chinn-Ito de jure openness measure.

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Study	Methodology	Findings	Implications
Dang et al. (2026)	Balanced panel of 106 countries from 2002–2021 using OLS, FE, IV/2SLS, traditional quantile regression, IVQR, and MM-QR. Institutional quality is measured with WGI (and PCA for robustness), with legal-origin dummies as instruments and climate vulnerability as a moderator.	Institutional quality has positive causal effects on FDI inflows at all quantiles, rising from 0.672 to 1.217 in SIVQR and from 0.983 to 1.137 in MM-QR. The interaction with vulnerability is negative, and robustness checks with PCA and individual governance dimensions give similar results.	Better institutional quality attracts larger, technology-intensive FDI, especially when vulnerability is lower. Main limitations are unmodeled endogeneity of vulnerability, inability to distinguish FDI motives/types, and no explicit dynamic lagged-FDI specification.
Saha et al. (2022)	Panel data from 28 lower-middle income countries across six regions for 2002–2018, estimated with two-step system GMM and threshold analysis. Institutional quality is proxied by six World Governance Indicators, with regional dummies and macroeconomic controls.	Control of corruption and regulatory quality significantly increase FDI inflow, while rule of law and voice and accountability significantly reduce it; government effectiveness and political stability are insignificant. Regulatory quality is positive above GDP per capita 7.197 and voice and accountability above 7.776, with effects strongest in East Asia and Pacific.	Institutional quality matters for FDI in lower-middle income countries, especially corruption control and regulatory quality. The study is limited to 2002–2018 and missing data excluded some low-income countries.
Bhujabal et al. (2024)	Balanced panel of 18 South and Southeast Asian countries, 2002–2019, using a PCA-based institutional quality index from six governance indicators. FE models were selected via specification tests and estimated with iterated GLS to address heteroskedasticity, autocorrelation, and cross-sectional dependence.	Institutional quality has a positive and significant effect on FDI inflows in both regions. GDP growth, trade, financial development, and the interaction of exchange rate with institutional quality are positive, while gross capital formation, inflation, and exchange rate are negative; rule of law and voice/accountability are negative when entered separately.	Better governance and institutional quality help attract FDI and may spill over to growth, trade, and financial development. Key limitations are data availability starting in 2002 and the need to test other factors and newer methods in future work.
Kurul (2017)	Dynamic panel threshold analysis on 126 developing countries over 2002–2012, using a composite institutional quality index built by PCA. Endogeneity is addressed with lagged instruments and GMM estimation.	Institutional quality affects FDI positively only after a threshold of 0.40; below it, the effect is insignificant. Global liquidity, financial development, trade openness, and lagged FDI are positive; global risk, GDP growth, exchange rates, capital openness, and natural rents are insignificant or negative.	FDI responds nonlinearly to institutional quality, with higher-quality institutions attracting more inflows once a threshold is exceeded. The study is limited to developing countries over 2002–2012 and a threshold-panel specification.

Table 1 – continued from previous page

Study	Methodology	Findings	Implications
Buchanan et al. (2012)	Panel data analysis of 164 countries from 1996–2006 examining institutional quality and FDI levels and volatility. Uses OLS, IV, fixed-effects, and random-effects regressions with governance indicators and macroeconomic controls.	Institutional quality has a positive and significant effect on FDI; a one standard deviation increase raises FDI by a factor of 1.69. Governance also has a negative and significant effect on FDI volatility, and the main findings are robust across IV and panel specifications.	Good governance attracts more FDI and reduces its volatility, so institutional reform should accompany macroeconomic policies. A key limitation is that the study ends in 2006 and does not cover the later global financial crisis period.
Busse and Hefeker (2007)	Cross-country and unbalanced panel analysis of 83 developing countries from 1984–2003 using ICRG political risk/institutional indicators and FDI per capita. Estimated with cross-sectional averages, country fixed-effects models, and Arellano-Bond GMM dynamic panel methods.	Cross-section results found government stability, religious tensions, and democracy positively associated with FDI, with only 3 of 12 indicators significant. Fixed-effects and GMM models showed stronger effects: government stability, conflict, law and order, democratic accountability, and bureaucratic quality were consistently positive, and corruption and ethnic tensions became significant in GMM.	Political risk and institutional quality matter for FDI in developing countries, especially in dynamic panel estimates that address autocorrelation and endogeneity.
Behera et al. (2020)	Panel data from emerging South Asian economies, 2002–2016, analyzed with IPS unit root, cross-dependency and cross-sectional augmented IPS tests, panel ARDL-PMG, panel Granger causality, and Pedroni cointegration for robustness.	Institutional quality has a long-run relationship with FDI inflows, and globalization and financial development show long-run strong causality with FDI inflows. Short-run unidirectional causality from institutional quality to FDI inflows is not found for all countries.	Institutional quality increases FDI inflows, especially when paired with globalization or financial development, so policymakers should improve these factors to attract more FDI.
Akhtaruzzaman et al. (2017)	Empirical panel study of 83 developing economies, 1984–2015, using ICRG political risk indices and FDI inflows. The authors estimate fixed-effects and Blundell-Bond system GMM models, with alternative 12-index and 5-composite institutional specifications and a simple two-period theoretical model.	Expropriation risk is the only institutional measure consistently large and statistically significant; a one-unit improvement predicts up to a 32% increase in FDI, and a one-standard-deviation improvement predicts 58–72% higher FDI. Other institutional dimensions are small, inconsistent, or estimator-sensitive.	Expropriation risk dominates other institutional dimensions in explaining FDI to developing countries, and gross FDI is preferred over net FDI.

Drawing on the empirical gaps identified in the table and the enclave FDI theory, the study formulates the following testable hypotheses:

H1: Aggregate institutional quality provides insufficient statistical evidence to explain FDI inflows in a resource-dependent setting.

Multinational corporations in extractive sectors face severe sunk costs. They demand guarantees against expropriation. [Minović et al. \(2021\)](#) and [Ozekhome \(2022\)](#) suggest that the rule of law and political stability consistently correlate with capital allocation. This leads to the second hypothesis:

H2: Macro-institutional safeguards, specifically the rule of law and voice and accountability, correlate positively with FDI inflows.

Enclave investments often bypass standard administrative structures. General bureaucratic efficiency therefore has a minimal relationship with their capital commitments. The final hypothesis tests this mechanism:

H3: Micro-administrative institutions, such as regulatory quality and government effectiveness, exhibit no statistically significant association with FDI inflows.

3. Data and Methodology

3.1. Data Sources and Measurement

The study uses annual data from 1996 to 2024 for Zambia ($N = 29$). The dependent variable is net FDI inflows as a percentage of gross domestic product (GDP), sourced from the World Bank's World Development Indicators (WDI). To handle negative net FDI values smoothly while maintaining a logarithmic interpretation, the data undergoes an inverse hyperbolic sine (IHS) transformation. The independent variables are the six Worldwide Governance Indicators (WGI) developed by [Kaufmann et al. \(2010\)](#): Control of Corruption (CC), Government Effectiveness (GE), Political Stability (PV), Regulatory Quality (RQ), Rule of Law (RL), and Voice and Accountability (VA).

The WGI dataset does not provide observations for every year in the study period. Three isolated annual gaps (1997, 1999, and 2001) exist across the six governance dimensions. Because these missing observations occur within otherwise continuous series, linear interpolation preserves the annual time-series structure. No extrapolation was undertaken. The macroeconomic control variables include the official exchange rate, GDP growth, trade openness, and natural resource rents.

3.2. Econometric Methodology

Given the annual frequency and availability of consistent WGI data for Zambia, the analysis necessarily operates within a small-sample environment. The empirical strategy prioritizes parsimonious specifications, finite-sample bounds critical values, and extensive specification checks rather than highly parameterized models.

Pre-estimation unit-root testing evaluates the integration order of the series. Standard Augmented Dickey-Fuller (ADF) and small-sample-adjusted DF-GLS tests assess whether the variables contain unit roots.

To test H1, the study uses principal component analysis (PCA) to construct an aggregate institutional quality index. The study examines institutional-quality heterogeneity across lower- and higher-quality regimes using an ex-ante classification, splitting the index at the historical median. To test H2 and H3, the study estimates parsimonious, dimension-specific ARDL models consisting of one institutional indicator and the exchange rate. The basic ARDL specification takes the form:

$$\Delta \ln FDI_t = \beta_0 + \sum_{i=1}^p \beta_{1i} \Delta \ln FDI_{t-i} + \sum_{j=0}^{q_1} \beta_{2j} \Delta INST_{t-j} + \sum_{k=0}^{q_2} \beta_{3k} \Delta \ln EXR_{t-k} + \lambda_1 \ln FDI_{t-1} + \lambda_2 \ln INST_{t-1} + \lambda_3 \ln EXR_{t-1} + \epsilon_t \quad (1)$$

Where FDI_t is the transformed investment variable, $INST_t$ represents the specific institutional measure, and EXR_t is the exchange rate. The long-run relationships are evaluated using the bounds test, comparing the F-statistic and t-statistic against the [Kripfganz and Schneider \(2020\)](#) finite-sample critical values.

4. Results

4.1. Descriptive Statistics and Correlation Analysis

Table 2 presents the summary statistics for the dataset spanning 1996 to 2024. Table 3 provides the pairwise correlation matrix for the governance variables. The correlations among the WGI dimensions are predictably high. Evaluating them simultaneously in a single regression would introduce severe multicollinearity.

Table 2
Descriptive Statistics

Variable	Obs.	Mean	SD	Min	Max
IHS(FDI)	29	2.128	0.666	-0.221	2.939
Exchange rate	29	7.866	6.542	1.208	26.166
GDP growth	29	5.146	2.749	-2.785	10.298
Trade openness	29	68.273	8.282	56.121	86.209
Resource rents	26	13.250	6.272	5.200	35.264
Control of Corruption	29	-0.554	0.214	-0.927	-0.269
Government Effectiveness	29	-0.829	0.325	-1.353	-0.446
Political Stability	29	0.005	0.245	-0.371	0.457
Regulatory Quality	29	-0.521	0.121	-0.838	-0.355
Rule of Law	29	-0.453	0.093	-0.657	-0.324
Voice & Accountability	29	-0.380	0.211	-0.731	-0.085

Table 3
Pairwise Correlations (WGI Dimensions)

Variable	CC	GE	PV	RQ	RL	VA
CC	1.000					
GE	0.813*	1.000				
PV	0.599*	0.133	1.000			
RQ	0.301	0.329	0.300	1.000		
RL	0.089	-0.180	0.408*	-0.081	1.000	
VA	0.921*	0.673*	0.612*	0.070	0.347	1.000

Note: * indicates significance at the 0.05 level.

Table 4
Principal Component Analysis of Institutional Quality

Indicator	PC1 Loading	Component	Eigenvalue	Variance (%)	Cumulative (%)
Control of Corruption	0.5526	PC1	3.093	51.55	51.55
Government Effectiveness	0.4318	PC2	1.408	23.46	75.01
Political Stability	0.3996	PC3	0.956	15.94	90.95
Regulatory Quality	0.2169				
Rule of Law	0.1438				
Voice & Accountability	0.5299				

4.2. Principal Component Analysis and Aggregate Institutional Quality

Table 4 reports the PCA results used to construct the aggregate institutional quality index. The first principal component (PC1) accounts for 51.55% of the total variance with an eigenvalue of 3.093. PC1 exhibits positive loadings across all six dimensions, suggesting it serves as a coherent mathematical aggregate of institutional quality.

4.3. Unit-Root Tests and ARDL Model Selection

Table 5 presents the ADF unit-root test results. The testing process verifies a mixture of $I(0)$ and $I(1)$ series, with no variables integrated at $I(2)$. As a result, VECM is statistically inadmissible for this dataset.

Table 6 summarizes the selected ARDL specifications based on the Akaike Information Criterion (AIC). Due to sample size constraints, the maximum lag length was restricted to one.

4.4. Bounds Tests and Long-Run ARDL Estimates

Table 7 presents the long-run estimates and bounds test results. The aggregate model (ex-ante median split) yields insignificant coefficients for both the low-quality and high-quality regimes, alongside an inconclusive F-statistic

Table 5
Unit-Root Tests (ADF)

Variable	ADF Level Z(t)	p-value	Order
IHS(FDI)	-2.265	0.184	I(1)
Exchange rate (ln)	-1.163	0.690	I(1)
Control of Corruption	-1.466	0.550	I(1)
Government Effectiveness	-1.500	0.533	I(1)
Political Stability	-1.722	0.420	I(1)
Regulatory Quality	-3.068	0.029	I(0)
Rule of Law	-1.047	0.736	I(1)
Voice & Accountability	-1.750	0.406	I(1)
PCA Institutional Index	-1.660	0.452	I(1)

Table 6
Selected ARDL Specifications

Institutional Variable	Selected ARDL Model	Observations
Aggregate Index (Regimes)	ARDL(1,0,1,0)	28
Control of Corruption	ARDL(1,1,0)	28
Government Effectiveness	ARDL(1,0,1)	28
Political Stability	ARDL(1,0,1)	28
Regulatory Quality	ARDL(1,0,0)	28
Rule of Law	ARDL(1,0,0)	28
Voice & Accountability	ARDL(1,0,1)	28

Table 7
ARDL Long-Run Estimates and Bounds Tests

Variable	Aggregate	CC	GE	PV	RQ	RL	VA
Inst. indicator	-1.364 / 0.422	1.231	0.942	1.021	-0.704	3.964**	1.727**
Exchange rate	-0.428**	-0.557***	-0.705**	-0.291	-0.374	-0.106	-0.515***
Bounds F-stat	4.381	5.278*	3.634	3.835	3.336	5.328**	5.767**
Bounds t-stat	-3.571	-3.939**	-3.252	-3.226	-3.073	-3.932**	-4.091***
5% I(0) F-crit	3.772	4.305	4.305	4.305	4.307	4.307	4.305
5% I(1) F-crit	5.169	5.576	5.576	5.576	5.531	5.531	5.576
Cointegration	Inconclusive	Inconclusive	No	No	No	Yes (t-stat)	Yes

Note: *** $p < 0.01$, ** $p < 0.05$, * $p < 0.1$. Critical values sourced from [Kripfganz and Schneider \(2020\)](#).

(4.381). The disaggregated models reveal substantial heterogeneity. Government Effectiveness and Regulatory Quality yield statistically insignificant coefficients. Conversely, Rule of Law and Voice & Accountability exhibit positive, statistically significant coefficients.

4.5. Short-Run Dynamics and Error-Correction Results

Table 8 outlines the short-run error correction estimates for the statistically supported models (Rule of Law and Voice & Accountability). The coefficients on the error correction terms (ECT) are negative and highly significant. A coefficient near -1.0 suggests that short-term disequilibrium corrects rapidly within the subsequent period. In a sample of $N = 28$, this magnitude warrants cautious interpretation.

4.6. Robustness Checks

To evaluate the stability of the findings, Table 9 reports alternative specifications introducing additional controls. The bounds F-statistics generally drop into the inconclusive region when extra controls are added, an expected mathematical consequence of lost degrees of freedom. To address the interpolation procedure, an exogenous dummy

Table 8
Short-Run Error-Correction Estimates

Variable	Rule of Law Model	Voice & Accountability Model
Δ Institutional indicator	3.943** (0.044)	1.571** (0.022)
Δ Exchange rate	-0.106 (0.582)	1.185 (0.124)
Constant	4.100*** (0.003)	3.192*** (0.001)
ECT(-1)	-0.995*** (0.001)	-0.909*** (0.000)

Note: p-values in parentheses.

Table 9
Robustness of Bounds Tests to Additional Controls

Specification	Rule of Law F	Rule of Law t	Voice F	Voice t
Baseline	5.328	-3.932	5.767	-4.091
+ GDP growth	4.383	-3.367	4.860	-3.840
+ Trade openness	3.834	-3.832	4.147	-3.976
+ Resource rents	4.413	-3.744	5.882	-4.467
+ Interpolation dummy	5.364	-3.934	5.536	-3.978

Table 10
Post-Estimation Diagnostic Tests (Rule of Law Model)

Test	Null hypothesis	p-value	Conclusion
Jarque-Bera / Skewness-Kurtosis	Normal residuals	0.058	Do not reject
Breusch-Pagan	Homoskedasticity	0.504	Do not reject
Breusch-Godfrey LM	No serial correlation	0.750	Do not reject

Table 11
Summary of Hypothesis Tests

Hypothesis	Empirical test	Key evidence	Decision
H1	Aggregate PCA index	No statistically supported long-run relationship	Partially supported
H2	Rule of Law; Voice	Positive and significant long-run coefficients; valid bounds tests	Supported
H3	Govt. Effectiveness; Reg. Quality	Insignificant coefficients	Supported

variable representing the three interpolated years (1997, 1999, 2001) is added to the specification. The bounds tests for both Rule of Law ($F=5.536$) and Voice & Accountability ($F=5.536$) remain robust to the interpolation dummy, suggesting the estimation is not an artifact of the interpolated years.

Figure 1 shows the cumulative sum of recursive residuals (CUSUM) for the Rule of Law model. The CUSUM statistic remains within the 5% critical bounds throughout the sample, providing no evidence of parameter instability.

4.7. Summary of Hypothesis Tests

Table 11 evaluates the empirical findings against the initial hypotheses.

5. Discussion

The empirical findings indicate that institutional quality is not homogeneous in its relevance to FDI. The aggregate institutional-quality specification does not provide statistically supported evidence of a long-run relationship with FDI. Disaggregation reveals significant heterogeneity. Macro-institutional safeguards associate positively with capital allocation, while administrative quality does not.

The lack of statistical significance for government effectiveness and regulatory quality questions the universal applicability of aggregate institutional indices. This pattern is consistent with an enclave-investment interpretation. The Zambian economy relies heavily on copper mining, an industry dominated by capital-intensive multinational corporations. These firms frequently operate outside the conventional domestic regulatory environment, relying on specialized development agreements negotiated directly with the national executive branch. Standard bureaucratic efficiency shows a negligible relationship with their capital commitment decisions.

The positive associations for Rule of Law and Voice & Accountability suggest that investors cannot insulate themselves from fundamental expropriation and political risks. The Rule of Law acts as a signal that contracts will be enforced across changes in political administration. Voice and Accountability relates to the presence of institutionalized political transitions. Where citizens can hold governments accountable through democratic mechanisms, the risk of sudden regime change drops.

These findings are consistent with literature indicating that expropriation risk and democratic accountability serve as primary institutional signals for foreign capital in the developing world (Akhtaruzzaman et al., 2017; Busse and Hefeker, 2007). When researchers combine contract enforcement with bureaucratic speed into a single index, the mathematical aggregation obscures the specific variance that dictates investment behavior.

The negative coefficient on the exchange-rate measure is consistent with an association between currency depreciation and lower FDI inflows, although the single-country design does not establish a causal effect. Foreign capital generally requires the dual assurance of property rights enforcement and monetary stability.

The policy implications of these results are specific. Host governments in resource-dependent contexts may help inform their investment promotion strategies by recognizing that minor administrative reforms may not independently generate large inflows of foreign capital. Governments could consider directing resources toward substantive judicial independence and transparent political governance, as these mechanisms reduce the risk premiums demanded by international investors.

6. Conclusion

This study investigates the relationship between institutional quality and foreign direct investment in Zambia. By disaggregating governance indicators and applying small-sample ARDL bounds testing, the analysis suggests that institutional quality exhibits an asymmetric relationship with foreign capital. Administrative institutions such as regulatory quality show no statistical association with FDI. In contrast, the rule of law and political accountability correlate positively with investment inflows. The findings are consistent with an enclave investment environment where multinational corporations bypass local bureaucracy but require guarantees against expropriation and political instability.

Investment generation strategies in extractive economies may yield better results if they prioritize judicial independence and democratic accountability rather than solely targeting regulatory simplification. A limitation of this study is the finite annual sample size ($N = 28$), an inherent constraint when utilizing the Worldwide Governance Indicators for single developing countries. Future research could investigate whether these asymmetric institutional pathways hold across other resource-dependent economies using nonlinear or threshold panel estimators.

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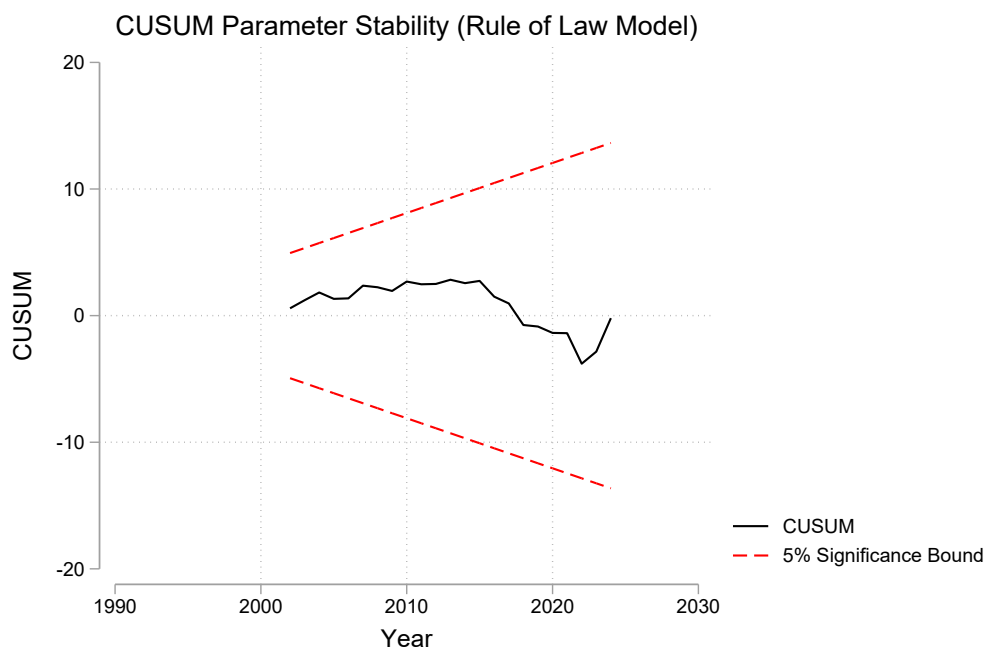


Figure 1: CUSUM Test for Parameter Stability: Rule of Law Model