THE IMPACT OF REGULATORY REFORMS ON FDI INFLOWS

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Abstract:

This research aims to investigate the multifaceted relationship between regulatory reforms and Foreign Direct Investment (FDI) inflows, with a focus on understanding the dynamic impact of regulatory changes on global economic landscapes. Regulatory reforms, encompassing changes in policies, legal frameworks, and institutional structures, play a pivotal role in shaping the attractiveness of a country for foreign investors. The study employs a mixed-methods approach, combining quantitative analysis of FDI data with qualitative assessments of regulatory changes across a diverse set of countries and industries. By examining the experiences of both developed and emerging economies, the research seeks to identify patterns, trends, and causal relationships that define the interplay between regulatory reforms and FDI inflows.

keywords: *Regulatory, FDI, Inflows*

Introduction:

Foreign Direct Investment (FDI) plays a pivotal role in the economic development of countries, fostering capital inflows, technological transfer, and job creation. The global landscape for FDI is constantly evolving, influenced by various factors, including economic conditions, political stability, and regulatory frameworks. Regulatory reforms, in particular, have a profound impact on shaping the attractiveness of a country for foreign investors.

Over the years, nations worldwide have engaged in regulatory reforms to enhance their business environments, streamline bureaucratic processes, and attract foreign capital. These reforms are often driven by the desire to boost economic growth, create employment opportunities, and integrate into the global economy. Understanding the intricate relationship between regulatory reforms and FDI inflows is crucial for policymakers, economists, and businesses seeking to navigate the complexities of the global investment landscape.

This study aims to explore the multifaceted impact of regulatory reforms on FDI inflows, delving into the mechanisms through which changes in regulatory environments influence investment decisions. By examining case studies from diverse regions and sectors, we aim to provide insights into the effectiveness of regulatory reforms in attracting and sustaining FDI. Additionally, this research seeks to identify common trends, challenges, and best practices that can guide policymakers in optimizing their regulatory frameworks to foster a conducive environment for foreign investors.

The following sections will delve into the theoretical foundations of FDI and regulatory reforms, review relevant literature, analyze case studies, and present findings that contribute to a comprehensive understanding of the relationship between regulatory reforms and FDI inflows. By doing so, this study seeks to inform policymakers, scholars, and practitioners about the nuanced dynamics at play in shaping the global investment landscape and offer recommendations for fostering sustainable and mutually beneficial relationships between host countries and foreign investors.

Improved Business Environment:

Regulatory reforms that simplify bureaucratic processes, reduce red tape, and streamline administrative procedures create a more favorable business environment. Investors are more likely to invest in countries where they can establish and operate businesses with ease, leading to an increase in FDI.

Legal and Institutional Reforms:

Strengthening legal frameworks and institutions that protect property rights, enforce contracts, and provide a transparent legal system can attract foreign investors. Investors seek assurance that their investments will be protected and that they have recourse in case of disputes.

Trade Liberalization:

Regulatory reforms that focus on reducing trade barriers, tariffs, and non-tariff barriers can encourage FDI by creating a more open and competitive market. Investors are attracted to countries that provide access to larger consumer markets and facilitate international trade.

Tax Reforms:

Changes in tax policies, such as lowering corporate tax rates or providing tax incentives for foreign investors, can make a country more attractive for FDI. Investors often consider the tax implications of their investments, and favorable tax policies can positively impact FDI inflows.

Financial Sector Reforms:

A well-functioning financial sector is crucial for attracting FDI. Reforms that improve access to credit, enhance financial stability, and encourage the development of capital markets can attract foreign investors looking for a robust financial infrastructure.

Labor Market Reforms:

Flexibility in the labor market, along with skilled and educated workforce, is attractive to foreign investors. Reforms that facilitate the hiring and firing of employees, while also ensuring a skilled labor force, can positively impact FDI.

Infrastructure Development:

Regulatory reforms that focus on improving infrastructure, including transportation, communication, and energy, can enhance a country's appeal to foreign investors. Good infrastructure reduces operational costs and increases the efficiency of business operations.

Environmental and Social Regulations:

Investors are increasingly considering environmental, social, and governance (ESG) factors when making investment decisions. Countries that implement responsible and sustainable business practices may attract FDI from investors with a strong focus on ESG considerations.

Methodology

Data and variables

From 2006–2019, 93.6% of India's total foreign direct investment (FDI) came from just 20 investing nations, and those nations are the ones that this study focuses on. In the appendix, you may find Table A1 which lists the nations and their investment contributions. With 280 data from 20 cross-sections, the study looks into the connection between institutional factors and FDI. A number of control variables that include other aspects of the company environment are also included in the study. Aside from all other variables being displayed in the natural log form, the research reports trade openness and population growth in percentage terms.

Foreign Direct Investment

The study use the natural log value of FDI inflows instead of FDI stock as the dependent variable to guarantee that the dependent variable is monitored consistently. There are a lot of zeroes and negative figures when measuring the stock of foreign direct investment (FDI) from different investing nations. Due to a dearth of information on India FDI stock from its investment partners, FDI flows provide a more suitable variable to utilize.

Institutional quality variables

Institutional quality is the degree to which the host country's institutions are efficient, which in turn reduces transaction costs and increases investment profitability. Foreign direct investment (FDI) inflows are so strongly correlated with institutional quality. Several sources

provided the research with the institutional quality metrics used in the study. Ease of Doing Business by the World Bank, Economic Freedom by the Heritage Foundation, and Economic Policy Uncertainty by the World Bank are some of the sources mentioned.

The World Development Indicators

The World Bank database on ease of doing business (EODB) records twelve development indicators. A representative firm operating environment is shaped by the nation's regulatory and institutional quality which may be measured by these measures. These institutions include courts and credit bureaus. In order for governments to effectively foster private sector growth and offer clear standards for economic involvement, high-quality regulations are a need. You may quantify the strength of legal institutions, the expense and complexity of regulatory processes, and the absolute change in regulatory business environments across economies over time with these metrics. Every single one of the Doing Business indicator scores is on a scale from zero to one hundred, with zero being the very poorest performance and one hundred the very best. The score shows how near an economy is to the best regulatory performance on each Doing Business indicator, and it serves as a benchmark for regulatory best practices overall.

Result & discussion

We often employ generalized linear models (GMM), fixed and random effect models (FEMs), and pooled ordinary least squares (OLS) to examine the data. The first strategy that is used is the pooled OLS estimation technique. The results are normal, according to the Jarque-Bera test. Jarque Bera's claim that "data is normally distributed" cannot be rejected because the p-value is 0.426. We explore the static model since data pooling is not viable due to data diversity. To test for cross-sectional dependency between the FE and RE models, experiments are run. The study used sys-GMM, a method that is more reliable than standard GMM when heterogeneous error cross-sectional dependence is present, because the Pesaran CD test results clearly indicate a cross-sectional reliance (p-value = 0.000). Table 2 and Table 2 both provide the collected descriptive data. Table 1 displays the mean, standard deviation, minimum, and maximum values for each variable. In any case, two separate models take into account the factors that suggest a rather weak link. These variables are as follows: EPU and PopGr (0.524), EOSB and RI (0.668), and EOSB and PopGr (0.814). The components mentioned in the explanation do not appear to be highly correlated, according to the correlation matrix supplied in Table 3. When the correlation coefficient between two variables exceeds 0.70, it indicates the presence of multicollinearity between the variables. If you want to know how multicollinearity affects the variance of your regression model's coefficients, you may use the variance inflation factor, or VIF, a statistical tool. On the other hand, research frequently suggests a lower cutoff of 5 or even 2.5 for more accurate estimation. Multicollinearity is present when the VIF is more than 10, in comparison to other

factors. This is why the study uses two separate models to account for linked variables; the VIF statistics show that this is necessary (mean VIF = 5.34; see Tables 5 and 6). To find out if variables are stationary, one uses the unit-root test. This is due to the fact that results derived from non-stationary data tend to be misleading and incorrect. It is shown in Table 7 that the common unit root in the study is not true since the LLC unit root test, created by Levin et al. (2002), is applied to all of the variables in the study. The RE model also seems to be more applicable than the pooled OLS model, according to the Breusch-Pegan test.

Model 1

Static Eq:

$$FDI_{it} = \alpha + \beta_1 lnGDP_{sum} + \beta_2 ln|GDPpc| + \beta_3 TO + \beta_4 PopGr + \beta_5 lnTAB + \beta_6 lnRI + e_{it}$$

Dynamic Eq:

$$FDI_{it} = \alpha + \delta_1 lnFDI_{i,t-1} + \beta_1 lnGDP_{sum} + \beta_2 ln|GDPpc| + \beta_3 TO + \beta_4 PopGr + \beta_5 lnTA + \beta_6 lnRI + e_{it}$$

Model 2

Static Eq:

$$lnFDI_{it} = \alpha + \beta_1 lnGDP_{sum} + \beta_2 ln|GDP_{pc}| + \beta_3 TO + \beta_4 lnLF + \beta_5 lnEPU + \beta_6 lnEoSB + e_{it}$$

Dynamic Eq:

$$lnFDI_{it} = \alpha + \delta_1 lnFDI_{i,t-1} + \beta_1 lnGDP_{sum} + \beta_2 ln|GDP_{pc}| + \beta_3 TO + \beta_4 lnLF + \beta_5 lnEPU + \beta_6 lnEoSB + e_{it}$$

Table 1. Statistics for description

Variable	Mean	Std. Dev.	Min	Max	Obs
FDI In flow	6.046	1.672	0.861	9.696	280
Pop Growth	1.247	0.176	1.015	1.546	280
GDP precipitate	10.479	0.735	7.164	11.672	280
GDP sum	28.877	0.608	27.949	30.660	280
Trade openness	2.669	4.497	0.007	23.456	280
Labor freedom	3.996	0.019	3.955	4.029	280
Trading across borders	4.132	0.100	3.975	4.347	280
EPU	4.512	0.410	3.902	5.223	280
Starting a business	3.997	0.275	3.287	4.388	280
Resolving insolvency	3.608	0.183	3.482	3.996	280

Table 2. Correlation matrix

	FDI	GDPpc	GDPSum	TO	PopGr	LF	EPU	EoSB	TAB	RI
FDI	1.000									
	-									
GDPpc	0.036	1.000								
	(0.554)	-								
GDPsum	0.109	0.180***	1.000							
	(0.079)	(0.003)	-							
TO	0.291*	0.267***	−0.289***	1.000						
	(0.000)	(0.000)	(0.000)	-						
PopGr	0.328***	−0.097	−0.229***	0.061	1.000					
	(0.000)	(0.105)	(0.000)	(0.306)	-					
LF	0.197***	0.063	0.031	0.025	0.497***	1.000				
	(0.001)	(0.292)	(0.615)	(0.680)	(0.000)	-				
EPU	−0.009	−0.002	−0.132**	0.008	0.524***	−0.114*	1.000			
	(0.885)	(0.878)	(0.033)	(0.843)	0.000	0.056	-			
EoSB	0.274***	0.076	0.212***	0.049	0.814***	0.221***	0.276***	1.000		
	(0.000)	(0.224)	(0.001)	(0.427)	(0.000)	(0.000)	(0.000)	-		
TAB	0.129***	0.059	−0.091***	0.015	0.299***	0.458***	0.208***	.166***	1.000	
	(0.000)	(0.224)	(0.001)	(0.427)	(0.000)	(0.000)	(0.000)	(0.007)	-	
RI	0.152**	0.053	0.019	0.035	0.494***	0.148**	0.088	0.668***	0.488*	1.000
	(0.014)	(0.392)	(0.765)	(0.574)	(0.000)	(0.017)	(0.158)	(0.000)	(0.000)	-

Source: Authors Calculation. Note: p-values are in parenthesis. *, **, ***are significant levels at 10%, 5%, 1% respectively.

When the research aims to draw conclusions from a specific set of entities rather than a randomly selected sample, the FE estimator is preferred over the RE estimator. For both models, the Hausman test found a statistically significant difference between the coefficients of the RE and FE estimators (p-value = 0.020). This gives support for the idea that FE estimators are appropriate for the investigation, as it demonstrates that the null hypothesis is rejected. It is clear that a dynamic model should be used because of the presence of endogeneity (cov $(x,\varepsilon)\neq 0$) and autocorrelation (D-W test, p-value larger than 0.05). Since FDI is inherently dynamic, this study also employs a system GMM estimator that takes lagged FDI into account as an explanatory variable. Issues with endogeneity, simultaneity, missing variables, measurement error, and sample selection may be well handled by the System GMM method. The Sargan and Hansen tests remove the over-identification problem, which supports the instruments' validity. To back up the generalized technique of moments estimation, the Arellanobond autocorrelation rules out second-order autocorrelation. The study finds that GMM criteria are adequate for interpretation when the Hausman test is considered. The results of the post-estimation tests show that AR (1) is statistically significant, while AR (2) is not. This proves the absence of second-order autocorrelation in the data and the presence of first-order autocorrelation. The null hypothesis that the computed coefficients are jointly and considerably different from zero is rejected since the values of $\chi 2$ are significant according to the Wald test statistics. The model's ability to make accurate predictions is demonstrated by this. Since the Sargan-Hansen test was employed to rule out over-identification of constraints, it can be concluded that all instruments are capable of adequately describing the model. Applying Windmeijer finite-sample correction allows for

more accurate control over the instrument matrix. Both models utilize the FDI influx that is a bit behind schedule as a tool. Citations of prior work on foreign direct investment (FDI) by Aziz and Mishra (2016) and Mina (2020) provide credence to the idea that showcasing the results of existing FDI is essential to attracting more of this type of investment. This is in line with the theory that nations with a high level of foreign direct investment (FDI) are more attractive to multinational firms. As a result, it appears that MNE success in the nations where they operate is a key factor in luring more investment from MNCs. The delayed foreign direct investment variable is the tool used in the inquiry.

Model 1 (Table 3) depicts the chosen control parameters that may impact FDI inflow. These included GDPsum, GDPpc, PopGr, and TO, along with the institutional and regulatory variables TAB and RI. The GMM estimate indicates that the explanatory variables lagged FDI, GDPsum, TO, and TAB have a strong positive correlation with the FDI influx. Contrarily, RI is not a major factor in foreign direct investment. The flow of foreign direct investment (FDI) is significantly correlated with PGR in the opposite direction. Tables 5 and 6 show the macroeconomic parameters that are a part of Model 2, which includes GDP, GDPpc, and TO. Contrarily, institutional or regulatory variables that may affect FDI influx include the LF, EPU, and EoSB. The GMM estimate has demonstrated that the following explanatory variables—lagged FDI, GDP, TO, EoSB, and EPU—have a substantial positive correlation with the FDI inflow. Conversely, foreign direct investment (FDI) is negatively affected by LF. In the GMM formulation, lags in FDI inflows serve as a positive and statistically significant explanatory variable. The results are the same for model 1 ($\beta = 0.287$, p-value = 0.000) and model 2 ($\beta = 0.283$, p-value = 0.000). The results show that the current level of foreign direct investment (FDI) is a key indicator for future FDI attraction. Given the enormous investment already made by multinational corporations, India has a high chance of attracting further foreign direct investment (FDI). According to Aziz (2018), a comparable finding was reported. When there is a regulatory climate that encourages new businesses to launch with simpler, quicker, and more investment-friendly processes, it makes it easier to start a business. Making it easier to form a firm within the nation, India has been enacting a number of business measures since 2015. As part of these changes, the costs associated with forming a company in India have been removed, and all of the previous application forms have been consolidated into one generic incorporation form. The results of the generalized linear model show that "EoSB is a significant variable that positively affects FDI inflows ($\beta = 0.002$, p-value = 0.089)". A p-value of 0.000 and an EPU index coefficient of 0.424 show that FDI inflows to India are positively and significantly impacted by the declining level of uncertainty over time. There is an inverse link between a country's level of policy uncertainty and its amount of foreign direct investment (FDI), as the EPU index rises, claims the hypothesis. Nevertheless, to adhere to our study's requirements and satisfy the stationarity limitations, we will be employing the following:

Table 3. Panel regression results for Model 1

Dependent variable: ln FDI

	FDI	GDP pc	GDP Sum	TO	Pop Gr	LF	EPU	Eo SB	TAB	RI
FDI	1.000									
	-									
GDP pc	0.036	1.000								
	(0.554)	-								
GDP sum	0.109	0.180***	1.000							
	(0.079)	(0.003)	-							
TO	0.291*	0.267***	-0.289***	1.000						
	(0.000)	(0.000)	(0.000)	-						
Pop Gr	0.328***	-0.097	-0.229***	0.061	1.000					
	(0.000)	(0.105)	(0.000)	(0.306)	-					
LF	0.197***	0.063	0.031	0.025	0.497***	1.000				
	(0.001)	(0.292)	(0.615)	(0.680)	(0.000)	-				
EPU	-0.009	-0.002	-0.132**	0.008	0.524***	-0.114*	1.000			
	(0.885)	(0.878)	(0.033)	(0.843)	0.000	0.056	-			
Eo SB	0.274***	0.076	0.212***	0.049	0.814***	0.221***	0.276***	1.000		
	(0.000)	(0.224)	(0.001)	(0.427)	(0.000)	(0.000)	(0.000)	-		
TAB	0.129***	0.059	-0.091***	0.015	0.299***	0.458***	0.208***	.166***	1.000	
	(0.000)	(0.224)	(0.001)	(0.427)	(0.000)	(0.000)	(0.000)	(0.007)	-	
RI	0.152**	0.053	0.019	0.035	0.494***	0.148**	0.088	0.668***	0.488*	1.000
	(0.014)	(0.392)	(0.765)	(0.574)	(0.000)	(0.017)	(0.158)	(0.000)	(0.000)	-

Source: AuthorsCalculation.Note:p-valuesareinparen.*,**,***aresignificantlevelsat10%,5%,1% respectively.

a shift in EPU from t-1 to t during the sample period has been determined. There has been a decline from period t-1 to period t, as seen by the data points, which have a negative sign. The reason behind this is that the index measuring policy uncertainty in India has been steadily declining throughout the course of the sample period. A positive coefficient is formed in our numerical equation as a result of combining this with the supposedly negative β. The finding is in line with the theory that states that FDI inflows are positively affected by a low domestic EPU. While global policy uncertainty has been on the rise, especially in the US, UK, and China, domestic policy uncertainty has been steadily declining since the start of 2015. Indian policymakers have enabled forward momentum to reduce EPU by consistent actual policy, which has helped create a climate that is friendly to commercial investment. Consistent with what Barrero et al. (2017) found, we find similar results here. Although resolving insolvency is a positive-valued variable, it does not have statistical significance according to the GMM criteria ("β = 0.005, p-value = 0.610"). India aims to make insolvency settlement more accessible to the general public by enacting a new law that favors

reorganization processes "for corporate debtors and streamlines the debtor's ability to do business during insolvency proceedings". However, the dilemma is not entirely resolved by the statutes that prohibit dissident creditors from receiving the same amount in liquidation as they would in a reorganization. The trade across border variable is positive, but not statistically significant ($\beta = 0.130$, p-value = 0.768), as per the Generalized Method of Moments (GMM) specification. As of 2008, the Indian government has been steadily enacting changes to the corporate sector in an effort to ease commerce with other countries. Among these changes are the following: the establishment of post-clearance audits; the development of port infrastructures; the strengthening of electronic document submission; and the integration of trade stakeholders into a single electronic platform. Additional institutional measures are required, nevertheless, to have a meaningful influence on FDI inflows.

Table 5. Panel regression results for Model 2
Dependent variable: in FDI

Variables	Fixed Effects		Random Effects		GMM(Two-step)	
	coeff	P-value	co-eff	P-value	co-eff	P-value
In FDI(−1)	-	-	-	-	0.283*** (0.037)	0.000
in GDP sum	1.242*** (0.424)	0.005	0.136(0.093)	0.145	0.801*** (0.221)	0.000
in GDPpc	1.067*** (0.316)	0.001	0.043(0.075)	0.564	0.567*** (0.201)	0.005
Trade openness	0.295*** (0.095)	0.002	0.087**(0.037)	0.021	0.432*** (0.156)	0.006
In Labor freedom	−5.205* (3.139)	0.099	−3.373(3.494)	0.118	−4.038** (1.720)	0.019
in EPU	0.439*** (0.156)	0.005	0.662*** (0.182)	0.000	0.424*** (0.083)	0.000
in EOSB	0.164(0.021)	0.440	−0.031(0.023)	0.196	0.002*(0.015)	0.089
_cons	−59.841*** (22.508)	0.008	−10.002 (16.330)	0.540	−32.140 (16.115)	0.046
R-square	0.394		0.3879		AR(−1)	0.003
Pesaran Test	3.4333	0.000	3.562	0.000	AR(−2)	0.059
	Hausmanteststatistic= 0.000				Sargantest=0.006	
					Hansen test=0.285	

Source: Authors Calculation.

Note.Std.errorsareinparenthesis.*,**,***aresignificantlevelsat10%,5%,1%respectively.

Table 6. VIF results

Variable	VIF	1/VIF
GDP sum	1.13	0.88
GDP pc	1.33	0.75
Trade openness	1.17	0.85
Labor freedom	2.81	0.36
EPU	5.75	0.17
EOSB	11.10	0.09
Pop Gr	10.89	0.09
Tradeacrossborder	5.59	0.18
Resolving in solvency	6.51	0.15
Mean VIF	5.34	

Source: Authors Calculation.

The deterioration of labor freedom significantly affects FDI inflows, as per the Generalized Method of Moments (GMM) formulation ("$\beta = -4.038$, p-value = 0.019"). Determining the deterioration of LF score for this study is as simple as "subtracting the yearly LF score from 100, where 100 represents" the maximum degree of freedom. In sectors that rely heavily on human labor, the quality of the labor market has a significant influence on labor costs. The flexibility of pay determination, redundancy costs, severance obligations, and the ease of recruiting and firing rules are all examples of such constraints. Furthermore, FDI (foreign direct investment) flows are encouraged by these regulations. During the study period, the Labor Freedom in India dropped significantly, dropping from 62.30 to 41.80. This has led to a decline in FDI, especially in the industrial sector that relies heavily on human labor.

Table 7. Unit root test

Variables	LLC	Decision
FDI In flows	$-6.056^*(0.000)$	Stationary
GDP sum	$-3.420^*(0.000)$	Stationary
GDP pc	$-2.294^*(0.000)$	Stationary
Pop Gr	$-27.052^*(0.000)$	Stationary
EPU	$-4.283^*(0.000)$	Stationary
Eo SB	$-2.404^*(0.000)$	Stationary
Trade across border	$-3.349^*(0.000)$	Stationary
Resolving in solvency	$-18.689^*(0.000)$	Stationary
Trade openness	$-4.681^*(0.000)$	Stationary
Labor freedom	$-5.841^*(0.000)$	Stationary

Note. All statistic results are as follows: LLC is Levin–Lin–Chu (adjusted t *) P-values in brackets. * denotes significance at the 1% levels for p-values

To gauge the magnitude of the horizontal market, it is proposed to utilize the combined Gross Domestic Product of the host and source countries. It is found in both the Model 1 GMM (o = 0.695, p-value = 0.060) and Model 2 GMM (H = 0.801, p-value = 0.000) specifications that the variable is positive and statistically significant. The results show that India has succeeded in attracting a larger quantity of FDI by capitalizing on its massive market size. The findings of this investigation corroborate those of Finding the absolute difference in the GDP per capita between the home nation and the host nation allows one to evaluate the talent imbalance and capture the vertical foreign direct investment push. In countries with a surplus of trained personnel, the cost of skilled labor would be low since factor endowments are believed to be the main determinant in determining factor costs.

Conclusion

This research takes a look at how certain institutional and regulatory elements affect India's foreign direct investment (FDI) flows. According to the North's Institutional framework, which forms the basis of the study, a country's capacity to attract foreign investment depends on the strength of its institutions, and countries with strong institutions are able to give higher returns to their investors. To create an atmosphere that is conducive to the business operations of international investors, the Indian government has spent the better part of the last several years working to streamline administrative processes, strengthen legal institutions, and reduce regulatory requirements. Strategic decision-makers should pay close attention to the study's results because of their far-reaching implications.

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