Triangular Relationship among Governance, Foreign Direct Investment, and Economic Growth: Cross Country Analysis and Cambodia's Case Study

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Abbreviations

ADB	Asian Development Bank
AFTA	ASEAN Free Trade Area
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textiles and Clothing
BLDP	Buddhist Liberal Democratic Party
CAR	Council for Administrative Reform
CIDS	Cambodia Institute of Development Studies
CLJR	Council for Legal and Judicial Reform
COM	Council of Ministers
CPP	Cambodian People's Party
CR	Cambodian Riel
DP	Development Partner
FDI	Foreign Direct Investment
FSDS	Financial Sector Development Strategy
FUNCINPEC	National United Front for an Independent, Neutral, Peaceful and Cooperative Cambodia
GAP	Governance Action Plan
GATT	General Agreements on Tariffs and Trade
GMAC	Garment Manufacturers' Association of Cambodia
GSP	Generalized System of Preferences
HRP	Human Rights' Party
IMF	International Monetary Fund
LDC	Least Developed Country
LOI	Law On Investment

MFA	Multi-Fiber Arrangement
MFI	Microfinance Institution
MFN	Most Favored Nation
MOC	Ministry of Commerce
MOJ	Ministry of Justice
NA	National Assembly
NBC	National Bank of Cambodia
NGO	Non-Governmental Organization
NIS	National Institute of Statistics
NPAR	National Program for Administrative Reform
NTR	Normalized Trade Relationship
PAILJRS	Plan of Action for Implementing Legal and Judicial Reform Strategy
PRC	People's Republic of China
PRK	People's Republic of Kampuchea
PRP	People's Revolutionary Party of Cambodia
QIP	Qualified Investment Project
RGC	Royal Government of Cambodia
SARS	Severe Acute Respiratory Syndrome
SME	Small and Medium-sized Enterprise
SOC	State of Cambodia
SPZ	Special Processing Zone
TI	Transparency International
UCTA	US-Cambodia Textile Agreement
UNDP	United Nations Development Programme
UNESCO	United Nations Educational, Scientific and Cultural

	Organization
UNTAC	United Nations Transitional Authority in Cambodia
USSR	Union of Soviet Socialist Republics
WB	World Bank
WTO	World Trade Organization

Chapter 1: Introduction

1.1 Background

The role of governance and its implication on economic performance has been the center of policy discussions in the last two decades. According to Arndt and Oman (2006), this explosive growth of interest in governance is a combination of four reasons: 1) the spectacular increase in international investment in developing countries; 2) the end of cold war; 3) the failure of development policy reforms in the 1980s and the 1990s; and 4) a new awareness of the importance of politics in economic development and policy reform.

Despite its increasing awareness and importance in the development economics, the definition and usage of governance remains unclear and differs depending on the users. Different institutions define and use the term governance differently, depending on their interests and agenda. For example, the World Bank and the Asian Development Bank define governance as "*the manner in which power is exercised in the management of a country's social and economic resources for development"*. However, the United Nations Development Programme defines governance in a broader sense as *"the exercise of political, economic and administrative authority in the management of a country's affairs at all levels. It comprises mechanisms, processes and institutions, through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences".* As for the International Monetary Fund, the definition of governance is only limited to *economic aspects*, as its primary concern is on macroeconomic stability, external viability, and orderly economic growth.

At the same time, as the world economy is getting more globalized, the role of Foreign Direct Investment (FDI) is also becoming increasingly crucial for the development of an economy. FDI is, in general, believed to have a positive relationship with economic growth of the recipient country. One of the main features of FDI, which is different from portfolio

investment, is that it is regarded not only as an important source of foreign private capital inflow, but also an important channel of technology transfers, and management know-how to the recipient country. FDI also creates jobs and tends to have a more prolong effect on the host economy, whereas portfolio investment is regarded as rather foot-loose.

1.2 Objective

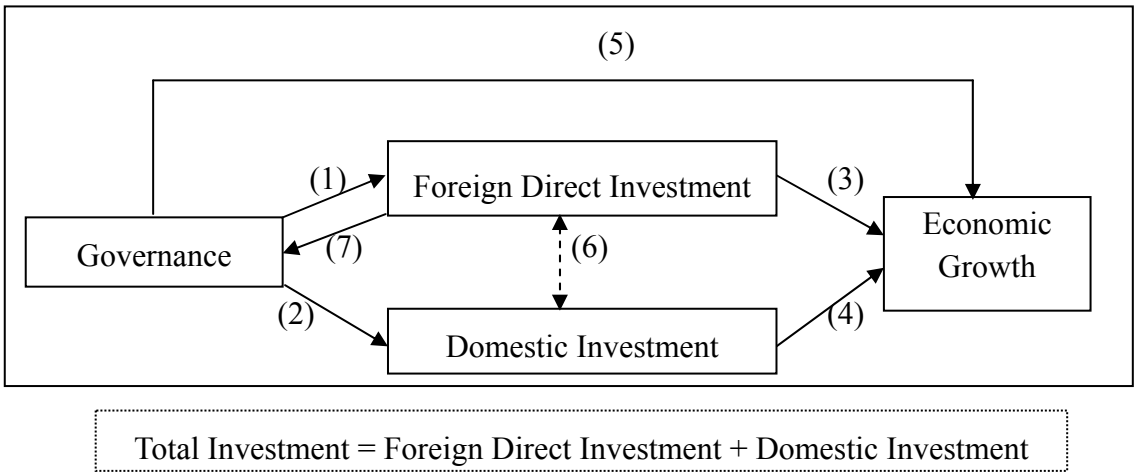
Given the special characteristics and important roles of governance and FDI on economic development, this dissertation aims to examine their triangular relationship in detail. Specifically, this dissertation, through its two-stage cross-country regression model, aims to explore the impact and mechanism by which governance affects economic performance, both directly and indirectly through FDI inflow. To complement this regression analysis, a case study on Cambodia is provided to investigate their relationship, particularly the impact of FDI on governance quality betterment. In general, better governance is perceived to attract more FDI into the country. However, in Cambodia the presence of FDI per se can be a significant factor in improving the quality of governance in that country by exercising its pressure on the government. If it is the case, governance quality improvement can then be further justified for FDI attraction.

In addition to the main objectives above, this dissertation also aims to clarify the concept of governance utilized by different international organizations so that potential confusions and misunderstandings can be minimized. As governance is a key factor affecting economic performance, the misunderstandings by policy makers can negatively affect the economy as a whole. Basic theories of FDI and its impact on economic development are also reviewed by classifying by income groups. Countries at different stage of development tend to attract different type of FDI. Therefore, its impact on growth on the recipient country is also different.

1.3 Analytical Framework

The research analyses the impact of governance on FDI inflow and economic performance. The triangular relationship among governance, FDI, and economic growth differ depending on the stage of development. Low-income economies, in general, have limited resources (both physical and human) and tend to attract only a limited amount of FDI inflow, a large portion of which is resource-seeking FDI (both natural resources such as oil, natural gas and non-natural resources such as cheap labor). Natural resource seeking FDI is generally considered location-specific and not a subject of competition with other FDI recipient countries. In comparison with low-income states, middle-income economies have better basic infrastructure and supporting domestic industries. With these minimum sufficient economic conditions in place, market-seeking FDI and efficiency-seeking FDI tend to find it easier to operate in the middle-income states than in the low-income ones. And since manufacturing production costs generally increase rapidly as an economy develops, market-seeking FDI seems to be replaced by strategic asset-seeking FDI in high-income economies (Narula and Dunning, 2000).

Figure 1.1: Triangular Relationship among Governance, FDI, and Economic Growth



Source: Author.

Governance is considered to affect economic growth directly and indirectly through total investments, which is a combination of domestic investment and FDI (See Figure 1.1). Although there is an important relationship between governance and domestic investment (2), and domestic investment and FDI (6), it is not the main focus of this dissertation. This dissertation, through its cross-country regression analysis in Chapter 4, primarily discusses the impact of governance on FDI (1), FDI on economic growth (3), and governance on economic growth (5) by classifying the countries in separate three income groups: low-income, middle-income, and high-income. In addition to this, the case of Cambodia will be used to investigate the impact of FDI on governance quality (7) in Chapter 5.

The relationship between FDI and domestic investment, although it is not the prime concern in this dissertation, is also a very important issue for economic growth. FDI is also considered to affect domestic investments, both positively through its *crowd-in effect* and negatively through its *crowd-out effect*. The crowd-in effect, where FDI complements domestic investments, tends to bring about linkages between the two and finally result in technology transfer and management know-how. The crowd-out effect is the case where FDI firms compete and force domestic firms to downsize or even go bankrupt. However, empirical evidence shows that, in general, the positive impact of FDI exceeds its negative one, leading to higher growth for the recipient country.

1.4 Data Sources

1.4.1 Governance Indicators

Two sources of governance indicators are used in this dissertation, namely Country Policy and Institutional Assessments (CPIA), and International Country Risk Guide (ICRG). CPIA indicators was produced by the World Bank in the 1970s with the objective of helping to guide the allocation of interest-free loans and grants by the International Development Association (IDA) to the poorest countries. For this reason, this indicator has wide coverage

on low-income economies, but with insufficient historical data. On the other hand, ICRG data was first created in 1984 with a wide coverage of more than 130 countries in 2010. Despite its richness in historical data, its main focus is only on middle-income and high-income countries, with data on low-income countries insufficient. For this reason, CPIA governance indicators are used for low-income economies and ICRG indicators are used for middle-income and high-income economies.

CPIA governance indicator includes: 1) *Economic Management* (macroeconomic management, fiscal policy, debt policy); 2) *Structural Policies* (trade, financial sector, business regulatory environment); 3) *Policies for Social Inclusion/Equity (*gender equality, equity of public resource use, building human resources, social protection and labor, policies and institutions for environment sustainability); 4) *Public Sector Management and Institution* (property rights and rule-based governance, quality of budgetary and financial management, efficiency of revenue mobilization, quality of public administration, transparency, accountability, and corruption in the public sector).

The ICRG indicator is used as part of a governance indicator and has six elements of governance; namely: 1) *voice and accountability* (measuring the degree of civil liberties and independence of media); 2) *political stability* (measuring the ability of citizens to peacefully select and replace those in power*)*; 3) *government effectiveness* (measuring the quality of bureaucracy); 4) *regulatory quality* (measuring the market-friendliness); 5) *rule of law* (measuring the confidence in the rule of society and contract enforcement); 6) *control of corruption* (measuring the degree to which public power is used for private gain).

Other data with the characteristics of economic governance and which represent the policy stance of a government such as *inflation rate*, *trade openness ratio to GDP*, and *general government final consumption expenditure ratio to GDP* are also included in the analysis. These data are taken from World Development Indicators 2006.

1.4.2 Non-governance indicators

Non-governance variables such as *initial per capita GDP* (to examine the conditional convergence effect), *life expectancy* (representing health conditions), *fertility rate* (representing the population pressure on per capita growth), and *educational variables* (representing human capital) are also taken from World Development Indicators 2006. Those original data were later rearranged to be suitable for the cross-country analysis.

1.5 Methodology

This study employs a two-stage cross-country analysis by following a Barro-type ad hoc growth equation and then extends it by adding governance elements as explanatory variables. In the first stage, per capital GDP growth rate was taken as dependent variable and governance variables were included as explanatory variables but without total investment ratio to GDP. As total investment ratio is a major variable in explaining GDP growth, the use of this method aims to capture the marginal effects of governance factor on per capita GDP growth. In the second stage, it is divided into two analyses. First, total investment ratio to GDP is taken as dependent variable, leaving other controlled variables the same as in the first stage. Second, FDI ratio to GDP is taken as dependent variable, and controlled variables are also basically held the same as in the first stage. The analysis on the second stage is purely to examine the impact of governance factor on FDI and total investment. The result of this analysis can also suggest implications on the sensitivity of governance with domestic investment vis-à-vis FDI inflow.

The Cambodian case study to ascertain the impact of FDI on governance is primarily based on the interview surveys with relevant institutions such as the Council for the Development of Cambodia (CDC), the Ministry of Planning, the Garment Manufacturers' Association in Cambodia (GMAC), the Arbitration Council (AC), the Cambodia Development Resource Institute (CDRI), the Economic Institute of Cambodia (EIC), among

others. The results from the interviews are analyzed and organized to serve the purpose of the research. Reports produced by the Royal Government of Cambodia (RGC) are also widely used to illustrate the government's stance/policy and progress of governance reform in the country.

1.6 Structure of Dissertation

This dissertation consists of six chapters. Chapter 1 is the introduction. Chapter 2 discusses the concepts of governance used by different organizations such as the World Bank, the Asian Development Bank (ADB), the United Nations Development Programme (UNDP), and the International Monetary Fund (IMF). Despite its significant role in determining economic performance, the definition of governance is still unclear and depends on the interests and agenda of the users. Given its qualitative nature, an operational definition of governance is provided in an attempt to measure its quality. A series of governance indicators such as the CPIA indicator, the ICRG indicator, the political right and civil liberties index (Freedom House), the corruption perception index (Transparency International), the World Bank governance indicator (so-called KKZ indicator) were introduced and discussed. In principle, there are two types of governance indicators: *facts-based* indicators and *perceptions-based* indictors. Facts-based governance indicators refer to the *de jure* rules on books, while perceptions-based indicators refer to the *de facto* realities on the ground. In addition, the mechanism through which governance affects economic performance is discussed.

In Chapter 3, motives and basic theories on the determinants of FDI are discussed. There are four main motives for FDI firms to invest abroad. Those motives include: 1) resource-seeking FDI; 2) market-seeking FDI; 3) efficiency-seeking FDI; and 4) strategic asset-seeking FDI. Different types of FDI tend to invest in countries of different stages of development. For example, resource-seeking FDI tends to go to low-income countries, while market-seeking FDI prefers middle-income countries whose market size is sufficiently large.

Efficiency-seeking FDI can be seen mainly in middle-income countries, but with some small portion in low-income and high-income countries depending on its strategy either to take advantage of cheaper cost or to exploit the comparative advantages in developed markets. Strategic asset-seeking FDI tends to take place in high-income economies where knowledge and technology are available. At the end of the chapter, the impact of FDI on countries of each income group (both on home and host countries) is discussed.

Chapter 4, the core chapter of this dissertation, analyses the impact of governance on FDI inflow and economic growth in different income groups: low-income, middle-income, and high-income. The analyses employ a two-stage least square cross-country regression model with an attempt to capture the marginal effect of governance on GDP growth. As each income group has a different level of governance quality and economic structure, the understanding of the impact of governance on growth performance either directly or indirectly through investment channel (both domestic and FDI) can provide an important implications for economic policy.

Chapter 5 discusses Cambodia's case study on the relationship among governance, FDI inflow, and economic development. First it starts with overview of Cambodian economy after 1993, the year of United Nations-backed election and formation of a new government. This is followed by a review of the political and economic structure of Cambodia from1953 (the year Cambodia gained independence from France) until present. Since 1953, Cambodia has experienced six regime changes that later resulted in serious consequence for the political, economic, and social systems of the country. Among them, the Democratic Kampuchea (the so-called Pol Pot regime: 1975-1979) destroyed most of the infrastructure and institutions. With the historical context explained, the chapter moves on to the present governance structure in Cambodia, which is examined by classifying it into the six governance elements of the World Bank. In this section, governance reform policy by the government and its outcome are introduced to provide a rough idea of the country's overall governance status at

present. Finally, the impact of FDI inflow on governance improvement in Cambodia is discussed. Governance improvement is considered primarily a result of pressure from private sector on the government and not originally intended by FDI on the governance itself. The presence of FDI affects governance through the government-private sector forum, and specifically on the garment industry through labor standard requirement by ILO. The establishment of the Arbitration Council has also contributed to the improvement of industrial relations between employers and employees. It has thus helped to compensate for deficiencies in the court system.

Chapter 6, as the concluding chapter of this dissertation, summarizes the key issues and findings, especially the core analysis on the impact of governance on FDI inflow and economic performance, as well as findings on the impact of FDI on governance in Cambodia's case study. Possible future research is also recommended at the end.

Chapter 2: Concept of Governance and Its Impact on Economic Development

2.1 Introduction

In recent years, there has been increasing awareness and concern of governance in the development agenda. This has been reflected in many debates and studies by leading international organizations. As Arndt and Oman (2006) explains, the explosive growth of interest in the quality of governance is a combination of four reasons: 1) the spectacular increase in international investment in developing countries; 2) the end of the cold war; 3) failed development policy reforms in the 1980s and the 1990s; and 4) a new awareness of the importance of politics in economic development and policy reform.

First, international investment to developing countries has increased tremendously in the last 15 years. Foreign Direct Investment (FDI) to those countries has grown from an average annual net inflow of about 10 billion USD in the early 1980s to over 46 billion USD in 1990-92 and about 445 billion USD in 2006-2008[1]. Equally important for driving up interest in local governance has been the growth of international *portfolio* investment in developing and emerging economies, mainly by major pension funds and other institutional investors from developed countries. The net annual flows have increased from below 2 million USD in the late 1980s to about 20 billion USD in bonds and another 26 billion USD in portfolio equity in the 1990s. With large amount of money being exposed to risk, international investors are concerned about the credibility of policy implementation, predictability of government behavior, and above all the governance system itself. Together with the tremendous surge in both direct and portfolio investment, there is also a sea change in economic policy orientation towards a more market-friendly, investor-friendly one. This market-friendly policy is widely implemented by developing countries' governments and

[1] UNCTAD 2010, World Investment Report 2010.

competes with each other in order to attract international investors into his/her own country. In this regard, governance quality has become a crucial element in the decision-making of investment destination.

Second, the end of the cold war has brought OECD governments as well as development agencies to pay more attention to governance. During the cold war, assistance to developing nations did not take into consideration the governance quality of the recipient countries. Instead, it put almost the entire weight on the fight against communism. After the demise of the Soviet Union, the threat of communism faded. International developing agencies and OECD governments started to emphasize the promotion of living standards, and the alleviation of poverty of the developing world. In order to ascertain that aid money is properly used, governance system of the recipient countries became an issue.

Third, the failed policy reform undertaken in the 1980s and 1990s by the developing economies also spurred interests on governance. The debt crisis in 1982 especially by Latin American countries such as Argentina, Brazil, and Mexico made it difficult for them to borrow money from international financial markets. Reacting to macroeconomic crisis in those Latin American countries, the Washington Consensus scheme was first presented in 1989 with ten broad sets of policy recommendation. The policy recommendation mainly targets developing countries to open trade and liberalize their economies, meaning expanding the role of market forces and constraining the role of state. In line with this Washington consensus, Washington-based development agencies such as the World Bank and the IMF extended loans to developing countries through the so-called structural adjustment programs (SAPs). However, the result proved relatively unsuccessful and disappointing. Given this failure, lending institutions have shifted attention to governance of the developing nations rather than by the structural adjustment programs itself. However, until today the real cause of this failure is still an open question.

Fourth is the emergence of the New Institutional Economics. Douglass North, a leading

figure in this field, has convincingly illustrated the importance of a country's system of governance. For example, North (1990, p.5) states that, "*institutions affect the performance of the economy by their effects on the costs of exchange and production*", and "*the costliness of information is the key to the costs of transacting, which consist of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements*" (ibid, p.27). The first part suggests the impacts of governance, especially the ineffectiveness of institutions or bureaucracy on exchange (transaction) and production cost. The latter part focuses on the importance of information costs where transparency is a key element. Moreover, protecting rights, policing rights, and enforcing rights are aspects of rule of law.

As stated earlier, these fours reasons have explained the history of growing interest in governance by developed nations and international development agencies. However, since governance is a relatively new and ambiguous topic in the development field, it is perceived in a different manner by the various international organizations. Its importance may also shift depending on the stages of development of the countries and the channel through which it is exercised. To properly understand it, it is necessary to revisit the concept of governance and its impacts on economic development.

2.2 Governance

2.2.1 Definition of Governance

Governance is a very vague and hard concept to measure. Perception of governance may vary from culture to culture. Therefore, to correctly understand its nature and application, a conceptual definition and operational definition of governance is needed. A conceptual definition of governance evolves overtime and also differs among international organizations, including the World Bank (WB), the Asian Development Bank (ADB), the United Nations for Development Programme (UNDP), and the International Monetary Fund (IMF). A detailed

discussion of the concept of governance by each organization is provided in the following section.

In addition to its concept, operational definition of governance is created to organize its elements and to be used as a method for measurement. However, given its qualitative nature it is almost impossible to accurately quantify or measure.

2.2.1.1 The World Bank

The World Bank first discussed the governance issues in the early 1990s. However, governance itself is not a new issue for the World Bank. It has grappled with these issues from its inception. Between 1965 and 1980, this issue did not come into discussion because the world economy was enjoying a relatively good growth performance. But by the beginning of 1980s as growth decelerated sharply and the developing world was adversely affected by a severe worsening in the terms of trade, the emergence of a climate of relatively scarcity began to expose issues of governance in many countries (World Bank, 1992).

The general conceptual definition of governance of the World Bank is “exercise of authority, control, management, power of government”. And its detailed conceptual definition is “The manner in which power is exercised in the management of a country’s social and economic resources for development” (ibid, 1992). And good governance is defined as sound development management. Subsequently, Kaufman et al. (1999) used this definition to organize an operational definition of governance by classifying it into six clusters: (1) voice and accountability - measuring political, civil, and human rights; (2) political instability and violence - measuring the likelihood of violent threats to, or change in, government, including terrorism; (3) government effectiveness - measuring the competence of the bureaucracy and the quality of public service delivery; (4) regulatory burden - measuring the incidence of market-friendly policies; (5) rule of law - measuring the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence; and (6) control of

corruption - measuring the exercise of public power for private gain, including both petty and grand corruption and state capture.

Table 2.1 Governance Discussions at the World Bank

Subject	Points
Definition of governance	The manner in which power is exercised in the management of a country's social and economic resources for development.
Subset of governance	1. Voice and accountability; 2. Political instability and violence; 3. Governance effectiveness; 4. Regulatory burden; 5. Rule of law; 6. Control of corruption.
Good governance	Sound development management
Symptoms of poor governance	1. Failure to make a clear separation between what is public and what is private, hence, a tendency to divert public resources for private gain; 2. Failure to establish a predictable framework of law and government behavior conducive to development, or arbitrariness in the application of rules and laws; 3. Excessive rules, regulations, licensing requirements, and so forth, which impede the functioning of markets and encourage rent-seeking. 4. Priorities inconsistent with development, resulting in a misallocation of resources. 5. Excessively narrowly based or nontransparent decision-making.

Source: World Bank. 1992.

2.2.1.2 The Asian Development Bank

The Asian Development Bank (1999) defines governance exactly the same as the World

Bank (1992): "*The manner in which power is exercised in the management of a country's social and economic resources for development".* The concept of governance is concerned directly with the management of the development process, involving both the public and private sectors. In broad terms, governance is about the institutional environment in which citizens interact among themselves and with government agencies. ADB (1999) characterized the four basic elements of good governance as below.

1) *Accountability* means making public officials answerable for government behavior and responsible to the entity from which they derive their authority. This process infers the establishment of criteria to measure the performance of officials and oversight mechanisms to ensure that these criteria are met. Its existence is imperative for the functioning of governments.
2) *Participation* derives from an acceptance that people are at the heart of development; they are not only its ultimate beneficiaries, but also its agents, acting through groups or associations and as individuals.
3) *Predictability* means, in effect, the rule of law. It refers to (1) the existence of laws, regulations, and policies to regulate society and (2) their fair and consistent application. It encompasses well-defined rights and duties, as well as mechanisms for enforcing them and for settling disputes in an impartial manner. Its importance cannot be overstated, since without it, the orderly existence of citizens and institutions would be impossible.
4) *Transparency* refers to the availability of information to the general public and clarity about government rules, regulations, and decisions. Policies or decisions that are known only to the preparers and administrators of the information, distort the governance process. Transparency in government decision-making and public policy implementation reduce uncertainty and can help inhibit corruption among public officials. Hence, the citizen's rights to information may need to be strengthened with a degree of legal enforceability.

Table 2.2 Governance Discussions at the Asian Development Bank

Subject	Points
Definition of governance	The manner in which power is exercised in the management of a country's social and economic resources for development.
Good governance	
Economic governance	Sound development management
Purpose of governance	Development
Elements of good governance	1. Accountability 2. Participation 3. Prediction 4. Transparency
Key governance challenges	1. Anticorruption 2. Corporate Regulatory Frameworks 3. Legal and Justice Reform 4. Participation of the Civil Society in Public Decision-making 5. Pro-poor Service Delivery 6. Public Administration 7. Public Financial Management 8. Sub-National/Local Governance

Source: Asian Development Bank. 1999.

2.2.1.3 United Nations Development Programme

UNDP (1997) looks at governance from the viewpoint of human development and defined governance in a broader sense than the World Bank or ADB as *"the exercise of political, economic and administrative authority in the management of a country's affairs at all levels. It comprises mechanisms, processes and institutions, through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences"*. However, the essence of governance should not also be overstated. As mentioned in UNDP (2006, p.38), good governance is necessary but not sufficient for

countries to sustain progress over the longer term. The nine core characteristics of good governance suggesting its broad recognition are summarized as below (ibid, p. 35):

1) *Participation*: all men and women should have a voice in decision-making, either directly or through legitimate intermediate institutions that represent their interests. Such broad participation is built on freedom of association and speech, as well as capabilities to participate constructively;
2) *Rule of law*: legal frameworks should be fair and enforced impartially, particularly laws on human rights;
3) *Transparency*: transparency is built on the free flow of information. Processes, institutions and information are directly accessible to those concerned with them, and enough information is provided to understand and monitor them;
4) *Responsiveness*: institutions and processes try to serve all stakeholders;
5) *Consensus orientation*: good governance mediates differing interests to reach a broad consensus on what is in the best interest of the group, and where possible on policies and procedures;
6) *Equity*: all men and women have opportunities to improve or maintain their well-being;
7) *Effectiveness and efficiency*: processes and institutions produce results that meet needs while making the best use of resources;
8) *Accountability*: decision makers in government, the private sector and civil society organizations are accountable to the public, as well as to institutional stakeholders. This accountability differs depending on the organization and whether the decision is internal or external to an organization;
9) *Strategic vision*: leaders and the public have a broad and long-term perspective on good governance and human development, along with a sense of what is needed for such development. There is also an understanding of the historical, cultural and social complexities in which that perspective is grounded.

Table 2.3: Discussions of Governance of the UNDP

Subject	Point
Definition of governance	The exercise of political, economic and administrative authority in the management of a country's affairs at all level. It comprises mechanisms, processes and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations and mediate their differences.
Good governance	
Economic governance	Decision-making process that affect a country's economic activities and its relation with other economies.
Core characteristics of good governance	1. Participation 2. Rule of law 3. Transparency 4. Responsiveness 5. Consensus orientation 6. Equity 7. Effectiveness and efficiency 8. Accountability 9. Strategic vision

Source: UNDP. 1997.

2.2.1.4 The International Monetary Fund

Governance has been one of the main debate topics in the International Monetary Fund (IMF). As can be seen in its 1996 *Partnership for Sustainable Global Growth* declaration, the IMF identified "*promoting good governance in all its aspects, including ensuring the rule of law, improving the efficiency and accountability of the public sector, and tackling corruption*" as an essential element of a framework within which economies can prosper. The IMF acknowledged the difficulty in separating aspects related to economic governance from those tied to political factors. However, IMF is primarily concerned with macroeconomic stability, external viability, and orderly economic growth. Therefore, IMF's involvement in governance

is limited only to economic aspects of governance.

Table 2.4: Governance Discussions at the IMF

Subject	Points
Governance	Refers to economic governance
Purpose of good governance	● Economic efficiency and growth ● Macroeconomic stability and sustainable growth
Promotion of good governance	1. Reducing scope for generalized rent-seeking; 2. Enhancing transparency in decision-making and budgetary processes, reductions in tax exemptions and subsidies; 3. Improving accounting and control systems, 4. Improving the composition of public expenditure; 5. Accelerating civil service reform.
Policies advice of governance	*1. Improving the management of public resources* through reforms covering public sector institutions (e.g., the treasury, central bank, public enterprises, civil service, and the official statistics function), including administrative procedures (e.g., expenditure control, budget management, and revenue collection); *2. Supporting the development and maintenance of a transparent and stable economic and regulatory environment conducive to efficient private sector activities* (e.g., price systems, exchange and trade regimes, and banking systems and their related regulations).
Areas of concern/interest	1. Institutional reforms of the treasury; 2. Budget preparation and approval procedures; 3. Tax administration; 4. Accounting and audit mechanisms; 5. Central operation; 6. Official statistics function

Source: International Monetary Fund. 1997

The involvement of IMF in good governance (including the avoidance of corrupt practice)

is mainly through its policy advice and technical assistance to its member countries. This involvement includes: 1) *improving the management of public resource* through reforms in public sector institutions (e.g., the treasury, central bank, public enterprises, civil service, and the official statistics function), including administrative procedures (e.g., expenditure control, budget management, and revenue collection); 2) *supporting the development and maintenance of a transparent and stable economic and regulatory environment conducive to efficient private sector activities* (e.g., price systems, exchange and trade regimes, and banking systems and related regulations), (IMF, 1997).

2.2.1.5 Concluding Remarks

Governance is a very convenient term used to explain unexplained parts of economic growth. Despite the recognition of the importance of governance among international organizations, their weight of emphasis or/and concern differs. For example, the Asian Development Bank is likely to place emphases on *participation of the civil society in public decision-making*, while the World Bank focuses more on *voice and accountability* (see Table 2.1 and Table 2.2). The United Nations Development Programme defined governance from the viewpoint of human development and in a broader sense than the World Bank or the Asian Development Bank. For instance, consensus orientation and strategic vision are included in the UNDP, but not in the World Bank or Asian Development Bank. The International Monetary Fund limits its discussion and involvement of governance only to economic aspects.

2.2.2 Governance Indicators

It is almost impossible to measure the quality of governance precisely. However, understanding the nature of the indicators in use can help us interpret the result in a more correct manner. In generally, there are two types of governance indicators: *facts-based*

indicators (objective governance indicators or actual governance indicators) and *perceptions-based indicators* (subjective governance indicators or perceived governance indicators).

The main difference between the two indicators is that while facts-based governance indicators refer to the *de jure* rules on the books, perceptions-based governance indicators refer to the *de facto* realities on the ground. However, both types of indicators also have their strengths and weakness. One of the strength of facts-based indicators is considered to be the transparency of criteria/conditions in the construction of this data set. For example, data on the existence or non-existence of specific anti-corruption laws, or of a corruption-prosecution agency, the number of legal prosecutions for corrupt acts, the number of procedures/days needed to legally begin new business, are clearly set. At the same time, they also contain a striking weakness due to the reason that, in many cases, it does not reflect the reality. For example, countries may have extensive formal protections of property rights codified in the legal system but the effectiveness of the implementation varies tremendously. Another weakness can also be the distortion in the indirect proxy of governance. Let us, take, for example, the case of corruption. Since corruption is by nature an illegal activity, direct measure of its prevalence is impossible. As a result, an indirect alternative measure has to be employed; this, however, it also encounters difficulties. One of the proxies to indirectly quantify corruption is the frequency of references to corruption in the media. Since the proxy itself largely depends on the competence and independence of media in question, it does not necessarily reflect the actual corruption.

Perceptions-based governance indicators are presently thought to be the best alternative available. This is simply because, as noted earlier, they reflect the perception of the people and represent the de facto situations. But it is also not without critics. One of them is the "*halo effect*", meaning respondents might provide good governance score to richer countries simply because they are richer. Another criticism is the "*potential ideological bias*", meaning

respondents with different ideology such as left-of-center, center-of-center, and right-of-center might score governance differently too. However, Kaufman, Kraay, and Mastruzzi (2005) have conducted regression analyses and proved that most of their sources are not affected by ideological bias.

In conclusion, the distinction between the facts-based and perceptions-based indicators is important. And it would be wrong to say that facts-based indicators are more objective than perceptions ones just because for the sole reason that the criteria of the indicators are constructed with transparency. Both indicators should be used in a complementary manner given prior understanding of the strengths and weakness of each type of indicators. Below is the introduction of the most widely used governance indicators.

2.2.2.1 Country Policy and Institutional Assessment (CPIA) Indicators

The Country Policy and Institutional Assessment (CPIA) assess the quality of a country's present policy and institutional framework. The CPIA was initiated by the World Bank in the 1970s to help guide the allocation of interest-free loans and grants by the International Development Association (IDA) of the World Bank to the poorest countries. The result of CPIA's policy and institutional assessment of borrowing countries serves as an important criterion for IDA to determine their loans and grants to those countries. As a result, despite its similar per capita income level, countries with better governance quality tend to receive more loans and grants from IDA.

Given its focus on poor countries that borrow money from IDA, CPIA has a wider coverage of low-income economies in comparison with other governance indicators. The shortfall of CPIA data set is that it does not cover a consistent time-series. As such it serves the purpose of cross-country analysis rather than time-series or pooled analysis. After undergoing a number of revisions, the latest 2005 CPIA data set, disclosed for the first time to the public in the summer of 2006, has now been classified into four main clusters and consists

of 16 criteria. The rating is given from 1 (lowest) to 6 (highest) for each of the 16 criteria, and each cluster receives the same weight. The criteria for CPIA 2005 have been summarized as the following (CPIA, 2005).

A) Economic management

1) Macroeconomic Management: assesses the quality of the monetary/exchange rate and aggregate demand policy framework.
2) Fiscal Policy: assesses the short- and medium-term sustainability of fiscal policy (taking into account monetary and exchange rate policy and the sustainability of the public debt) and its impact on growth.
3) Debt Policy: assesses whether the debt management strategy is conducive to minimize budgetary risks and ensure long-term debt sustainability.

B) Structural Policies

1) Trade: assesses how the policy framework fosters trade in goods, focusing on the restrictiveness of trade and corruption in customs service.
2) Financial Sector: assesses the structure of the financial sector and the policies and regulations that affect it.
3) Business Regulatory Environment: assesses the extent to which legal, regulatory, and policy environment helps or hinders private business in investing, creating jobs, and becoming more productive.

C) Policies for social inclusion/equity

1) Gender Equality: assesses the extent to which the country has enacted and put in place institutions and programs to enforce laws and policies that 1) promote equal access for men and women to human capital development; 2) promote equal access for men and women to productive and economic resources; and 3) give men and women equal status and protection under the law.
2) Equity of Public Resource Use: assesses the extent to which the pattern of public

expenditures and revenue collection affects the poor and is consistent with national poverty reduction priorities.

3) Building Human Resources: assesses the national policies and public and private sector service delivery that affect access to and quality of: 1) health and nutrition services, including population and reproductive health; 2) education, ECD[2], training literacy programs, and 3) prevention and treatment of HIV/AIDS, tuberculosis, and malaria.
4) Social Protection and Labor: assesses government policies in the area of social protection and labor market regulation; this reduces the risk of becoming poor, assists those who are poor to better manage further risks, and ensures a minimal level welfare to all people.
5) Policies and Institutions for Environmental Sustainability: assesses the extent to which environmental policies foster the protection and sustainable use of natural resources and the management of pollution.

D) Public Sector Management and Institutions

1) Property Rights and Rule-based Governance: assesses the extent to which private economic activity is facilitated by an effective legal system and rule-based governance structure in which property and contract rights are reliably respected and enforced.
2) Quality of Budgetary and Financial Management: assesses the extent to which there is 1) a comprehensive and credible budget, linked to policy priorities; 2) effective financial management systems to ensure that the budget is implemented as intended in a controlled and predictable way; and 3) timely and accurate accounting and fiscal reporting, including timely and audited public accounts and effective arrangement for follow-up.
3) Efficiency of Revenue Mobilization: it assesses the overall pattern of revenue mobilization – not only the tax structure as it exists on paper, but also revenue from all

[2] ECD refers to Early Child Development programs, including both formal and non-formal programs (which may combine education, health, and nutrition interventions) aimed at children aged 0 to 6.

sources as they are actually collected.

4) Quality of Public Administration: assesses the extent to which civilian central government staff (including teachers, health workers, and police) and is structured to design and implement government policy and deliver services effectively.
5) Transparency, Accountability, and Corruption in the Public Sector: assesses the extent to which the executive can be held accountable for its use of funds and the results of its actions by the electorate and by the legislature and judiciary, and the extent to which public employees within the executive are required to account for the use of resources, administrative decisions, and results obtained.

2.2.2.2 International Country Risk Guide (ICRG) Indicators

The International Country Risk Guide (ICRG) indicators were first created in the early 1980s by a privately owned organization to assess *financial, economic, and political risks* among countries and over time. ICRG's *financial-risk* assessments rely wholly on *objective* measurements, including ratios of a country's foreign debt to its GDP, its foreign debt service and its current-account balance to exports of goods and services, and its net international liquidity to imports, and exchange rate stability. Specifically, ratio of foreign debt to GDP is estimated by taking gross foreign debt divided by gross domestic product in a given year, after conversion into US dollars at the average exchange rate for that year. Similarly, foreign debt service ratio to exports of goods and services and current account ratio to exports of goods and services are also calculated using the same method. Net international liquidity as months of import is estimated by the total official reserves for a given year, divided by the average monthly merchandise import cost. Total official reserves here include official holdings of gold, but exclude the use of IMF credits and the foreign liabilities of the monetary authorities. Exchange rate policy is calculated as a percentage change (appreciation or depreciation) of one currency against US dollar over a calendar year or the most recent 12-month period.

As with financial-risk assessments, ICRG's *economic-risk* assessments also capture objective measurements. However, the components used in assessments are different. These include: GDP per capita, real GDP growth, annual inflation rate, budget balance ratio to GDP, and current account ratio to GDP. Specifically, GDP per capita is calculated as a percentage of the average of the estimated total GDP of all the countries covered by ICRG. Real GDP growth is the annual change in the estimated GDP, at constant 1990 prices, of that country.

Table 2.5: ICRG Financial, Economic, and Political Risk Components

	Component (points)	Explanation
Financial Risk Component (50 points)	Foreign debt ratio to GDP (10p)	Gross foreign debt divided by GDP.
	Foreign debt service ratio to export of goods and services	Foreign debt service divided by total exports of goods and services.
	Current account balance ratio to export of goods and services	Current account balance of payments divided by total exports of goods and services.
	Net international liquidity as months of import (5p)	Total official reserve divided by average monthly merchandise cost.
	Exchange rate stability (10p)	Percentage change (appreciation or depreciation) of local currency against USD.
Economic Risk Component (50 points)	GDP per capita (5p)	Percentage of the average of the estimated total GDP of all the countries covered by ICRG.
	Real GDP growth (10p)	Annual change of GDP at constant 1990 prices.
	Annual Inflation rate (10p)	Annual change of unweighted average of CPI.
	Budget balance ratio to GDP (10p)	Percentage of general government budget balance (excluding grants) to GDP.
	Current account ratio to GDP (15p)	Percentage of current account balance of payment to GDP.
	Government Stability (12p)	Government ability to carry out its declared programs, and its ability to stay in office.

Political Risk Component (100 points)	Socioeconomic Conditions (12p)	Socioeconomic pressure at work in society that could constrain government action or fuel social dissatisfaction.
	Investment Profile (12p)	Factors affecting the risk to investments that are not covered in other political, economic, and financial risk components.
	Internal Conflict (12p)	Political violence in the country and its actual or potential impact on governance
	External Conflict (12p)	Risk to the incumbent government from foreign action, ranging from non-violent external pressure to violent external pressure.
	Corruption (6p)	Corruption within the political system.
	Military in Politics (6p)	Military is not elected by anyone; thus its involvement in politics is a diminution of democratic accountability.
	Religion in Politics (6p)	Involvement of religion into politics can lead to the replacement of civil to religious law, and exclusion of other religions.
	Law and Order (6p)	Strength and impartiality of the legal system and popular observance of the law.
	Ethnic Tensions (6p)	Degree of tension within a country attributable to racial, nationality, or language division.
	Democratic Accountability (6p)	Responsiveness of government to its people.
	Bureaucracy Quality (4p)	Institutional strength and quality of bureaucracy, enabling to minimize the revisions of policy when governments change.

Source: ICRG 2003, Brief Guide to the Ratings System.

The annual inflation rate is estimated as the percentage change of unweighted average of the Consumer Price Index. Budget balance ratio GDP is calculated as the percentage of general government budget balance (excluding grant) for that year in national currency to GDP. Current account ratio to GDP is estimated as the percentage of current account balance of payments for that year to GDP of that country.

Table 2.6: Construction of ICRG Governance Indicator

World Bank Governance	Corresponding Elements in	Explanation
Voice and Accountability	Military in politics	♦ Military Involvement in politics is to diminution in democratic accountability.
	Democratic Accountability	♦ Responsiveness of government to its people.
Political Stability	Internal Conflict	♦ Political violence in the country and its actual or potential impact on governance
Government Effectiveness	Government Stability	♦ Government ability to carry out its declared programs, and its ability to stay in office.
	Bureaucratic Quality	♦ Institutional strength and quality of bureaucracy, enabling to minimize the revisions of policy when governments change.
Regulatory Quality	Investment Profile	♦ Factors affecting the risk to investments that are not covered in other political, economic, and financial risk components.
Rule of Law	Law and Order	♦ Strength and impartiality of the legal system and popular observance of the law.
Control of Corruption	Corruption	♦ Corruption within the political system.

Source: ICRG (2003), Kaufman et al. 2003.

In contrast to *financial* and *economic risk* assessments, *political-risk* assessments are a product of its experts' *subjective* interpretations of pre-specified risk components whose weights are decided the same for all countries to facilitate comparison across countries and over time. The 12 components used in political risk assessment include: government stability, socio economic conditions, investment profile, internal conflict, external conflict, corruption, military in politics, religion in politics, law and order, ethnic tension, democratic accountability, and bureaucracy quality.

Among the three categories (political, economic, financial) of ICRG Political Risk Rating System, political risk component is closely related with the governance concept. Out of 12 political risk elements of ICRG, 8 components are used by the World Bank to construct its governance indicators. One of the main reasons for the World Bank's use of ICRG political risk elements is its richness in historical data, which dates back to 1984, and wide coverage of more than 130 countries. The relationship between the two sets of governance indicators are shown in Table 2.6.

In ICRG's original political risk component, some elements hold different weights in comparison to others. For example, *government stability, investment profile, internal conflicts* have twice of *democratic accountability, military in politics, law and order, and corruption*. However, there is no logical explanation on why ICRG uses different weight. ICRG governance indicator itself is based on the experts' *subjective* interpretation of each element. Therefore, ICRG governance indicator can be considered as a *perceived* indicator, rather than an *actual* one.

In addition to individual risk index, the composite index of financial, economic, and political risk rating can be calculated based on the weight, where the political risk index is comprised of 100 points, the financial risk index of 50 points, and the economic risk index of 50 points. The total points from the three indices are divided by two to produce the weights for inclusion in the composite country risk scores, which range from zero to 100. The score

range from 0.0% to 49.9% indicates "Very High Risk"; 50% to 59.9% "High Risk"; 60% to 69.9% "Moderate Risk"; 70% to 79.9% "Low Risk"; 80% or more indicates "Very Low Risk". The formula to calculate this aggregate political, financial, and economic risk is as below:

CPFER (country A) = 0.5 (PR + FR + ER), where

CPFER = Composite political, financial and economic risk ratings

PR = Total political risk indicators

FR = Total financial risk indicators

ER = Total economic risk indicators

2.2.2.3 Freedom House Indicators

Freedom House (FH) is a private non-governmental advocacy organization established in the United States in 1941. It serves as "a vigorous proponent of democratic values and a steadfast opponent of dictatorships of the far left and the far right."[3] From 1973 Freedom House has rated a country's political rights and civil liberties on a scale of 1 (highest) to 7 (lowest). Underlying those ratings are more detailed assessments of country situations based on a 40-point scale for political rights and a 60-point scale for civil liberties. The average of the two ratings is used to designate the country's status as "free" (a score below 3), "partially free" (3 to 5) or "not free" (above 5). In the latest survey edition, Freedom in the World 2010, the 7 subcategories that compose assessments of what constitute political rights and civil liberties were released. The rating process is based on a checklist of 10 political rights questions and 15 civil liberties questions (Freedom House 2010).

The political rights questions are classified into 3 subcategories:

1) *Electoral process:* a) to see whether the head of government and/or other chief national authority are/is elected through and fair elections; b) to see whether national

[3] Freedom House. http://www.freedomhouse.org/template.cfm?page=2

legislative representatives are elected through free and fair elections; c) to see whether the electoral law and electoral framework is fair.

2) *Political pluralism and participation*: a) to see whether the people have the rights to organize in different political parties or other competitive political groupings of their voices, and to see whether the system is open to the rise and fall of these competing parties or groupings; b) to see whether there is a significant opposition vote and a realistic possibility for the opposition to increase its support or gain power through elections; c) to see whether the people's political choices are free from domination by the military, foreign powers, totalitarian parties, religious hierarchies, economic oligarchies, or any other powerful group; d) to see whether cultural, ethnic, religious, or other minority groups have full political rights and electoral opportunities.

3) *Functioning of government*: a) to see whether the freely elected head of government and national legislative representatives determine the policies of the government; b) to see whether the government is free from pervasive corruption; c) to see whether the government is accountable to the electorate between elections and that it operates with openness and transparency.

The civil liberties questions are classified into 4 subcategories:

1) *Freedom of expressions and belief*: a) to see whether there is a free and independent media and other forms of cultural expression; b) whether religious institutions and communities are free to practice their faith and express themselves in public and private; c) whether there is academic freedom and an educational system that is free of extensive political indoctrination; d) whether there is open and free private discussion.

2) *Associational and organizational rights*: a) to see whether there is freedom of assembly, demonstration, and open public discussion; b) whether there is freedom for nongovernmental organizations; c) whether there are free trade unions and peasant

organizations or equivalents, effective collective bargaining, and free professional and other private organizations.

3) *Rule of law*: a) to see whether there is an independent judiciary; b) whether the rule of law prevails in civil and criminal matters, and whether police are under direct civilian control; c) whether there is protection from political terror, unjustified imprisonment, exile, or torture by either groups that support or oppose the system as well as freedom from war and insurgencies; d) whether laws, policies, and practices guarantee equal treatment of various segments of the population.

4) *Personal autonomy and individual rights*: a) to see whether the state control travel or choice of residence, employment, or institutions of higher education; b) whether citizens have the right to own property and establish private business, and also whether private business activity is unduly influenced by government officials, the security forces, political parties/organizations, or organized crime; c) whether there are personal social freedoms, including gender equality, choice of marriage partners, and size of family; d) whether there is equality of opportunity and the absence of economic exploitation.

2.2.2.4 Transparency International

Transparency International (TI) was founded in 1993 as a small NGO by a group of people committed to fight against corruptions worldwide. In 1995, it first published its annual publication on *Corruption Perception Index* (CPI), which has drawn a remarkable attention from media and it is widely used by investors, donors, analysts and academics all over the world. The CPI 2009, a composite index, ranks 180 countries and is calculated using data from 13 different surveys (assessments) produced by the following 10 independent organizations (Transparency International 2009). However, the number of surveys included might vary from one year to another depending on the availability. These 10 organizations are listed below:

1) Asian Development Bank (ADB): Country Performance Assessment ratings 2008.
2) Africa Development Bank (AfDB): Country Policy and Institutional Assessments 2008.
3) Bertelsmann Foundation (BF): Bertelsmann Transformation Index 2008.
4) Economist Intelligence Unit (EIU): Country Risk Service and Country Forecast 2009.
5) Freedom House (FH): Nations in Transit 2009.
6) Global Insight (GI): formerly World Markets Research Center – Country Risk Rating 2009.
7) Institute for Management Development (IMD): World Competitiveness Report 2008 and 2009.
8) Political and Economic Risk Consultancy (PERC): Asian Intelligence 2008 and 2009.
9) World Economic Forum (WEF): Global Competitiveness Report 2008 and 2009.
10) World Bank (WB): Country Policy and Institutional Assessment for IDA countries.

To reduce abrupt variations in scoring that might arise due to random effect, the CPI annual ranking is based on data from the past two years. For example, 2007 CPI combines assessments of annual survey and data from 2006 and 2007[4]. CPI differs from other indicators in that it focuses only on corruption matters. And the definition of corruption used by TI is *"the misuse of public power for private gain"*, for example bribing public officials, kickback in public procurement, or embezzlement of public funds. Survey methodology utilized by TI is a perceptions-based one since it is almost impossible to measure the actual corruption in practice.

For time series comparisons, CPI data is suitable only for the country's score, not its rank. This is because a country's rank can vary simply when new countries enter the index or others drop out. However, cross-country comparisons can also used but only with prudent attention to the standard deviation of the data set.

[4] The Methodology of Perception Corruption Index 2007, pp 2.

2.2.2.5 World Bank (KKZ) Governance Indicators

Maybe one of the most widely used governance indicators at present are the indicators established by Daniel Kaufmann, Aart Kraay, Zoido-Lobaton, and their team at the World Bank Institute. Taking the team members' initials, these indicators are later commonly called KKZ indicators. Kaufman et al. define governance simply as "*the traditions and institutions by which authority in a country is exercised*". Interpretation of governance is comprised of three dimensions of six composite indicators: Voice and Accountability, Political Stability, Government Effectiveness, Regulatory Quality, Rule of Law, and Control of Corruption, as can be seen in Table 2.7. These six indicators are constructed from hundreds of existing indicators produced by 37 different data sources, supplied by 31 different organizations. To produce each of these KKZ composite indicators, Kaufmann et al. follow five stages.

Stage one: KKZ identify existing indicators and aggregate them by source in order to calculate a single number for each source. This aggregation method calculates a simple, un-weighted average of all existing indicators they use from a source to maintain the rule of one source one number for one composite indicator. For example, in the case of 2005 "Rule of Law", 24 sources in 2004 were used. One of them is "World Markets Online". Among the several indicators produced by World Markets Online, KKZ choose "Judicial Independence" and "Crime" as a relevant composite indicator for Rule of Law. So KKZ calculate the arithmetic mean of these two indicators and name it as "World Markets Online" source for Rule of Law. This "World Markets Online" is later combined with other 23 sources to compute a final "Rule of Law" indicator.

Stage two: KKZ apply a formula to each source to be used in the construction of the particular composite indicator to decide whether the source covers a large enough number of countries in different income groups and regions to qualify as a "*representative"* source. Particularly, for the case of "Rule of Law", out of 24 sources used in 2004, only 10 qualify as *representative*.

Table 2.7: The World Bank Governance Indicator

Definition	Elements	Explanations
The process by which government are selected, monitored, and replaced.	Voice and Accountability (VA)	● The extent to which citizens of a country are able to participate in the selection of governments. ● The freedom of expression, association, and media.
	Political Stability (PS)	● Perception of likelihood that the government in power will be destabilized or overthrown by possibly unconstitutional and/or violent means, including domestic violence and terrorism.
The capacity of the government to effectively formulate and implement sound policies	Government Effectiveness (GE)	● The quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies.
	Regulatory Quality (RQ)	● The ability of the government to formulate and implement sound policies and regulations that permits and promotes private sector development.
The respect of citizens and the state for the institutions that govern economic and social interactions among them	Rule of Law (RL)	● The extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence.
	Control of Corruption (CC)	● The extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests.

Source: Adopted from Kaufmann et al. (2003, 2007)

Stage three: KKZ aggregate the "*representative*" sources into one preliminary composite indicator. In this stage, in contrast to stage one where the same weight is applied to all existing indicators, different "representative" sources are weighted according to the strength of their correlation with one another. The more particular sources are highly correlated with other sources the higher weight given to those sources. This is also because a higher correlation suggests smaller "error variance", meaning the source is more trustworthy. The logic of this weighting procedure is based on the assumptions that errors in the numbers of one source are both independent across countries (for the same source) and independent of the errors in the numbers from other sources used in the same composite indicator (although the authors admit that it is unrealistic). This way, statistical correlation found among the numbers of different sources can be interpreted as *factual accuracy*. In other words, sources that are highly correlated with one another are considered more informative, attributing to lower error variances and higher weights.

Stage four: KKZ regress the "non-representative" sources on the preliminary composite indicators produced in stage three to obtain estimates of the errors variances of those sources. The procedure is similar to stage three; sources that are more highly correlated with others will have lower estimated error variances and therefore provided higher weights.

Stage five: for this final stage, KKZ calculates new weights for all sources according to their error variances obtained in stage three (representative sources) and in stage four (non-representative sources). In this stage, the final composite indicators are aggregated. Sources of KKZ indicators are shown in Table 2.8.

Despite this careful construction, KKZ governance indicators still face some technical concerns such as the likelihood of correlation of errors among sources; lack of comparability over time; sample bias; and insufficient transparency. First, the assumption of non-correlation of sources errors is unrealistic, as was also recognized by the authors, because they are in fact affected. Second, since the nature of KKZ indicators themselves are *static* across country;

Table 2.8: Sources of Governance Data Used to Construct KKZ Indicators

Cross-Country Surveys of firms (5 sources)
1. Global Competitiveness Survey (VA, PS, GE, RQ, RL, CC)
2. World Competitiveness Yearbook (VA, PS, GE, RQ, RL, CC)
3. Business Environment and Enterprise Performance Survey (GE, RQ, RL, CC)
4. World Business Environment Survey (VA, PS, GE, RQ, RL, CC)
5. Africa Competitiveness Report 1998 (PS, GE, RQ, RL, CC)
Cross-Country Surveys of Individuals (5 sources)
1. Voice of the People (VA, PS, GE, RL, CC)
2. Gallup International Millennium Survey (VA, PS, GE, RL, CC)
3. Latinobarometro (VA, PS, GE, RL, CC)
4. Afrobarometer (VA, PS, GE, RL, CC)
5. Latin America Public Opinion Project (VA, RL, CC)
Expert Assessments from Commercial Risk Rating Agencies (10 sources)
1. Business Risk Service (PS, GE, RL, CC)
2. Quantitative Risk Measure in Foreign Lending (PS, GE, RL, CC)
3. Country Risk Review (PS, GE, RQ, RL, CC)
4. International Country Risk Guide (VA, PS, GE, RQ, RL, CC)
5. EIU Country Risk Service and Country Forecasts (VA, PS, GE, RQ, RL, CC)
6. World Markets Online (VA, PS, GE, RQ, RL, CC)
7. iJET security risk rating (PS)
8. Gray Area Dynamics (PS, GE, RQ, RL, CC)
9. Political Economic Risk Consultancy (CC)
10. Opacity Index (GE, RQ, CC)
Expert Assessments from NGOs, Think Tanks (12 sources)
1. Press Freedom Index (VA)
2. Index of Economic Freedom (RQ, RL)

3. Freedom in the World (VA)
4. Nations in Transit (VA, GE, RL, CC)
5. Countries at the Cross Roads (VA, RL, CC)
6. Cingranelli & Richards Human Rights Database (VA, PS, RL)
7. Political Error Scale (VA, PS, RL)
8. Bertelsamann Transformation Index (VA, GE, RQ, RL)
9. Global E-Governance Index (GE)
10. Media Sustainability Index (VA)
11. Index of Budget Transparency (VA)
12. State Capacity Survey (VA, PS, GE, RL, CC)
Expert Assessments from Governments, Multilaterals (5 sources)
1. World Bank Country Policy and Institutional Assessments (GE, RQ, RL, CC)
2. Transit Report, European Bank for Reconstruction and Development (VA, PS, GE, RQ, RL,
3. African Development Bank's Country Policy and Institutional Assessments (GE, RQ, RL, CC)
4. Asian Development Bank's Country Policy and Institutional Assessments (GE, RQ, RL, CC)
5. Progress towards Good Governance in Africa, UNECA (The United Nations Economic

Source: Kaufmann et al. (2005a), compiled by the author.

Note: Parentheses contain the governance elements to which each source refers.

thus it is not suitable to be compared over time. However, Kaufmann et al. (2005a) construct, in addition to their original *static* model, a *dynamic* model that allows comparisons of countries' governance scores, but only after 1996. Third, another concern is the sample bias issue. As noted earlier, in the aggregation procedure more weight is given to the majority and less weight is given to the minority. This procedure, in fact, results in more weight to experts' assessments and enterprise surveys than to individual surveys.[5] For example, in the case of

[5] See Kaufmann et al. 2005a.

"Voice and Accountability", sources with highest weights are Freedom House's "Nations in Transition" (0.39) and "Freedom in the World" (0.12) and the Economist Intelligence Unit's "Country Risk Service" (0.18), while sources based on population surveys Afrobarometer, Latinobarometer and Gallup International's "Voice of the People" carry almost no weight (0.01)[6]. Finally, the sources from which KKZ indicators are obtained and used are of insufficient transparency for many reasons, including the unclear criteria to determine its country rankings.

2.2.2.6 Concluding Remarks

In conclusion, there exist no perfect or precise governance indicators. However, each governance indicator has distinguishing features (See Table 2.9 for details). For example, CPIA indicators cover a wide range of low-income economies but shortage in time-series. ICRG indicators provide a combination of economic, financial, and political risks indicators. And while economic and financial risk indicators are based on objective assessments, the political risk indicator is of subjective ones. The World Bank's KKZ indicator, which is one of the most carefully constructed and sophisticated indicators, through its five-stage method, combines both facts-based and perceptions-based governance indicators. Therefore, given the different nature of governance indicators, one should be careful in how they are used and interpreted to avoid misunderstandings.

Given the strength and weakness in each governance indicator, in this dissertation ICRG and CPIA indicators are selected and used in the intra-income group analysis in Chapter 4. The ICRG indicator is selected for two reasons. First, it has wide coverage of governance elements which correspond to all of the World Bank's Governance Indicators (KKZ Indicators). Second, ICRG indicator is rich in both time-series and cross-country data, especially for middle-income and high-income countries. However, its shortcoming is that the

[6] See Kaufman et al. 2003. Governance Matters 3: Governance Indicators for 1996-2002, pp. 46.

coverage for low-income countries is limited. To complement this drawback, the World Bank's CPIA governance indicator is used. The main reason for employing this indicator is that, in addition to its wide coverage of low-income countries, the elements covered by the CPIA governance indicator are also broad.

A better way to understand governance is to look at either its short-term or long-term effect. Short-term effect of governance refers to the policy stance of the government that can be changed or adjusted in a few years such as trade policy, inflation management policy, exchange rate management policy, and government fiscal deficit management policy. On the other hand, long-term effect of governance refers more to structural issues which can takes years or decades to change. As such, misunderstanding of time frame of governance can result in policy confusions.

Table 2.9: Summary of the Features of Governance Indicators

	TI	FH	ICRG	CPIA	KKZ
Governance Indicators	CPI	Political	Economic	CC	VA
		Civil	Financial	SP	PS
			Political	PSIE	GE
				PSMI	RQ
					RL
					CC
Time Series Comparability	Yes	Yes	Yes	No	No
(Starting Year)	1995	1995	1984	?	1996
Cross Country Comparability	Yes	Yes	Yes	Yes	Yes
Number of Country Coverage	180 (2009)	202 (2008)	138 (2003)	76 (2005)	212 (2006)

Source: Compiled by the author.

2.2.3 Economic Governance

As has been well summarized in Ishihara (2003, Ph.d. dissertation), there is no fundamental difference in definitions between governance and economic governance. Economic governance can be regarded as a subset of governance, which deals with economic affairs. In general, the definition of governance is rather broad as it covers also social and political affairs. For instance, the World Bank (1992) defines governance as *"the manner in which power is exercised in the management of a country's social and economic resources for development*". And out of its 6 subsets of governance from the World Bank, "*Regulatory Burden*" and *"Rule of Law"* can be considered as the core elements for economic governance. The Asian Development Bank (1999), economic governance is defined as *"sound development management"*, while the definition of the United Nations Development Programme (1997) is the *"decision-making process that affect a country's economic activities and its relation with other economies".*

In common with, IMF acknowledges the difficulty in separating the aspects of economic governance from political ones. And since the main concern of IMF is more related with economic affairs, the term governance used by the IMF is implicitly considered a synonym to economic governance. According to the IMF (1997), the purpose of good governance is (1) economic efficiency and growth, and (2) macroeconomic stability and sustainable development (See Table 2.4 for details).

2.3 Economic Governance and Economic Development

The main determinants of growth in early neoclassical models were physical and human capital. Based on their assumption of diminishing returns to capital, convergence between the per capita incomes of developing and developed countries will occur in the long run. However, empirical evidence to underpin this prediction is scarce. Growth accounting model based on the aggregate production function approach was created to explain the sources of growth.

Neoclassical economists advocated the major sources of growth were factor inputs such as labor and capital. However, the growth from improved nutrition, health, and education were also substantial. Such gains in factor productivity come either through the channels of improved quality of labor, management of resources, or through other channels. Later, Romer (1986, 1990) and Lucas (1988) extended those models by formulating them into the so-called endogenous growth theory.

The endogenous growth theory treats human capital, where physical capital is included, and technology as the very important factors of production function to explain growth dynamics of an economy. Different from the original neoclassical model, the endogenous growth model assumes that production factors (physical capital and technology) are subject to increasing returns, meaning there is no priori reason that rich and poor countries converge in terms of per capital income levels.

In line with this endogenous growth theory, a separate strand of thinking started from the early 1980s attempted to provide an alternative view to explain the process of economic development. It is called *New Institutional Economics* (NIE), and can be traced back to the work of Douglass North (1981, 1990). By emphasizing the crucial role of institutions in explaining growth performance, the NIE argues that the assumption of neoclassical and its extended theory, where decision-making is a frictionless process and institutions play a neutral role in the background is false. Decision-making is carried out through the intermediation of economic and political markets, where all actors respond to the given incentives in those markets. If the incentives are favorable it brings productive results; however, if they are not, it encourages predatory behaviors. In short, the NIE argues that among other factor inputs, institutions play a central role in allocating and managing resources, both physical and human, and influence developmental outcome (Chakravarti, 2005).

Based on the new understanding that the state is not neutral, there have been a growing

number of studies examining the influence of political/institutional variables on growth. These political/institutional factors are also called governance factors, although the definition and variables of governance itself differs among international organizations.[7] Using data on corruption, bureaucracy, red tape and the efficiency from the judicial system from Business International, Mauro (1995) found that for the period of 1960-85, democratic efficiency and corruption were significantly associated with per capita GDP growth and investment/GDP ratio. The study concluded that poor economies have corrupt, cumbersome bureaucracies and that this institutional inefficiency leads to lower future growth prospects.

Knack and Keefer (1995) extended the study by aggregating the institutional indicators compiled by the International Country Risk Guide (ICRG) and Business Environment Risk Intelligence (BERI) to investigate their impacts on growth performance. They found that the inclusion of the ICRG and BERI indices strengthened the explanatory power of the equations, and that one standard deviation increase in the ICRG index is associated with a 1.2 per cent increase in per capita income growth rate. Using ad hoc growth equation, Barro (1997, p.28) also found a similar result. He concluded that maintenance of the rule of law is important for investment and growth.

In recent years, the World Bank has also been keen to conduct substantive studies to confirm the relationship between economic and political governance and growth. As can be seen in section 2.2.2.5 in this chapter, Kaufmann and his team at the World Bank have constructed six fundamental governance indicators. They are: *"voice and accountability"* to measure degree of civil liberties and independence of media; *"political stability"* to measure the ability of citizens to peacefully select and replace those in power; *"government effectiveness"* to measure the quality of the bureaucracy; *"regulatory quality"* to measure the degree of market-friendliness; *"rule of law"* to measure the confidence in rule of society and contract enforcement; *"control of corruption"* to measure the degree to which public power is

[7] Details are explained in "section 2."

used for private gain. Undertaking a cross-country comparison for between 155 and 173 countries based on data for 1997 and 1998, Kaufmann et al. (1999) found that there was a strong causal relationship that improved governance leads to better developmental outcomes.

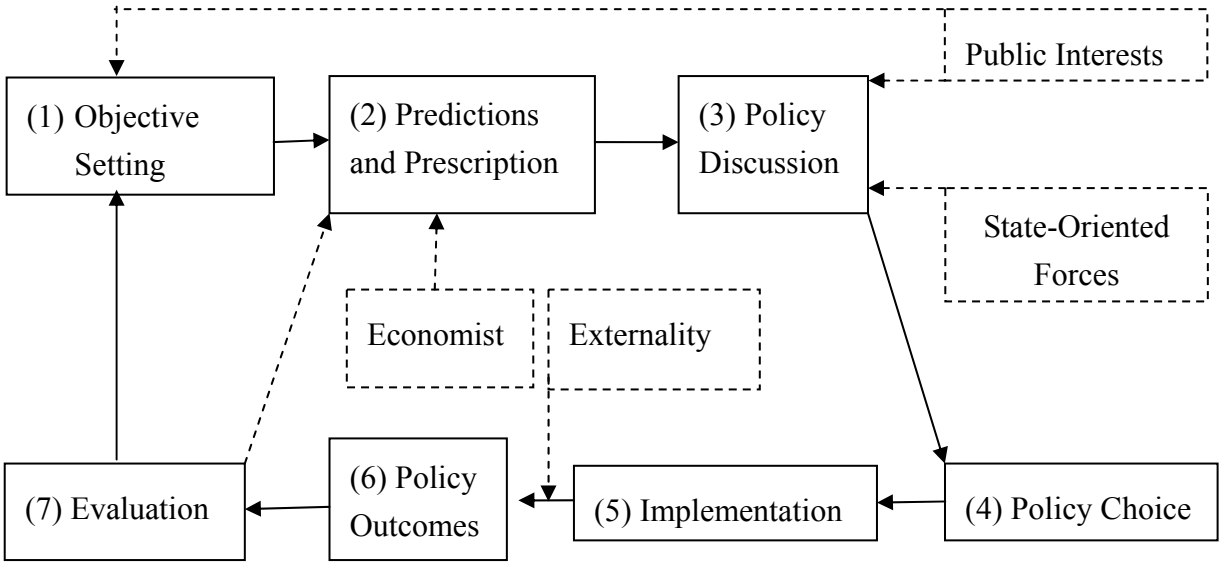
In summary, we can say that although the indicators used as proxies for governance differ, in general, empirical studies have proved that governance plays a vital role in growth performance. The next section explains how governance affects growth outcome.

2.3.1 How Governance Affects Economic Performance

Countries with relatively good governance tend to grow faster, while countries with relatively bad governance tend to grow more slowly. Thus, elements of good governance play a crucial role in determining the growth rate of an economy. Good governance, however, is also defined as sound economic management. Modified from Meier (1995, p. 581), Ishihara (2005) explained the process by which economic management affects an economic policy, as can be seen in Figure 2.1. There are seven components: (1) objective setting, (2) predictions and prescriptions, (3) policy discussion, (4) policy choice and formulation, (5) implementation, (6) policy outcomes, and (7) evaluation. Ishihara (2005) treats economic management as a circular process by adding “objective setting” and “evaluation” compared to Meier (1995), where he treats economic management as a linear process. This process begins with an objective setting, and then predictions and prescription are made with the help of economists. Based on policy predictions and prescriptions, policy makers carried out the discussions. And then society-centered forces such as interest groups and voters have some influence. Policies are chosen from several alternatives. Policy outcomes after implementation are also the products of various kinds of externalities. And finally, an evaluation of the outcomes is taken into consideration for the next round of objective setting (Ishihara, 2003). Elements of economic governance affect each component of economic management.

1) **Objective setting**: Public interests should be well understood and reflected in the objective setting process. This objective setting is closely related to *participation* in which all stakeholders have a voice in decision-making. Unless objectives are set in a participatory manner, policy outcomes may not be satisfactory to stakeholders even if the set-objectives are achieved;
2) **Predictions and prescriptions**: *Transparency* and *rule of law* are the key elements for better predictions and prescriptions of the policy. If *rule of law* is not in place and the decision making process is not *transparent*, it would be difficult to predict the results as well as its prescriptions.
3) **Policy discussion by policy makers**: For the same reason as in objective setting, this action requires *participation* of policy makers so that all policies are well understood before they are put for the selection.
4) **Policy Choice and formulation**: *Accountability* is vital for this component. Accountability here means that public officials are responsible and accountable for their actions. Without a sense of accountability, policies would not lead to desired outcomes. For example, policy formulation is just to favor public officials or a certain group of people and it could be a source of corruption;
5) **Implementation:** *Accountability, transparency, and rule of law* are important in this component. A lack of sense of accountability and transparency can create room for corruption in policy choice and formulation. And although a policy maybe good, if it is not carried out based on laws and regulations, individuals may intervene in the policy and distort the implementation.
6) **Evaluation:** After the policies are implemented, their outcomes are subject to be evaluated before the selection of a new project. Again in this process, *transparency* is crucial so that real outcome is reflected.

Figure 2.1: Relationships between Economic Policy Formulation and Economy



Source: Meier (1995, p. 581), modified by Ishihara (2003)

2.3.2 Economic Governance, Transaction Costs and Economic Performance

Many economists argue that countries with a lower level of governance tend to achieve lower economic growth. North (1990, p.64) stressed the importance of an efficient judicial system to enforce contracts as a crucial determinant of economic performance. He also asserted "*institutions affect the performance of the economy by the effect on the costs of exchange and production*" *and "the costliness of information is the key to the costs of transacting, which consists of the costs of measuring the valuable attributes of what is being exchanged and the costs of protecting rights and policing and enforcing agreements."* (ibid, p.27). The latter part of North's assertion emphasizes the importance of information costs, implying the significance of *transparency* as a key element for transaction costs. The former, protecting rights, policing and enforcing agreements are aspects of the *rule of law (*ibid, p.5). Mauro (1995) also emphasized that low security of property rights over physical capital, profits, and patents may reduce incentives and opportunities to invest, innovate, and obtain foreign technology. Inefficient and complex red tape may also delay the distribution of

permits and licenses and therefore slow down the process of technological advancement.

The discussion on the effect of corruption on economic growth is particularly zealous. Leff (1964) and Huntington (1968) suggested that corruption might foster economic growth under two conditions. First, corruption having the characteristics as "speed money" would enable individuals to avoid delay. Second, government employees who are allowed to accept bribes would work harder, especially in the case where bribes act as a piece rate. The first mechanism suggests that corruption is beneficial to growth only in countries where bureaucratic regulations are cumbersome, while the second one would operate regardless of the level of red tape. In contrast, Mauro (1995) argues that corruption lowers private investment, thereby reducing economic growth, even in subsamples of countries in which bureaucratic regulations are very cumbersome.

The most influential theory to explain the relationship between governance and economic performance is probably North's *Transaction Cost Theory*. Unlike the traditional neoclassical model, North (1990, p.28) defines the costs of production as the combination of transformation costs of resource inputs (such as land, labor, capital) into the physical attributes of a good (size, weight, color, location, chemical composition, and so forth) and transaction costs – such as protecting and enforcing the property rights to goods. This transaction cost, which is assumed to be free in the neoclassical model, is considered closely correlated with the quality of governance itself. For example, out of the components of transaction costs, "search and information costs" are related with *transparency* and *regulatory quality* of the government. Another important element is the "policing and enforcement costs". This element is considered closely associated with the aspects of *rule of law*.

In conclusion, as the costs of production are the combination of costs of transformation and costs of transaction, if the level of economic governance affects the costs of transaction, it therefore also affects the economic performance.

2.3.3 Impact of Economic Governance and Stage of Development

In neoclassical economics, physical and human capitals serve as the main inputs for economic output. The New Institutional Economics (NIE) extends this model by incorporating the institution/governance factors as *endogenous* variables to manage and allocate those resources. And as proved by empirical studies earlier, it is clear that governance positively affects economic growth in general. However, so far, only a few studies have proved the effects of governance based on the income groups. This section aims to address this shortage.

Based on the assumption that the economic growth is affected by the level of human capital and physical resources injected, we can conclude that a country with high level of human capital and physical resources tends to grow faster. In contrast, if a country possesses a lower level of human and physical inputs, it tends to grow slower (see neoclassical growth theory). If governance is considered as the management of those resources (human and physical), a country with abundant resource tends to be more affected by the change of quality of governance. For example, in the low-income economies where both physical and human resources are rather limited, the impact of governance on low-income economies is also considered limited. For the same logic, for the middle-income economies where basic infrastructures, institutions, and human capital necessary for economic activities are in place, the role of governance is also becoming increasingly important. Given a relatively larger size of resources to manage, the impact of governance on growth performance is also considered more influential. Finally, in the high-income economies, where resources are relatively more abundant, incremental changes in governance structure can largely affect growth outcome. Nevertheless, this is not to say that governance is not important in low-income economies, but rather to suggest that its impact on growth is smaller in comparison with more developed states. Details of the analysis are discussed in Chapter 4.

2.4 Conclusion

This chapter introduced the concept and usage of governance, economic governance and its indicators. In spite of the increasing recognition and importance of governance, its definition is still vague and varies depending on the context and the purpose of the users. Even among the international organizations, there is no consistent definition. For example, the World Bank and Asian Development Bank define governance as the "*the manner in which power is exercised in the management of a country's social and economic resources for development",* while United Nations Development Programme defines it in a broader sense as "*the exercise of political, economic and administrative authority in the management of a country's affairs at all levels",* reflecting its emphasis on the human development aspect. As for IMF, since its main concern is more related with the economic issue, the term governance implicitly means economic governance per se.

Economic governance, in principle, is considered as a subset of governance, which deals with economic issues. However, it is difficult to draw a clear distinction between economic aspects of governance from political and social ones. For example, "rule of law", "transparency" carry both economic and political aspects.

With the variations of definition of governance, different governance indicators were also produced to serve each purpose. Freedom House (FH), whose main concern deals with the political affairs, produces indicators of political rights and civil liberties of more than 200 countries worldwide. Transparency International's (TI) main governance indicator is the Corruption Perception Index (CPI), evaluating the corrupt practices of more than 170 countries. Both FH and TI indicators have sufficient historical data and are suitable for cross-country analysis. The World Bank also constructed governance indicators, namely CPIA data and KKZ data set. CPIA data evaluates the present policy and institutional framework of low-income countries, and has been used by IDA as a criterion in providing interest-free loan. Therefore, this data set has a wide coverage of low-income countries but in short of time

series. KKZ data is now considered the most comprehensive governance data set by the World Bank. There are six elements in this indicator: voice and accountability, political stability, government effectiveness, regulatory quality, rule of law, and control of corruption. This data covers more than 200 countries and is suitable for cross-country analysis but short of historical data.

Given the qualitative nature of governance, it is almost impossible to accurately measure its quality. However, most economists agree with the positive relationship between the quality of economic governance and economic performance. This is because lower level of economic governance pushes up the transaction costs, distorts the market and therefore leads to slower growth. In other words, better economic governance improves investment environment, and thus lead to higher growth.

Chapter 3: Concepts of Foreign Direct Investment and Its Role in Economic Development

3.1 Introduction

Since the late 1990s, the importance of governance in growth performance has been widely recognized and the researches on the relationship between governance and economic growth have been increasing significantly in numbers. Knack and Keefer (1995), Mauro (1995, 1997), Hall and Jones (1999) have emphasized the role of political, institutional and legal environment of a country to determine the economic performance. At the same time, there has also been a growing interest in the determinants of foreign direct investment (FDI) especially in developing countries. The volume of FDI has also been growing significantly since 1980 and it has been perceived by many host governments of developing countries as one of the stable sources of capital flows.

As stated in ADB (1999), most economists accept that a positive correlation exists between total investment and growth. Therefore, if corruption affects total investment, it must affect growth. Similarly, although not as clear as total investment, the positive correlation between FDI and growth is also widely recognized. By the same logic, if corruption affects FDI, it also affects economic growth of a country.

Although it is not the prime concern in this dissertation, the relationship between FDI and domestic investment is another crucial issue in discussions of the role of FDI on economic growth. The impact of FDI on domestic investment appears to be different from one country to another, depending on the stage of development and government policy towards the attraction of FDI. For example, the impact of FDI on domestic investment can be both positive, through the *crowd-in effect*, and negative through the *crowd-out effect*. The crowd-in effect, where FDI complements domestic investments, is likely to bring about linkages between the two and tends to result relatively high in technology transfer and management

know-how. In this case, domestic industry is likely to become increasingly more competitive. The crowd-out effect, on the other hand, is the case where FDI firms compete with domestic investments. And given the superior technology and management know-how of FDI, domestic firms are forced to downsize or go bankrupt. Consequently, this situation could slow down the development of domestic industry and become an impediment of economic growth as well. However, empirical evidence shows that the positive impact of FDI generally exceeds its negative one, resulting in higher growth for the recipient country.

This chapter mainly focuses on two issues. First, the concept and types of FDI and its role in the economic development are discussed. Then, literature reviews on the relationship between FDI and economic growth are provided with an emphasis on the impact of FDI on economic performance of different income groups in the host and home economy.

3.2 Concept of FDI

FDI has increasingly been perceived as an important source of foreign private capital inflow, especially for countries where domestic savings fall behind domestic investments. In comparison with other foreign private sources such as external commercial borrowing, and portfolio investment, FDI, by nature, is considered as a relatively less risky and more stable source of capital. For external commercial borrowings, borrowers must pay back both principal and interest on commercial debt for both good and bad projects. And portfolio investment is, in general, rather a foot-loose and volatile source due to the fact that investors tend to care more about short-term profits. However, FDI puts more emphasis on long-term management of the firms.

Definition of FDI

UNCTAD (2002) defined FDI as “an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign investor

or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate)". Similarly, the World Bank defines FDI as "investment made to acquire a lasting management interest (usually at least 10 % of voting stock) in an enterprise operating in a country other than that of the investor".

3.2.1 Motives of FDI

The motive for a foreign investment is essential in determining how linkages and externalities develop. And the relative importance of each motive partly reflects the state of development. (Narula and Dunning, 2000). There are four main motives for investments: (1) to seek natural resources; (2) to seek new markets; (3) to restructure existing foreign production through rationalization; (4) to seek strategically related created assets. The first three represent motives that are primarily asset exploiting in nature: that is the investing company's primary purpose is to generate economic rent through the use of its existing firm-specific assets. The last is a case of asset-augmenting activity, whereby the investing firm wishes to add to its existing assets (Narula and Dunning, 2000).

3.2.1.1 Resource-Seeking FDI

Resource-seeking FDI refers to FDI whose objective is to obtain resources both natural such as minerals, raw materials, agricultural products and non-natural resources such as unskilled labor. The former tends to be location-specific and substitute is quite limited. In addition, it can also be justified by the fact that FDI flows from most industrialized countries to less developed countries where natural resources are abundant. The latter including unskilled labor tends to be less attractive as the cost of this input rise, especially when the productivity improvements fail to match wage cost increases.

One of the characteristics of resource-seeking FDI is generally (but not always) that it has

low value adding activity and low capital expenditure on plant and equipment (extractive industry is the exception). This type of FDI tends to be less sticky or more footloose, as it is located largely in least developed economies and it decreases as the countries start to develop.

3.2.1.2 Market-Seeking FDI

Market-seeking FDI refers to FDI which seek to supply local or adjacent markets. This type of FDI becomes significant either when there are substantial barriers to exporting from home the country or when opportunities of producing in the host country can help achieve considerable economies of scale. Simultaneously, it also requires a sizable population and human resource/ability to be engaged in the operation of the firms.

Market-seeking FDI these days are different from decades ago. Economic integration such as globalization, regionalization such as EU, NAFTA, and ASEAN has significantly reduced trade barriers and made it easier for FDI firms to export to adjacent markets. In other words, membership of a free trade area allows small domestic markets to expand their de facto market size. This type of FDI tends to concentrate in economies where the market size is sufficiently big, many of which are the middle-income and the high-income states.

3.2.1.3 Efficiency-Seeking FDI

Efficiency-seeking FDI has two forms. In the most common form, firms often seek to raise cost efficiency by transferring their production, totally or partially, to locations with lower labor cost. This type of FDI often takes place in labor-intensive industries where unskilled labor or semi-skilled labor represents an important part of the production costs, which can be mainly seen in both low-income and middle-income economies. The second type of efficiency-seeking FDI corresponds to FDI that seeks to rationalize the operations of existing firms. Its target is perhaps to exploit the comparative advantages in adjacent markets or to exploit the economy of scale and scope. In general, this second type of

efficiency-seeking FDI tends to take place in middle- and high-income countries.

3.2.1.4 Strategic Asset-Seeking FDI

Strategic asset-seeking FDI is rather an asset-augmenting FDI than asset-exploiting one. It corresponds with FDI that strives to obtain strategic assets (either tangible or intangible) that maybe crucially important for the operation of the firm in the long run and not available at home. In contrast to other motives, strategic asset-seeking FDI does not imply the exploitation of existing Ownership (O-) advantages, but instead it tries to build O- advantages that will support its long-term operations at home and abroad. For example, the establishment of research and development (R&D) in host economies is not necessary at the present but considered as an important strategy to augment the profit in the future. From its nature, strategic asset-seeking FDI tends to take place in high-income economies where knowledge and technology are available.

3.2.2 Concluding Remarks

Different stages of development of host economies tend to attract different types of FDI. And different types of FDI tend to offer different level of spillovers to host economies. For instance, resource-seeking FDI (low value added) such as mining tend to be capital intensive and provide fewer spillovers compared to market-seeking manufacturing FDI (relatively high value added) to host countries. Efficiency-seeking FDI, which seeks to lower cost or rationalize its operation, can be seen, depending on its activities, in both middle-income and high-income economies. For example, if efficiency-seeking FDI is engaged in manufacturing sector, it can be seen more in many middle-income economies than high-income ones. Strategic asset-seeking FDI generally engages in a long-term prospect business in countries where knowledge and technology are in place, many of which are high-income states.

3.3 Basic Theories on the Determinants of FDI

3.3.1 Capital Theories

The capital theory is a firm–level approach that explains the differences in the rates of return on capital and risk diversification activities of the firms as the main determinants of FDI.

3.3.1.1 Differential Rate of Return Theory

This theory explains that FDI was the international investment response to differences in the rates of return on capital between countries. That is, investors tend to move from the country of lower rate of return on capital to higher rate return on capital. Later, this theory was reinforced by an empirical observation that showed that many American firms (the major source of FDI in the 1950s) obtained a higher rate of return from their European investments than in the home country (Mundell, 1957).

However, this differential rate of return hypothesis could not explain the increasing investments of US firms in Europe in the 60s (Hufbauer, 1975). The deficiency of this approach was first exposed by Hymer in 1960. He pointed out that there are several inconsistencies with this differential rate of return hypothesis, which can be observed in international investments. Moreover, international differences in expected returns are not sufficient to induce FDI (Caves, 1982; p.25). Under perfect markets, an increase in the short-term profits of firms in one country would not induce international investment. Instead, it would attract new entrants to the markets and would phase out the excess profits. Perfectly competitive markets and MNEs are not compatible (Hymer, 1960; Kindleberger, 1969; Hufbauer, 1975).

3.3.1.2 Portfolio Theory

This approach was developed in the 1960s using the Tobin/Markowits stock adjustment

model. It is somewhat a more refined model than the differential rate of return hypothesis. The portfolio approach assumes that a proportion of the excess profits that should be earned in foreign markets are simply rents for higher risk associated with this alternative use of capital. In 1992, Brainard and Tobin[8] proposed the hypothesis that FDI is simply just one of the alternatives to portfolio investment. The rates of return for the different alternative investments are matched with an element of risk in the choice between (imperfectly) substitutable assets to build an efficient portfolio. However, this portfolio hypothesis was not able to explain the differences between industries that invest abroad.

According to Dunning (1973, p.299), the reason why portfolio theory can only partly explain foreign direct investment is that it ignores the change of which ownership is different from portfolio investment. FDI is involved in the transmission of inputs other than money capital, such as entrepreneurship, technology, and management expertise. FDI, similar to money capital, is apparently affected by the relative profitability of the use of these resources in different countries. Moreover, MNEs are not necessarily profits maximisers. Even if they were, there is no reason why they should forcibly seek higher profits on FDI than on domestic investments (Agarwal, 1980, p.743).

3.3.1.3 Risk Diversification Theory

Risk diversification theory was developed by Rugman (1975, 1979) and Lessard (1976). This theory explains that international diversification of portfolios is a way of reducing the firm's risk of earnings. This can also be applied to foreign direct investment to show that the variance of a firm's profits can be reduced by diversification of international sales. In other words, the multinational corporation, through its foreign operation, is able to reduce the risk of its profits when compared with their products sold in a single country. This theory can be simply explained by the following equation.

[8] Cited from Jong and Vos (1994, p.9).

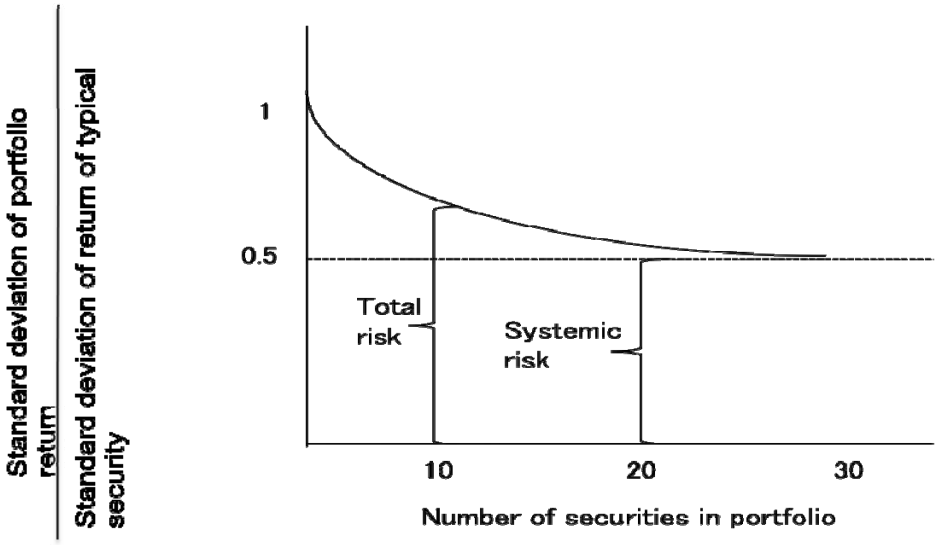
As long as returns from different assets are not subject to exactly the same risks, the risk of a portfolio containing these assets will be less than the risk of a typical security in the portfolio. The implication here is that the risk of an asset in the context of a well-diversified portfolio, called *systemic risk,* will be less than or *total risk* or *diversifiable risk*. Having this in mind, risk-averse investors will hold diversified portfolio of assets rather than one single asset. As a result, the premiums which individuals demand for bearing risks will reflect only the systemic risk, that portion of a risk, which cannot be diversified away within an economy.

$$R_j = r + \text{risk premium}$$

Where, R_j : is the required rate of return on asset j.

r : is the nominal interest rate on a riskless security.

Figure 3.1: Risk Reduction through Diversification



Source: Lessard, R. Donald. 1993.

3.3.1.4 Concluding Remarks

Capital theories, in principle, explain the movement of capital from a country with a lower rate of return on investment to a country of higher rate of return on investment. But it fails to

explain FDI inflows among developed countries where profits rates are similar. In the case of Cambodia, this theory can, to some extent, explain the FDI inflow into the country because the profit rates in Cambodia are relatively higher than those in the countries' of investors.

3.3.2 International Trade Tradition

International trade economists were among the first to study the FDI phenomenon. Foreign production can be a substitute for exports, as it can influence the terms of trade and can change the whole pattern of specialization. This approach mainly discusses the substitute and complementary effects of FDI and trade.

3.3.2.1 Mundell and the Heckscher-Ohlin Model

Mundell (1957) used an extension of the basic model to show that trade and capital movements can be substitutes, arguing that the introduction of tariffs would induce a flow of FDI toward the country being protected[9]. A similar result was found in Heckscher-Ohlin's original model[10], in which restrictions on international movements of factors can be substituted by trade. At the same time, trade restrictions can also be replaced by international movements of factors, especially by capital where imperfect mobility of labor exists. The latter was supported by empirical evidence in the 1980s where Japanese FDI shifted their production bases to the US due to import restriction.

Two limitations of these hypotheses were pointed out by scholars: firstly, FDI was analyzed as a re-equilibrium device within a generally perfectly competitive economy and, secondly, in reality the market is still far imperfect.

[9] Corden (1974) shows that tariff is not the only impediment to trade that originates FDI from a situation of different endowments.

[10] See Paul R. Krugman and Maurice Obsfeld. 2003. pp. 67-78.

3.3.2.2 Kojima's Macroeconomic Approach

The basic theorem of this approach is that "Direct Foreign Investment should originate in the investing country's comparatively disadvantaged industry (or activity), which is potentially a comparatively advantaged industry in the host country" (Kojima, 1982, p.2). He tried to explain the distinctive characteristics of trade-oriented Japanese FDI, following the principle of comparative advantages, and US investment conducted in an oligopolistic market structure, anti-trade oriented and damaging to both home and host countries in the long run.

Kojima claimed that the trade-oriented (or Japanese-type) FDI is not a substitute for international trade but complements it. As a consequence, there are benefits for an investing country if FDI goes abroad from its comparatively disadvantaged and marginal industry (or activity), for the purpose of producing goods in the host country at costs lower than at home through the transfer of efficient technology, and then management, and then importing them back to the home country (or exporting them to third markets) (Dunning, 1993b, Kojima, p. 222).

However, the macroeconomic approach has been criticized for its drawbacks. For instance, its neoclassical perfect market assumptions are clearly a major limitation because they ignored the market of scale, product differentiation and other forms of market failure (Dunning, 1993a; Jong and Vos, 1994). Another limitation of the macroeconomic approach that has been pointed out is that Kojima was too concerned about the distinction between the Japanese-type FDI and US-type FDI. He claimed that since Japanese-type FDI uses comparatively disadvantaged technology, the gap in exported technology between the home and host country was not large. In contrast, because US-type FDI is technologically advanced, it does not suit the host country's factor endowments and associated comparative advantages. Buckley (1983b, 1985, 1991) and Clegg (1987) noted that, due to the narrowness of its assumption, Kojima's theory is not applicable even to most Japanese-type direct investments. Japanese-type investment is no more frequent in Japan than it is in other developed countries (Buckley,

1983b; p.346). The distinction between Japanese-type and US-type FDI is reduced as the technology of Japanese MNEs gets matured.

Considering the current situation of Japanese FDI to China, Kojima's theory is rather inapplicable. For example, without utilizing advanced technology, Japanese MNEs would find it very difficult to meet the increasingly sophisticated demands of Chinese markets.

3.3.2.3 The Product Cycle Theory

This theory was developed by Raymond Vernon in 1966 and describes the cycle of product development of the US companies before 1950s. He assumes that the movement of FDI firms to lower-cost production countries is associated with the developmental stage of products. Vernon divided the cycle of the product into 3 stages, namely (1) new product, (2) maturing product, and (3) standardized product.

A. New Product

Vernon assumed that enterprises in any one of the advanced countries of the world are not distinguishably different from those in any other advanced countries, in terms of their access to scientific knowledge and their capacity to comprehend scientific principles. But it does not mean that all enterprises have the equal capacity to turn this knowledge or technology into marketable products. Vernon described American firms, which at that time had relatively highly skilled labor and R&D resources in comparison to other developed countries. This sophisticated supply matched well with the sophisticated domestic demand. And this situation prompted US firms to innovate new products to satisfy its domestic markets. At this stage the newly invented product is called *new product*. Simultaneously, this new product is also subject to the demands of consumers in relatively high-income class of other developed, than to consumers in developing countries.

B. Maturing Product

Later, as products and technology become matured, these advantages progressively eroded,

and the US firms were forced to move to new product development. Here comes the second stage, *the maturing product*. In this stage, if the product has a high income elasticity of demand or if it is a satisfactory substitute for high cost labor, the demand will begin to grow quite rapidly in relatively advanced countries. Once the market in such an advanced country expands, entrepreneurs will start to think of the possibility of setting up a local production facility. But as long as the marginal production costs plus the transportation costs of the goods exported from the United States is lower than the average cost of prospective production in the market of import, United States producers will presumably prefer to avoid an investment. In other words, if the production costs plus transport costs in the foreign country are still lower than the production cost in the United States, investors will probably choose to move the production base to the lower cost country. In terms of the production destination, it first moves to another developed country with lower production costs. After some time, as production costs in that country started to rise, it will move to a lesser-developed country to take advantage of this relatively lower production cost again. If the product becomes more standardized and does not require high technology to produce, then increasingly less developed countries can be a more attractive destination for production base. However, this decision depends largely on the investors' capacity to project cost of production in a country that is quite different from home. In this stage, the production in the developed country is for supplying its domestic markets, and if production surplus can be maintained, they will export back to the United States, and to other less developed countries.

C. <u>Standardized Product</u>

As the maturation process of products and technology progress, in time, the product enters a certain stage called *standardized product.* Generally, at an advanced stage in the standardization of some products, less-developed countries may offer competitive advantages as a production location. Also, their production function is such as to require significant input labor; otherwise, there is no reason to expect lower costs in less-developed countries. Unless

the production normally starts from the products with high price elasticity to demand for the output of individual firms, there is no strong incentive to take the risks of starting production in a new country.

Vernon's Product Cycle Theory was later the subject of criticism. Clegg (1987, p.24) claims that "[the product cycle] is not, itself, a complete theory of DFI as it does not explain the ownership of production", and he added that "the product cycle is primarily a theory of new DFI, and it has little to say on the extensions of existing investments by a mature foreign-investing nation" (p.26). Vernon (1971, p.108) admitted that "by the 1970s, the product cycle model was beginning in some respects to be inadequate as a way of looking at the US-controlled multinational enterprises". However, the theory also received much empirical support from studies undertaken in the 1950s and 1960s.

3.3.3 Concluding Remarks

The international trade approach was influential for its explanation of the substitute and complementary effects of FDI and trade in 1970s-80s. However, this approach fails to explain the changing pattern of FDI today. These theories also fail to explain the reasons why firms prefer to choose FDI rather than exporting or licensing. This deficiency is considered partly a result of its perfect market assumption. This international trade tradition model applies only in part to Cambodia's case. This is because even if the government can use protective trade measures today, it does not necessarily seem to act as a decisive factor on the decision of FDI to invest in this country. It would be more natural to say that the advancement of FDI activity in Cambodia stems from other factors, including its abundant and cheap labor, export-friendly conditions, world-heritage tourist site, etc.

3.3.3 Market Imperfections and Industrial Organization

The basis for this new approach of international production was proposed by Hymer

(1960) under the assumption of market imperfection. Hymer's major concern deals with the organization of production rather than trade flows. His industrial organizational approach differs from the other international trade arguments in the sense that it is basically focused on micro-analysis (firm-level analysis) rather than macro level analysis.

3.3.4.1 Hymer-Kindleberger Approach

The hypothesis of Hymer-Kindleberger suggests that, since foreign firms have necessarily some disadvantages in comparison with domestic firms, such as knowledge of the market, and communication, they need to have some firm-specific advantages if they want to engage in foreign production (Hymer, 1960). However, foreign direct investment is not simply the transfer of capital - it is also the transfer of technology, skilled personnel, business techniques proprietary and intangible assets (Hymer, 1960; p.69). Hymer (1960) added that FDI is exclusively the result of imperfections in the international markets for these assets. The firm "internalizes or supersedes" these market failures through direct investment (Hymer, 1960; p.48).

Another noteworthy aspect of the Hymer-Kindleberger approach is its rationalization of the reason why firms should choose to exploit their ownership advantages through direct investment, rather than from exporting, licensing, or other forms of international markets servicing. Hymer seems to believe that FDI is the most efficient internationalization strategy, especially when compared with licensing. He presented three reasons for its efficiency: (1) the firm's advantage may be difficult to price; (2) FDI removes the costs of managing a licensing agreement; (3) it is simply not possible to sell oligopolistic power.

Surprisingly, Hymer-Kindlebergerf's approach is quite consistent with the mainstream Marxist approach to foreign investment. The Marxist assertion is that the level of concentration (monopolization) of the industries in capitalist countries generates very high profits. But since oligopolistic collusion leads to the restrictions of the reinvestment of the

profits at home, they are forced to invest abroad.

3.3.4.2 The Internalization Approach

The internalization approach was synthesized in a book by Buckley and Casson (1976), with substantial contributions from Hymer, Kindleberger and Caves. It is an explanation of motives for FDI. This theory is a refinement of the market imperfections approach, and it explains why the MNE has a firm specific rather than a country specific advantage. These advantages are achieved through acquiring lower input factor costs, better distribution and marketing facilities, information, research, and knowledge than its rivals. Under this imperfect situation, the firm can create an internal market to substitute for, or supersede the regular external market[11]. In other words, the MNE overcomes externality by internalization.

Buckley and Casson's (1976) assertion that MNEs are typically both vertically and horizontally integrated led them to a model centered on the relationship between knowledge, market imperfections, and the internalization of markets for intermediate goods. Caves (1996, p.13) mentioned that the comprehensive treatment of vertical and horizontal FDI is possible in so much as " the vertically integrated firm internalizes as a market for an intermediate product, just as the horizontal MNE internalizes for proprietary assets".

Buckley and Casson (1976, pp.37-38) specified five types of market imperfections that call for internalization:

1. when the co-ordination of resources over a long period is needed;
2. when the efficient exploitation of market power requires discriminatory pricing;
3. when bilateral monopoly produces unstable bargaining situations;
4. when a buyer cannot price correctly the (usually intangible)goods on sale, or when public goods are involved;

[11] See Hymer, 1960.

5. when the government interventions in international markets create incentives for transfer-pricing.

Many experts have contributed theories on market imperfections theories. For example, Johnson (1968, 1970) suggested that, “knowledge is public good with near-zero social cost but non-zero private cost”. This is why the firm better exploits its knowledge-based advantages through internal markets. Aliber (1970) created a model which suggested that firms from countries with strong currencies could borrow at lower cost, thus enabling them to engage in risky investments in weak-currency areas. From his model, he was implying that firms internalize imperfections in the capital and exchange markets, as they would do with any other market failure.

3.3.4.3 The Eclectic or OLI Paradigm

The eclectic paradigm was developed by John H. Dunning (1979), and resulted from his dissatisfaction with the existing theories only partly explaining the phenomena of FDI activities. The theory integrates existing theories into a general and eclectic model, embracing both firm and country levels. Dunning (1979, p.275) explains that a firm engages in FDI if three conditions are satisfied:

1) Ownership (O-) advantages vis-à-vis firms from other countries in serving particular markets. These O-advantages largely take the form of possession of intangible assets (e.g., technology, management know-how) or the advantage of common governance, which are at least for a period of time, exclusive or specific to the firm possessing them.
2) Locational (L-) advantages of a particular country vis-à-vis other country. While O-advantage is an internal endowment to FDI firm, L-advantage is an external endowment. These L-advantages take the form of factor inputs (including natural resources) of host economies, which are normally not available at home.

3) Internalization (I-) advantages of a particular firm vis-à-vis other firms. These include the possession of advantages to use one's own firm final product, rather than selling or leasing it to foreign firms, as an intermediate input of other final products.

Dunning accepts that some ownership advantages are the direct result of firms internalizing the market for their intermediate products across national borders. However, what draws the line with internalization theory and eclectic theory is that Dunning (1979, p.276) distinguished between two sets of ownership advantages: asset ownership advantages which result from an exclusive access to inputs, intangible assets or markets, and which are directly associated with multi-nationality (transaction ownership advantages).

The eclectic paradigm was criticized for incorporating so many variables that it loses any operationality. Dunning (1991, p.125) partially accepts this criticism, although he comments that it is an unavoidable result of trying to integrate rather different motivations behind FDI into one general theory. The major examples of OLI advantages are classified below in Table 3.1 according to the types of FDI.

Table 3.1: Determinants of International Production

Types of International Production	Ownership Advantages	Location Advantages	Internalization Advantages
1. Resource-based	Capital, technology, access to markets.	Possession of resources.	● To ensure stability of supply at right price. ● Control of markets.
2. Import-substituting Manufacturing	● Capital technology, management and organizational skill; ● Surplus R&D and other capacity, economies of scale; ● Trade marks.	Material & labor costs, markets, government policies (with respect to barrier to imports, investment incentives, etc)	● Wish to exploit technology advantages; ● High transaction or information costs; ● Buyer uncertainty, etc.
3. Export platform Manufacturing	As above, but also access to market;	● Low labor costs ● Incentives to local production by host government.	The economies of vertical integration.
4. Trade & distribution	Products to distribute.	● Local markets. ● Need to be near customers. ● After-sale servicing, etc.	Need to ensure sales outlets & to protect company's name
5. Ancillary services	Access to markets (in the case of other foreign investors).	Markets	Broadly as for 2/4.
6. Miscillaneous	Variety but include geographical diversification (airlines & hotels).	Markets.	Various (see above).

Source: John H. Dunning ed. (1993), pp. 202-203

Table 3.2: Characteristics of OLI Based on Country, Industry, and Firm Specific

	Country (Home-Host)	Industry	Firm
Ownership	Factor endowments (e.g., resources and skilled labor) and market size and character. Government policy towards innovation, protection of property rights, competition and industrial structure, and government controls on inward direct investment.	Degree of production or process technological intensity; nature of innovations; extent of product differentiation; production economies (e.g., if there are economies of scale); importance of favored access to inputs and /or markets.	Size, extent of production, process or market diversification; extent to which enterprise is innovative, or marketing-oriented, or values security and/or stability, e.g., in sources of inputs, markets etc.; extent to which there are economies of joint production;
Internalization	Government intervention and extent to which policies encourage MNEs to internalize transactions, e.g., transfer pricing; government policy towards mergers; difference in market structures between countries, e.g., with respect to transaction costs, enforcement of contracts, buyer uncertainty etc.; adequacy of technological, educational, communications etc., infrastructure in host countries and ability to absorb contractual resource transfers.	Extent to which vertical or horizontal integration is possible/desirable, e.g., need to control sourcing of inputs or markets; extent to which internalizing advantages can be captured in contractual agreements (cf. early and later stages of product cycle); use made of ownership advantages; extent to which local firms have complementary advantages to those of foreign firms; extent to which opportunities for output specialization and international division of labor exist.	Organizational and control procedures of enterprise; attitudes to growth and diversification (e.g., the boundaries of a firm's activities); attitudes toward subcontracting ventures, e.g., licensing, franchising, technical assistance agreement etc.; extent to which control procedures can be built into contractual agreements.

Location	Physical and psychic distance between countries; government intervention (tariffs, quotas, taxes, assistance to foreign investors or to own FDI firms, e.g., Japanese government's financial aid to Japanese firms investing in South East Asian labor intensive industries.	Origin and distribution of immobile resources; transportation costs of intermediate and final goods products; industry specific tariff and non-tariff barriers; nature of competition between firms in industry; can functions or activities of industry be split? Significance of sensitive locational variables, e.g., tax incentives, energy and labor costs.	Management strategy towards foreign involvement; age and experience of foreign involvement; (position of enterprise in product cycle etc.); psychic distance variables (culture, language, legal and commercial framework); attitudes towards centralization of certain functions, e.g., R&D; regional office and market allocation etc.; geographical structure of asset portfolio and attitude to risk diversification.

Source: John H. Dunning ed. (1993), pp. 204-205

3.4 Impact of Foreign Direct Investment on Economic Development

FDI has been increasingly playing a crucial role on economic development in the last several decades. Fundamental FDI theories introduced in the previous section explain its importance. So far most of the studies have primarily focused only on its impact on the host economies. However, this section examines the impact of both outward FDI and inward FDI on both home and host economies. I argue that the magnitude of the impact of FDI, both outward and inward, depends largely on the stage of development, economic structure and policies of that economy, motivations and types of FDI.

3.4.1 Investment Development Path (IDP) Theory

Dunning and Narula (1996, pp.1-9) noted that, in their Investment Development Path (IDP) theory, countries tend to go through five main stages of development and that these stages can be usefully classified according to the propensity of those countries to be outward and/or inward direct investors. This propensity will rest on the combination of Locational advantages, Internalization advantages, and Ownership advantages, of countries, industries, and FDI firms. In this section, the classification of IDP theory is extended by comparing it with the stage of economic development of the countries. For details, see Table 3.3.

3.4.1.1 Stage 1

During the first stage of development, L-advantages of a country are considered insufficient to attract inward FDI, with the exception of some countries that are rich in natural assets[12]. The deficiency in location-bound created assets reflects the limited domestic markets. This limited domestic market can be a result of low per capital income, an inappropriate

[12] Natural assets refers to the "fruits of the earth" and the stock of unskilled labor. Created assets are those derived from the upgrading of natural assets. They can be tangible or intangible, and include capital and technology as well as those pertaining to skilled labor, such as technological, managerial, and organizational expertise. See Dunning and Narula ed. (1996) for details.

economic system or unsuitable government policies, inadequate infrastructure, and poorly educated, trained or motivated labor force (Dunning and Narula, 1996). Outward FDI is very unlikely in this stage. Ownership advantages of domestic firms in this stage are presumed to be very few with little or no indigenous technology accumulation. So what would exist would be the primary product sector and labor-intensive manufacturing, through government protection such as subsidies and import controls. However, most of these protection measures are now been made illegal under the WTO framework.

Table 3.3: Development Stage and IDP Stage

IDP stage	Countries' development stages
Stage 1	Least Developed Countries
Stage 2	Low Income Countries
Stage 3	Lower Middle Income Countries
Stage 4	Upper Middle Income Countries
Stage 5	High Income Countries.

Source: Author

3.4.1.2 Stage 2

In stage 2, inward FDI starts to rise, whereas outward FDI remains low. Domestic markets tend to expand both in size and purchasing power. FDI firms started to advance its production bases to these countries aiming to supply the domestic market for economies pursuing import-substituting policies. For countries pursuing export-oriented policies, FDI firm advancement is still limited. But this can vary largely depending on the ability of host economies to provide necessary infrastructure such as transportation, communication facilities and supplies of skilled and unskilled labor. In other words, a country with desirable

L-advantages tends to attract more FDI.

O-advantages of domestic firms at this stage would have increased from stage 1 with better accumulation of created assets. Primary product sectors still continue and the manufacturing sector starts to shift towards semi-skilled and moderately knowledge-intensive consumer goods. Together with the O-advantages, outward FDI also starts to emerge in this stage. Outward FDI of this stage can be either of a market-seeking type in adjacent markets or of a strategic asset-seeking type in more developed economies. The destination of market-seeking outward FDI here tends to be economies at a lower development stage, whereas strategic asset-seeking outward FDI goes to economies at a higher one aiming to acquire competitive advantages. During this stage, net FDI inflow (or net inward investment) continues to increase.

3.4.1.3 Stage 3

In stage 3, inward FDI gradually decreased while outward FDI continue to accelerate, resulting in decreasing net FDI inflow (or increasing net FDI outflow). Domestic markets demand standardized goods with higher quality. Comparative advantages in labor-intensive production activities decline due to increases in wages, pushing for more outward FDI towards countries of lower developmental stage with lower labor costs. L-advantages such as enlarged market and improved domestic R&D capacity accrue to host nations, but with wage hikes, investors are encouraged to shift to a more technology-intensive manufacturing method. At the same time, inward FDI where O-advantages, especially the intangible knowledge or skills also move to more knowledge-intensive activities, supported by the growing accumulation of created assets of the host economies. In summary, at stage 3, L-advantages of host nations and O-advantages of FDI firms encourage the changes of industrial structure from labor-intensive to more technology-intensive manufacturing methods.

Domestic firms, with competition from FDI firms, are forced to acquire new technology,

which can be achieved through the linkages, spillovers, and R&D. At this stage, domestic firms' O-advantages based on the proprietary assets are considered similar to those FDI firms from developed countries, except for some very high-tech sectors. These O-advantages of domestic firms may be a pushing factor for outward FDI, which consists of two main objectives. First, FDI firms go to economies with lower stage of development, stage 1 or 2, aiming to seek natural resources and/or lower labor costs, which are not available at home. Second, they go to economies with a similar stage or higher stage of development, stage 3 or 4, partly as a market-seeking strategy and strategic asset-seeking strategy. For market-seeking purposes, these outward FDI firms can sell products in markets of similar or larger size. And for strategic asset-seeking purpose, they can protect and upgrade their O-advantages.

3.4.1.4 Stage 4

Stage 4 of IDP is characterized as the amount of outward FDI equals to or exceeding inward FDI, with a growth rate of outward FDI that is still rising faster than inward FDI. The production process in this stage is likely to use capital-intensive method, as the cost of labor is higher than the cost of capital. L-advantages of the countries rely almost entirely on created assets. And O-advantages of inward FDI firms can also be classified into two patterns. If they come from other stage 4 countries or higher, they tend to be more *transaction-oriented* than *asset-related* (Dunning, 1993b). However, if they come from countries of lower stages of development, they are likely to be of a market-seeking, trade-related, and/or asset-seeking type.

Outward FDI in this stage continues to grow, partly as a result of growing competition at home. Some of the firms shift their operations to lower stages countries (stage 2 or 3) to take advantages of their superior technology, managerial and organizational know-how, while others move to similar or higher stages countries mainly to internalize the market for their O-advantages. As O-advantages of industries (e.g., degree of technological intensity, product

differentiation, nature of innovations, etc.) and countries at this stage are quite similar, intra-industry trade and production, especially within FDI firms, becomes relatively more important.

3.4.1.5 Stage 5

Countries in stage 5 of IDP are generally characterized as the amount of outward FDI exceeds inward FDI. In 2009, outward FDI recorded 820 billion USD while inward FDI was only 565 billion USD (UNCTAD, 2010). As the economic structure of the countries at this stage is broadly mature, no single country is likely to have the absolute O-advantage of created assets. In addition, the O-advantages of FDI firms are likely to be less dependent on their countries' natural resources but more on the ability to acquire assets and on the ability to organize their advantages more efficiently. Another feature of FDI of this stage is that as firms become globalized, their nationalities become indistinct. Their operations do not necessary reflect the interests of their home countries, but rather reflect the interests their firms.

Regarding inward FDI firms coming to countries of this stage, they are of two kinds. First, they come from countries of lower stage of development, which are mainly market-seeking and knowledge-seeking types. Their main objectives are to access the existing large markets and to obtain technology, management know-how in order to improve the competitive advantages of the firms both at home and other countries. Secondly, they come from countries of similar stages of development (stage 4 or 5) and are mainly of efficiency-seeking and strategic asset-seeking types. These types of FDI are seen in sectors where economies of scale and scope are encouraged.

Table 3.4: Investment Development Path

	Stage 1	Stage 2	Stage 3	Stage 4	Stage 5
Level of FDI	● Limited L-advantage: little or no inward FDI. Few domestic firms with O-advantages: no outward FDI. ● Inward FDI ＞ Outward FDI	● "Generic" L-advantage: growing inward FDI. Growth of domestic industry in support sectors: little outward FDI. ● Inward FDI ＞ Outward FDI	● Created-asset type L-advantages are developed. Rising inward FDI, strong domestic industry, rising outward FDI. ● Inward FDI ≧ Outward FDI	● Strong L-advantages in created assets. Strong created-asset O-advantages of domestic firms. ● Outward FDI ≧ Inward FDI.	● As for stage 4, but fluctuating net zero or positive level of inward and outward FDI. ● Outward FDI ≧ Inward FDI.
Economic Structure	Primary Sector → declining				
		increasing → Manufacturing sector → declining			
			Service sector → increasing		
Motives for FDI	Resource-seeking investment – L-advantages limited to natural resource endowments.	Resource-seeking FDI, but growing L-advantages, particularly unskilled labor and infrastructure attracts labor-intensive manufacturing. Growing presence of market-seeking FDI.	Market-seeking FDI and increasing efficiency-seeking FDI in manufacturing, as L-advantages become increasingly created-asset-based.	Efficiency-seeking FDI, market-seeking FDI, and asset-augmenting FDI.	

Source: Narula and Dunning, 2000. Modified by Author.

3.4.16 Concluding Remarks

In summary, the motives of FDI and determinants of FDI (Ownership, Location, and Internalization) as described by Dunning depend largely on the stage of developments of those countries. Table 3.4 explains the economic structure of countries classified by IDP and its relationship with FDI in details. Countries at a lower stage of development tend to attract mainly resource-seeking FDI and unskilled or semi-skilled manufacturing FDI, whereas countries of higher stages of development tend to attract more market-seeking FDI, efficiency-seeking FDI, and strategic asset-seeking FDI. These various forms of FDI can have impacts on both home and host economies.

3.4.2 Impact of FDI on Economic Development

FDI firms have increasingly been playing a very central role in the development of many countries, especially developing ones. And the impact on the economy of both home and host country can be enormous. Empirically, many developing countries have been competing to attract FDI firms by providing various types of incentives, both financial and fiscal. So far, a host of studies has focused on the impact of FDI inflow into host developing countries while the studies on the impact of FDI outflow on the home country remain moderate. As indicated in Table 3.5, outward FDI generally originates from middle-income and high-income countries. This section will discuss the impact of FDI firms on both home and host countries characterized by income group.

Table 3.5: Destination of FDI by Income Group

Income Group	Outward FDI	Inward FDI
Low Income Economies	Almost none	Yes from (mainly MI, HI)
Middle Income Economies	Yes to (LI, MI, HI)	Yes from (mainly MI, HI)
High Income Economies	Yes to (LI, MI, HI)	Yes from (mainly MI, HI)

Source: Author.

Note: LI: Low-income countries, MI: Middle-income countries, HI: High-income countries.

3.4.2.1 Impact of FDI on Low-Income Economies

3.4.2.1.1 Impact of Outward FDI on Home Low-Income Economies

The main characteristics of economies are the scarce capital, low level of technology, insufficient infrastructure, and abundant unskilled and semi-skilled work force. The agricultural sector accounts for a significant part of total economic output. A large share of the work force is engaged in agricultural production, while a small portion is involved in manufacturing or the service sector. Most of the domestic manufacturing is labor-intensive utilizing low or semi-skilled technology. They produce relatively simple products mainly to supply domestic markets as final goods or to supply foreign firms as intermediate goods.

Given the relatively limited technology, management know-how, and knowledge of firms from low-income countries in comparison with the global international firms, it is almost impossible for them to advance their operations abroad and compete with domestic firms in host economy and other FDI firms operating in that country. As the evidence shows, instead of investing abroad, the firms from low-income economies tend to export their products to foreign markets, a large portion of which are primary goods. As such, we can conclude that because the quantity of FDI outflow itself is limited, the impact resulting from FDI outflow on own home economies is also considered minimal.

3.4.2.1.2 Impact of Inward FDI on Host Low-Income Economies

Despite the limited FDI outflow, the economies in general receive a certain amount of FDI inflow, depending on the economic fundamentals and government policies toward foreign investors in that country. Economies with relatively better infrastructure (road, seaport, communication, etc) and generous investment policies (tax incentives, long-term land lease, etc) tend to be able to attract more FDI inflows than other countries at a similar stage of development. In short, investors prefer to operate in those countries that give higher return with lower risk. The risk here includes nationalization of FDI firms, and high governance costs (including corruption, dispute resolution, etc).

However, once a FDI firm operates in a foreign country it generally exerts a huge impact on the welfare and economic development of that country. The magnitude of the impact varies depending on the type of FDI itself. For example, resource-seeking FDI tends to generate less employment creation effects if it is capital-intensive such as natural resource seeking FDI. Also, other spillover effects or linkage effects can hardly be expected. In contrast, if it is a labor-intensive FDI such as low skill manufacturing, it tends to generate high employment for the host country. In the case of market-seeking FDI and efficiency-seeking FDI, by and large they tend to affect more on the host low-income economies than resource-seeking FDI in a number of ways. First, FDI firm initially interacts with the local industry by building production facilities, hiring employees, many of whom may require training. Second, FDI firm also establishes linkages with local firms both forward (with distributors and sales organizations) and backward (with suppliers). These linkages can, however, stimulate production in supplier and distributor firms and organizations in the host country, leading to the transfer of technology. Hence, we can say that FDI may provide an amplified effect on the local economy beyond its initial direct effect, including employment creation effect. Third, FDI firm may incentivize local industries to improve their performance through competition. At the same time, local firms can also be forced to go bankrupt if they cannot compete with those foreign firms.

The source of FDI may also affect the market size of the host low-come economies. Empirically, inward FDI from middle-income economies tends to invest in relatively small low-come country, whereas FDI from high-income economies tends to invest in relatively larger low-come ones. This is also probably because the former tends to have a short- or middle-term strategy while the latter tends to have a longer term one. FDI from middle-income countries generally regards low-income economies as the production site for exports, given the advantages of its cheap labor costs. Moreover, they utilize mainly middle-tech technique. On the other hand, high-income economies, with their longer-term

vision, also regard low-income economies as the markets for their final products in the future, on top of product sites for exports alone. The technology they use is, in general, more sophisticated than FDI from the middle-income countries. However, given the limited absorptive capacity of the host country, it can be difficult at the beginning. But if we consider it in a long run as a dynamic process, this can be achieved through training provided by the firms.

In summary, the inflow of FDI firms plays a central role on the development of the low-income economies. Their impact includes employment creation, and linkages with and spillover on local firms. However, this impact also depends on the type of FDI and source of FDI. FDI from developed countries tend to provide a longer-term contribution to host low-income countries.

3.4.2.2 Impact of FDI on Middle-Income Economies

3.4.2.2.1 Impact of Outward FDI on Home Middle-Income Economies

As the country reaches a higher stage of development, the industrial structure also changes. Middle-income economies also expand their FDI outflow both to low-income economies as well as middle-income and high-income economies. FDI outflow to countries of different level of development tends to be accompanied by a different objective and strategy which leads to different impact, both positive and negative, on home countries. The positive impact includes an increase in competitiveness resulting from improvement of created assets there that can also be used at home. The negative impact includes structural job losses, especially for efficiency-seeking FDI.

First, the advancement of FDI to low-income economies tends to concentrate on resource exploiting industry or labor-intensive manufacturing industry. In the case of resource exploiting industry, it is a matter of L-advantages of that country which is not available at home, and thus, it is a not subject of substitution with home country. Therefore,

we can say that the negative impact on the home economy is small because it would not also operate at home even though it foregoes its operation abroad. On the other hand, it tends to utilize those resources as industrial inputs at home. In the case of labor-intensive manufacturing industry, it is a matter of cheaper labor costs abroad in comparison with the rising wages at home. The positive impact of foreign advancement in this sector is that it can raise competiveness of the firms involved because the same product can be produced at lower costs. However, this competitiveness also comes with job losses at home, especially in low-skill manufacturing sectors, which are subject to substitution abroad.

Second, FDI outflow from middle-income economies to other middle or/and high-income economies may also cast a huge impact on its home economy. This impact can be very different from FDI outflow to low-income economies in the sense that it concentrates more on market-seeking, efficiency-seeking, and strategic asset-seeking purposes. Through its advancement to countries of a similar or higher stage of development, middle-income economies' FDI firms are able to absorb new technology, and managerial skill, which later leads to the improvement of competitiveness of the firms. However, this improvement in competiveness of the company does not necessarily translate into competitiveness of the home economy as a whole. Outward FDI can affect a home economy directly through its economic activity, and indirectly through the transmission of the firm's improved competitiveness to the rest of the economy. Specifically, the impact of outward FDI to middle-income and/or high-income economies on its home economy can be characterized into three dimensions:

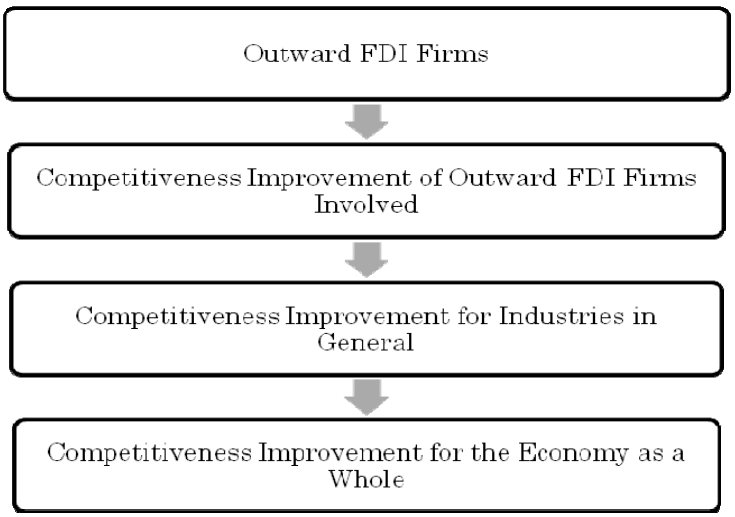
- *Impact on firm level*: linkages with local firms; spillovers to local firms; competitive effects on local business (including crowding in/out); linkages and interactions with institutions such as universities and research centers (i.e. the national innovation system in general).
- *Impact on industrial level*: how FDI effects the structural change of the industry (for

instances, shifting from lower value-added product to higher value-added and/or quality product); employment also needs to shift to higher skill.

- *Impact on country level:* financial resource flows and balance of payments (net financial outflow at the initial phase that gradually changes to net inflows once the firm yields returns); domestic investment (FDI outflow does not necessarily lead to a fall in domestic investment. On the other hand, it boosts domestic investment in higher value-added production); international trade (FDI outflow generally complements rather than substitute cross-border trade); employment (structural unemployment while moving from lower value to higher value production). See Figure 3.2 for details.

In conclusion, FDI outflow from middle-income country to other middle or/and high-income countries tends to have a more positive impact than negative impact on home economy. However, the extent of the impact depends largely on the types of FDI and the competitiveness of firms and industries involved.

Figure 3.2: Channel through which Outward FDI Affects Home Economy



Source: UNCTAD 2006, World Investment Report 2006, p.182. Compiled by the author

3.4.2.2.2 Impact of Inward FDI on Host Middle-Income Economy

The impact of inward FDI on host middle-income economies differs from the impact on host low-income economies in several ways. First, the motive of FDI coming to middle-income economies by and large is associated with market-seeking and efficiency-seeking reasons, as compared to the resource-seeking reason in low-income economies. The prime target of market-seeking FDI is to sell final products to host economies' markets, and thus could affect the balance of payment. For example, if FDI firms purchase intermediate inputs from abroad and produce final products and sell in domestic markets, then the import of those intermediate inputs will impact on the trade balance. However, if this market-seeking FDI plays the role of import-substitution, the impact on the total balance of payment will be restricted. That is, market-seeking FDI can reduce host economies' imports if FDI results in local production that replaces imports.

Efficiency-seeking FDI whose prime motive is to attain location, where cheaper production costs in comparison with home country. This type of FDI tends to come from high-income countries or the same middle-income economies but with stronger competitive advantages, including Asian NIES. With a relatively educated labor force, efficiency-seeking FDI to middle-income economies focuses on automobile manufacturing, electrical and electronic products, while low-skill manufacturing such as textiles and garments are seen in low-income economies. And with its relatively high absorptive capacity, positive spillover effects can also be expected. In many cases, after several years of working experience with FDI firm, some employees turn into local entrepreneurs, which also contributes to and stimulates the economy as a whole.

For asset-seeking FDI, the impact on the host economy normally depends on the nature of the acquired asset itself. For instance, if a FDI firm is meant to establish distribution network or the production of a brand name already known to consumers in the host economies, its impact may primarily be to increase imports. On the other hand, if FDI firm

sets up an R&D institution it is likely to serve as a place where cutting-edge technology can be transferred. In general, the establishment of R&D institution is the phenomenon where countries of a lower stage of development invest in countries of a higher stage as part to the strategy to acquire new technology. But it can also happen in the reverse direction, when a host middle-income country has a strong competitive advantage in a certain field. For example, India attracts R&D in information technology (IT) industry from many developed countries (UNCTAD, 2006).

Another essential impact of FDI on the host middle-income economies is its job creation effect. It plays a central role in absorbing employment in addition to those created by domestic firms. Employment engaged with FDI firms normally is exposed to better working standards, better technology, and management know-how, which are difficult to obtain from local firms. The ability to absorb the newer knowledge from FDI firms is increasingly becoming an important agenda for one economy to achieve a sustainable and long-term growth.

In sum, the impact yielded by FDI firms on host middle-income economies can be seen in a number of ways, and each impact may also depend on the motive of each FDI firm itself. Market-seeking FDI provides a deeper impact on the local markets and imports, whereas efficiency-seeking FDI, many of which are from developed countries, creates spillover effects on local economies. Asset-seeking FDI affects imports if its objective is to establish distribution network or production of the existing known brand name.

3.4.2.3 Impact of FDI on High-Income Economies

3.4.2.3.1 Impact of Outward FDI on Home High-Income Economies

High-income economies have been playing a very important role as the main source of world FDI outflows. In 2007, 2008, and 2009, FDI outflows by countries of this income group recorded 1,923 billion USD, 1,571 billion USD, and 820 billion USD, respectively

(UNCTAD, 2010). These numbers made up approximately 85% of the world's total FDI outflows. Given this large share by high-income group, we assume that the impact of outward FDI on both home high-income economies and host recipient countries are considered significant. This section will first discuss the impact of FDI on home high-income economies.

Generally speaking, the impact stemming from outward FDI on its home high-income economy can be both positive and negative. Although there is no doubt that in general the positive impact tends to exceed the negative one, the effects itself largely depends on the nature and characteristic of the FDI involved. For example, resource-seeking FDI whose destination concentrates in developing countries (both low and middle income) plays a central role in acquiring natural resources and in providing a stable supply specifically to its home country. Among them energy-related resources such as oil and natural gas, are indispensable for the fundamental economic activities of the home countries. Meanwhile, this type of FDI is not subject to substitution with domestic firms, meaning its outward advancement does not particularly harm any employment at home. In summary, it can be said that the positive impact accruing from resource-seeking FDI activities overwhelmingly exceeds its negative one on the home countries.

In the case of market-seeking FDI, its main destinations are broadly middle-income economies with large market size and high-income economies. For middle-income economies where input costs are lower and growth rate of demand is higher, FDI firms from high-income economies can easily adopt its internalization strategy by exercising its O-advantages. Given their superiority in technology, management know-how, FDI firms can raise their profit by expanding their activities in the fast growing middle-income economies to complement the slow growing demand at home. On the other hand, if FDI firms go to other high-income countries, their strategy should be different from the middle-income ones. As technology and other kinds of knowledge are presumed to be of

similar stage, competition with local firms is expected to be fiercer. Hence, R&D investment, both at home and host economies, is a decisive determinant to obtaining superior position in the competition.

In the case of efficiency-seeking FDI, production is usually carried out in lower cost countries and the final products are exported to third countries or are imported back to FDI-originated countries. If they are imported back to the home country, related local industry is affected due to the production substitution. As a result, local firms are forced either to go bankrupt or to increase competitiveness through technological improvement/innovation to survive. If they survive, productivity increase can be expected. If, however, they go bankrupt negative impact resulting from job loss can be serious.

Finally, strategic or created asset-seeking FDI seeks to build the firm's O-advantages rather than exploiting it in search of long-term profits. FDI of this type such as R&D, in general, concentrates in high-income countries where human capital is rich. Innovation, production development, etc, stemming from high quality human resource of the host countries can push up the competitiveness of the firm. And once those strategic assets can be applied in FDI's home country, a positive impact can be noted. At the same time, the negative impact on home country can be considered very limited for the reason that FDI of this type is just an additional investment to a host country rather than a substitution of investment of home country.

3.4.2.3.2 Impact of Inward FDI on Host High-Income Economies

A large number of studies have focused on the impact of FDI on host developing countries; however, there are many fewer studies on its impact on host developed (high-income) economies. For this discrepancy in the research is probably because the relative impact of FDI inflows into developing countries is considered more significant due to its scarce capital and knowledge. In the case of developed countries where production factors at home are relatively favorable, the marginal impact of foreign factor resources are

considered relatively small. The impact of FDI inflows into high-income economies is different from developing countries in several ways.

According to UNCTAD 2007, the average annual FDI inflows into high-income economies during 2003-2005 indicates that primary, manufacturing, and service sectors accounted for 43.6 billion USD (6.8%), 156.4 billion USD (24.7%), and 433.1 billion USD (68.4%), respectively.[13] This number is also supported by the IDP theory, which suggests the decline of manufacturing sector and the increase of service sector of countries of higher stage of development. Higher wages at home that act as a push factor, and lower wages abroad that serve as a pull factor have encouraged manufacturing FDI to go to low-income and middle-income countries.

The main difference between manufacturing FDI in high-income economies and developing economies is that FDI inflows into the former primarily seeks to supply the domestic market, whereas the latter also seeks to export to the third and/or home countries. In addition, the products they produce are often more sophisticated, required state of the art technology, in order to meet the quality demand of the consumers. In general, FDI inflows into developed countries are less volatile than FDI inflows into developing countries. In a dynamic sense, as the economy expands, worker wages also increase which leads to higher costs of production. In this situation, FDI firms tend to move to other cheaper countries resulting in huge job losses. But this situation is not very likely to happen in high-income countries, given the fact that workers are generally considered highly educated and thus can adjust to new jobs rather more easily.

The service sector, making up almost 70% of total FDI inflows, has the largest impact on the economy. It affects host high-income economies through several channels such as source of financial injections into the market, competition with domestic firms, knowledge absorption, and employment. First, extra source of capital injection can play a role to

[13] UNCTAD, 2007. World Investment Report 2007. Annex Table A.I.12. p.228.

lubricate money supply. However, if the money is raised locally, it may also raise the interest rates as well. Second, similarly to manufacturing sector, service competition with local firms is likely to increase effectiveness and efficiency of the operation, leading to higher productivity of the industry as a whole. However, it also comes with some negative consequences such as the crowding out of domestic firms, resulting in job losses. Third, absorption of knowledge, which is often in the form of organization management, and in the manufacturing sector in the form of technology transfer, can also be expected especially if it is a well-known FDI firm with superior O-advantage. Fourth, employment generated by FDI firms generally requires high skill. Although the number of employment per capital invested is smaller, per head wage is usually much higher than the manufacturing sector.

3.4.2.4 Concluding Remarks

In the present globalised economy, FDI firms can exert a great impact on both their home and host countries. The magnitude of the impact varies depending primarily on the type of FDI itself and the stage of development of the country related. For example, in low-income countries where domestic capital is scarce and technology is low, FDI outflow is almost negligible. On the other hand, for low-income countries where L-advantages such as natural resources are abundant or labor costs, most of which are unskilled and semi-skilled, are cheap, FDI inflows to exploit these advantages do play an essential part and provide a significant impact on the economic development of that country. For example, revenue coming from natural resources extraction can be used to establish basic infrastructure, which is a very critical precondition for economic take-off to the next step. For countries with cheap labor costs, the employment creation effect of labor intensive manufacturing FDI firms as such garment and textile, and footwear is great.

For middle-income economies, outward FDI continues to increase, although inward FDI remains larger in number. In terms of outward FDI, if it is bound for a high-income group

the impact on home middle-income country is more related with the absorption of new technology, organizational management skill, and other knowledge. In addition, the channels through which it affects the home economy can be grouped into three levels: firm, industry, and country. First, through direct economic activities it increases the competiveness of local firms through linkages (both backward and forward) and spillovers. Second, for the industry as a whole, with higher technology in the hands the firms are likely to shift to higher value-added production, for example from textile manufacturing to electrical appliance manufacturing. Third, as the industrial structure advances, the economic structure of the country as a whole also shifts to a more sophisticated one.

For high-income economies, FDI outflows, in many cases, exceed FDI inflows. The main sources of inward FDI are from middle-income and high-income economies, whose main objective is to obtain advanced technology, management know-how and penetrate the well-developed market. The destination of outward FDI from high-income economies can be to all parts of the world, depending on the country-specific advantages. For example, outward FDI to low-income countries tends to concentrate on natural resource-related investment, whereas to middle-income countries it tends to focus on manufacturing and the service sector. The main advantages of outward FDI from high-income into middle-income countries, in general, can be categorized by its relative cheap labor cost and fast-growing domestic markets. On the other hand, inward FDI from middle-income countries tends to seek to obtain advanced technology, management know-how that are expected to be applicable in home countries. As mentioned earlier, 70% of inward FDI to high-income economies concentrates on service sector, reflecting the high cost of production in manufacturing activities.

3.5 Conclusion

In this chapter basic theories on the determinants of FDI and its impact on economic

development were reviewed and discussed. Capital theory such as differential rate of return theory, portfolio theory, and risk diversification theory, in principle, explains the movement of capital from country of lower rate of return to country of higher rate of return on investment. However, these theories fail to explain the movement of FDI to high-income whose rate of return is similar.

International trade tradition model, based on its perfect market assumption, uses international trade theory to explain the determinants of FDI movement. Mundell stated that the imposition of higher tariff rates on a certain industry of a country could induce FDI into that industry. However, Kojima, in his macroeconomic approach, argues that FDI tends to originate in the investing country's comparatively disadvantaged industry, which is potentially a comparatively advantaged industry in the host country. Finally, Vernon, in his product cycle theory, argued that the reason FDI firms move to the country with lower cost production is closely associated with the developmental stage of that product itself.

Hymer's market imperfections and industrial organization approaches, under the assumption of market imperfection, argued the movement of international production by focusing on firm level, rather than on country level analysis. He pointed out that FDI is not simply the transfer of capital, but also technology, skilled personnel, business techniques, proprietary and intangible assets. As such, given the imperfect market, the movement of FDI is exclusively for these assets. In addition, the internalization approach explains the reasons why FDI firm overcomes externality by internalization of its market. OLI paradigm, established by Dunning, is today considered one of the most influential theories to explain the determinants of FDI. Dunning explains the movement of FDI on the advantages of both at firm and country level. As a result, this model possesses a large variety of variables leading to criticism of operationality.

Regarding the impact of FDI on economic development, it is considered different depending on the type of FDI and income group of the recipient countries. For example, in

a low-income country where domestic accumulated technology is rather scarce, there tends to come resource-seeking FDI, both natural resource and non-natural resource including cheap abundant labor. For FDI in natural resource, the job creation effect is small but it generates a large income for the state coffer that can be used for national development including infrastructure. In terms of FDI in labor-intensive manufacturing, the job creation effect is large. However, given its low absorptive capacity as a result of low domestic accumulated skill, the spillover effect tends to take time.

In middle-income countries, at the beginning host country is generally regarded as the production base for FDI firms. However, as the size of domestic market starts to expand, it also becomes an important market for those firms. This market-seeking FDI is considered to reduce the host economies' imports if they result in local production that replaces imports. Given its relatively highly educated labor force and accumulated skill, efficiency-seeking FDI tends to focus more on sophisticated production such as automobile manufacturing, electrical and electronic products. Highly educated labor force, however, also means high absorptive capacity of skill and knowledge from FDI firms, which later can be translated into the development of entrepreneurs for the country.

In high-income economies, while outward FDI goes to various sectors, inward FDI tends to concentrate in service sector. It affects host economies through several channels such as source of financial injections into the market, competition with domestic firms, knowledge absorption, and employment. The competition with local firms can result in higher competitiveness in the whole industry but at the same time can also lead to the rationalization of domestic firms.

Chapter 4: Quantitative Analysis: Governance, FDI, and Economic Growth

4.1 Introduction[14]

Chapters two and three discuss the concept and role of governance and foreign direct investments in economic development. The findings in the above two chapters led to the conclusion that countries of different stages of development tend to have different structures of governance and attract different types of FDI. And as a result, the impacts of both governance and FDI on economic development can be different as well. This chapter aims to quantitatively analyze the impacts of governance on FDI inflow and in turn on economic performance based on their income groups: low-income, middle-income, and high-income.

4.2 Literature Reviews

There have been so far many theories developed to explain cross-country differences in income level and economic growth rate. Among them, neoclassical theory of economic growth and institutional economic theories were groundbreaking. Neoclassical theory of economic growth stresses the role of physical and human capital in the production process. With this neoclassical approach to economic growth, Y is the function of capital K, and labor, L, so Y = f (K, L). Both K and L are somehow easy to quantify. This theory was based on Solow (1956) and then developed by many researchers including Lucas (1988) and Romer (1986, 1990).

However, the institutional approach stresses the importance of institutional environment that is generally supporting markets. Institutional quality, by nature, is not easy to quantify

[14] This chapter is based on the author's paper "Governance, Foreign Direct Investment and Economic Growth", published in the Forum of International Development Studies, Vol. 36, pp. 255-278.

and this makes it difficult to measure the degree to which institutions affect economic growth. Using Gastil's (1978, 1987) political rights and civil rights indicators, Scully (1988, 1992) showed the relationship between freedom and growth. Scully (1988, p.652) found that the institutional framework has significant and large effects on the efficiency and growth rate of economies. Furthermore, politically open societies, which subscribe to the rule of law, to private property, and to the market allocation of resources, grow at three times the rate and are two and one-half times as efficient as societies in which these freedoms are abridged. In his later study, Scully (2002, p.77) found that economic freedom promotes both economic growth and equity, and that there is a positive but relatively small trade-off between growth and income inequality.

Barro (1996, pp.23-24), in his panel regression analysis of about 100 countries from 1960 to 1990, found that democracy enhances growth for countries at low levels of political freedom but depresses growth when a moderate level of freedom has already been attained. He argued that more democracy is not the key to economic growth although it may have a weak positive effect for countries that start with few political rights. In addition, the political freedoms tend to erode over time if they get out of line with a country's standard of living. That is, economic institutions such as property rights and free markets tend have a larger impact on growth than political institutions.

North (1990), in his study about the relationship between institutions and economic performance, suggested that "institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction". North argued that individuals (actors) frequently make choices based on imperfect information and the resultant institutional changes often have unintended consequences that are not always the optimal choice for improving the economic welfare of the organization.

Hall and Jones (1999) also stressed the importance of institution. He argued that differences in physical capital and educational attainment could only partially explain the

variation in output per worker. By treating institutions and government policies (so-called social infrastructure) as endogenous, Hall and Jones found that a country's long-run economic performance is determined primarily by the institutions and government policies that make up the economic environment within which individuals and firms make investments, create and transfer ideas, and produce goods and services.

To investigate the influence of political institutions on growth performance, Kaufmann et al. (1999) constructed six aggregate governance indicators corresponding to six fundamental governance concepts, used in this study for the middle-income and high-income groups. In their cross-country analysis of between 155 and 173 countries based on data for 1997 and 1998, Kaufmann et al. found that one standard deviation improvement in aggregate governance indicators led to a 2.5 percentage point increase in per capita income. In their later study, Kaufmann and Kraay (2002, 2003) found a strong causal relationship between better governance and higher per capita income. Gwartney and Lawson (2003) constructed Economic Freedom of the World (EFW) that incorporates 38 components to measure a nation's institutions. Using that EFW index, Gwartney et al. (2006) found that one unit increase in EFW (1980) is positively associated with a 2.59 percentage point increase in private investment/GDP ratio and each unit increase in private investment/GDP ratio is positively associated with a 0.47 percentage point increase in per capita GDP growth rate.

However, so far most of the existing studies mainly discussed only the direct relationship between governance and economic growth rate for all income groups at a time. Therefore, they could neither see the different impacts of governance in each income group (low-income, middle-income, and high-income) nor the channels through which governance affects growth. In this study the author hypothesizes that governance affects growth rate directly and indirectly through the channels of either domestic investment or FDI depending on the stage of development of each economy. To investigate the impacts of

governance in each income group, the author classifies the sample countries into three separate income groups: low-income, middle-income, and high-income. The analyses are also divided into three main steps. Step 1 (in equation 1) investigates the impacts of governance on per capita growth performance, where per capita growth rate is taken as the dependent variable. Step 2 (in equation 2) investigates the impacts of governance on total investment-GDP ratio, where total investment-GDP ratio is taken as the dependent variable. Step 3 (in equation 3) analyses the relationship between governance and FDI inflow, where FDI inflow ratio to GDP is taken as the dependent variable.

4.3 Analytical Framework

In the neoclassical model, only labors, (L) and capital, (K) are used as inputs for the production function, while the influence of governances on investment was completely ignored. But as researchers started to realize that the neglect of governance factors was a serious omission, many responded by inserting various indicators of governance quality into the models along with physical and human capital. Out of which, Barro's ad hoc growth equation is a good example.

The analyses below seek to examine the influences of governance on economic performance. However, the quality of governance can simultaneously affect growth performance of a country through two channels, direct and indirect channels. Indirect channel here refers to the impact of governance on economic growth through the enhancement of investment activities and productivities, while direct channel here can be taken literally as the direct impact of governance on growth performance itself. For example, one of the six elements of the governance indicators, *government effectiveness*[15], defined by the World Bank exerts both direct and indirect impacts on growth. Its direct

[15] *Government Effectiveness* is defined as quality of public services, the quality of civil services and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of government's commitment to such policies.

impacts include the smooth transition from one government to another, manageability of bureaucrats in the cases of policy changes, etc. Its indirect impacts include the quality of public services that largely affects the investment activities of the private sector. For some countries where bureaucratic procedure is complicated, it provides negative impacts on private investment activities.

The triangular relationship among governance, FDI, and economic growth also differ depending on a country's stage of development. Low-income economies that have limited resources (both physical and human) tend to attract only a limited amount of FDI inflow, a large portion of which is resource-seeking FDI. This type of FDI is generally considered location-specific and not a subject of competition with other FDI recipient countries. In a comparison with low-income states, middle-income economies tend to have more favorable basic infrastructure and supporting domestic industries. With these minimum sufficient economic conditions in place, market-seeking FDI and efficiency-seeking FDI tend to find it easier to operate in the middle-income than in the low-income states. In addition, since manufacturing production costs also rise as an economy develops, market-seeking FDI seems to be replaced by strategic asset-seeking FDI from high-income economies (Narula and Dunning, 2000).

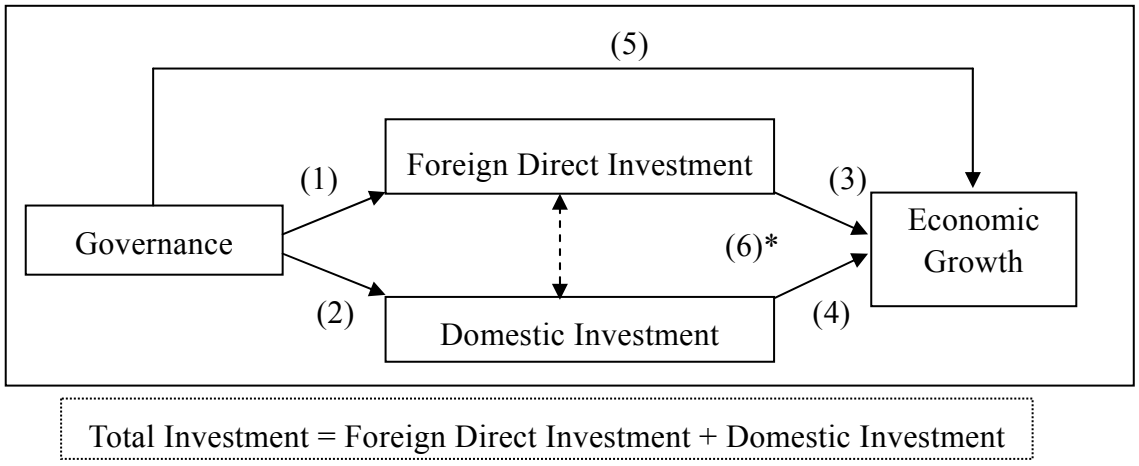
There are many factors and elements that affect growth performance. Among them, human and physical resources are the major production inputs. Meanwhile, governance also affects growth. It affects growth of a country through the management of those resources. In general, if the governance is good the economy tends to grow faster. In contrast, if the governance is bad the economy tends to grow at a slower pace. As such, in the low-income countries, where resources are limited, naturally the quality of governance is considered to play a limited role in economic growth. However, in middle-income and high-income countries, since the amounts of both physical and human resources are likely to increase, the impact of governance quality on economic performance can also be considered

increasingly important.

On the other hand, most economists also accept that a positive connection exists between total investment and economic growth. If governance affects total investment, then it also affects economic growth. In most cases, if not all, FDI is also considered to have a positive relationship with economic growth of a recipient country. By the same logic, if governance quality affects FDI, it also affects economic growth through this FDI channel.

Total investment used here is the summation of both domestic investment and FDI. If governance affects total investment but not through the channel of FDI, we can conclude that governance affects through the channel of domestic investment and vice versa. The relationship among governance, FDI, and economic growth are summarized in Figure 4.1.

Figure 4.1: Relationship among Governance, FDI, and Economic Growth



Source: Author

Note: (6)*: There is an important relationship between domestic investment and FDI. As it is not discussed in this chapter, please refer to Section 3.1 of Chapter 3.

4.4 Data, Regression Models, and Methods

4.4.1 Data

The data used in the analyses comes from four different sources. First, variables such as per capita growth rate, initial real per capita GDP, ratio of trade to GDP, inflation rate, general government final consumption expenditure (GGFCE), life expectancy at birth, and education enrollment rate for 1991 are from the World Development Indicators (WDI) 2006. But educational enrollment rate for 1985 is from Barro and Lee (1993). Second, political rights and civil liberty, used as proxies for democracy variables, are from Freedom House 2006, ranging from 1 (worst) to 7 (best).

Third, the governance indicator for the low-income group is derived from Country Policy and Institutional Assessments (CPIA) 2005, which was the newest available data. However, the limitation of this data is that it covers only cross-country, but not time-series. This data set was established by the World Bank to assess the quality of a country's policy and institutional framework and its result is used as an important criterion to determine loans and grants from the World Bank. CPIA data covers mainly member countries of the International Development Association (IDA), with a rating system ranging from 1 (worst) to 6 (best). This data is comprised of 16 criteria and grouped into four clusters:

①) *Economic Management:* is comprised of 1) macroeconomic management, 2) fiscal policy, and 3) debt policy;

②) *Structural Policies*: is comprised of 1) trade, 2) financial sector, and 3) business regulatory environment;

③) *Policies for Social Inclusion/Equity:* is comprised of 1) gender equality, 2) equity of public resource use, 3) building human resources, 4) social protection and labor, and 5) policies and institutions for environmental sustainability;

④) *Public Sector Management and Institutions:* is comprised of 1) property rights and rule-based governance, 2) quality of budgetary and financial management, 3)

efficiency of revenue mobilization, 4) quality of public administration, and 5) transparency, accountability, and corruption in the public sector.

Fourth, governance indicators for middle-income and high-income groups are taken from the International Country Risk Guide (ICRG) 2003. The ICRG data set is originally generated from its political risk indicators. Actually, this ICRG political risk rating system itself does not have governance indicators, but given its advantage of broad coverage both across countries (mainly for middle-income and high-income countries) and over time, the World Bank transformed this data set into governance indicators, ranging from 1 (worst) to 12 (best). Although the classification of governance indicators in this ICRG data set is somehow different from the CPIA one, the two data sets mainly cover the same elements of governance. Hence, the interpretation of the impact of governance on growth rate for low-income, middle-income and high-income countries should not differ greatly.

ICRG governance indicators are classified into 6 groups:

1.1 *Voice and Accountability* - measuring political, civil, and human rights;

1.2 *Political Stability* – measuring the likelihood of violent threats to, or change in, government, including terrorism;

1.3 *Government Effectiveness* – measuring the competence of the bureaucracy and the quality of public service delivery;

1.4 *Regulatory Quality* – measuring the incidence of market-friendly policies;

1.5 *Rule of Law* – measuring the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence;

1.6 *Control of Corruption* – measuring the exercise of public power for private gain, including both petty and grand corruption and state capture.

4.4.2 Regression Models

In this study, the author follows Barro's (1996) ad hoc growth equation and then extends it by adding governance as explanatory variables. As seen in Barro (1996), in equation form, the model can be represented as:

$$Dy = f(y, y^*)$$

where, *Dy* is the growth rate of per capita output, *y* is the current level of per capita output, and *y** is the long-run or steady-state level of per capita output. The growth rate, *Dy*, is diminishing in y for given *y** and rising in *y** for given *y*. In a word, Barro's main hypothesis is the conditional convergence between the poorer states and the richer states in the long run. Other explanatory variables (trade ratio, inflation, education, government size, rule of law, etc) are utilized because they define the long-term growth rate.

Specifically, the main purpose of this paper is to examine the impact of governance quality on FDI, domestic investment, and GDP growth rate in different income groups. The author hypothesizes that governance should play a relatively more significant role in bringing about higher GDP growth and in inducing FDI inflow into the middle-income economies, where resources are relatively abundant, than in low-income economies, where resources are limited.

Representative models of the regressions are as below:

Per capita growth rate as dependent variable:

GDP = f (initial level of income, trade openness, macroeconomic management, health condition, fertility rate, initial educational attainment, democracy, governance) (1)

Investment ratio as dependent variable:

INV/GDP = f (initial level of income, trade openness, macroeconomic management, health condition, fertility rate, initial educational attainment, democracy, governance) (2)

FDI ratio as dependent variable:

FDI/GDP = f (initial level of income, trade openness, macroeconomic management, health condition, fertility rate, initial educational attainment, democracy, governance) (3)

In equation 1, it is noteworthy that total investment is not included as an explanatory variable. However, this total investment is taken as dependent variable in equation 2 by leaving the explanatory variables basically the same as equation 1. This is a two-stage regression method because the author wishes to capture marginal effects of explanatory variables on per capita growth rate. Since total investment ratio is a major variable in explaining growth rate, in many cases, it is likely to capture a major effect on growth performance and cause other marginal variables to be statistically insignificant. Similarly, in equation 3 where FDI ratio is taken as dependent variable, controlled variables are also basically held the same as in equation 1 and equation 2. By doing so, we can examine whether those explanatory variables influence growth performance directly or indirectly through the channels of total investment or FDI. To correct standard error, the White Heteroskedasticity consistent coefficient covariance has been employed.

In these analyses, both non-governance and governance variables are incorporated. Non-governance variables include: 1) Initial level of real per capita GDP, which represents the level of conditional convergence between the poor and the rich states in the long run. Hence, the expected sign of estimated coefficient is negative. 2) The macroeconomic management, which represents the policy stance of the government includes: trade openness, inflation rate, and general government final consumption expenditure (GGFCE). These variables can also be considered as economic governance variables and affect growth performance in the short-run. Trade openness represents the degree of openness of trade of an economy. Inflation rate represents the fluctuation of inflation whose effect on the economy differs largely depending on its degree of fluctuation. For example, chronic or hyperinflation adversely affects growth rate while stable and low level of inflation tends to

contribute to growth. GGFCE represents the size of government. It is predicted to have a negative coefficient with growth rate because relatively bigger government tends to use a larger share of economy's resources rather unproductively. Another reason is that government spending is closely associated with taxation, and thus may reduce growth rate. 3) Life expectancy here is used as a proxy to explain the health condition of the population. Hence, positive estimated correlation with growth rate is expected. 4) Fertility rate variable represents the population pressure on per capita income growth rate. It is expected to be negatively correlated with growth rate because the fruit of development has to be shared a by larger population. 5) Initial educational enrollment rate represents the initial level of human capital and is divided into gross primary enrollment rate, gross secondary enrollment rate, and male secondary enrollment rate.

Democracy can be treated as part of the governance variables to represent the degree of political rights and civil liberty in an economy. The focused governance variables used in this study are divided into two parts. CPAI governance variables were used for low-income countries and ICRG governance variables were used for middle-income and high-income countries.

It should also be noted that, trade, inflation, and GGFCE represent the stance of economic policy of the government. And it is considered to impact on investment and GDP growth in the short run, while other governance variables represent the quality of governance in a broader sense. In principle, as the quality of governance takes time to improve in a country, its impact on investment and growth is considered a long-run effect. Variables used in the analysis are shown in Table 4.1.

Table 4.1: Summary of Actual Variables Used in the Regression Analysis

Y : Average per capita GDP growth rate for each period

INV/GDP : Average ratio of total investment ratio to GDP for each period

FDI/GDP : Average ratio of FDI inflow to GDP for each period

Ln : Natural log of real per capita GDP for initial year

Trade : Average ratio of trade to GDP for each period

Inflation : Average inflation rate (GDP deflator) for each period

GGFCE : Average ratio of general government final consumption expenditure (proxy of government size) for each period

Life : Average life expectancy at birth for each period

Fertility : Average total fertility rate for each period

Primary : Gross primary enrollment rate of initial period

Secondary : Gross secondary enrollment rate of initial period

Malesec : Gross male secondary enrollment rate of initial period

Democracy : PR: Average political rights index for each period

CL: Average civil liberties index for each period

Governance (low-income): EM: Economic management index for 2005

SP: Structural Policies index for 2005

PSIE: Policies for social inclusion/equity index for 2005

PSMI: Public sector management and institutions index for 2005

Governance (middle-income and high-income):

VA: Average voice and accountability index for each period

PS: Average political stability index for each period

GE: Average government effectiveness index for each period

RQ: Average regulatory index for each period

RL: Average rule of law index for each period

CC: Average control of corruption index for each period

In order to avoid the multicollinearity issues of key variables, cross-correlation is provided in Table 4.2. As clearly indicated in Table 4.2, the correlation among those key variables is low. Thus, we can assume that the multicollinearity issue is not a problem in this analysis.

Table 4.2: Cross-correlation Table for the Key Variables

	Inflation	Trade	GGFCE	EM	SP
Inflation	1.000				
Trade	0.079	1.000			
GGFCE	0.122	0.301	1.000		
EM	-0.039	-0.043	-0.263	1.000	
SP	-0.324	0.088	-0.224	0.573	1.000

Source: Author

4.4.3 Estimation Methods

As noted earlier, in equations 1, 2, and 3, the average per capita growth rate, investment ratio, and FDI ratio are taken as dependent variables, respectively. All of the regressions employ two-stage least squares method to avoid reverse influences of dependent variables on explanatory variables. In general, the earlier value of each variable is selected and used as instrument. For example, in equation 1 for the low-income group, the instrument for average value of 2000-2004 life expectancy is its 1997 value; trade ratio and GGFCE are their 3-year average earlier values; and PR and CL are their 1999 values. The inflation variable is not instrumented here as medium and long-term average rate of inflation is considered to be controlled not by growth rate but rather by other elements such as monetary policy and fiscal deficit management. Despite attempts to use instruments for governance variables in the low-income group, they cannot be used here based on two reasons: 1) appropriate instruments cannot be found; 2) we assume that there is not much

growth-induced change in the governance structure in this 5-year period analysis.

For the middle-income and high-income groups, the regressions are carried out for two periods (period one: 1986-93, period two: 1994-03). Instruments for the first period for trade ratio, GGFCE, life expectancy, and fertility rate use the 3-year earlier average value and for the second period are their 5-year earlier average values; for example, the average value of 1983-85 is instrumented for 1986-93 equation, and the average value of 1989-93 is instrumented for 1994-03 equation. For school enrollment rate no instrument is necessary here because the data used in the analysis is already at its earlier value. And for the same reason as for low-income group, no instrument is needed for inflation because growth rate is not considered to affect inflation rate in the medium and long term. For the democracy variable and governance variable, we use earlier average values as instruments, except for regulatory quality for the middle-income group. This is because the influence of growth rate on regulatory quality is considered very limited. Change of regulatory quality is rather related to systematic/political factors, especially in transition countries, many of which are categorized as middle-income.

In equation 2, investment ratio as dependent variable, the instrument used for each variable here is also each variable's earlier value, as noted earlier (in equation 1). However, for all governance indicators in the low-income group and regulatory quality in the middle-income group regressions, instruments are not utilized. Instruments are not used for educational enrollment variables (secondary enrollment, male secondary enrollment) because earlier values are already used. And no instrument is used for inflation variable because it is considered not affected by total investment ratio.

In equation 3, FDI ratio as dependent variable, regression for the low-income group uses no instruments for governance indicators for reasons noted earlier. For the middle-income group, no instrument for regulatory quality is utilized, and educational enrollment variables and inflation variable are also omitted.

4.5 Results of Regression Analyses

4.5.1 Governance and Per Capita Growth Performance

4.5.1.1 Low-Income Economies

As seen in Table 4.3, variable ln98, which represents initial real per capita income (1998), is negatively associated with growth rate and statistically significant at 10 per cent. This result can be interpreted in a way that a relatively lower real per capita state tends to grow faster than a higher one amongst low-income states. Thus, we can say that intra group conditional convergence is likely to take place. Although inflation, government size (GGFCE), and secondary enrollment rate shows statistically significant results with expected sign, trade and life expectancy cannot be found significant in here. Trade and inflation, which represent the economic management or governance, are considered to have a positive impact on growth performance. However, the impact of these variables appear in short-term effect, which is different to the governance variables below that tend to require long-term process to take effect.

Democracy indicators, both political rights and civil liberty are found to have a negative but statistically insignificant relation with growth. This is probably because democracy in the low-income group is still at a low level, in a so-called fledgling democracy. And this fledgling democracy does not necessarily promote economic growth; instead, strong and authoritarian leaders seem to be more able to maintain political stability as can be seen in many countries. However, economic growth here should be carefully distinguished from social development as a whole.

Regarding our governance indicators, SP_1 variable has a negative but statistically insignificant relationship with growth (coef= -1.188, t=-0.97). Other governance variables such as EM_1, $PSIE_1$, and $PSMI_1$ have positive but also statistically insignificant relationships with growth. This result justifies this dissertation's hypothesis.

Table 4.3: Regressions for Low-Income Economies' Per Capita Income Growth

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
No. of Ob.	38	38	38	38	38	38	38
C	22.555***	22.663***	12.997	27.733***	15.781	20.618**	17.237
	(3.47)	(3.23)	(1.44)	(2.88)	(1.66)	(2.41)	(1.63)
LN98	-2.446**	-2.450**	-1.676	-2.521**	-2.144**	-2.328**	-2.140**
	(-2.49)	(-2.37)	(-1.70)	(-2.61)	(-2.35)	(-2.47)	(-2.22)
TRADE.	0.014	0.013	0.016	0.013	0.015	0.013	0.014
	(1.02)	(1.03)	(1.30)	(1.00)	(1.21)	(1.09)	(1.17)
INFLATION.	-0.036***	-0.036***	-0.026**	-0.043***	-0.028**	-0.034**	-0.030**
	(-3.88)	(-3.90)	(-2.24)	(-3.07)	(-2.06)	(-2.62)	(-2.02)
GGFCE.	-0.140***	-0.140***	-0.115*	-0.174**	-0.143***	-0.140***	-0.130**
	(-3.24)	(-3.11)	(-1.89)	(-2.48)	(-2.99)	(-2.90)	(-2.10)
LIFE.	-0.050	-0.052	-0.055	-0.071	-0.054	-0.056	-0.054
	(-0.76)	(-0.74)	(-0.86)	(-0.90)	(-0.80)	(-0.79)	(-0.75)
SECONDARY.	0.066**	0.066**	0.055**	0.079***	0.060**	0.067**	0.062**
	(2.47)	(2.43)	(2.01)	(2.73)	(2.04)	(2.42)	(2.08)
PR.	-0.175						
	(-0.81)						
CL.		-0.158					
		(-0.57)					
EM.			0.985				
			(1.46)				
SP.				-1.188			
				(-0.97)			
PSIE.					1.298		
					(0.95)		
PSMI.						0.252	
						(0.20)	
Adjusted R^2	0.491	0.491	0.531	0.495	0.513	0.484	0.496

Note: number in parentheses ( ) is the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.1.2 Middle-Income Economies

Regression results for middle-income countries for 1986-1993 and 1994-2003, as shown in Table 4.4, show strong negative and statistically significant correlation between initial GDP and per capita growth. This result is similar to the low-income group, suggesting possible intra group conditional convergence of per capita GDP. Other non-governance variables, in the first period, show the expected sign but are statistically insignificant.

However, in the second period, trade ratio measuring the level of trade openness, was found to have a negative but statistically insignificant correlation with GDP growth rate. GGFCE, measuring government size, shows a positive relationship. One possible explanation for this result can be evidenced from the empirical facts that many Latin American middle-income countries were forced to cut government expenditure when receiving a loan from the International Monetary Fund or the World Bank. The reduction in government spending has led to a budget reduction in many sectors, which were also deemed necessary for economic growth. The reduction in those sectors probably had a negative impact on growth performance in these middle-income countries.

Among governance indicators, voice and accountability shows a positive correlation in the first period and negative correlation in the second one, but for either period the correlation is statistically insignificant. Political stability is found to have a positive relationship in both periods but is significant only in the second period (coef=0.333, t=1.89). Government effectiveness shows a positive relationship but is significant only in the first period (coef=0.854, t=3.16. Regulatory quality has a positive and statistically significant relationship in both periods (first period: coef=1.272, t=4.44; second period: coef=0.536, t=2.49). This result suggests that there is direct and positive relationship of market-friendly policies on growth performance as empirically evidenced in many economies, especially in transition ones. Rule of law shows positive signs but is statistically significant only in the second period (coef=0.728, t=2.83). Control of corruption shows a positive relationship, but is not significant in either of the periods.

In conclusion, we can say that in general governance factors have positive impacts on growth performance in the middle-income countries although they differ in degrees among indicators and over time.

Table 4.4: Regressions for Middle-Income Economies' Per Capita Income Growth

	1986-1993								1994-2003								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)		(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
No. of Ob.	42	42	38	38	38	38	38	38	No. of Ob.	51	51	37	37	37	41	37	37
LN84	-3.13*	-3.31*	-2.71*	-2.91*	-3.08*	-3.21*	-3.09*	-2.82*	LN92	-1.58*	-1.83*	-2.22*	-2.33*	-2.33*	-2.48*	-2.16*	-2.54*
	(-3.05)	(-3.16)	(-2.65	(-2.62	(-3.42)	(-3.89)	(-2.80)	(-2.85)		(-2.03)	(-1.90)	(-2.35)	(-3.03)	(-2.51)	(-2.60)	(-2.64)	(-2.27)
TRADE$_{2}$	0.01	0.01	0.01	0.01	0.01	0.00	0.01	0.01	TRADE$_{3}$	0.00	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01	-0.01
	(1.01)	(0.65)	(0.57)	(0.74)	(0.95)	(0.37)	(0.55)	(0.52)		(-0.35)	(-0.62)	(-0.72)	(-1.50)	(-1.06)	(-0.93)	(-1.33)	(-1.36)
INFLATIO	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	INFLATIO	-0.02*	-0.02*	-0.03*	-0.03*	-0.03*	-0.02*	-0.03*	-0.03*
	(-1.20)	(-1.17)	(-1.36	(-0.95	(-1.18)	(-0.58)	(-1.26)	(-1.79)		(-2.38)	(-1.96)	(-2.70)	(-3.20)	(-2.72)	(-2.46)	(-2.90)	(-2.90)
GGFCE$_{2}$	-0.02	-0.02	0.01	-0.02	-0.09	-0.06	-0.03	-0.01	GGFCE$_{3}$	0.09	0.08	0.19**	0.12*	0.18**	0.14**	0.08*	0.13
	(-0.19)	(-0.15)	(0.10)	(-0.14	(-0.60)	(-0.57)	(-0.22)	(-0.07)		(1.56)	(1.36)	(2.19)	(1.91)	(2.15)	(2.18)	(1.71)	(1.67)
LIFE$_{2}$	0.10	0.09	0.08	0.08	0.10	0.14	0.07	0.06	FERTILIT	-1.27*	-0.98*	-1.53*	-1.34*	-1.46*	-1.20*	-1.31*	-1.39*
	(0.76)	(0.71)	(0.64)	(0.69)	(0.96)	(1.27)	(0.64)	(0.53)		(-2.98)	(-2.17)	(-3.48)	(-3.60)	(-3.51)	(-2.98)	(-3.43)	(-2.71)
PRIMARY	0.03	0.03	0.04	0.03	0.03	0.01	0.02	0.03	MALESEC	0.03**	0.04**	0.02*	0.03**	0.02*	0.03**	0.03*	0.02
	(0.88)	(0.81)	(0.97)	(0.59)	(0.79)	(0.45)	(0.58)	(0.93)		(2.45)	(2.89)	(1.68)	(2.23)	(1.74)	(2.11)	(1.85)	(1.35)
PR$_{2}$	0.44								PR$_{3}$	-0.21							
	(1.20)									(-1.11)							
CL$_{2}$		0.56							CL$_{3}$		0.05						
		(1.14)									(0.18)						
VA$_{2}$			0.10						VA$_{3}$			-0.08					
			(0.45)									(-0.30)					
PS$_{2}$				0.19					PS$_{3}$				0.33*				
				(0.87)									(1.89)				
GE$_{2}$					0.85**				GE$_{3}$					0.11			
					(3.16)									(0.22)			
RQ$_{2}$						1.27**			RQ$_{3}$						0.54**		
						(4.44)									(2.49)		
RL$_{2}$							0.59		RL$_{3}$							0.73**	
							(1.50)									(2.83)	
CC$_{2}$								0.64	CC$_{3}$								0.95
								(1.66)									(1.31)
Adjusted R^2	0.34	0.34	0.31	0.31	0.44	0.55	0.38	0.33	Adjusted R^2	0.50	0.48	0.50	0.59	0.51	0.63	0.60	0.48

Note: numbers in parentheses ( ) are the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed)

4.5.1.3 High-Income Economies

Table 4.5 shows the results of regressions for the high-income group for 1986-1993 and 1994-2003 analyses. Initial per capita GDP, ln84 for first period and ln92 for second period, has a strong negative and significant relationship, suggesting conditional convergence of per capita GDP among high-income states. Other non-governance variables could not be found statistically significant except life expectancy in the first period and secondary enrollment rate in the second period.

Political rights and civil liberty, proxies of democracy, have a positive correlation with GDP growth rate but are statistically significant only in the second period. This implies that voice and participation of the people is essential in economic management/performance in high-income countries. As for governance indicators, they show a positive correlation with per capita growth in both periods, despite differences in significance levels. In the first period, although positive, voice and accountability, political stability, and rule of law are not statistically significant. This suggests that the above variables do not seem to play a crucial role in growth performance. However, government effectiveness, regulatory quality, and control of corruption are observed to be more significant with coefficient of 0.647 (t=2.01), 0.882 (t=2.74), and 0.566 (t=1.70), respectively. Among them, regulatory quality, which measures the incidence of market-friendly policies, is likely to play the most important role in growth performance. This suggests that countries pursuing a higher level of market-friendly approaches tend to achieve higher growth.

In the second period, voice and accountability (coef=0.90, t=2.19), political stability (coef=0.75, t=2.15), effectiveness of government (coef=1.99, t=1.96), and rule of law (coef=2.47, t=2.27) show statistically significant results while regulatory quality and control of corruption are insignificant. The reason regulatory quality and control of corruption show little influence on growth rate is probably due to the already-high level of market-friendly policies and relatively low level of corruption across country in this high-income group.

Table 4.5: Regressions for High-Income Economies' Per Capita Income Growth

	1986-1993							
	1	2	3	4	5	6	7	8
No. of Ob.	31	31	29	29	29	29	29	29
Ln84	-4.45***	-4.45***	-6.00***	-5.95***	-6.12***	-6.10***	-6.13***	-6.08***
	(-4.03)	(-4.03)	(-5.74)	(-6.02)	(-7.41)	(-7.69)	(-6.11)	(-6.52)
$TRADE_4$	0.01	0.01	0.02*	0.02*	0.02**	0.02**	0.02*	0.02*
	(1.26)	(1.26)	(1.87)	(2.00)	(2.52)	(2.27)	(1.88)	(2.03)
$INFLATION_4$	-0.07	-0.07	-0.07	-0.06	-0.06	0.03	-0.06	-0.10
	(-1.01)	(-1.01)	(-1.25)	(-0.99)	(-1.19)	(0.64)	(-1.03)	(-1.34)
$GGFCE_4$	-0.03	-0.03	-0.05	-0.03	-0.05	-0.01	-0.04	-0.07
	(-0.47)	(-0.47)	(-0.97)	(-0.68)	(-1.09)	(-0.14)	(-0.92)	(-1.43)
$LIFE_4$	0.20	0.20	0.40***	0.42***	0.39***	0.42***	0.41***	0.25
	(1.06)	(1.06)	(2.80)	(3.00)	(3.02)	(3.03)	(2.85)	(1.30)
$SECONDARY_4$	0.00	0.00	-0.01	-0.01	-0.02	-0.01	-0.01	-0.01
	(0.03)	(0.03)	(-0.57)	(-0.66)	(-1.20)	(-0.99)	(-0.58)	(-0.90)
PR_4	0.25							
	(0.86)							
CL_4		0.25						
		(0.86)						
VA_4			0.13					
			(0.75)					
PS_4				0.18				
				(1.29)				
GE_4					0.65**			
					(2.01)			
RQ_4						0.88***		
						(2.74)		
RL_4							0.33	
							(1.13)	
CC_4								0.57*
								(1.70)
Adjusted R^2	0.67	0.67	0.70	0.70	0.76	0.74	0.70	0.70

	1994-2003							
	9	10	11	12	13	14	15	16
No. of Ob.	30	30	25	25	25	25	25	25
LOG92	-2.99***	-3.06***	-3.81*	-1.94	-3.95**	-2.26**	-3.59**	-1.71
	(-3.42)	(-3.84)	(-1.90)	(-1.64)	(-2.03)	(-2.30)	(-2.10)	(-1.41)
$TRADE_5$	0.00	0.00	0.00	-0.01	0.00	0.00	0.00	0.00
	(0.17)	(-0.81)	(0.25)	(-1.10)	(-0.06)	(-0.59)	(-0.55)	(0.40)
$INFLATION_5$	0.06	0.12*	0.12	0.55**	0.28	0.12	0.50***	0.24
	(0.56)	(1.72)	(0.70)	(2.01)	(1.40)	(1.18)	(2.83)	(1.41)
$GGFCE_5$	-0.09	-0.07	-0.06	0.00	0.00	-0.03	-0.07	-0.05
	(-1.07)	(-1.04)	(-0.77)	(0.05)	(-0.06)	(-0.35)	(-0.94)	(-0.47)
$FERTILITY_5$	0.90	0.73	1.33	-0.02	-0.34	-0.35	-0.28	-0.25
	(1.13)	(1.22)	(1.39)	(-0.04)	(-0.83)	(-0.72)	(-0.86)	(-0.56)
$SECONDARY_5$	0.04***	0.04***	0.05**	0.06**	0.02	0.05**	0.05***	0.03
	(3.07)	(3.15)	(2.11)	(2.26)	(1.57)	(2.39)	(2.75)	(1.64)
PR_5	0.63**							
	(2.32)							
CL_5		0.62***						
		(2.96)						
VA_5			0.90**					
			(2.19)					
PS_5				0.75**				
				(2.15)				
GE_5					1.99*			
					(1.96)			
RQ_5						0.17		
						(0.53)		
RL_5							2.47**	
							(2.27)	
CC_5								0.43
								(1.50)
Adjusted R^2	0.61	0.67	0.52	0.41	0.60	0.44	0.56	0.43

Note: numbers in parentheses ( ) are the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.1.4 Summary

There have been many studies explaining conditional convergence between developed and developing nations. In this study, intra group conditional convergence is also confirmed. Factors influencing growth performance may be different among income groups. For instance, in the low-income group, control of inflation and size of government, which are parts of macroeconomic governance, and educational enrollment seem to be important in promoting growth. Other governance factors, rather than economic governance characterized by inflation rate and government size, do not seem to play a significant role and provide a reasonable explanation. This is probably because of the amount of resources to be managed in this income group is limited.

However, in middle-income and high-income economies, this governance factor is observed to play a crucial role although it differs in degrees among indicators. So, we can conclude that governance factors, which require a long process to take effect do not necessarily contribute to growth in low-income states in the short run, but once the country starts to develop with an accumulation of productive factors it will become an important element to promote growth.

4.5.2 Governance and Investment Ratio

So far, equation 1 has explained the factors affecting growth performance in each income group, but total investment was not included as an explanatory variable. Now in equation 2, we examine factors affecting total investment by taking an investment ratio as a dependent variable and using explanatory variables basically the same as those in equation 1. This two-stage regression is based on the assumption that total investment positively affects growth performance.

To quantitatively prove the positive relation between total investment and GDP growth rate, the regressions have been expanded to include period average of investment ratio as

explanatory variable in equation 1. For example, in the expanded regression in column 1 of Table 4.3 of low-income countries, the estimated coefficient of investment ratio is found to have a strong positive and statistically significant correlation with growth rate (coef=0.20, t=3.16). For middle-income countries, in columns 1 and 9 of Table 4.4, the estimated coefficient on investment ratio is found to be positive but not statistically significant (column 1: coef=0.14, t=1.65; column 9: coef= 0.07, t=1.34). And for high-income countries, in columns 1 and 9 of Table 4.5, the estimated coefficient on investment ratio is positive but not statistically significant (column 1: coef=0.14, t=1.15; column 9: coef=0.002; t=0.03).[16] These results are not shown in the tables. The insignificant result in this high-income group probably derives from the small variation in their investment ratio; however, it does not necessarily mean that investment does not contribute to growth rate.

4.5.2.1 Low-Income Economies

Regression results for the low-income group, Table 4.6, shows that initial real per capita income has a positive relationship (though not significant with total investment), implying that a level of per capita income that is too low is not likely to induce more investment. Governance variables, positive and significant results can only be seen for economic management (EM_1) while other variables such as SP_1, $PSIE_1$, $PSMI_1$ are statistically insignificant. This result is intuitive because better economic management, in general, leads to more investment activities.

[16] GGFCE is excluded from the equation to avoid multicollinearity issue. GGFCE is highly correlated with investment ratio (0.402).

Table 4.6: Regressions for Low-Income Economies' Total Investment Ratio

	1	2	3	4	5	6
	38	38	38	38	38	38
C	-4.468	-8.140	-33.619	2.921	-14.489	-25.222
	(-0.22)	(-0.37)	(-1.23)	(0.09)	(-0.51)	(-0.75)
LN98	4.170	4.465	6.354**	3.554	3.951	4.887
	(1.59)	(1.62)	(2.25)	(1.11)	(1.49)	(1.68)
TRADE	0.059	0.060	0.072*	0.062	0.066*	0.068*
	(1.67)	(1.64)	(1.96)	(1.44)	(1.74)	(1.76)
INFLATION	-0.065***	-0.066***	-0.030	-0.071*	-0.047	-0.037
	(-2.84)	(-2.81)	(-0.97)	(-1.79)	(-1.37)	(-0.95)
GGECE	0.051	0.049	0.145	0.038	0.034	0.104
	(0.32)	(0.31)	(0.93)	(0.17)	(0.26)	(0.63)
LIFE	-0.232	-0.234	-0.191	-0.198	-0.194	-0.177
	(-1.12)	(-1.11)	(-1.06)	(-0.84)	(-0.99)	(-0.90)
SECONDARY	0.003	0.008	-0.056	-0.002	-0.007	-0.040
	(0.04)	(0.10)	(-0.68)	(-0.02)	(-0.10)	(-0.51)
PR	1.039					
	(1.45)					
CL		1.369*				
		(1.78)				
EM			4.032**			
			(2.31)			
SP				-0.285		
				(-0.07)		
PSIE					4.264	
					(1.13)	
PSML						4.830
						(1.31)
Adjusted R^2	0.325	0.325	0.409	0.297	0.354	0.358

Note: number in parentheses ( ) is the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.2.2 Middle-Income Economies

Regression results for the middle-income group, as can be seen in Table 4.7, show that initial per capita GDP has a negative and significant relationship in both periods as expected. A positive correlation between trade and investment ratio is also found. Inflation shows a slightly positive result in the first period but negative significant result in the second one. The result in the first period is probably because of the centrally planned economic structure of

transitional economies where investment is carried out without taking into consideration of the inflation rate. In the second period when the transformation is complete, inflation does play a role in the determination of investment activities.

Governance indicators, in general, do not seem to have any correlation with the investment ratio. Among all the variables, only political stability is found to have a positive relationship, but is statistically significant only in the first period (first period: coef=0.762, t=1.89; second period: coef=0.545, t=1.14). This result makes sense because investors tend to invest more in a nation where political stability is guaranteed. As mentioned earlier, total investment is comprised of both domestic and foreign investments. And although we know that, in general, domestic investment makes up the majority of total investment, the above investigation has not clarified the separate impacts of governance on each of them. We will examine the separate impacts of governance on domestic and foreign investment in detail in Section 4.5.3.

Table 4.7: Regressions for Middle-Income Economies' Total Investment Ratio

	1986-1993								1994-2003							
No. of Ob	1	2	3	4	5	6	7	8		9	10	11	12	13	14	15	16
	42	42	38	38	38	38	38	38	No. of Ob.	51	51	37	37	37	41	37	37
LN84	-4.47**	-3.59*	-4.84***	-5.67***	-5.32***	-4.84***	-5.21***	-4.81***	LN92	-2.40	-1.59	-2.90*	-3.23*	-3.52**	-3.08*	-3.03*	-3.12*
	(-2.51)	(-1.84)	(-2.91)	(-3.87)	(-3.91)	(-2.84)	(-3.14)	(-3.33)		(-1.12)	(-0.76)	(-1.76)	(-1.98)	(-2.23)	(-1.98)	(-2.01)	(-1.96)
$TRADE_2$	0.04	0.06	0.02	0.03	0.04	0.03	0.03	0.03	$TRADE_3$	0.05**	0.06**	0.04*	0.03*	0.03	0.04**	0.04**	0.04**
	(1.13)	(1.49)	(0.57)	(0.81)	(0.99)	(0.87)	(0.82)	(0.80)		(2.20)	(2.60)	(1.96)	(1.73)	(1.53)	(2.45)	(2.24)	(2.17)
$INFLATION_2$	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	$INFLATION_3$	-0.04*	-0.05**	-0.07***	-0.07**	-0.06*	-0.04**	-0.07***	-0.07***
	(0.86)	(0.95)	(0.39)	(1.41)	(0.98)	(0.80)	(0.80)	(0.14)		(-1.76)	(-2.05)	(-2.86)	(-2.63)	(-1.91)	(-2.27)	(-2.76)	(-2.84)
$GGFCE_2$	-0.02	-0.09	0.09	-0.04	-0.13	-0.01	-0.02	0.02	$GGFCE_3$	-0.08	-0.07	0.03	-0.11	-0.07	-0.03	-0.08	0.02
	(-0.08)	(-0.32)	(0.34)	(-0.16)	(-0.44)	(-0.04)	(-0.07)	(0.07)		(-0.42)	(-0.36)	(0.13)	(-0.54)	(-0.35)	(-0.15)	(-0.41)	(0.09)
$LIFE_2$	0.20	0.27	0.12	0.14	0.19	0.19	0.13	0.11	$FERTILITY_3$	-1.63	-2.25**	-2.56***	-2.22**	-2.35**	-1.84**	-2.24**	-2.45***
	(0.90)	(1.22)	(0.47)	(0.56)	(0.74)	(0.79)	(0.51)	(0.42)		(-1.42)	(-2.09)	(-2.71)	(-2.32)	(-2.54)	(-2.33)	(-2.47)	(-2.75)
$PRIMARY_2$	0.00	0.00	0.04	-0.01	0.02	0.02	0.01	0.03	$MALESEC_3$	0.00	-0.02	-0.03	-0.03	-0.03	-0.02	-0.03	-0.03
	(-0.05)	(-0.01)	(0.48)	(-0.09)	(0.37)	(0.28)	(0.19)	(0.46)		(0.02)	(-0.35)	(-0.75)	(-0.60)	(-0.81)	(-0.40)	(-0.70)	(-0.78)
PR_2	-0.49								PR_3	0.20							
	(-0.80)									(0.35)							
CL_2		-1.43*							CL_3		-0.66						
		(-1.89)									(-1.06)						
VA_2			0.36						VA_3			-0.23					
			(0.85)									(-0.37)					
PS_2				0.76*					PS_3				0.55				
				(1.89)									(1.14)				
GE_2					1.56				GE_3					1.57			
					(1.41)									(0.96)			
RQ_2						0.79			RQ_3						-0.50		
						(0.83)									(-0.87)		
RL_2							0.93		RL_3							0.53	
							(1.02)									(0.66)	
CC_2								1.01	CC_3								-0.24
								(0.84)									(-0.18)
Adjusted R^2	0.21	0.16	0.24	0.29	0.35	0.25	0.27	0.26	Adjusted R^2	0.21	0.23	0.49	0.39	0.44	0.41	0.47	0.47

Note: numbers in parentheses ( ) are the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.2.3 High-Income Economies

Among non-governance variables in this high-income group, only government size is found to be statistically significant with the expected negative sign with total investment ratio. This result implies that a relatively big government tends to have more waste/inefficiency than small government. And the spending of the government is closely associated with taxation, a majority of which comes from private sectors. The more tax levied on private sectors, the less money that can be used for investment activities.

Governance factors do not seem to have a crucial impact on investment in the high-income group. Most of the variables are statistically insignificant. Although the impact of governance on investment ratio also depends on each element, the result suggests that, in general, decision-making regarding investment in high-income countries is relatively independent from the governance structure.

4.5.2.4 Summary

Total investment is found to have been affected by many factors across countries in each income group and over time. In the low-income group, effective control of elements of governance related to sound economic management, including inflation seem to influence investments in general and then lead to higher growth. Since the share of domestic investment dominates total investment, in general, we can say that improvement in economic governance is more likely to influence domestic investors when they, in most cases, are capable of investing in their own countries. In the middle-income and high-income groups, as a general tendency, investment does not seem to have any significant relationships with governance indicators. For example, investors in high-income states are, in general, relatively strong and independent and are not influenced by the changes of governance structure.

Table 4.8: Regressions for High-Income Economies' Total Investment Ratio

	1986-1993								1994-2003						
	1	2	3	4	5	6	7		8	9	10	11	12	13	14
No. of Ob.	31	29	29	29	29	29	29		30	27	27	27	27	27	27
Ln84	-4.78**	-1.81	-3.74	-4.08	-4.99	-3.57	-4.52	Ln92	-2.41	-6.74	-5.00	-6.55	-4.67*	-3.80	-5.13
	(-2.41)	(-0.63)	(-1.17)	(-1.18)	(-1.49)	(-1.20)	(-1.29)		(-0.58)	(-1.62)	(-1.22)	(-1.50)	(-1.90)	(-1.11)	(-1.29)
$TRADE_4$	0.00	0.00	-0.01	0.00	-0.01	0.00	-0.01		-0.01	-0.01	-0.02	-0.02	-0.01	-0.01	-0.02
	(-0.18)	(-0.28)	(-0.37)	(-0.28)	(-0.45)	(-0.30)	(-0.37)		(-0.49)	(-0.84)	(-0.65)	(-0.89)	(-0.42)	(-0.64)	(-0.80)
$INFLATION_4$	-0.02	-0.19	-0.17	-0.15	0.03	-0.17	-0.16	$INFLATION_5$	0.28	0.09	0.05	0.05	0.27	0.01	0.08
	(-0.13)	(-1.49)	(-1.65)	(-1.27)	(0.19)	(-1.55)	(-1.17)		(0.76)	(0.27)	(0.15)	(0.13)	(0.89)	(0.02)	(0.22)
$GGFCE_4$	-0.41***	-0.33***	-0.33***	-0.31**	-0.23*	-0.31***	-0.32***	$GGFCE_5$	-0.49**	-0.43**	-0.40**	-0.38**	-0.34**	-0.36**	-0.39**
	(-3.43)	(-3.13)	(-2.75)	(-2.54)	(-1.94)	(-2.72)	(-2.76)		(-2.36)	(-2.58)	(-2.49)	(-2.25)	(-2.05)	(-2.23)	(-2.08)
$LIFE_4$	0.86**	0.70	0.35	0.31	0.22	0.36	0.13	$FERTILITY_5$	-0.76	-0.15	-1.81	-1.59	-2.79	-1.80	-1.70
	(2.44)	(1.63)	(0.80)	(0.72)	(0.51)	(0.84)	(0.27)		(-0.36)	(-0.13)	(-1.48)	(-1.51)	(-1.99)	(-1.49)	(-1.30)
$SECONDARY_4$	0.01	0.00	-0.02	-0.03	-0.05	-0.03	-0.04	$SECONDARY_5$	-0.01	-0.02	-0.03	-0.04	-0.05	-0.04	-0.03
	(0.15)	(0.11)	(-0.59)	(-0.70)	(-1.11)	(-0.66)	(-1.01)		(-0.19)	(-0.51)	(-0.57)	(-0.73)	(-0.81)	(-0.65)	(-0.53)
PR_4	-1.54**							PR_5	-0.11						
	(-2.09)								(-0.11)						
VA_4		-0.99*						VA_5		0.80					
		(-2.00)								(1.57)					
PS_4			-0.30					PS_5			-0.16				
			(-1.07)								(-0.18)				
GE_4				-0.20				GE_5				1.14			
				(-0.24)								(0.70)			
RQ_4					1.57			RQ_5					-2.39***		
					(1.52)								(-2.98)		
RL_4						-0.47		RL_5						-1.16	
						(-0.87)								(-0.72)	
CC_4							0.42	CC_5							0.00
							(0.44)								(-0.00)
Adjusted R^2	0.48	0.40	0.35	0.34	0.29	0.36	0.34	Adjusted R^2	0.29	0.49	0.41	0.44	0.58	0.44	0.41

Note: numbers in parentheses ( ) are the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.3 Governance and FDI Ratio

4.5.3.1 Low-Income Economies

Table 4.9 shows the regression results for low-income economies where ratio of FDI to GDP is taken as dependent variable. The result shows that most of the non-governance variables are not statistically significant except that trade ratio reveals strong and positive correlation with FDI inflow. This result supports the empirical fact that FDI firms generally

Table 4.9: Regressions for Low-Income Economies' FDI Ratio

	1	2	3	4	5	6	7
	38	38	38	38	38	38	38
C	7.023	5.324	10.489	15.748	10.381	13.216	14.542
	(0.59)	(0.44)	(0.62)	(0.75)	(0.58)	(0.77)	(0.70)
LN98	0.221	0.382	-0.030	0.058	0.173	0.169	-0.087
	(0.17)	(0.31)	(-0.02)	(0.04)	(0.12)	(0.12)	(-0.06)
TRADE	0.071***	0.070***	0.069***	0.070***	0.069***	0.069***	0.068***
	(3.28)	(3.44)	(3.49)	(3.25)	(3.39)	(3.24)	(3.39)
INFLATION	-0.017	-0.016	-0.021	-0.028	-0.022	-0.026	-0.027
	(-1.24)	(-1.25)	(-1.03)	(-1.20)	(-1.03)	(-1.28)	(-1.08)
GGFCE	-0.081	-0.080	-0.093	-0.135	-0.078	-0.075	-0.099
	(-1.11)	(-1.10)	(-1.00)	(-0.98)	(-1.15)	(-1.13)	(-1.03)
LIFE	-0.135	-0.144	-0.143	-0.165	-0.144	-0.142	-0.148
	(-1.35)	(-1.49)	(-1.34)	(-1.40)	(-1.37)	(-1.35)	(-1.33)
SECONDARY	-0.025	-0.023	-0.017	-0.004	-0.017	-0.022	-0.012
	(-0.58)	(-0.55)	(-0.39)	(-0.09)	(-0.40)	(-0.52)	(-0.27)
PR	-0.203						
	(-0.51)						
CL		0.078					
		(0.16)					
EM			-0.531				
			(-0.48)				
SP				-1.901			
				(-0.76)			
PSIE					-1.013		
					(-0.47)		
PSMI						-1.966	
						(-0.85)	
Adjusted R^2	0.302	0.300	0.305	0.318	0.308	0.334	0.316

Note: number in parentheses ( ) is the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

regard low-income economies as production base because production costs, especially labor costs, are low. They come to low-income countries simply to produce and then export those products to foreign markets. None of the governance variables have a significant relationship with FDI inflow. This is probably because FDI firms do not regard governance factors as a crucial criterion when selecting a destination among low-income economies.

4.5.3.2 Middle-Income Economies

Table 4.10 shows the regression results for the middle-income group. For non-governance variables, most of them show statistically insignificant results, except trade ratio. The positive relation between trade ratio and FDI inflow is very intuitive because in most cases, if not all, trade complements rather than substitute FDI inflow. This can be explained by the fact that a country with a relatively open trade policy also has relatively open capital movement. Open capital movement makes it easier for FDI firms to advance their operation in other countries, thus leading to more trade volume.

As for governance variables, most of them show a positive but statistically insignificant correlation with FDI inflow. Among them, only regulatory quality is found to have a positive and significant relationship in both periods. This result also supports many empirical studies, including Ishihara (2001, p.20). It clearly demonstrates that regulatory quality, which represents market-friendly environment is the most important of the governance elements attracting FDI inflow

Table 4.10: Regressions for Middle-Income Economies' FDI Ratio

	1986-1993									1994-2003							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)		(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)
	42	42	38	38	38	38	38	38		50	50	36	36	36	40	36	36
LN84	-1.029	-0.82	-0.78	-0.65	-0.618	-0.62	-0.857	-0.67	LN92	-1.630	-2.516*	0.871	0.817	0.770	0.515	0.897	0.875
	(-1.73)	(-1.40	(-1.52	(-1.44	(-1.56)	(-1.42	(-1.84)	(-1.53		(-1.27)	(-1.71)	(0.91)	(0.96)	(0.89)	(0.63)	(1.01)	(0.98)
$TRADE_2$	0.013	0.015	0.016	0.025	0.027*	0.021	0.024*	0.023	$TRADE_3$	0.036*	0.015	0.039**	0.037**	0.036**	0.037**	0.037**	0.039**
	(0.65)	(0.78)	(1.14)	(1.50)	(2.02)	(1.71)	(1.75)	(1.62)		(2.43)	(0.86)	(2.99)	(3.82)	(3.58)	(3.89)	(3.76)	(3.88)
INFLATIO	0.000	0.000	0.000	0.000	0.000	0.000	0.000	0.000	INFLATIO	0.010	0.017	-0.017	-0.017	-0.015	0.001	-0.016	-0.018
	(-0.54)	(-0.28	(0.02)	(0.51)	(0.56)	(1.04)	(0.74)	(-0.32		(0.68)	(0.99)	(-1.17)	(-1.19)	(-0.90)	(0.10)	(-1.05)	(-1.25)
$GGFCE_2$	0.162	0.148	-0.00	-0.05	-0.084	-0.05	-0.076	-0.04	$GGFCE_3$	0.099	0.101	-0.158	-0.170	-0.171	-0.169	-0.203	-0.138
	(1.30)	(1.08)	(-0.07	(-0.48	(-0.72)	(-0.60	(-0.69)	(-0.47		(0.83)	(0.78)	(-1.25)	(-1.42)	(-1.25)	(-1.56)	(-1.64)	(-1.14)
FERTILITY	0.011	-0.07	0.038	-0.05	-0.038	-0.12	0.033	-0.04	FERTILITY	-0.274	0.391	-0.916*	-0.876*	-0.880*	-0.782*	-0.779	-0.915*
	(0.04)	(-0.29	(0.13)	(-0.18	(-0.15)	(-0.61	(0.10)	(-0.16		(-0.39)	(0.49)	(-1.71)	(-1.79)	(-1.78)	(-1.93)	(-1.48)	(-1.87)
$PRIMARY_2$	0.022	0.019	-0.00	-0.00	-0.003	-0.01	-0.012	-0.00	$MALESEC_3$	0.014	0.030	0.018	0.018	0.018	0.016	0.020	0.018
	(0.96)	(0.80)	(-0.07	(-0.53	(-0.16)	(-0.68	(-0.69)	(-0.22		(0.51)	(0.98)	(0.83)	(0.85)	(0.82)	(0.80)	(0.87)	(0.84)
PR_2	0.359								PR_3	0.934*							
	(1.40)									(2.68)							
CL_2		0.103							CL_3		2.256**						
		(0.36)									(3.57)						
VA_2			0.287						VA_3			-0.041					
			(1.45)									(-0.12)					
PS_2				0.145					PS_3				0.042				
				(0.76)									(0.17)				
GE_2					0.471				GE_3					0.223			
					(1.18)									(0.25)			
RQ_2						0.631			RQ_3						0.520*		
						(1.92)									(1.78)		
RL_2							0.525		RL_3							0.303	
							(1.19)									(0.65)	
CC_2								0.510	CC_3								-0.293
								(1.07)									(-0.39)
Adjusted R^2	0.340	0.344	0.438	0.404	0.490	0.504	0.432	0.423	Adjusted R^2	0.341	0.216	0.428	0.436	0.433	0.511	0.372	0.433

Note: numbers in parentheses ( ) are the value

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.5.3.3 High-Income economies

Table 4.11 shows the regression results of the high-income group. Initial real per capita GDP is found to have no significant correlation with FDI inflow. This result suggests that initial per capita income is not related with FDI inflow in the high-income economies. Trade and inflation variables show a positive correlation but are statistically significant only in the second period. The major cause of FDI inflow in the first period probably derived from other factors including, for example, the significant depreciation of the US Dollar against other major currencies after the Plaza accord. This dollar depreciation forced many FDI firms to invest in the United States, including Japanese investors, instead of simply exporting products. Government size, life expectancy at birth, and gross secondary enrollment was also found to have no significant results.

As for governance indicators, in the first period, they all show a positive relationship, but only rule of law is statistically significant. In the second period, no significant correlation is found in any of the governance variables. This result implies that governance factors do not play important roles in promoting FDI inflow amongst high-income nations. This is probably because FDI firms coming to invest in the high-income states are generally strong and independent from the influence of the host economies' governance structures.

4.5.3.4 Summary

The analysis reveals that most of the explanatory variables used here do not have any correlation with FDI inflow. However, trade openness is positively correlated with FDI inflow in all income groups. This is due to the complementary effects of trade and FDI. It is also clear that governance factors are not necessarily crucial in attracting FDI in all income groups. In the low-income group, where basic economic components are not yet in place, governance factors matter more to domestic investments than to FDI. Improvement in governance structure is not directly linked to more inflow of FDI. Inflow of FDI starts when minimum

sufficient conditions are met. For the reasons noted, policy to promote domestic investment is needed before attracting FDI.

As for the middle-income states, where basic economic components are in place, differences in governance quality across countries start to matter. In particular, regulatory quality matters even more when FDI and Trade start to play an important role in growth performance. However, in the high-income states, the impact of governance diminishes because FDI firms get stronger and more independent.

Table 4.11: Regressions for High-Income Economies' FDI Ratio

	1986-1993								1994-2003						
	1	2	3	4	5	6	7		8	9	10	11	12	13	14
No. of Ob.	26	25	25	25	25	25	25	No. of Ob.	26	22	22	22	24	22	22
Ln84	-0.95	-1.42	-1.04	-1.17	-0.50	-2.25**	-0.83	LOG92	-0.06	-0.13	0.18	0.94	0.44	0.59	-0.67
	(-1.43)	(-1.12)	(-1.36)	(-1.25)	(-0.80)	(-2.71)	(-1.09)		(-0.01)	(-0.03)	(0.04)	(0.18)	(0.16)	(0.14)	(-0.17)
$TRADE_4$	0.01	0.01	0.01	0.02*	0.01	0.01	0.02	$TRADE_5$	0.13***	0.15***	0.15***	0.16***	0.13***	0.14***	0.13**
	(1.26)	(1.37)	(1.33)	(1.69)	(1.22)	(1.53)	(1.45)		(2.83)	(2.81)	(2.91)	(2.82)	(2.79)	(2.93)	(3.15)
$INFLATION_4$	-0.05	0.00	0.00	-0.01	0.02	0.02	-0.05	$INFLATION_5$	-0.86***	-1.05**	-1.28**	-2.46	-0.93**	-0.85*	-0.92**
	(-1.49)	(-0.04)	(0.07)	(-0.32)	(0.17)	(0.43)	(-1.23)		-4.166	(-2.12)	(-2.56)	(-1.41)	(-3.18)	(-1.71)	(-2.12)
$GGFCE_4$	0.03	0.00	0.01	-0.01	0.00	0.01	-0.03	$GGFCE_5$	0.08	0.04	0.02	-0.23	0.08	0.09	0.15
	(0.92)	(-0.11)	(0.22)	(-0.15)	(0.04)	(0.37)	(-0.79)		(0.51)	(0.27)	(0.12)	(-0.68)	(0.61)	(0.52)	(0.86)
$LIFE_4$	0.12	0.19	0.24*	0.22	0.24*	0.17	0.04	$FERTILITY_5$	-0.58	-0.29	-1.46	8.23	-0.02	-0.54	-0.35
	(1.08)	(1.33)	(1.75)	(1.52)	(1.84)	(1.35)	(0.18)		(-0.27)	(-0.14)	(-0.59)	(0.97)	(-0.01)	(-0.30)	(-0.14)
$SECONDARY_4$	-0.02	-0.02	-0.02	-0.04	-0.03	-0.02	-0.03	$SECONDARY_5$	-0.05	-0.04	-0.06	0.06	-0.04	-0.05	-0.01
	(-1.33)	(-1.34)	(-1.33)	(-1.54)	(-1.07)	(-1.25)	(-1.64)		(-0.75)	(-0.77)	(-1.05)	(0.46)	(-0.80)	(-0.83)	(-0.21)
PR_4	0.71**							PR_5	1.54						
	(2.66)								(0.33)						
VA_4		0.25						VA_5		-1.28					
		(1.05)								(-0.84)					
PS_4			0.22					PS_5			-1.22				
			(0.97)								(-1.45)				
GE_4				0.73				GE_5				-9.13			
				(1.42)								(-1.05)			
RQ_4					0.29			RQ_5					0.77		
					(0.53)								(1.21)		
RL_4						0.77**		RL_5						-0.83	
						(2.39)								(-0.46)	
CC_4							0.54	CC_5							-1.32
							(1.48)								(-1.33)
Adjusted R^2	0.28	0.26	0.16	0.16	0.09	0.30	0.28	Adjusted R^2	0.73	0.74	0.74	0.63	0.75	0.75	0.74

Note: numbers in parentheses ( ) are the value of t-statistics.

*: significant at 10%; **: significant at 5%; ***: significant at 1% (two-tailed).

4.6 Conclusion

This study investigated the impacts of governance on FDI inflow ratio, domestic investment and growth performance in different income groups: low-income, middle-income, and high-income. The result of the analyses can be summarized in Table 4.12 and Table 4.13 below.

Table 4.12: Short-term Governance Elements (Policy Stance)

	Growth	INV/GDP	FDI/GDP
LI Countries	Inflation, GGFCE	Trade, Inflation	Trade
MI Countries	Inflation	Trade, Inflation	Trade
HI Countries	Trade	GGFCE	Trade, Inflation

Source: Author

Table 4.13: Middle- and Long-term Governance Elements (Institution)

	Growth	INV/GDP	FDI/GDP
LI Countries		CL, EM,	
MI Countries	GE, RQ, RL	PS	PR, CL, RQ
HI Countries	PR, CL, VA, PS, GE		PR, RL

Source: Author

In low-income group, none of the governance variables have statistically significant correlations with per capita GDP growth rate and FDI inflow ratio. Among the four elements of governance variables, only economic management is found to have a statistically significant positive correlation with total investment ratio. This result implies that governance factors play a limited role in promoting growth performance, and domestic investment is likely to be more sensitive than foreign investment to governance structure. This is supported

by the fact that in low-income economies domestic investors tend to invest only in their own country, while FDI investors have more choices and tend to invest in countries where basic economic conditions are in place, many of which are middle-income countries.

For the middle-income countries, most governance elements have a positive correlation with per capita GDP growth. Regulatory quality, among other governance variables, shows a positive significant relationship with FDI ratio, while none of the governance variables have a significant relationship with investment ratio. This result implies that governance plays a crucial role in promoting growth performance. This is partly because middle-income economies possess the minimum sufficient economic resources/conditions such as basic infrastructure, human resources, etc. A further implication is that FDI inflow ratio is generally more sensitive than domestic investment to governance indicators, despite the difference in degree among the governance indicators.

For the high-income economies, governance factors show a positive relationship with growth performance but with neither investment ratio nor FDI ratio. This result reconfirms the direct impacts of governance on growth performance. However, its indirect impact through either domestic or foreign investment cannot be clearly seen. The limited indirect impacts of governance suggest that difference of governance structure among high-income countries is not a decisive determinant of investment.

In conclusion, we can say that governance does not have a clear positive relationship with growth performance in the low-income economies. Sound development governance is essentially a good management of accumulation and efficient allocation of the accumulated productive resources. Once the country starts to develop with accumulation of productive factors, then the elements of governance will become important to promoting growth.

Chapter 5: Case Study – Relationship among Governance, FDI, and Economic Development in Cambodia

Cambodia is relatively a young economy, given its transition from centrally-planned to market-oriented in 1989. As a war-torn country, which underwent a genocidal so-called Khmer Rouge regime (1975-1979) and more than another decade of civil war, Cambodia could finally launch a general election, under the supervision of the United Nations Transitional Authority in Cambodia (UNTAC)[17], in 1993. From the beginning, the new government had no choice but to rely heavily on foreign assistance, both physical and human. Physically, the source of revenue for the government was almost catastrophic and the tax collection system was almost unfunctional. As for human resources, during the Khmer Rouge regime educated people were the prime target of execution and as a result many of them were murdered.

In early 1990s, in line with the transition to a market economy, various state-owned enterprises were privatized and foreign investments were targeted and attracted to serve as the main engine of economic growth for the country. In 1994, soon after the new government was formed, the Law on Investment (LOI) was passed by the National Assembly and came into effect. Foreign direct investment (FDI) started to flow into the country, especially into the garment sector from Chinese-related companies. In mid-2000, construction booms by Korean FDI also helped push the growth but soon faded out together with the world financial crisis in 2008.

Another important issue affecting the development of Cambodia is the low quality of governance. It has long been perceived by investors as the core obstacles to business activities in the country. For example, the Corruption Perception Index (CPI) by Transparency

[17] UNTAC is a special mission of the United Nations, established to ensure the implementation of the agreements on the Comprehensive Political Settlement of the Cambodia Conflict, signed in Paris on October 23, 1991.

International (TI) ranked Cambodia 158 of out of 180 in 2009[18] and 154 out of 178 countries in 2010[19]. This number can be considered as a very serious hindrance for the economic activities both by domestic and foreign investors.

The purpose of this chapter is first to provide an overview of the economic situation and development of Cambodia after 1993, followed by an in-depth discussion on the current conditions of governance and its impact on the economic growth. Finally, the impacts of FDI on governance structure in Cambodia will be analyzed, using the cases of Government-Private Sector Forum (G-PSF), US-Cambodia Textile Agreement (UCTA), and the Arbitration Council (AC).

5.1 Overview of Cambodian Economy after 1993

5.1.1 Introduction

After its UN-backed general election in 1993, Cambodia has accelerated its transition from a centrally planned economy to a market-oriented one. In a move to further economic liberalization, Cambodia joined the Association of South-East Asian Nations (ASEAN) and the World Trade Organization (WTO) in 1999 and 2004, respectively. This regional and global integration has acted as an external pressure for the government to speed up the transition and reform process. To conform to the ASEAN and WTO rules, the once-centrally-planned economy had no choice but to undergo drastic economic, administrative, and legal reforms towards a more democratic and market-oriented political and economic system. Although some of the reforms are still under way, Cambodia is now becoming one of the most open economies in the region. This section provides an overview of Cambodian macroeconomic performance in general, following by a discussion of the

[18] Transparency International, 2009a. Corruption Perceptions Index 2009. (Accessed Dec. 1, 2010): http://www.transparency.org/policy_research/surveys_indices/cpi/2009/cpi_2009_table

[19] Transparency International, 2010. Corruption Perceptions Index 2010. Accessed Dec. 1, 2010. http://www.transparency.org/policy_research/surveys_indices/cpi/2010/results

undergoing reforms in governance structure. The impact of FDI on governance is also discussed in detail.

5.1.2 Structure of the Economy

In August 1994, the National Assembly approved and passed the Law on Investment (LOI), which is considered very generous to foreign investors by providing various investment incentives, expressing the willingness and determination of the government to attract foreign investments into the country. On the other side, it also reflected the needs of external sources of capital to fill the badly needed saving-investment gap in the country. Gross domestic savings until mid-1990s was very low, mirroring the underdeveloped private sector and banking system in the country. As indicated in Table 5.1, the ratio of gross domestic savings to GDP was only 8.1% in 2000; however, the number jumped to 13.8% and 16.1% in 2006 and 2007, respectively. This reflects a steady growth of the private sector and the increasing confidence of the public in the banking sector. For the investment side, gross domestic investment to GDP grew steadily from 16.9% in 2000 to 20.8% in 2007. In 2008, due to world financial crisis the investment fell to 16.6% (Asian Development Bank, Key Indicators 2009).

Although the saving-investment gap has been narrowing slightly, Cambodia still largely depends on external sources of capital. This situation is mainly attributed to the ineffective mobilization of domestic savings into investments due to its high lending interest rate, which is approximately 16% per annum (National Bank of Cambodia, 2008 p.13). This also partly contributes to the underdevelopment of SMEs in the country. The engine of economic growth for Cambodia can be divided into four main sectors: agriculture, garment (manufacturing), construction, and tourism. The following section introduces the overall structure of output with emphasis on sources of growth.

Table 5.1: Resource Gap in Cambodia, 1994-2008

	1994	2000	2001	2002	2003	2004	2005	2006	2007	2008
Gross Domestic Savings (% GDP)	0.4	8.1	11.6	8.5	9.1	8.5	9.9	13.8	16.1	30.3[20]
Gross Domestic Investment (% GDP)	11.7	16.9	18.5	18.1	20.1	16.2	18.5	20.6	20.8	16.6
Saving-Investment gap	-11.3	-8.8	-7.0	-9.6	-11.0	-7.7	-8.6	-6.8	-4.7	13.7

Source: ADB, Key Indicators 2009.

5.1.3 Structure of Output and Sectoral Growth

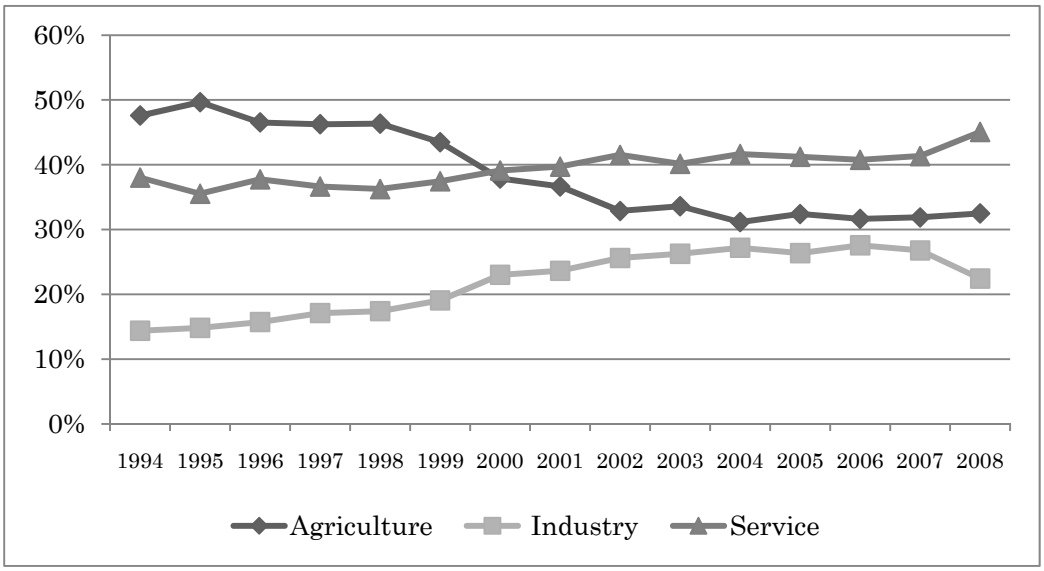
The agricultural sector used to dominate the total GDP with almost 50% in 1994; however, this proportion gradually declined to only 32.5% in 2008 due to the more rapid expansion of industry sector. During the same period, the share of the industry sector to GDP increased significantly from 14.4% to 22.4%, while the share of the service sector increased only marginally from 38.0% to 45.1% (See Figure 5.1).

Economic growth in the last several years has been strong, registering 13.3%, 10.8%, 10.2%, and 6.7% in 2005, 2006, 2007, and 2008, respectively (See Figure 5.2). In absolute terms, the estimated nominal GDP at current price jumped from 21438.3 billion CR in 2004, to 44,529.8 billion CR[21] in 2008 (ADB, Key Indicators 2009). However, it should also be noted that the foundation of growth in Cambodia is still very fragile and very much depends on external factors. For example, for agricultural sector, due to insufficient irrigation system the production relies on the weather conditions. In addition, agricultural practice remains traditional: animals are often used instead of machinery, and old seeds instead of high yield varieties. Knowledge on fertilizer and pesticide usage is also considered limited.

[20] Although there is no evidence to prove this sudden increase in domestic savings in 2008, it is presumably the result of the accumulation of private savings coming from real estate sector.

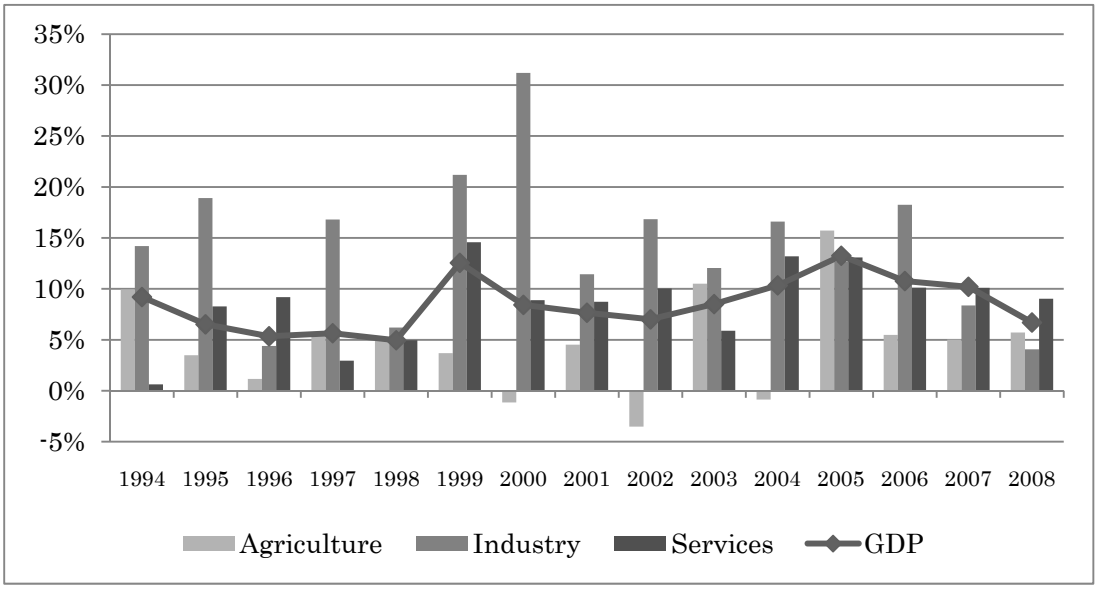
[21] USD-CR exchange rate has been very stable, ranging between 4000CRs and 4100CRs per USD during 2004-2008. See ADB, Key Indicators 2009 for more details.

Figure 5.1: Structure of Output (% of GDP at current prices)



Source: ADB, Key Indicators 2009

Figure 5.2: Annual GDP and Sectoral Growth Rates, 1994-2008



Source: ADB, Key Indicators 2009

5.1.4 Agricultural Sector

The agricultural sector dominated the total GDP with almost 50% in 1994 but its share gradually declined due to the relatively more rapid expansion in other sectors, especially the manufacturing. In 2007, the agricultural sector, where rice is the main product, made up only 32.5% of the total GDP output with more than 70% of the total population and 60% of the work force (ADB, Key Indicators 2009). In principle, agricultural products in Cambodia can be divided into two categories: rice and non-rice products.

Rice Products

Rice can be cultivated twice a year: wet season rice from May to January and dry season rice from February to April. Wet season rice makes up approximately 80% of total rice production with dry season rice making up the rest. Rice production in Cambodia remains traditional and is severely affected by natural conditions due to the insufficiency of and poorly managed irrigation systems, causing unstable output from year to year. For example, in 2001 the agricultural output was badly affected by severe flooding. In 2002 and 2004, drought and the late arrival of the monsoon rain also affected the harvest. In 2005, 2006, and 2007, due to favorable weather condition and expansion of agricultural lands, the overall rice production jumped significantly from 4,170 million tons in 2004 to 6,727.1 million tons in 2007 (National Institute of Statistics, 2008 p. 214).

As also indicated in Table 5.2, the supply-demand balance of rice can be divided into two periods. First, from 1995 to 2004, total rice production in Cambodia fluctuated around 4 million tons and total domestic demand of rice consumption fluctuated around 3 million tons. This suggests that Cambodia's rice self-sufficiency ranged about 130% during this period. Second, from 2005 to 2007, total rice production registered between 5,986 million tons and 6,727.1 million tons. Although data on domestic consumption during this period is not available, we can assume that it is approximately around 3 million tons. Thus, we can

conclude that Cambodia has the capacity to export rice between some 3 million tons to 3.7 million tons from 2005 to 2007. This number implies the importance of rice production in Cambodian economy.

Table 5.2: Rice Production (Unit: 1,000 tons)

	1995	2000	2001	2002	2003	2004	2005	2006	2007
Total Production	3,447.8	4,049.0	4,099.0	3,822.1	4,170.9	4,170.3	5,986.2	6,264.0	6,727.1
Rainy Season[1]	2,802.8	3,332.9	3,276.0	2,916.0	3,837.9	3,132.6	4,734.3	4,973.7	5,363.7
Dry Season[2]	645.0	708.0	823.1	907.0	873.0	1,037.0	1,251.9	1,290.3	1,363.4
Total Demand	na	3,095.0	2,997.0	3,081.0	3,027.0	2,978.0	na	na	na

Source: National Institute of Statistics 2008: Statistical Yearbook of Cambodia 2008, p. 214.

Non-Rice Products

Apart from rice, Cambodia also produces other non-rice agricultural products such as maize, cassava, sweet potato, vegetable, mung beans, peanuts, soybeans, sugar cane, sesame and tobacco (See Table 5.3). However, the production of each non-rice products is, in general, cultivated by small-scale individual farmers. The annual volume of production also varies from year to year, making it more difficult to stably supply both domestic and foreign markets. For example, in 2006 and 2007, the production of cassava jumped remarkably, resulting from the speculative high oil price and the movement to switch to alternative source of energy, where cassava can be converted into bio-ethanol. However, this movement was short-lived due to the drop in oil price in the following years.

The production of non-agricultural products also face various constraints, resulting in relatively low productivity as a result of ineffective management of weeding, extermination of pests, and fertilization. Similarly to rice production, the low level of irrigation system makes production more dependent on rainwater, and as a result leads to the instability of income for farmers. Given that the majority of people under the poverty line are engaged in this sector

and its huge employment absorptive capacity, the development of this sector is necessary to reduce poverty and promote growth in the long run.

Table 5.3: Production of Other Agricultural Products (Unit: 1000 tons)

	2000	2001	2002	2003	2004	2005	2006	2007
Maize	157.0	185.6	148.9	314.6	256.7	247.8	376.9	522.7
Cassava	148.0	142.3	122.0	330.0	362.1	535.6	2,182.0	2,215.4
Sweet Potato	28.2	26.3	31.5	34.9	35.1	39.1	45.3	38.3
Vegetables	196.0	184.6	143.2	139.6	179.1	172.4	222.9	226.4
Mung Bean	15.1	17.2	23.9	31.8	45.3	45.0	59.9	54.5
Peanuts	7.5	8.9	9.7	18.5	21.5	22.6	23.8	30.5
Soybean	28.1	17.2	38.6	63.2	110.3	179.1	98.3	117.9
Sesame	10.0	9.0	10.0	22.0	55.0	n.a.	24.8	31.9
Sugar cane	164.2	169.3	208.8	173.1	130.4	118.2	141.7	286.8
Tobacco	8.0	4.7	2.5	7.6	2.5	14.1	14.2	13.6

Source: National Institute of Statistics 2008, p. 215.

5.1.5 Industrial Sector

The industry sector has been expanding rapidly since the onset of the transformation to a market-economy in 1989. Its share to total GDP output expands significantly from 14.4% in 1994 to 22.4% in 2008, a significant increase in 13 years (ADB, Key Indicators 2009). The average growth rate in this sector is also remarkable, recording 14% per annum during 2000-2008. Out of which, the garment sector, which includes textile, wearing apparel, and footwear sub-sectors (hereafter, it is called garment sector for simplicity) has served as the main engine of growth for the economic development of Cambodia. It expanded rapidly in the late 1990s, employing approximately 325,000 people in 2008. The average annual growth rate of this sector during 1994-2007 recorded some 37% per annum. From early 2000s, the construction sector mainly from South Korea started to gain momentum by investing in real

estate business in the capital of Phnom Penh and the surrounding areas. This boom was partly a result of a real estate bubble in mid-2000s that collapsed together with the world financial crisis in 2008. The breakdown of industrial growth rate by sector is summarized in Table 5.4.

Table 5.4: Breakdown of Industrial Growth Rate (Constant Prices 2000)

	1994	2000	2001	2002	2003	2004	2005	2006	2007
Mining	29.2	26.0	11.5	25.6	18.1	24.2	26.3	15.9	6.4
Manufacturing	9.0	30.3	15.9	14.6	12.3	17.7	9.7	17.4	8.9
Food, Beverage & Tobacco	-4.9	-3.9	4.5	-0.7	4.7	-5.2	9.0	3..3	3.1
Textile, Wearing Apparel & Footwear	25.1	68.2	28.4	21.4	16.8	24.9	9.2	20.4	10.0
Wood, Paper & Publishing	84.4	-9.7	-29.7	0.7	-14.3	4.2	10.0	8.4	4.9
Other Manufacturing	4.5	8.6	2.8	8.9	7.7	8.1	17.3	15.0	6.7
Electricity *	8.6	6.9	5.1	16.7	9.1	11.2	12.5	31.7	11.5
Construction	23.4	36.8	-1.8	27.1	11.1	13.2	22.1	20.0	6.7

Source: National Institute of Statistics, 2006 and 2008. From 2003 onwards, Gas and Water are also included.

The garment sector has been serving as the main growth engine for Cambodian economy since late 1990s. As such, a detailed examination on this sector is needed to provide a deeper understanding of the Cambodia's economic environment. Some stylized facts of garment industry and the domestic and international environment related with this sector is discussed in the following section.

Some Stylized Facts on Garment Sector

As indicated in Table 5.5, the number of garment factories grew almost from nothing in 1995 to 292 in 2007. In 2008, this sector was affected by the decreasing demand in the US market as a result of world financial crisis. Some of the factories were forced to reduce production and some even forced to shut down. According to the Ministry of Commerce, this

sector creates approximately 25,000 jobs per annum during 2000-2007. In 2007, total employment reached its peak at 335,000 jobs and then gradually decreased to some 325,000 jobs and 278,000 jobs in 2008 and 2009, respectively. The main cause of this job loss was a result of the Lehman shock in the United States in 2008, to where about 70% of Cambodian garment is exported.

Table 5.5: Evolution of Garment Factories and Employment in Cambodia

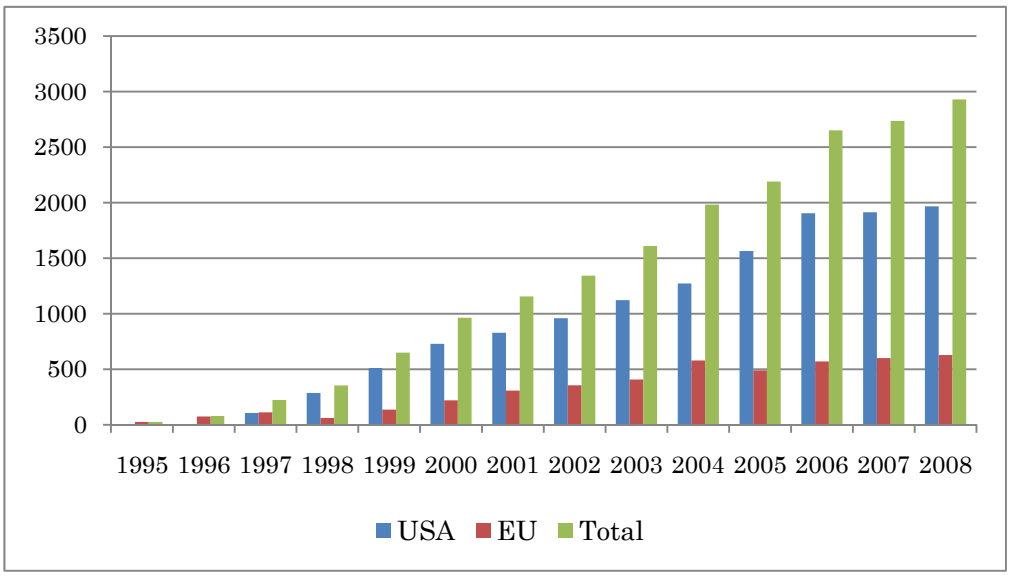
	1995	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Number of Factories	20	190	185	188	197	219	247	290	292	284	243
Employment (thousand)	18.7	162.4	187.1	201.4	234.0	269.8	283.9	334.1	335.0	324.9	278.4

Source: Ministry of Commerce (As of December for each year)

Note: The number of factories indicates the "effectively operating" factories, not the registered ones.

According to a living wage survey conducted by Kang Chandararot and Liv Dannet of Cambodia Institute of Development Study (CIDS) on 353 garment workers from 47 factories in December 2008, it was found that 91% of workers are female and only 9% are male and their average age was 24 years old. Their average earnings, which includes basic salary, attendance bonus, seniority bonus, overtime, living support allowance, specialization premium and other allowances (i.e. food, transport), was found to be 79 USD per month. Out of this sum 76% of the interviewed workers (269 workers) send home an average of 15 USD per month in remittances. This finding suggests that the garment industry does not only provide jobs and salaries to their workers, but also indirectly helps maintain the living standard of their families in the villages. Some of the money was also believed to send their siblings to school or to continue schooling.

Figure 5.3: Cambodia's Garments and Textiles Export (Unit: Million USD)



Source: Ministry of Commerce. 2009

Cambodia's prime garment export markets are the U.S. and EU. As indicated in Figure 5.3, the total garment export increased sharply from 224 million USD to 2,930 million USD during 1997-2008, about 13 folds. Out of which, export to US market increased exponentially, making up approximately 70% of total garment exports today. Then second important export market for Cambodia is the EU market, making up about 20% of total garment exports. The remaining 10% are mainly shared by the Canadian and Japanese markets.

Garment industry in Cambodia is predominantly foreign-owned. According to the Garment Manufacturers' Association of Cambodia (GMAC), as of December 2008, approximately 60% of the firms were owned by Chinese-related capital (Taiwan, Hong Kong and China), generating approximately 60% of total employment in this sector. The rest was shared by South Korea, Cambodia, Malaysia, etc. (See Table 5.6). The high prevalence of foreign firms in the garment sector in Cambodia is considered the result of low domestic production capacity and the international trade environment of this sector. To understand the full picture of the Cambodian garment sector, it is worth elaborating on the international trade

environment of garment products and domestic environment.

Table 5.6: Garment Firms by Ownership and Employment (As of December, 2008)

Country of Ownership	% of firms	
	Firms	Employment
Taiwan	26.3	27.5
Hong Kong	18.8	19.1
China	18.8	13.5
South Korea	10.2	8.4
Malaysia	6.3	9.3
Cambodia	5.1	2.9
Singapore	4.3	7.1
USA	3.9	2.6
Others	6.3	9.6
Total	100	100

Source: GMAC Database. Calculated by the author.

The Multi-Fiber Arrangement (MFA) took effect in 1974 under General Agreements on Tariffs and Trade (GATT) by agreeing to deviate from its non-discriminatory principle by allowing for rational quantitative restriction. Under this MFA framework, major importing countries such as the U.S. and EU were able to establish bilateral agreement with major exporting countries including China by imposing import quantity restriction in the name of domestic industry protection. This measure implied a serious limitation on those garment-exporting countries, but on the other hand it provided greater opportunities to smaller exporting countries that did not receive quantitative restriction (export quotas) or small countries with export quotas but could not utilize them to their full extent. This MFA served as a catalyst to promote investments of this sector in their home countries. Together with the establishment of WTO, the successor of GATT, in 1995 which aimed to promote freer trade, it

set an article on Agreement on Textiles and Clothing (ATC) to replace MFA by agreeing on a gradual phase-out. The deadline for a complete phase-out of MFA was January 1, 2005 and it was invalidated as planned.

As for domestic environment, the government of Cambodia adopted a very liberal Law on Investment (LOI) in 1994, which was later amended in 2003, aiming to invite foreign investments to revitalize the devastated domestic economy. As reflected in LOI, the government provides various and generous investment incentives to FDI firms in the sector prioritized by the government, including the garment sector. In particular, in 1994 LOI, the corporate tax rate was set only at 9% and its exemption was made available for up to 8 years. In addition, there was to be no taxation on the distribution of dividends or profit, and 100% import duties exemption on raw materials and spared parts used for exports.

Apart from this, another major push for the growth of garment sector was the resumption of Normalized Trade Relationship (NTR) with the United States in 1996. Under the agreement of NTR, Cambodia was provided Most Favored Nation (MFN) status; enabling the country to export the products at MFN tariff rate.[22] In the following year, the U.S. and EU further granted the Generalized System of Preference (GSP), enabling Cambodia to export even at a lower tariff rate. The combination of Cambodia's LOI and export opportunity to U.S. and EU markets accelerated factory owners from Malaysia, China, Taiwan, Hong Kong and other parts of Asia, who had already reached quota limits for their garment exports in their home countries to invest in Cambodia.

As the United States' government recognized the rapid exports growth from Cambodia, in 1999 the US-Cambodia Textile Agreement (UCTA) was concluded by imposing quantitative restriction of exports on 13 categories of products. This quota portion is mainly distributed to factories based on size, performance, and through bidding conducted by the Ministry of

[22] MFN tariff rate is, in principle, applied only among WTO members. Although Cambodia was not yet a WTO member until 2004, MFN status was provided to the country so that she could export the products at MFN rate just like other WTO members.

Commerce.

According to Wells (2006), the major take-off for Cambodia's garment export did not happen until the US-Cambodia Textile Agreement (UCTA) in 1999 (it was later renewed for another three years in 2002 until the end of 2004). Under this UCTA, as an incentive for an increase of Cambodia's garment export quotas to the US market under GSP, Cambodia had to fulfill a substantial compliance on labor standard, including ILO core standards, all of which Cambodia ratified in 1999. As a result, Cambodia was able to increase its export quotas with an increase of 9% in 2000 and 2001, 12% in 2002, 14% in 2003, and 18% in 2004.

The complete phase-out of MFA on Jan. 1, 2005, also meant the complete liberalization of trade in textile and clothing under WTO framework. Many studies, including Nordas (2004), predicted that Cambodia would face fierce international competition in the international market, especially with giant producers like China and India. Contradictorily to those predictions, Cambodian garment exports continued to expand steadily after 2005. However, this expansion was in fact not a result of the increased competitiveness of Cambodia garment industry itself, but rather a result of U.S. safeguard measure on Chinese garment exports after 2005.

China's WTO accession agreement in December 2001 allows the United States and other member countries to impose import quotas on textile and apparel imports from China if they believe that Chinese-origin imports of targeted products are causing "market disruption" in their home countries. As such, although after the complete abolishment of quantitative restrictions on January 1, 2005, the United State and some member countries were still able to impose quotas on Chinese garment imports. In November 2005, a comprehensive agreement was reached between the U.S. and China to establish import quotas in 34 textile and apparel products for a three-year period until December 31, 2008. A similar agreement was also reached between EU and China in June 2005 (Jones, 2006). This safeguard measure not only had impacts on US garment producers, but also greatly affected small garment exporting

countries like Cambodia. Under this safeguard, Cambodia was able to avoid fierce competition with Chinese producers and instead succeeded in inviting more garment-related FDIs. As a result, we can say that after 2005, by acting as the third country to export to EU and US markets, Cambodia was able to continue expanding its garment export to these markets.

In summary, Cambodia was successful in inviting FDIs especially garment-related investments into the country. This success can be considered as a combination of the government's LOI with generous investment incentives and the resumption of normalized trade relationships with the U.S in 1996. External factors such as the safeguard measure by the U.S. on China in 2005 until Dec. 31, 2008, also favored Cambodia as a destination for investment of garment products. The impact of garment industry on Cambodia's economy is huge. It created a total of approximately 320,000 jobs and the remittances of these workers also helped improve the living conditions of their families in rural villages.

5.1.6 The Service Sector

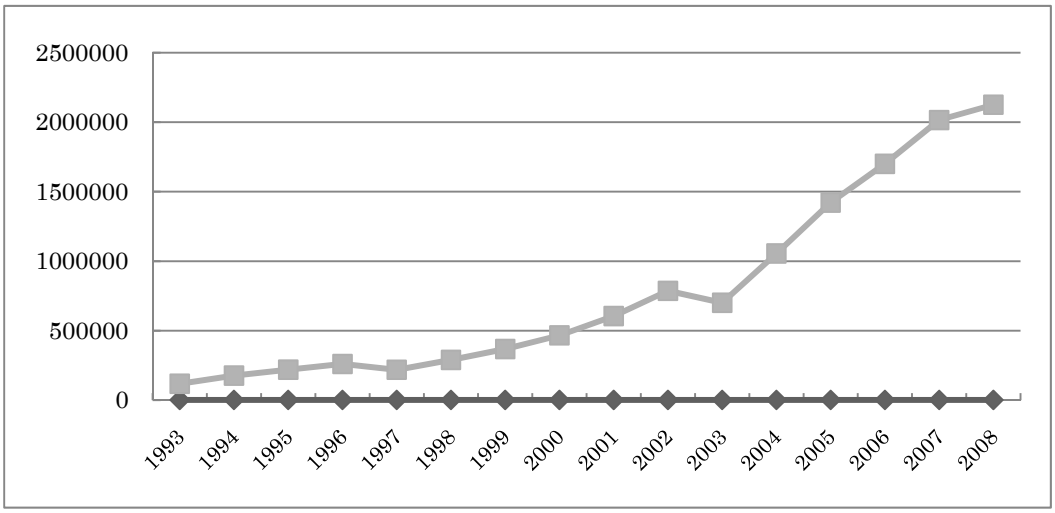
The service sector has the biggest portion in GDP. In 2008, it accounted for 45.1%, a slight increase from 38.0% in 1994 (ADB, Key Indicators 2009). The service sector has recorded relatively high and stable growth in recent years, registering 10.1%, 10.1%, and 9.0% in 2006, 2007, and 2008 respectively. Its average growth rate per annum was about 5% during 1994-1998, and about 10% during 1999-2007. The major contributors to this sector are tourism, retail/wholesale trade, and financial subsectors.

Tourism

Tourism ranks as the second largest source of foreign currency for Cambodia after the garment sector, making up about 1,600 million USD in 2008 from 600 million USD in 2004, a 2.5 increase in 5 years. This reflects the growing importance of this sector in the economy. The main attraction of tourists to Cambodia largely rests on the United Nations Educational,

Scientific and Cultural Organization (UNESCO) world heritage site, Angkor Wat. Angkor Wat's revenue is very closely related with the number of tourists who actually come into the country.

Figure 5.4: Trend of Tourists` Arrival to Cambodia, 1993-2008



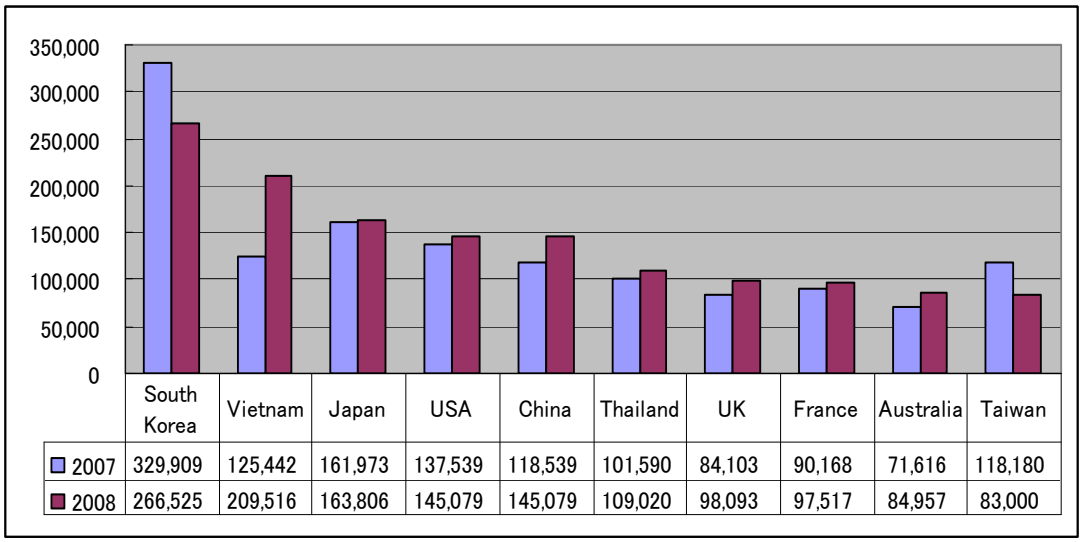
Source: Ministry of Tourism, Tourism Statistical Report 2008.

From 1993, after Cambodia reopened its doors to the world, the number of tourist started to expand steadily. As shown in Figure 5.4, this sector has grown at approximately 20% per annum since 1993, in which year the number of visitors only around 120,000. By 2008, it jumped to more than 2 million people. One of the main factors to further this growth was the Open Sky Policy in 1997 that allowed international airlines to fly directly to Siem Reap, the province where Angkor Wat is situated. According to Sok Hach et al. (2001), the introduction of this policy, which was part of the strategy by Thailand and Cambodia to increase tourists under the slogan "Two Kingdoms, One Destination", is considered to have been very successful.

Despite its increasing trend, in 1997 the number of tourists dropped by about 15%. The main cause of this decline was a combination of internal conflict and regional economic crisis.

In 2003, the spread of avian flu, which caused Severe Acute Respiratory Syndrome (SARS), also contributed to the 10% drop in tourist visits in that year. The 1997 and 2003 events proved the volatility of this sector to external shock and political stability at home.

Figure 5.5: Top 10 Tourists` Arrival to Cambodia by Country, 2007-2008



	South Korea	Vietnam	Japan	USA	China	Thailand	UK	France	Australia	Taiwan
2007	329,909	125,442	161,973	137,539	118,539	101,590	84,103	90,168	71,616	118,180
2008	266,525	209,516	163,806	145,079	145,079	109,020	98,093	97,517	84,957	83,000

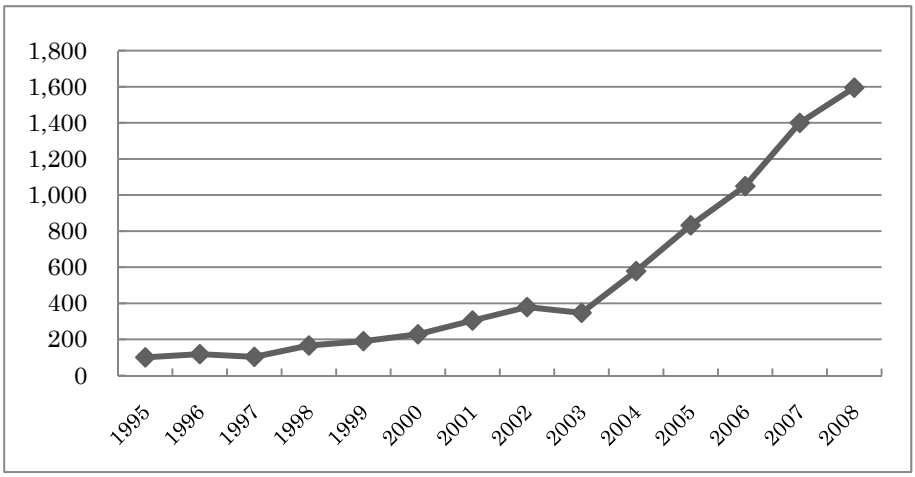
Source: Ministry of Tourism, Tourism Statistical Report 2008.

As indicated in Figure 5.5, regarding the number of tourists by country of origin, South Korea ranked top at about 270,000 in 2008. However, this figure also showed a substantial drop from 330,000 people in 2007, seemingly due to the world financial crisis. The number of visitors from Vietnam, which was only 125,000 in 2007, jumped rapidly to 210,000 in 2008, putting it in second place. However, the number of tourists from Japan continued to increase slowly, from approximately 161,000 people in 2007 to 163,000 people in 2008.

Despite its large revenue as indicated in Figure 5.6, this sector is considered to have a limited impact on poverty reduction. One of the main reasons for this is considered to be the low usage of local contents in this tourism business. For example, most of the hotels are predominantly foreign-owned and they prefer to use imported rather than local inputs to serve

their customers, given its more stable supply and better quality. Local producers of souvenirs, due to their weak bargaining power, are forced to sell their products at a low price to middlemen, who later can double or triple the price to tourists.

Figure 5.6: Revenue Generated by Tourism, 1995-2008 (Unit: Million USD)



Source: Ministry of Tourism, Tourism Statistical Report 2008.

Trades

Since early 1990s, Cambodia's trade policy has been reformed towards a more liberal trade regime. As the first stage, in 1994 all quantity restrictions on trade were removed, although some import tariffs were introduced in their places. As the second stage in late 1990s, Cambodia took a more positive step towards more trade liberalization. Accession to ASEAN in 1999, in particular, reflected the commitment of the government to a freer trade regime by complying with the progressive tariff reduction in the ASEAN Free Trade Area (AFTA) framework in the decade to come. Furthermore, accession to WTO in 2004 has further integrated Cambodia into the global economy. Necessary institutions were amended or created to comply with the WTO rules.

The success of this openness can be seen in the increasing trade volume, especially in the achievement of exports of the garment sector, from 1 billion USD in 2000 to 3 billion USD in

2008. The export of this sector makes up of more than 70% of the country's total exports. In other words, the garment sector is the only leading export industry of the country and as a result it tends to be more vulnerable to external shocks such as the global economic crisis in 2008. As indicated in Table 5.7, besides garment products, Cambodia also exports primary products such as animals, vegetables, woods, rubbers, etc to the neighboring countries. Nonetheless, smuggling at borders without official records is also believed to be significant in volume.

Table 5.7: Breakdown of Merchandise Exports for 2000-2007 (Unit: Million USD)

	2000	2001	2002	2003	2004	2005	2006	2007
Animal and vegetable products	80.4	123.5	125.8	189.0	207.2	279.8	451.1	553.6
Wood and products	103.3	71.3	41.2	23.4	19.1	20.0	22.3	25.6
Rubber and products	60.0	52.4	62.7	97.7	114.8	118.9	174.6	156.8
Beverages and tobacco	42.3	42.4	41.1	41.6	49.0	32.3	41.3	44.3
Textiles and textile articles	1022.2	1198.5	1403.6	1639.8	2091.8	2274.8	2742.5	2957.6
Other manufactured goods	1.2	1.1	0.9	0.6	0.7	0.6	0.5	0.7
Miscellaneous n.e.s	87.7	82.1	94.5	94.6	106.5	183.8	260.9	350.0
Total Exports	1397.1	1571.2	1769.8	2086.8	2588.9	2910.3	3693.2	4088.5

Source: NIS, Cambodian Statistical Yearbook 2008, p. 352.

Regarding the import structure, mineral fuels and related materials, textiles and textile articles, and machinery and transport equipments make up about one-forth each of total import in 2007. Textiles and textile articles here are mostly the raw materials to be used as inputs for the production of garment products. The remaining one-forth is shared by other commodities such as beverages, tobacco, and other manufacturing goods (See Table 5.8 for details).

Table 5.8: Breakdown of Merchandise Import for 2000-2007 (Unit: Million USD)

	2000	2001	2002	2003	2004	2005	2006	2007
Animal and vegetable products	29.9	30.7	31.9	35.1	7.0	9.3	10.9	13.2
Mineral fuels and related materials	323.4	355.5	371.5	434.1	611.5	845.9	1128.9	1355.6
Beverage and tobacco	83.2	83.7	81.9	84.3	96.5	102.1	123.5	138.5
Textiles and textile articles	538.6	613.2	715.3	827.7	1025.8	1124.9	1321.0	1402.8
Machinery and transport equipments	477.4	546.0	643.6	743.5	968.2	1077.9	1280.4	1381.9
Other manufactured goods	155.1	181.4	163.3	178.7	180.9	191.7	228.8	251.8
Miscellaneous n.e.s	328.2	283.6	353.1	364.7	379.7	575.9	655.9	879.7
Total Import	1935.7	2094.0	2360.5	2668.1	3269.5	3927.8	4749.2	5423.6

Source: NIS, Cambodian Statistical Yearbook 2008, p. 352

Issues of trade competitiveness through exchange rate management are a central part of trade policy. In the case of Cambodia where multiple currencies are in circulation and out of which dollar makes up about 80% of the transaction, exchange rate policy does not have much implication. This high rate of dollarization in Cambodia literally suggests that it is the fluctuation of US dollar, rather than Cambodian Riel, that affects the international price competitiveness. Since a large amount of Cambodian export is bound for the US market, the exchange rate risk is minimized by this dollarization. On the other hand, it shows the limitation of Cambodian authority on exchange rate policy instruments because it is almost impossible for the government to effectively engage in currency management to boost export competitiveness. The key events in the evolution of trade policy in Cambodia are summarized in Table 5.9.

Table 5.9: Evolution of Major Events on Trade Policies

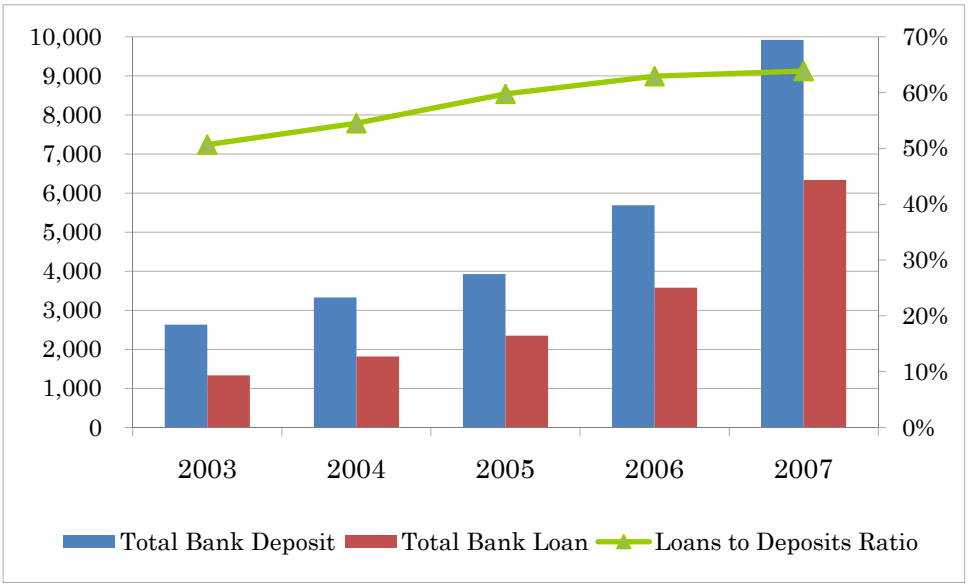
Year	Major Events on Trade Policies
1960s	Exported agricultural products, largely rice, rubber and corn
1970s	Virtual collapse of foreign trade
1980s	New trading system controlled the level and composition of trade through quantitative restrictions and state-owned trading bodies. Tariffs and trade taxes applied merely for revenue purposes. Market-oriented liberalization in the late 1980s, abolishing state monopoly of foreign trade. Foreign investment law was promulgated in 1989 enabling private companies to engage in foreign trade.
1990	From 1993, restrictions limiting the ability of firms and individuals to engage in international trade were largely removed.
1994	All quantitative restrictions on trade were eliminated in 1994.
1996	Cambodia gains MFN status from the US.
1997	Cambodia gains GSP status.
1999	April, Cambodia becomes the member of ASEAN. Committed to a gradual reduction in most tariff ranges by 2010 for trade with other ASEAN members. US quota imposed on 12 broad categories of garments. End of year, Cambodia gained MFN/GSP status from 28 countries.
2000	The application for membership of WTO has led to the rationalization of the tariff structure.
2001	April, Cambodia designated as one of the three pilot countries (along with Madagascar and Mauritania) for pro-poor trade sector strategy formulation under the integrated framework. Reform of the tariff structure with the number of tariff categories falling from 12 to 4, can the top tariff rate reduced to 35%. July, Pro-poor Trade Sector Strategy at Cambodia's Third Consultative Group meeting in Tokyo. China's accession to WTO.
2004	August, Cambodia's accession to WTO.
2005	U.S. and E.U. export market quotas are set to expire.
2008	Quantitative restrictions on imports of textiles and apparel products originating in China expire at end of year.

Source: Melanie et al. (2004). The Macroeconomics of Poverty Reduction in Cambodia, p.146, cited from RGC and Ministry of Commerce 2002.

Finance

The financial sector in Cambodia is currently considered at a very early stage of development and requires many more reforms. In 1999 and 2000, the government of Cambodia with assistance from ADB, developed a long-term strategic plan to develop this sector, namely the *Financial Sector Development Blueprint for 2001-2010.*[23] With the changing economic environment, the FSDP 2001-2010 was revised and updated into the *Financial Sector Development Strategy 2006-2015.*[24] The main objectives of these reforms are to bring about a sound market-based financial system with an attempt to increase resource mobilization, enhance intermediation and allocation, and stimulate economic growth with equitable distribution. On the one hand, this reform has deregulated and made it easier for the new entry of banks, while on the other hand, it established a stricter supervision mechanism to ensure public confidence in this sector.

Figure 5.7: Total deposits and loans of commercial banks, 2003-2007 (Unit: Billion CR)



Source: National Bank of Cambodia, Annual Report 2007

[23] Asian Development Bank, 2001. *Cambodia: Financial Sector Blueprint for 2001-2010.* http://www.adb.org/Documents/Reports/CAM_Blueprint/default.asp. Accessed October 10, 2009.
[24] Royal Government of Cambodia, 2007. Financial Sector Development Strategy 2006-2015.

Until the late 1990s, public confidence in banking sector had been very weak, and most of the household savings were kept at home under the mattress, leading to the ineffectiveness of the intermediary function of banks. In recent years, public trust in this sector has increased remarkably. For instance, as can be seen in Figure 5.7, total bank deposits in 2003 were only 2,632 billion CRs, while in 2007 they jumped to 9,922 billion CRs (2,480 million USD), which is almost a four-fold increase in four years (National Bank of Cambodia, 2008; pp.1-3). Total bank loans also increased steadily from 1,334 billion CRs in 2003 to 6,336 billion CRs in 2007, suggesting the rapid expansion of economic activities in the country. At the same time, loans to deposits ratio have also been stable, moving between 50% and 60% during 2003-2007. In 2007, total interest income from loans recorded 726,441 million CRs, while total interest expenses paid to depositors was only 171,522 million CRs, suggesting sound profitability in this sector.

The expansion of commercial banks has lubricated business activities in many ways. It is not only the intermediary function of bank but also its settlement function that has helped improve business efficiency greatly. Until late 1990s, money collection from one place to another was rather a common method for business account settlement. This activity is normally risky and time-consuming. At present, medium-size enterprises and above actively utilize the banks' settlement function in their business activities.

Partly owing to this reform, as of December 2007, there were seventeen licensed commercial banks, including three representative offices of foreign banks, and seven specialized banks operating in the country. All of these banks were private, except the "Foreign Trade Bank of Cambodia" which is jointly financed by the government and private sector. For details of those banks, see Table 5.10.

Table 5.10: Commercial Banks in Cambodia, 2007 (Billion CRs)

	Name	Total Assets	Total Deposits	Total Loans
1	Cambodia Public Bank Ltd	2,260,384	1,240,226	1,453,101
2	Canadia Bank Plc.	2,242,342	1,829,825	1,391,814
3	ANZ Royal Bank (Cambodia) Ltd.	2,241,988	2,085,989	580,470
4	Acleda Bank Plc.	1,899,200	1,377,646	1,275,143
5	Foreign Trade Bank of Cambodia	882,057	739,216	263,941
6	Cambodian Commercial Bank Ltd.	651,741	544,640	163,285
7	May Bank, Phnom Penh Branch *	579,078	458,937	131,640
8	Vattanac Bank	525,085	415,487	328,635
9	Union Commercial Bank Plc.	484,253	384,182	266,474
10	Krung Thai Bank Public Co. Ltd. *	286,990	123,021	66,783
11	Cambodia Mekong Bank Public Ltd.	248,674	144,801	29,501
12	First Commercial Bank *	239,441	154,336	76,919
13	Singapore Banking Corporation	195,825	132,163	81,586
14	Advanced Bank of Asia Ltd.	163,154	88,934	51,115
15	Shinhan Khmer Bank	146,180	88,527	8,590
16	Cambodia Asia Bank Ltd.	129,027	67,647	48,915
17	Camko Bank	94,792	42,316	15,963
	Sub-total	13,270,211	9,917,893	6,233,875

Source: National Bank of Cambodia, Annual Report 2007. Compiled by Author.

.: representative offices of foreign banks.

Table 5.11: Microfinance in Cambodia 2007

	Name	Total Assets	Deposit	Loan
1	AMRET	153,280	3 ,522	121,191
2	PRASAC	148,067	1 ,016	13,429
3	Cambodia Enterpreneur Building	95,808	5 ,609	89,887
4	Hattakaksekar	65,590	2 ,636	56,704
5	Thaneakea Phum Cambodia	62,577	461	48,275
6	Vision Fund Cambodia	54,211	595	42,791
7	Angkor Microherhvatho Kampuchea	49,318	517	41,795
8	CREDIT	43,758	4 ,766	41,245
9	SEILANITHIH	15,429	1 ,096	14,085
10	Intean Poalroath Rongroeung	11,855	n.a.	7,022
11	CHC	7,666	31	7,109
12	Entean Akpevath Pracheachun	6,790	n.a.	5,846
13	Farmer Union Development Fund	4,387	n.a.	n.a.
14	Cambodian Business Integrate in Rural	3,941	563	3,479
15	MAXIMA	3,679	398	3,227
16	Pisit Akphiwat Sethakech	1,135	0.1	637
17	Tong Fang Microfinance	504	n.a.	318
Total		727,995	21,210	617,906

Source: NBC, Annual Report, 2007

In addition to commercial banks, there are also a range of Microfinance Institutions (MFIs) in Cambodia. Unlike commercial banks that mainly concentrate in urban area, MFIs plays a more important role in savings and financial intermediation for individuals and micro enterprises, especially outside the main urban areas of the country. As indicated in Table 5.11, as of December 2007, 17 microfinance institutions were registered and operated with total assets of 727,995 million CRs, out of which 71% of the share was foreign-owned (NBC,

2008b). Credit issued by MFIs has increased sharply in the last few years, contributing to the development of small and medium size enterprises and the agriculture sector in the country. For instance, loans extended by MFIs jumped three fold from 204,572 million CRs to 617,906 million CRs during 2005-2007.

In summary, while the outreach of commercial banks is limited to the main urban areas, MFIs cover more in the rural areas of the country. And the target of commercial banks is primarily medium-size enterprises and above; however, MFIs' main customers are individuals and micro enterprises. Despite their different roles and target groups, the expansion of this sector can be considered to have greatly contributed to the business activities and poverty reduction at local level. Moreover, in the future as the economic activities are expected to expand, the roles of this sector will be even more important and thus public trust and confidence must be guaranteed.

5.2 Review of Political and Economic Regimes of Cambodia After 1953

Cambodia has experienced six political and economic regimes since its independence from France in 1953, namely 1) "The Kingdom of Cambodia" from 1953 to 1970; 2) "The Khmer Republic" from 1970 to 1975; 3) "The Democratic Kampuchea" from 1975 to 1979; 4) "The People's Republic of Kampuchea" from 1979 to 1989; 5) "The State of Cambodia" from 1989 to 1993; and 6) "The Kingdom of Cambodia" from 1993 to present.

The change of the regime sometimes happened suddenly without prior indication. Those frequent and abrupt changes of these six regimes as well as their political and economic systems are considered to have large impacts on the governance system today. Particularly, during the Democratic Kampuchea regime, the so-called Pol Pot regime, from 1975 to 1979 has left a tremendous negative legacy for the contemporary reconstruction and development of the country. Therefore, in order to understand the present structure of governance in Cambodia, a review of the past political and economic systems is needed. Table 5.12

summarizes the legal system, political system, political power, and economic regime of Cambodia, starting from 1953 to present.

Table 5.12: Transition of Political, Legal, and Economic Systems in Cambodia

Era System	Legal System	Political System	Political Power	Economic Regime
Pre-1953	French based Civil Code and Judiciary	Under the French Protectorate	Held by the French	Colonial type
1953-1970 (The Kingdom of Cambodia)	French based Civil Code and Judiciary	Constitutional Monarchy	Held by Prince Norodom Sihanouk as Prime Minister	Market and then nationalization
1970-1975 (The Khmer Republic)	French based Civil Code and Judiciary	Republic	Held by Lon Nol	Market, war economy
1975-1979 (Democratic Kampuchea)	Legal System destroyed	All previous systems abolished, extreme Maoist agro-communism	Khmer Rouge (Pol Pot)	Agrarian, centrally planned
1979-1989 (The People's Republic of Kampuchea)	Vietnamese-oriented model	Communist party, central committee, and local committees	Cambodian People's Party	Soviet-style central planning
1989-1993 (The State of Cambodia)	Greater economic rights	Communist party, central committee, and local committees	Cambodian People's Party	Liberalized central planning
1993-present (The Kingdom of Cambodia)	French based Civil Code combined with common law in certain sectors	Constitutional Monarchy	1993-97: FUNCIPEC shared with CPP. 1997-present: CPP	Transition of a market economy.

Source: Compiled from Chandler M. David (1991) and ADB (2000) Cambodia: Enhancing Good Governance for Sustainable Development.

5.2.1 The Kingdom of Cambodia (1953-1970)

Cambodia gained the full independence she had lost to France for 90 years in November 1953. Under the French protectorate, all the powers were concentrated in the France's hands and the king played a role just as a constitutional monarch. In March 1955, Norodom Sihanouk[25] who regarded himself merely a ceremonial king abdicated the throne that he had for fourteen years to de facto take command of Cambodian politics. He founded a national political movement, the Sangkum Reastr Niyum (meaning Popular Socialist Community) regime, and then allowed himself to fully become involved in politics. Under this 1947 constitution, Cambodia was governed by a monarchy with two parliaments- the National Assembly and the Popular Assembly.[26] The members of both parliaments were elected by the general elections. Nonetheless, all powers- the executive, the legislative, and the judiciary emanate from the King.

In 1957, the 1947 constitution was amended and became the second constitution in Cambodia. The new constitution guaranteed basic rights such as freedom of belief, the freedoms of speech, writing, printing, broadcasting, meeting and assembly, and freedom in elections, including the right to stand for election to the parliaments.[27]

During the Sangkum Reastr Niyum regime (1955-1970), Cambodia pursued a market economic system and enjoyed a stable and prosperous economic development under the leadership of Prince Norodom Sihanouk acting as head of state. Together with the large amount of foreign aid that flowed into the country, basic infrastructure such as sea and river ports, domestic and international airports, roads, schools, sports facilities, railways, and electricity plants were constructed to further support the economy.

However, in late 1960s, the influence of Prince Norodom Sihanouk faltered due to his

[25] Norodom Sihanouk is a very central figure in Cambodian history. He reined as the king of Cambodia from April 1941 to March 1955, and from September 1993 to October 2004.
[26] Jennar, Raoul M.,1995. The Cambodian Constitutions (1953-1993).
[27] Jennar (1995,) ibid, pp. 38-40.

authoritarian way of running the country and his leaning, despite his official statement of neutrality, towards the communist nations such as China and North Vietnam. During the Vietnam War, Sihanouk secretly provided bases to North Vietnam to supply logistics to fight against South Vietnam. Gradually, movements against him erupted and the economic progress lagged. To resume his influence, Sihanouk executed a nationalization policy aimed at expanding the role of state in the market economy. This situation forced foreign companies to move out of the country and resulted in a more severe damage to the development.

5.2.2 The Khmer Republic (1970-1975)

On 18 March 1970, Prince Norodom Sihanouk was ousted from power by Prince Sisowath Sirik Amatak[28], the police chief, and General Lon Nol, the army chief at that time. General Lon Nol, backed by the United States, took on all the power as head of state, which was the beginning of *the Khmer Republic*. This regime introduced a new constitution that utilized multiparty political system and democratic principles. The president was the top of the executive branch and commander-in-chief of the national armed forces. The parliament included a National Assembly and a Senate with members elected by general elections. The courts were independent and monitored by a supreme court. The Supreme Council of Courts guaranteed the independence of the Judiciary, and held the power to discipline magistrates.[29]

This new regime immediately demanded that the North Vietnamese army leave the country. Prince Norodom Sihanouk himself fled to Beijing and mobilized forces, many of which were Khmer Rouge, to fight against the American-supported Lon Nol government. While Prince Sihanouk had no power over the Khmer Rouge at all, the movement was able to use his name to gain great support from people in rural areas where he had popular support.

[28] Prince Sirik Matak is cousin to Prince Norodom Sihanouk. He is believed to be the person who engineered the coup against prince Sihanouk in March 1970. It is also believed that CIA was behind this coup.

[29] Jennar (1995), ibid.

This movement ignited the civil war in Cambodia and led to the widespread US bombing that resulted in significant destruction of farmland and led to instability of the regime. In 1973, US congress voted to cut off support to Lon Nol government. This decision significantly undermined the regime that relied heavily on US military aid in the civil war. In April 1975, the Khmer Republic came to its end and the new regime started, *The Democratic Kampuchea*.

5.2.3 The Democratic Kampuchea (1975-1979)

On 17 April 1975, the Khmer Rouge captured the capital of Cambodia, Phnom Penh, and the new regime started under the name of *Democratic Kampuchea*. Soon the new regime forced urban people to evacuate to the countryside causing thousands of deaths. During the period of the regime, approximately 1.7 million lives of Cambodians died as a result of a combination of political execution, starvation, and forced labor. This number signifies approximately 25% to 30% of the entire population at that time. Among the victims, a large number of educated citizens such as teachers, doctors, and military and police officers were the prime targets of execution.

The regime unified the three branches of government- the Executive, the Legislative, and the Judiciary- under a single institution called the Central Committee, led by Pol Pot, whose real name was Saloth Sar. Economically, Pol Pot tried to follow foreign leftist models without acknowledging that they were ill-suited to Cambodian conditions. The model included the French Revolution, the collectivization of agriculture as practiced in the Soviet Union and Vietnam, the total mobilization of the population for collective purposes, as in China's *Great Leap Forward* of the late 1950s, and the a pervasive notion of self-reliance resembling the *chuche* policies of North Korea. In this regime, no private ownership was allowed and harvests belonged to the collective property, the currency was abolished, and domestic trade or commerce could be conducted only through barter. Foreign trade was completely halted except with the People's Republic of China (Chandler, 1991). The abolishment of the market

economic system and mass destruction of human lives, especially educated ones, took Cambodia back to “year zero”.

5.2.4 The People’s Republic of Kampuchea (1979-1989)

On 7 January 1979, the Pol Pot regime was put to an end by Vietnamese troops and Cambodian resistance forces supported by Vietnam. The Khmer Rouge soldiers were forced to withdraw from Phnom Penh and major cities but still occupied areas along the Thai-Cambodian border and went on with the civil war. They also continued to hold Cambodia’s seat in the United Nations, while the new government was established with direct support and guidance from Vietnam following the communist system, *The People’s Republic of Kampuchea (PRK).* As this new government was installed by Vietnam, it was not recognized by the international community as the legitimate government.

Due to the massive destruction of physical and human resources during the Pol Pot regime, the building of economic system had to start from scratch. The main source of food to feed the people was coming from the socialist bloc, especially the Soviet Union. Domestically, during its first half of the regime, agricultural collectivization was implemented in hope of mitigating this food problem (Gottesman, 2004). However, it turned out to be unsuccessful and the policy was later relaxed in 1985. Legal title of land ownership was not provided but occupancy rights were recognized in Phnom Penh and some other locations. International trade could be performed only by the state and domestic trade was strictly banned, except small household trade.

On the international stage, the PRK regime was allied with the socialist bloc especially the Union of Soviet Socialist Republics (USSR) from which a large portion of Cambodia’s assistance was coming. The West, key ASEAN countries, and the People’s Republic of China (PRC) supported the Khmer Rouge and other non-communist resistance forces to fight against the PRK. The West also put an international embargo and economic sanctions on the

new regime, retarding the recovery of the nation wrought by the Khmer Rouge regime.

Heng Samrin, the former Khmer Rouge commander who later became the Cambodian resistance army that removed the Khmer Rouge from power, was selected to be president of parliament and head of state of the PRK. The Council of Ministers was the government and promulgated laws. The role of National Assembly was to make laws and it also had the formal power to elect and expel the president, vice-president, and members of the State Council and Council of Ministers. The Council of Ministers governed society and had the power to direct and mange the economy (Fernando, 1998). The only Communist Party in the country was named the *People's Revolutionary Party of Cambodia (PRP)*. This PRP later become the *Cambodian People's Party (CPP*), which is the present ruling party. The Central Committee of the PRP also set up provincial and municipal courts, an appeal court, and a supreme court (ibid, 1998).

Throughout the period of 1979 to 1989, approximately two hundred thousand Vietnamese troops were stationed in Cambodia causing mixed sentiments among Cambodian people. Some perceived Vietnamese as liberators from the Khmer Rouge regime, while others perceived them as invaders because of their prolonged presence in Cambodia and their indirect control of all the state apparatuses. At the same time, civil war also continued until the Paris Peace Accord was signed in 1989, a comprehensive settlement giving the United Nations full authority to supervise ceasefire, repatriate the displaced Khmer along the border with Thailand, disarm and demobilize the factional armies, and to prepare the country for free and fair election. Cambodia entered a new phase, called *The State of Cambodia.*

5.2.5 The State of Cambodia and the UNTAC (1989-1993)

In September 1989, after Vietnam announced the completion of withdrawal of its troops, the process of reconciliation accelerated and the constitution was amended to reunite the country. The PRK was renamed the *State of Cambodia (SOC)*. The SOC began to shift

economic policy towards a market-oriented one. Private ownership of property was reintroduced for the first time since its abolishment by the Khmer Rouge in 1975. However, this privatization of state-owned enterprises took place in an unregulated scale and most of them were a sell-out.

On 28 February 1992, the Security Council of the United Nations authorized the establishment of *United Nations Transitional Authority in Cambodia (UNTAC)* to ensure the implementation of the Agreements on a Comprehensive Political Settlement of the Cambodia Conflict, signed in Paris on 23 October 1991. The main mission of UNTAC was to: 1) supervise the ceasefire, the end of foreign military assistance and the withdrawal of foreign forces; 2) regroup, canton and disarm all armed forces of the Cambodian parties, and ensure a 70% level of demobilization; 3) control and supervise the activities of the administrative structures, including the police; 4) ensure and respect of human rights; 5) and organize and conduct free and fair elections.[30]

On 15 March 1992, the head of UNTAC, the secretary-general's special representative for Cambodia, Yasushi Akashi, officially arrived in Phnom Penh to start its mission. In early May 1992, some 4,000 United Nations personnel, including some 3,600 troops were also in place. At its peak, UNTAC numbered over 21,000 military and civilian personnel from more than 100 countries. In May 1993, the general election was held under its supervision.

5.2.6 The Kingdom of Cambodia (1993-Present)

Since 1993 until present, Cambodia experienced four general elections. The first election was conducted in May 1993 under the supervision of UNTAC. As indicated in Table 5.13, the vote count of the election showed that: FUNCINPEC (acronym from French meaning, National United Front for an Independent, Neutral, Peaceful and Cooperative Cambodia)

[30] United Nations, 2003. Accessed July 30, 2009. http://www.un.org/en/peacekeeping/missions/past/untacbackgr2.html

received 45.47% (58 seats); the CPP (Cambodian People's Party) received 38.23% (51 seats); the BLDP (Buddhist Liberal Democratic Party) received 3.81% (10 seats); and other political parties shared the rest[31]. The total number of seats in the National Assembly is 123.

Table 5.13: Results of General Election: 1993-2008

	1993	1998	2003	2008
FUNCIPEC	58	43	26	2
CPP	51	64	73	90
Sam Rainsy Party	x	15	24	26
BLDP	10	x	x	x
Human Rights Party	x	x	x	3
Others	4	1	0	2

Source: National Election Committee. 2008.

The CPP, which was the ruling party at that time, did not accept the election result. But after tough political negotiations, a coalition government was created in the form of co-prime ministers. Norodom Ranariddh from the FUNCINPEC party acted as the first prime minister and Hun Sen from CPP acted as the second prime minister. The mandate for UNTAC in Cambodia ended in September 1993 with the promulgation of the constitution for *the Kingdom of Cambodia* and the formation of the new government.

Under the new constitution of the new government, the Kingdom of Cambodia, the three branches of government, the executive, legislative, and judiciary branches, are independent and separate from each other. In the executive branch, the King reigns and acts as the head of state but does not govern. The executive is the Council of Ministers, which is the Royal Government of Cambodia (RGC), led by the Prime Minister. The National Assembly was the sole legislative body, but only until 1998. In September 1998, another chamber of parliament was created, the Senate. As a result, the parliament in Cambodia employs a bicameral system.

[31] United Nations, ibid.

The National Assembly is comprised of 123 members and the Senate of 61 members. The Judiciary is recognized as an independent power. All judges are under supervision of the Supreme Council of Magistracy. The Supreme Council of Magistracy takes disciplinary action against any delinquent judges and the Supreme Council is an independent body. However, in practice the influence of the executive branch on both the legislative and judiciary braches is still very strong until present.

In terms of economic transition to a market-oriented one, significant acceleration can be witnessed after the formation of the new government in 1993. In 1994, the Law on Investment (LOI) was passed by the National Assembly and promulgated by the government. This LOI, which was later amended in 2003, was able to successfully attract foreign investments into the country through its various generous investment incentives. Simultaneously, it also reflects the commitment of the government to economic liberalization. In 1999, Cambodia integrated itself into the Association of South-East Asian Nations (ASEAN) as the 10^{th} member. And in 2004, Cambodia also joined the World Trade Organization (WTO) as the 148^{th} member.

5.2.7 Concluding Remarks

After its independence from France in 1953 until present, Cambodia has experienced six political regimes. In the first Kingdom of Cambodia (1953-1970), Cambodia enjoyed relative economic prosperity under the leadership of Prince Norodom Sihanouk. However, having been caught in the cold war Cambodia was forced to choose between the West and the Socialist bloc. Despite declaring neutrality, Prince Sihanouk leant to the socialist bloc by providing bases to North Vietnamese troops.

In 1970, backed by the U.S., General Lon Nol ousted the left-leaning Prince Norodom Sihanouk and began *the Khmer Republic* regime. Together with the faltering interest of the U.S. in South-East Asia, the U.S. congress voted to cut military aid to Cambodia and put an end to the Lon Nol regime. In 1975, the Khmer Rouge regime headed by Pol Pot took over

the country and changed its name to *the Democratic Kampuchea.* This regime had caused some 1.7 million deaths through a combination of political execution, starvation, overwork, etc. Among them, the educated ones such as teachers, doctors, and high-ranking officers were the prime targets.

In 1979, Vietnamese troops and some Cambodian resistance forces ousted Pol Pot regime and took control of the country. The new government, *the People's Republic of Cambodia,* with assistance from Vietnam started to build the country from scratch by following the Communist system politically and the Soviet-style centrally planned system economically. At the same time, the government had also to face the civil war with the Pol Pot guerillas that were based along the Cambodia-Thai border.

Negotiations to end the civil war among the involved parties also took place in late 1980s and in 1991 the so-called Paris Peace Accords were signed. In 1993, under the supervision of UNTAC, a UN-backed general election was held and a new government was formed in the same year. Cambodia accelerated its market-oriented economic policies to integrate itself into ASEAN in 1999 and WTO in 2004. Presently, Cambodia enjoys relative high economic growth rate despite its many social problems.

With the historical background of Cambodia's political and economic legacy explained, the next section will discuss in depth the governance structure after 1993 until the present day.

5.3 Governance in Cambodia

Since outset of the formation of new government in 1993, governance has been viewed as an essential prerequisite for the sustainable development of Cambodia. In order to meet the challenges of development objective of the country, drastic reforms have been carried out in almost every sector. The strategic framework for governance reforms can be reflected in the Governance Action Plan I (GAP I) and Governance Action Plan II (GAP II). GAP I was officially adopted by the Royal Government of Cambodia (RGC) in March 2001 for a

four-year (2001-2004) implementation. This GAP was initiated by the General Secretariat of the Council for Administrative Reform (CAR) through broad consultations with ministries, institutions concerned and development partners and put emphasis on the strengthening of public institutions and improving public services, which is one of the very critical challenges for the government (Royal Government of Cambodia, 2006).

GAP I covers seven main governance sectors which include five cross-sectoral reforms and two sectors of sectoral reforms.

Five Cross-Sectoral Reforms:

1) Legal and Judicial Reform: Establishing basic rules of fairness and predictability;
2) Administrative Reform (Public Administration, Decentralization and De-concentration): Determining the effectiveness of government and its employees in carrying out public programs;
3) Public Finance Reform: Providing the financial underpinnings through which all government activities must take place;
4) Anti-Corruption: Establishing the framework of behavioral rules that set standards of probity in economic, social and political life;
5) Gender Equity: Contributing to poverty alleviation and social justice.

Two Sectoral Reforms:

1) Armed Forces Reform (Demobilization of Armed Forces): The role and size of military were to be redefined after the end of civil war in 1998.
2) Natural Resources Management (Land, Forestry, and Fisheries): Fair resolution to land issues and proper management of forestry and fisheries are essential to social peace and environmental sustainability. The resolution of land issues, including classification, registration, and tenure, is critical to basic rights and investments. Proper management

of forestry and fisheries resources is important for its long-term sustainability and the well being of the people.

To continue the reform efforts from GAP I, GAP II (2005-2008) was subsequently created to accelerate the state reform. In GAP II, in addition to the five cross-sectoral reforms and two sectoral reforms in GAP I, "social development" was included in the cross-sectoral area and "land policy" was separated from the natural resource management due to its growing importance. Social development in GAP II focuses mainly on the issues of poverty reduction, food security, education, health and rural development.

The above governance reforms by the RGC in both cross-sectoal and sectoral areas are also comparative with the World Bank governance indicators. The World Bank governance indicators are comprised of six operational indicators: Voice and Accountability (VA), Political Stability (PS), Government Effectiveness (GE), Regulatory Quality (RQ), Rule of Law (RL), and Control of Corruption (CC). According to these data for period of 1996- 2008, the quality of governance in Cambodia has shown some improvements in recent years but still ranks as one of the lowest in the region. One of the main reasons can be explained by the fact that Cambodia is a post-conflict nation and the governance quality itself was at low level.

The subsequent section discusses in-depth each element of governance in Cambodia by referring to the undergoing reforms taking place on the ground. By doing so, we can examine the effect of each reform and the perception of each correspondent governance indicator surveyed by the WB. For example, how reform in legal and judicial sector corresponds with the perception of *rule of law*, how reform in administrative sector corresponds with *government effectiveness,* and how reform in economic and financial sector corresponds with the *regulatory quality*, etc. At the same time, it should also be noted that there might be a lag between the effects of the reforms on the ground and the perception of governance conducted in the survey.

The Figures 5.8 to 5.14 below show the evolution of each element of governance

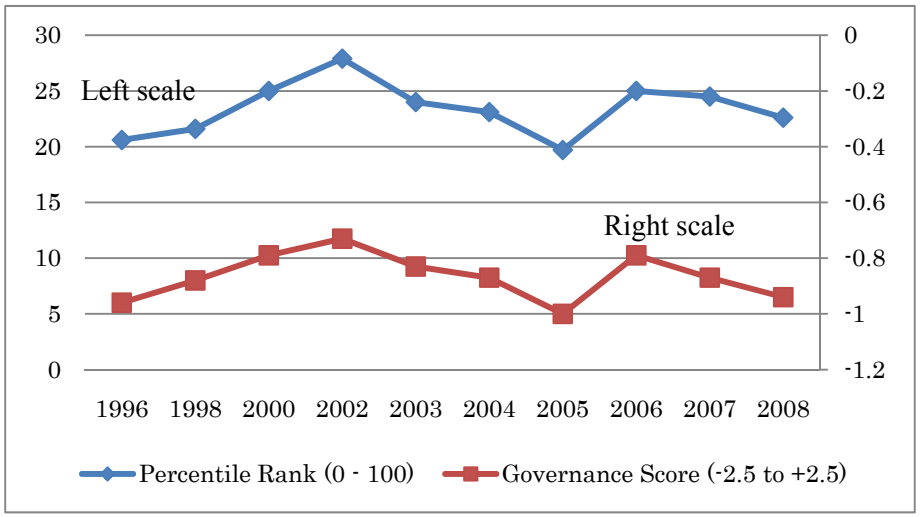
surveyed by the World Bank from 1996 to 2008. This assessment is based on indicators of perception drawn from numerous sources. The left scale of the figure represents the percentile rank on each element of the governance indicators. This percentile rank indicates percentage of the countries worldwide that rate below Cambodia. It suggests the governance performance of Cambodia relative to other countries. The right scale represents the actual value of governance obtained from the survey, reflecting its perception of the country. The number used in the survey ranged from -2.5 (low) to +2.5 (high) and has been subsequently adjusted to make it comparable in time series. The significance level in this survey is 90%.

5.3.1 Voice and Accountability

The World Bank defines *voice and accountability* as "the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media". As indicated in Figure 5.8, the indicator of voice and accountability in Cambodia was 20.6 percentile rank in 1996. It later reached its peak in 2002 with the value of 27.9 percentile rank, but gradually declined to 22.6 percentile rank in 2008. This section debates two main issues, the system through which the people are represented and the freedom of the media, and to association and expression.

According to Cambodia's current constitution, the executive authority is vested in the Royal Government of Cambodia (RGC), led by the Prime Minister. The bicameral parliament comprises a 123-seat National Assembly and a 61-seat Senate. The prime minister is elected by the National Assembly representatives and then appointed by the king. Since its first UNTAC-backed general election in 1993, National Assembly elections have been taken place regularly every 5 years. The Senate was established in March 1999 with a mandate of six years, resulting from a power sharing between the CPP and FUNCIFEC following the 1998 National Assembly election.

Figure 5.8: Voice and Accountability



Source: The World Bank. 2009.

National Assembly elections are open to multi-political parties. The Cambodian People's Party (CPP) has been the ruling party since 1979. Given its advantage of state apparatus, CPP has effectively restricted other political parties from opportunities to power shift through many channels, including the use of political threatening. For example, FUNCIPEC won a greater share of votes than CPP in the 1993 election but the latter was forced to form a coalition government and gradually gained control over administrative and security apparatus. The power struggle between CPP and FUNCIPEC co-prime ministers resulted in a coup of July 5-6, 1997. After the coup, although FUNCIPEC remained part of the coalition government, Hun Sen further consolidated political control and abated FUNCIPEC's role.

The Senate system was created in 1999 and was a unique system for Cambodia. The senate members were not directly voted by the people. Instead, out of 61 of the Senate members, three senators were CPP/FUNCIPEC nominees; two senators were nominated by the King, and the rest 56 Senate seats were shared by all political parties in proportion with their standing in the National Assembly. In this way, we can say that the Senate system could hardly represent the voice the people and they had no direct link with the grassroots level as

well. Constitutional amendments on the Senate Election Law eventually passed the National Assembly in May 2005. In this amendment, the National Assembly members and the electoral college of 11,384 commune councils now indirectly select senators.[32] The second term of the senate election was held in January 2006, where 57 senators were elected, two were nominated by the King, and another two were nominated by the parliamentarians. This new system can be considered a better system in comparison with the old one in the sense that senators are somewhat indirectly elected by the commune councils, rather than appointed. However, the role and function of the Senate are considered very limited due to the fact that it was established mainly for the purpose of power sharing rather than check and balance.

The freedom of media, association, and expression is considered partially free in Cambodia. Article 12 and 13 of the Press Law protects freedom of expression, press, and publication, as long as these do not adversely affect "public order," "national security," and "political stability". However, the interpretation is vague. It does not explain what concrete actions could harm the public order, national security, and political stability. Therefore, some of the newspapers and individuals have been harassed and sued in those names.

In terms of the election conduct, it has been somehow credible with regards to registration, polling and vote counting, despite some irregularity. However, uneven campaign opportunities, fraud, political violence, and intimidation can always been witnessed here and there before elections. For example, in the 2003 general election, in principle, all parties were allowed to campaign freely. However, given its advantage in state apparatus, the CPP used its control of the broadcast media to overwhelm its opponents. Moreover, it also used state resources, including transportation, personnel, and government official places to campaign. Although political violence such as intimidation, assassination of members from opposition parties has been decreasing, the absolute advantage of state apparatus of the ruling party does

[32] The Commune Council election was carried out to select the commune chiefs for the first time in 2002, as part of the government policy to devolve administration and decision making to the commune level. The elected commune council together with National Assembly selected the Senators.

not fully and fairly reflect the will of the people. In the 2008 general election, political harassment and violence against opposition parties dropped significantly, given the absolute advantage of ruling party to the opposition ones.

In sum, we can conclude that the voice of the people is not yet fully guaranteed but signs of improvement can be witnessed. Interpretation of freedom of expression, media, and association is still vague and in most case it favors the ruling party (CPP), at the expense of opposition ones. Political violence has decreased substantially in recent years. Although there have been some improvements, the act of using state resources to campaign by the ruling party and control of media broadcast has made the election itself far from free and fair.

5.3.2 Political Stability

Political Stability measures perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including domestic violence and terrorism. As indicated in Figure 5.9, the political stability in Cambodia has improved greatly, starting from 10.6 percentile rank in 1996 to 34.4 percentile rank in 2008. This percentage change represents a three-fold increase in 12 years. Improvement in political stability has significantly contributed to the business activities by providing a favorable investment climate to both domestic and foreign investors.

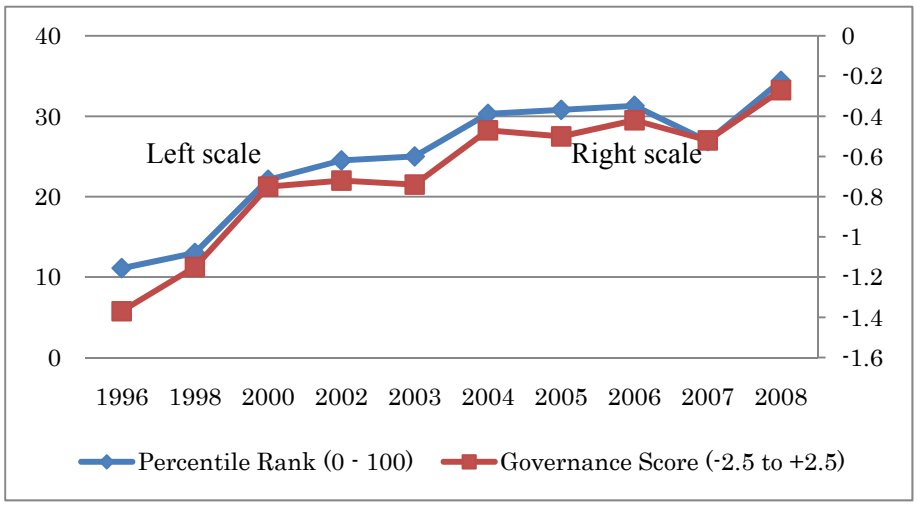
There are various reasons attributing to this political stability. First of all, the disarmament of Khmer Rouge soldiers in early 1990s was a decisive factor to achieving stability in the country. This success later led to a complete destruction of Khmer Rouge army after Pol Pot's death in 1998[33], officially declared as the end of civil war in Cambodia.

Another crucial factor for political stability, at least for the short term, is the absolute power superiority of the ruling party, CPP, over the opposition parties. While the power is

[33] Pol Pot died in April 15, 1998. The cause of death remains unknown as his body was cremated a few days later after this death. Despite the claim by his subordinate that he died of heart failure, suspicions remain.

concentrated in the hands of ruling party, the possibility of coup d'état or political violence to destabilize the government is substantially minimized, although the price to pay for this stability is the risk of moving towards authoritarianism.

Figure 5.9: Political Stability



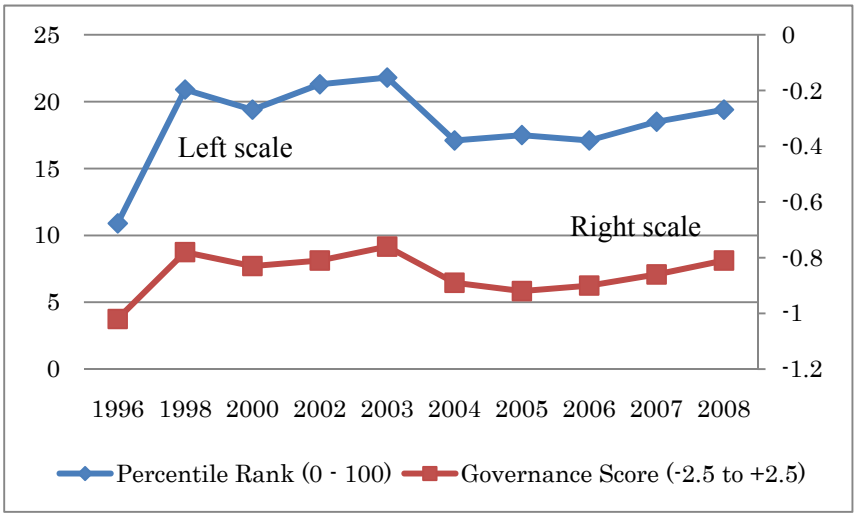
Source: The World Bank. 2009

With political stability in place, the execution of economic policies can be carried out rather smoothly, despite the widening economic gaps in the country. The macroeconomic management, in general, has been stable and the inflation rate has also been kept low at less than 6% between 1999 and 2007 (ADB, Key Indicators 2009). Foreign direct investments have been attracted into the country, much of which is concentrated in the garment sector producing some 40,000 jobs every year from 1999 to 2001. However, during 2002-2005 the creation of new jobs has decreased to between 20,000 and 25,000. The end of 2005 estimates the total direct employment created by the garment industry estimated be about 270,000 jobs while indirect employment is about 242,000 jobs (Economic Institute of Cambodia, 2007).

5.3.3 Government Effectiveness

Government Effectiveness measures the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. As can be seen in Figure 5.10, indicators of government effectiveness in Cambodia reached its peak in 2002 and then gradually decreased.

Figure 5.10: Government Effectiveness



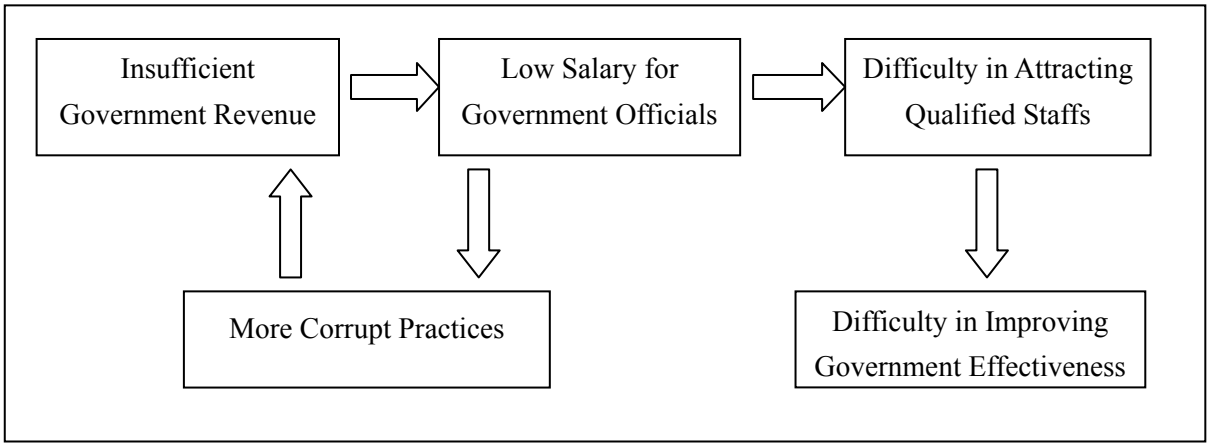
Source: The World Bank. 2009

The problem of government effectiveness in Cambodia is critical. One of the main causes responsible for this poor performance was the remarkably low salary of public servants. For example, the average monthly wage per civil servant in 1998 was only 24 US dollars.[34] In 2006, it was raised to 51.5 US dollars through 10% to 15% annual increases. However, in comparison with private sector this pay standard is still low. The minimum wage for the garment sector, which is a low-skilled labor-intensive sector, is now 61 USD, and its average monthly wage is estimated to be around 85 to 90 USD, undermining the working motivation

[34] Asian Development Bank, 2000. Cambodia: Enhancing Governance For Sustainable Development.

of public servants. Inevitably, they are faced with the needs to generate extra income in addition to the minimal monthly salary they receive. A low salary also creates an incentive for public officials to abuse their power to ask for unofficial money, and this is the root of corruption itself (See Figure 5.11). Should this sort of abuse of power also happen in the judicial apparatus, it would result in serious damage to the public's trust in the court system.

Figure 5.11: Vicious Circle of Low Wage in Public Sector on Governance



Source: Author

Acknowledging the gravity of the consequences emanating from low pay, administrative reform programs have been launched. For example, in 2001 the government completed a census of the civil service, finger printing and registering civil servants in all provinces. This census indentified about 9000 ghost workers who did not come to work but whose salaries were paid. In 2002, with assistance from the World Bank and other donors, a medium-term (2002-2006) civil service reform program, named National Program for Administrative Reform (NPAR) was executed. It aimed to 1) improve the delivery of public services; 2) enhance pay and employment; 3) develop the capacity of people and institutions; and 4) promote the use of Information and Communication Technologies.[35] However, the

[35] IMF Country Report, 2007. Cambodia: Selected Issues and Statistical Appendix, pp. 18-19.

implementation of NPAR was extremely slow and succeeded to raise the pay scale only up to 51.5 US dollars in 2006, remaining very low in comparison with the private sector.

According to the IMF country report 2007, the ratio of wage bill to GDP was on a declining trend form the mid-1990s, dropping from over 4% in 1994 to about 3% in 2004 and 2005 (See Table 5.14). This reflected the effects of civil administrative reforms by the government in cutting unnecessary or inefficient costs. At the same time, owing to political stability, the wage bill for national defense and security had gradually decreased, following the acceleration of the soldier demobilization program. This situation also implies that there is more room to increase the pay scale for public servants.

Table 5.14: Assessment of the Wage Bill for Cambodia, 1994-2006

	1994	2000	2001	2002	2003	2004	2005	2006 Est.
Wage bill, in % of GDP	4.1	3.7	3.3	3.5	3.4	3.0	2.8	2.8
Civil service	1.4	1.5	1.4	1.8	1.8	1.6	1.6	1.7
Defense 1/	2.7	2.2	1.8	1.7	1.6	1.4	1.2	1.1
Wage bill, in % of total expenditure	29.1	24.7	21.4	20.8	21.4	20.0	20.3	20.0
Civil service	10.0	10.2	9.4	10.8	11.4	10.7	11.5	12.0
Defense 1/	19.0	14.5	12.0	10.0	10.0	9.2	8.7	8.0
Wage bill, in % of total revenue	49.8	35.9	32.6	33.3	31.6	29.0	26.8	24.0
Civil service	17.2	14.8	14.3	17.3	18.4	15.6	15.3	14.5
Defense 1/	32.6	21.1	18.3	16.0	16.2	13.4	11.5	9.6

Source: Cambodian Authorities, IMF staff estimates, in IMF Country Report (2007).

1/ including national defense and security.

The optimal pay scale and optimal size for public servants are also equally important issues. Optimal pay scale here refers to the pay scale that prevents public servants from

moonlighting activities and from using their official position to generate private income. Theoretically, raising this pay scale to its optimal point, public servants will utilize their time fully for their duties. And given the pervasive moonlighting activities nationwide at present, the size of the public servant can still be reduced to carry out the same workload. When the size of public servants is reduced, we can then increase the per head pay scale.

In conclusion, the main cause of low level of government effectiveness in Cambodia can be said mainly to emanate from the out-of-line pay scale in the public sector, leading to the creation of perverse incentives, reduce morale, induce widespread absenteeism, and resulting in poor service delivery. This in turn impedes the recruiting of qualified personnel, and finally weakens the governance quality as a whole. Improving the effectiveness of government would need a long-term and committed effort through both development of human resources and increases in remuneration.

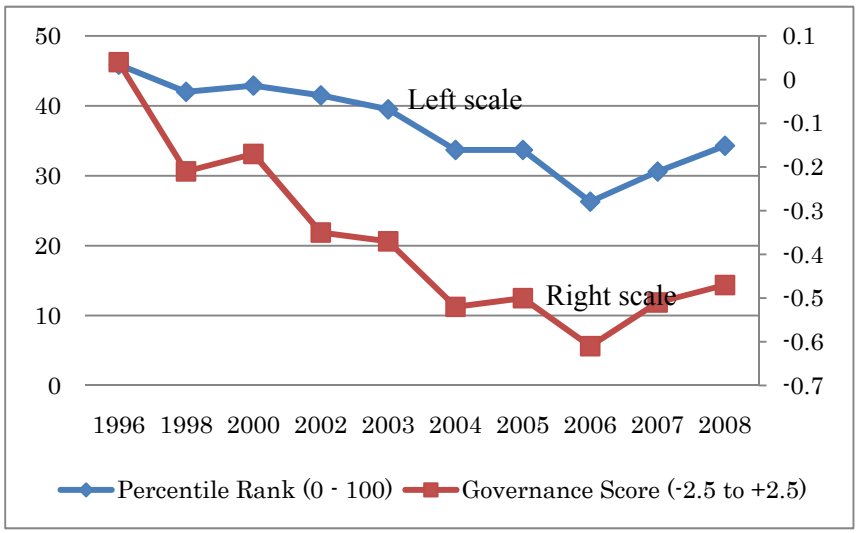
5.3.4 Regulatory Quality

Regulatory Quality measures the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development. Cambodia launched a very friendly economic policy at the onset of its economic transition in 1994. As indicated in Figure 5.12, the incident of regulatory quality recorded a 44.9 percentile rank in 1996, but in 2006 it dropped to only 26.3 percentile rank. One of the main reasons responsible for the decline in the regulatory quality indicator is the amendment of the 1994 Law on Investment (LOI) in 2003.

The Law on Investment (LOI), which passed the National Assembly in 1994, provided remarkably generous investment incentives to investors, reflecting the intention and determination of the government to promote more investment in the country to compensate for critical shortage of domestic investments. For instance, corporate tax for encouraged projects was set at only 9% and 20% for non-encouraged projects; corporate tax exemption

was made available up to 8 years depending on the types of projects; tax free reinvestment on profits; tax free repatriation of earnings; and 100% import duties exemption for raw materials for production at a Special Processing Zone (SPZ) where at least 80% of the final products are exported.

Figure 5.12: Regulatory Quality



Source: The World Bank. 2009

However, in the amended 2003 LOI investment incentives were reduced in an attempt to increase state tax revenues. In the amended LOI, corporate tax was raised to 20% for all projects, except 30% for natural resource business and 9% or 0% for existing and tax exempted qualified investors. This corporate tax exemption is automatically provided for 3 years and it can be extended, in principle, up to another 3 years depending on the annual certificate and compliance of the firms. In addition, while reinvestment on profits and repatriation of earnings was tax-free in the 1994 LOI, under the 2003 amended LOI they are now subject to taxation in. Table 5.15 summarizes the main features of 1994 LOI and the amended 2003 LOI.

Table 5.15: Features of 1994 LOI and amended 2003 LOI

1994 Law on Investment	2003 Amended Law on Investment
Corporate tax rate 9%	Corporate tax rate 20% for all projects, except 30% for natural resource business; 9% or 0% for existing and tax exempted qualified investors.
Corporate tax exemption of up to 8 years depending on the projects.	Tax exemption period: Trigger Period + 3 years + Priority Period. Maximum Trigger Period is to be first year of profit or three years after QIP earns its first revenue, whichever is sooner.
Five year loss-carried forward.	Five year loss-carried forward.
Tax free reinvestments on profits.	Introduction of investment allowance (special depreciation).
Tax free repatriation of earnings.	Repatriation of earnings is subject to taxation.
Full import duty exemption for 80% exporter.	Full import duty exemption for 100% exporter.
No export tax.	No export tax.
Decision to give Qualified Investment Project (QIP) license has to be made within **45** working days.	Decision to give Qualified Investment Project (QIP) license has to be made within **28** working days.

Source: Council for the Development of Cambodia

Although the amended 2003 LOI made it less generous for investors in terms of its investment incentives, it is still considered relatively generous in comparison with other countries in the region. For example, given the 20% of corporate tax rate in Cambodia, corporate tax rate in Vietnam, Thailand, Philippines, Malaysia, and Hong Kong register 32%, 30%, 32%, 28%, and 16%, respectively (Hing, 2006; p.101). Simultaneously, certain institutional reforms were also made to shorten the bureaucratic procedures. For example, the decision to grant a final registration certificate has been shortened to 28 working days, from 45 days in 1994 LOI. In addition, the time required to issue duty free import proposal by the government was also reduced from 3 weeks to just only 2 working days.

In sum, the decline of the regulatory quality indicator in Cambodia during 1996-2006 does not necessarily reflect the worsening of the investment environment in comparison with other countries in the region. Instead, the decline of the indicator was simply because the incentives provided at the beginning in 1994 LOI were too generous.

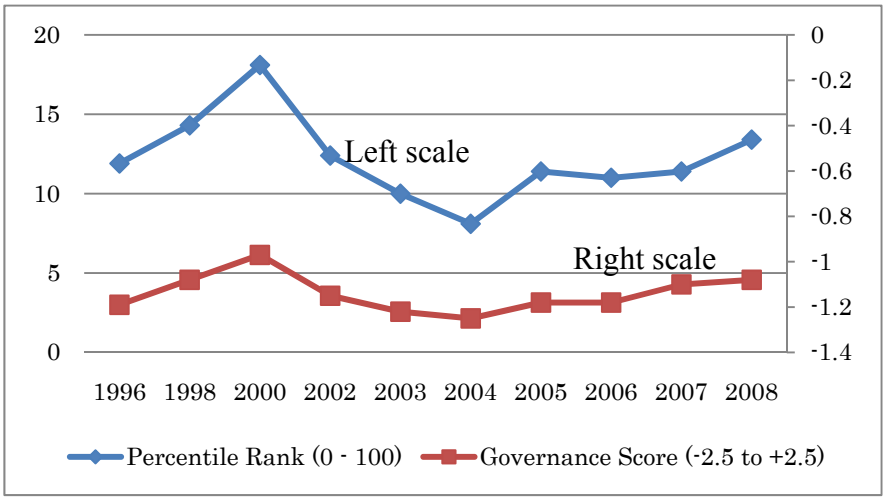
5.3.5 Rule of Law

Rule of Law measures the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, the police, and the courts, as well as the likelihood of crime and violence. The incident of rule of law in Cambodia has been fluctuating at a very low level in recent years, despite the commitment to drastic reforms in the legal and judicial sectors by the government. As indicated in Figure 5.13, the incident of the rule of law in Cambodia scored only 11.9 percentile rank in 1996, a very serious and critical issue for the development of Cambodia. In 2000, the rule of law incident reached its peak at 18.1 percentile rank, owing to various reforms effort by the government. However, after the formation of the second coalition government in 1998, the CPP gradually developed a firm grip of power and outweighed its coalition partner, FUNCIPEC. This absolute superiority of power later enabled the government to further exercise its influence on the legislative and judiciary branches. However, in recent years there have been signs of commitment to seriously carry out the reforms by the government. Investors view this commitment as a good step, which would positively favor their decision to invest in Cambodia.

The following section introduces the reform in the legal and judicial sector, which has been considered as one of the very critical issues for the development of the country. The legal system in Cambodia is mainly a hybrid of legal influences from the French legal system and the socialist system. However, the shift toward a market economy in 1989 and the establishment of the government in 1993 have brought remarkable changes to Cambodia's

legal system. In order to fit in the new system, various laws have been created and amended, with technical and financial supports from development partners (DPs).

Figure 5.13: Rule of Law



Source: The World Bank. 2009.

The judicial system that serves as the backbone of a system of checks and balances still requires some drastic changes. For example, judges who are supposed to be independent from the executive branch still hold the position as public officials under the Ministry of Justice (MOJ). This situation permits the MOJ to easily interfere in court decisions. Another issue is the closeness between the prosecutors and judges during both investigation and trial. This issue is almost a common practice in Cambodia, which can only be prevented by a greater separation between the two parties such as limiting their communications and contact. Specifically, prosecutors should not be allowed to communicate with a judge about a case without the presence of the lawyer (Asian Development Bank, 2000).

Legal and judicial reform is implemented based on the Plan of Action for Implementing Legal and Judicial Reform Strategy (PAILJRS), which were issued by the government in 2005 focusing on 97 priority actions to achieve the goal of establishing a credible and stable

legal and judicial sector. By 2008, 84% of PAILJRS was in the process of implementation and 16% remained unimplemented. Out of these, 72% were supported and implemented by development partners (DPs) and 12% were implemented by government agencies (Council for Legal and Judicial Reform, 2009).

Reform in the legal and judicial sectors is one of the very challenging tasks by the government. The limitation in both human and financial resources is a decisive element, causing capacity constraints of public officials leading to the compromise of ownership of the reform. On the contrary, DPs have the necessary means, especially financial to undertake whichever projects they desire. The reform in this sector is likely to take time and will require the training of local staff to draft and interpret laws by themselves after DPs have left.

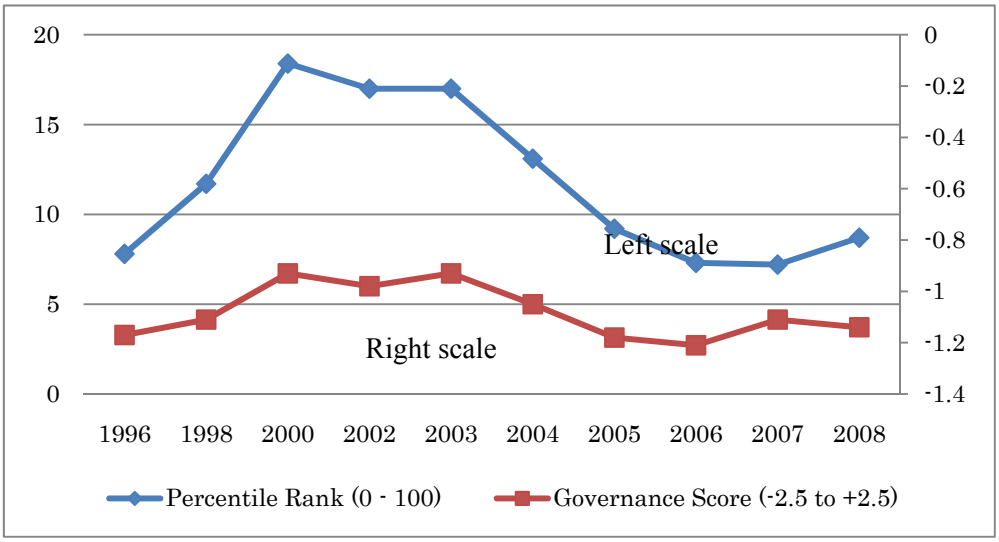
5.3.6 Control of Corruption

By definition, control of corruption measures the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests. The issue of corruption in Cambodia is considered to be the most serious one facing the country and something which is pervasive throughout all levels of public services in the country. As indicated in Figure 5.14, the incident of Control of Corruption (CC) fluctuated at a very low level in 1996 at about 8 percentile rank, and reached its peak in 2000 at 18.4 percentile rank. It later dropped significantly to its lowest level in 2007 after which it showed a tendency of picking up.

The issue of corruption has so far been one of the critical parts of governance and also a major cause that pushes up the costs of economic activities in Cambodia. According to a Productivity and Investment Climate Survey (PICS) conducted by the World Bank in 2003, 82% of firms, 368 out of 447, reported that there were bribe payments. These unofficial payments accounted for approximately 5% of total annual sales revenue, more than double that found in Bangladesh, Pakistan, or China. Over 80% of firms interviewed perceived the

judiciary and customs negatively. More than 60% of firms perceived the state tax office, the police, the Ministry of Commerce office dealing with trade, military, and council of ministers as corrupt. This finding implies a high level of costs of doing business in Cambodia as a result of corruption in comparison with other countries. Another interesting fact about corruption in Cambodia is that it does not function as catalyst to expedite the service as in the "efficiency grease" theory of corruption. Instead, it simply serves as a routine payment to public officials for basic public services, which are supposed to be free of charge (World Bank, 2004).

Figure 5.14: Control of Corruption

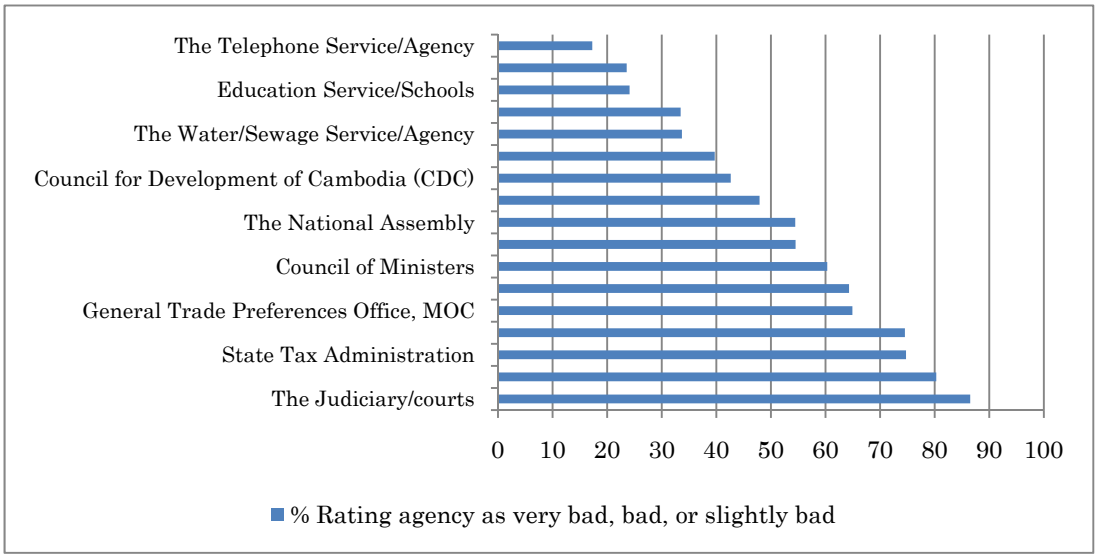


Source: The World Bank. 2009.

Anti-corruption law has been drafted and reviewed for more than 15 years and finally passed the National Assembly in March 2010. The lack of anti-corruption law in the past meant that the authorities had no legal grounds to investigate and charge the corrupt government officials. As a result, the tradition of "zero or low risk, high returns" has spread all over the government institutions. According to the World Bank (2004), the money lost through corruption in Cambodia accounts for approximately 500 million USD per year. And while the government refuses to give a figure on the amount of corruption, it does

acknowledge that the corruption in Cambodia is pervasive and places a big burden on government budget. The approval of the anti-corruption law has sent a strong message to both private and public sectors that the government is taking the issue seriously. However, the tradition of corrupt practices is not likely to change in the short run, unless a suitable salary scale is provided and this anti-corruption law is effectively enforced.

Figure 5.15: Negative Ratings of Agency Integrity in Cambodia



Source: The World Bank, Cambodia PICS 2003.

5.3.7 Concluding Remarks

Despite the general tendency of improvement in governance quality in Cambodia during 1996-2008, its degree differs depending on each governance indicator. For example, the improvement in political stability and government effectiveness has been significant, while the improvement in voice and accountability, rule of law, and control of corruption is minimal. The main reason for the improvement in political stability in Cambodia is largely attributed to the absolute superiority of the ruling party (CPP), vis-à-vis to the opposition parties. The improvement in government effectiveness is considered a result of administrative reforms by the government, including the identification of approximately 9,000 ghost workers in the

2001 census and a 10-15% annual increase of salary for public servants since 2002.

The improvement in voice and accountability, and the rule of law is rather slow, reflecting its nature as a long-term institutional/structural issue. Control of corruption, which is largely determined by the political will, showed a tendency of fluctuation in the early 2000s, and started to pick up in 2006. In March 2010, anti-corruption law was finally approved by the National Assembly and promulgated by the government. However, the tradition of corrupt practices may still remain in the short-run, given the current low salary scale. As for the regulatory quality, it showed a declining tendency during 1996-2006. However, this does not necessarily suggest the worsening of investment climate during the period, but is rather due to the amendment of the very generous 1994 LOI in 2003.

5.4 Relationship between FDI and Governance in Cambodia

As discussed in previous chapter, FDI is, in general, positively associated with economic growth. And at the same time, the quality of governance is also positively correlated with FDI inflow. In other words, holding other factors constant, countries with better governance tend to attract more FDI than countries of lower governance quality. This phenomenon can be partly explained by transaction cost theory, which emphasizes the costliness of information as the key to the costs of transacting, including the costs of protecting rights and policing and enforcing agreements. At the same time, a low level of governance quality tends to result in high transaction costs in business activities and more chances of uncertainty in business decision in the future. In this section, the reverse relationship between FDI and governance will be argued. That is to say, it is not only governance that affects FDI inflow, but the presence of FDI itself can also affect the quality of governance in return.

Cambodia started the transformation process into a market-oriented economy in 1989. Drastic reforms had been carried out so that the country could adapt to the new system. Of these reforms, the privatization of state-owned enterprises (SOEs) to reduce fiscal burdens

and attraction of FDIs were the core policies by the government to revive the economy. Owing to the fact that the centrally planned economy was a short-lived one lasting only a decade (from 1979 to 1989), it had not made deep roots into the fabric of the country. This meant that the privatization of SOEs was carried out relatively smoothly. And the same time, having contributed by the government's investor-friendly LOI and other favorable environments, Cambodia's FDI attraction was considered quite successful. Specifically, foreign investments concentrate in garment sector, generating over 320,000 jobs in 2008.

5.4.1 Impacts of FDI on Governance in General

Since its transition to a market-oriented economy in 1989, Cambodia carried out a drastic reform in various sectors of the economy to conform to the open and globalized market. Among them, privatization of state-owned enterprises (SOEs) and attraction of FDI were the key economic policies to revive the devastated economy. As a result, the inflow of FDI also increased steadily after the enactment of the investor-friendly Law on Investment (LOI) in 1994. According to the Council for the Development of Cambodia, actual (implemented) FDI inflow into Cambodia in 2008 was registered at 815 million USD, from 151 million USD in 1995, and it is on an increasing trend. And the accumulation of FDI inflow from 1995 to 2008 was recorded at 4.3 billion USD, which was approximately 36% of the approved FDI into the country during the same period (World Bank, WDI 2010).[36]

The Cambodian economy can now be characterized as FDI-led growth and its presence has been on an increasing trend from year to year. However, due to its low level of governance quality, various problems have also been faced. Some of the problems such as the issue of unofficial costs, complicated administrative procedures, and the unreliable court system were central for the economic activities of the private sector. As FDI represents a core

[36] World Bank, 2010. Word Development Indicator 2010. http://data.worldbank.org/country/cambodia . Accessed November 10, 2010.

part of the Cambodian economy and recognizing that economic progress depends on a business climate conducive to private investment and enterprise, a Public-Private Dialogue called Cambodian Government–Private Sector Forum (G-PSF) was established in 1999, as part of its private sector policy reform strategy.

5.4.1.1 Background and Objective of G-PSF

With recognition of the needs of favorable investment climate for private sector and pressure for better governance, G-PSF was initiated in 1999 by the Royal Government of Cambodia (RGC) with an objective to facilitate dialogue with the business sector to understand their needs and concerns regarding their business operation in Cambodia. At the onset, G-PSF was established without any involvement of development partners and originally named Private Sector Forum (PSF). Until 2002, the Secretariat of the PSF was hosted by the Council for the Development of Cambodia (CDC), the government agency in charge of managing international aid and promoting foreign investments in the country. The CDC's vice-chairman acted as the PSF secretary general, while the CDC provided core administrative and logistical resources. In 2002, development partners, especially the International Financial Corporation (IFC) and Australian government aid agency (AusAID) started to provide technical and financial support to the forum. Private Sector Forum (PSF) was also changed its name to Government- Private Sector Forum (G-PSF).

G-PSF was established partly as a result of pressure from the private sector for better governance and pursue of improved investment climate. From the government perspective, this kind of public-private dialogue channel is crucial for them to understand the private sector's needs and reflect their suggestions, and requests into the policy reform. Similar initiatives can also be seen in neighboring countries such as the Vietnam Business Forum (VBF) in Vietnam, and the Lao Business Forum (LBF) in Laos.

5.4.1.2 Structure and Function of Cambodian G-PSF

The Cambodian Government-Private Sector Forum (G-PSF) is a mechanism for public private sector consultation on investment climate issues ranging from policy to operational matters. G-PSF is held on a bi-annual basis, chaired by the Prime Minister and has the status equivalent to the formal cabinet meetings. Decisions made at the forum are legally binding as the government decisions and then forwarded to related ministries for enforcement.

The forum is the umbrella mechanism, under which sit eight Working Groups (WGs) as follows:

1) Agriculture and Agro-industry

2) Tourism

3) Manufacturing and SMEs

4) Law, Tax & Good Governance

5) Services, including Banking & Finance

6) Energy, Infrastructure & Transport

7) Export Processing & Trade Facilitation

8) Industrial Relations

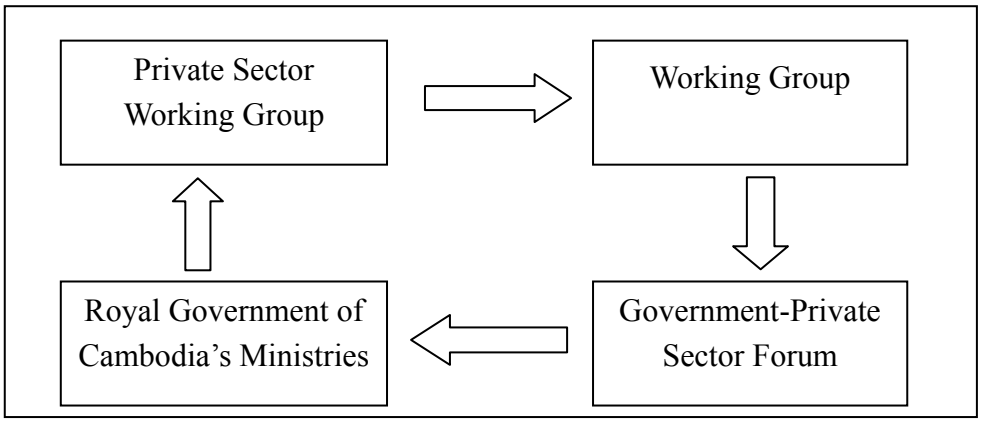
According to the World Bank (2007), these eight WGs are characterized as the "work horses" of the forum and in principle meets at two levels: private sector working groups and joint government-private sector working group.

1) Private Sector Working Groups (PSWG): Industry members discuss and agree internally on issues and raise them with their government counterparts. The agendas are prepared following a broad consultation among members of companies in that sector and consist of prioritized issues and recommendation. In PSWG, co-chairs from the private sector to represent themselves in the WG meetings, are also nominated or elected.

2) Joint Government-Private Sector Working Group: It is generally called the *Working*

Group (WG). The WG meetings are held at least once a month and more as needed and as appropriate. Each WG is co-chaired by a minister of the RGC and a representative from the private sector. The WG meetings discuss on agenda of information inquiries, issues and recommendations that are relevant to either policy or direct operational hindrances faced by the private sector. Outstanding issues, which cannot be solved at the WG meetings, are brought to the G-PSF meeting for cabinet review on a prioritized basis. Figure 5.16 summarizes the structure and mechanism of G-PSF.

Figure 5.16: Structure of Government-Private Sector Forum



Source: IFC, 2007. Modified by the author.

5.4.1.3 G-PSF and Improvement in Governance

Acting as the official channel of communication between government and business community, G-PSF also provides platform for the private sector to formally request the government for investment climate reforms. For example, at the 2006 G-PSF, requests from the WGs were made and could be divided into six categories (ibid. p.17).

1) *Law*: Request for modification, issue or refine an existing law. Law is understood in the sense of any legal enactment by the legislative branch;
2) *Regulation*: Request for modification, issue or refine an existing regulation. Regulation

is understood in the sense of any administrative or legal document issued by the executive branch and includes Circulars (Saracho), Decrees (Kret) and Sub-Decrees (Anu-kret) and other decisions;

3) *Enforcement*: Request the government to dedicate appropriate political will and resources to the enforcement of existing laws, regulations and institution operating guidelines;
4) *Institution*: Request for a change of scope or the establishment of a new government agency or institution;
5) *Infrastructure*: Request for the development of existing or new infrastructure; and
6) *Clarification:* Request the WG's RGC representative to clarify and interpret the existing administrative and legal procedures.

Among the requests from the private sector, most of them concentrate on *regulation* (69%) and *clarification* (17%). The other four types of request of reform accounted for less than 15%. In the same year 2006, 37% of the reforms were actually implemented. However, this varied greatly depending on the WGs and types of reform (ibid. pp.17-18).

5.4.1.4 Impacts of FDI on Governance Structure

As FDI accounts for the majority of total investment in Cambodia, the impact of FDI on Cambodian economy is considered huge, both directly and indirectly. Directly, FDI affects the economic growth through its investment activities by creating jobs, transferring technology, earning of foreign exchange, etc. However, another important impact, which in many cases is often underestimated, is its indirect impact through the improvement of governance. Particularly, in Cambodia, FDI largely contributes to the improvement of governance of the country as a whole. For example, in the G-PSF, it is dominated by foreign representatives not only in terms of theirs number, but also their degree of participation and contribution to the

substantiation and formulation of issues (ibid. p. 45).

Cambodia gained full sovereignty in 1998 after the death of Pol Pot, and began a new history as a post-conflict country, which had to build itself from scratch, including its wrecked institutional system. The negative legacy from the notorious Pot Pot Regime (1975-1979) and almost 30 years of civil war (1979-1998) left Cambodia with a serious deficiency of social capital and high level of mistrust, the absence of an effective court system to enforce creditor's rights and contracts, an inefficient bureaucratic system and a high level of corruption. Those issues were addressed in the WGs meetings and G-PSF in order to seek solution. As was clearly illustrated earlier in Figure 5.15 (World Bank, Cambodia PICS 2003), there was a deep mistrust in government agencies. More than 80% of firms perceived the judicial system negatively. The Council of Ministers' office, the military, general trade preferences office, police, state tax office, and customs office are also negatively perceived by over 60% of the firms. At the beginning, there were problems of coordinating conflicting interests both within the private sectors and with the government side. However, as time went by, the coordinating matter slowly faded down and substantial and constructive discussions were organized and request for the improvement of investment climate of private sector.

In the 6th G-PSF in 2002, a long-time taboo and very sensitive issue, corruption, was raised. As a consequence, the co-chairs of several private sectors were subject to intimidation and retaliation for their business and personal security. They were then compelled to publicly request "protection" from the prime minister. At present, trust and confidence of the private sectors towards the government have grown greatly and inputs from the private sector have played a significant role in the reform process with regards to economic policy of the country.

5.4.2 FDI and Governance in Garment Sector

Before the inflow of foreign investments in early 1990s, the Cambodian economy relied upon the SOEs and traditional economic activities such as brick production, earthenware

production, soy sauce production, furniture, tailoring, bicycle or motorcycle repair. In this traditional sector, there is no effective labor standard or clear rule to be protected by law. In principle, negotiation between workers and employers was the main, in fact, almost the only, method to solve related problems.

As the privatization process accelerated, the roles of SOEs started to decrease and then was later gradually substituted by FDIs. Among them, foreign investments in the garment sector has now become the main earner of foreign currency, accounting for approximately 70% of the country's total exports. However, the success of this industry is considered to be largely attributed to the improvement in labor standards and better governance in the industry. At the onset of FDI inflow in 1995, there were only 20 garment factories in Cambodia. By the end of 2009, the number of factories reached 243 creating approximately 280,000 jobs[37].

5.4.2.1 Garment Export and Labor Standard Requirement

The inflow of FDI in the garment sector in Cambodia contributes to the regulation of labor standards and the modernization of labor market, which are important elements of governance. Before the presence of FDI, despite the existence of domestic labor law, the implementation was weak and in principle can be considered ineffective. After the presence of FDI firms in the country, movement to protect the rights of workers started to gain its momentum and unionization in the garment industry also took place.

The symbolic event that helped to consolidate and improve the labor standards in Cambodia was the US-Cambodia Textile Agreement (UCTA). This UCTA was signed on January 20, 1999; the first bilateral U.S. trade agreement to include a labor standards provision to link increased market access to systematically and publicly monitor increasing compliance with labor standards in Cambodia (Wells, 2006). The bottom line of this

[37] The number employed in the garment sector dropped from some 320,000 280,000 during 2008-2009 due to the abrupt decline in exports to the US market, as a result of the Lehman shock.

agreement is, in exchange of substantial improvements in labor standards in the garment sector in Cambodia, the U.S. government provides an increased export quota of Cambodian-made garment products into the U.S. market.

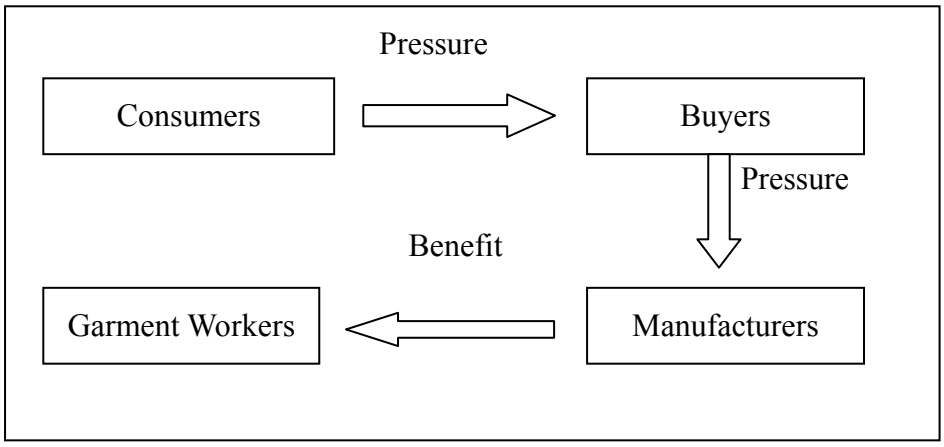
This agreement, however, also originated in response to international publicity, especially to mass media revelations of child labor that discouraged sourcing by image-sensitive international buyers. For instance, in 1998 NIKE-contracted supply factory in Cambodia was exposed by the media on the use of child labor in their production process. To mitigate the corporate reputation, in 1999 NIKE was forced to withdraw from the country. However, after UCTA took effect and ILO took on the role of monitoring body of the labor monitoring program, the government and contractors promised better labor compliance. After this event, NIKE returned to Cambodia and so did other image-sensitive international buyers. As a result, Cambodia was able to increase its export quota to the U.S. market by 9% in 2000, 2001, 12% in 2002, 14% in 2003, and 18% in 2004 (Wells, 2006). Total garment exports to the U.S. market also increased steadily from 512 million USD in 1999 to 1.5 billion USD in 2005, a three-fold increase in 6 years. In 2008, garment exports to the U.S. recorded about 2 billion USD, while Cambodia's total garment exports reached 3 billion USD in the same year.

5.4.2.2 Why are Labor Standards Important for Cambodian Garment Industry?

The essence of UCTA signed in 1999 was to link increased export of Cambodian-made garment products to the U.S. market and substantial improvement of labor standard in the garment industry. At first glance, the need to improve labor standards seems to only increase the cost of production and be considered as a burden for manufacturer. However, as the project began, it turned out that it benefited all the involved parties: garment workers, garment manufacturers, and U.S. buyers. This is because after the revelation of child labor by the media, consumers started to be more conscious about the products they purchased by valuing the labor standards and human rights. This situation left the international buyers no choice but

to adhere to the labor standard at the contracted factories where they purchased the garment products. Figure 5.17 illustrates the relationship among U.S. (or other western) consumers, buyers, manufacturers, and workers.

Figure 5.17: Relationship Among Workers, Manufacturers, Buyers, and Consumers



Source: Author

Meanwhile, Cambodian garment manufacturers whose sales primarily go to the U.S. market also had no choice but to oblige this labor standard. Prior to the UCTA, there were growing concerns about the violations of Cambodian labor law and international labor standards, including debt bondage, illegally excessive and forced overtime, wage infractions, repression of union organizing and worker dissent, poor occupational health and safety conditions, among many others (Wells, 2006). The situation was exacerbated in 1997 after the Asian Financial Crisis.

As the UCTA took effect and later at the request of U.S. and Cambodian governments, and Cambodia's labor unions and garment manufacturers' association, the ILO agreed to monitor the implementation of the labor standards. In 2001, the ILO project was established to make and maintain these improvements. In the agreement, Cambodia is obliged to ILO core standards including child labor, forced labor, workplace discrimination, freedom of

association and collective bargaining, together with Cambodia's national labor code. Cambodia's labor code includes: 1) 45 USD minimum wage, plus a 5 USD monthly bonus for turning up every day (this minimum wage was increased to 61 USD in October 2010)[38]; 2) 48 hours work per week and 6 working days with not more than two hours overtime per day; 3) an overtime rate of 150% for regular overtime and 200% for working Sundays, public holidays and night works; 4) 18 days leave a year and 25 public holidays, plus 7 days' special leave may be taken for family reasons; 5) 90-day unpaid maternity leave (half pay for workers of more than 12-month service); unpaid sick leave (The Ministry of Commerce recommends paid sick leave which some factories follow); 6) compensation for work-related accident and injuries.[39]

In summary, pressure from U.S. and other Western consumers on the practice of labor standards has forced buyers to be stricter on their contracted factories in developing countries, including Cambodia. Particularly, under the UCTA scheme, substantial improvement in labor standards in Cambodia has resulted in increased export quota to U.S. market, prompting this garment sector to become the growth engine of the country. In addition, although improved labor standards was the cause of price increases, it was also found contributing to a range of positive outcomes including higher productivity and quality of workers, lower rates of accidents, turnover, and absenteeism.

5.4.2.3 How Does the ILO Monitoring System Work?

At the request of U.S. and Cambodian governments, labor unions and garments' manufacturers' association, ILO agreed to act as the monitoring body of labor standards in the garment sector in Cambodia. This ILO monitoring program is managed and run by Better Factories Cambodia (BFC), formerly known as ILO Garment Sector Project. Better Factories

[38] This new minimum wage was agreed by the Cambodian Labor Advisory Committee on July 8, 2010. It was set to be effective from October 1, 2010 and would be reviewed in 2014.
[39] Better Factories Cambodia, 2005. *Facts and Figures*.

Cambodia is guided by a tripartite committee, with equal representation from the Royal Government of Cambodia, the Garment Manufacturers' Association in Cambodia (GMAC), and the Cambodian union federations. Monitors of BFC are trained in Cambodian labor law and international labor standards, interviewing techniques, among other necessary skills. In principle, the visits by the monitors to the factories are conducted on an unannounced basis. And each monitoring visit to the factories includes meeting with the management, unaccompanied walk-through, observation, collection of documents such as payrolls, contracts and leave records, and interviews with individual workers and union representatives.[40]

The request for The ILO monitoring project is officially based on two formal agreements: The U.S-Cambodia Trade Agreement (UCTA) and an agreement between ILO, the Cambodian government and GMAC to launch the monitoring initiative, signed on May 4, 2000 (Polaski, 2006). As a rule, there is no legal binding for factories to register and accept the ILO monitoring. However, since only ILO-registered garment factories are eligible for the application of export quotas to the U.S. markets, all of the factories operating in Cambodia feel compelled to register with BFC in order to obtain the status for the quota bidding. This registration also signifies the factory's commitment to improving labor standards, which provides ILO monitors with full access to the factories premises at all times. As for the image-sensitive international buyers, with pressure from their conscience consumers at home, they are forced to contract their purchase only with IL0-certified factories. And in reality, from 1999 through 2002, apparel exports from Cambodia to the US that were covered by the quotas increased by 44.8%, from a value of 443 million USD in 1999 to 627 million USD in 2002. Over the same period, exports of garments that were not covered by quotas increased by 302%, albeit from a smaller base of 83 million USD in 1999 to 334 million USD in 2002. Export of garment products to the U.S. on non-quota scheme in 1999 was only 19% of total

[40] Better Factories Cambodia Homepage. Accessed Oct. 30, 2010. http://www.betterfactories.org/ILO/monitoring.aspx?z=5&c=1

garment exports, while in 2002 they increased to 53%. This pattern of increase of non-quota exports reaffirmed the buyers' emphasis on the improvement of labor standards in producing countries (ibid. p.7). Together with UCTA, export quotas to the U.S. expired in the end of 2004. After the end of this quota, garment exports to the U.S. increased steadily, from 1,564 million USD in 2005 to 1,968 million USD in 2008.

Regarding the source of fund for BFC, at present besides the involved parties, the project also receives financial assistance from international development agencies, including Agence Francaise de Developpement (AFD), the Dutch Government, New Zealand's International Aid and Development Agency (NZAID), and the World Bank. As the international buyers value the labor standards as the condition for their purchase, sustaining the project is a crucial factor for the survival of Cambodia's garment industry. However, financial assistance from international aid agencies is scheduled to end in 2012. As a consequence, the source of finance has to be explored especially among the involved parties.

5.4.2.4 Impact on Governance Structure

The 1997 Labor Code in Cambodia was largely based on the advice from the ILO, providing a framework for the development of a free-market economy. This code only covers the private economy (private business and the industrial sector) but not the civil service and the informal sector (Sibbel and Borrmann, 2007). The court system in Cambodia is also widely perceived as unreliable and corrupt. The main problems in this respect are believed to be the overall weak institutional structure of the government as a whole. In general, the public servants including Labor Inspectorate are underpaid and under-trained. The average salary of civil servant is 51.5 USD in 2006, in comparison with worker in the garment sector at around 65 to 70 USD.

The monitoring and capacity building of ILO, which was originally designed only for the garment sector, certainly had a positive spillover effect on the development of institutional

frameworks for other sectors. For example, within the same framework of ILO it had brought about a structural change of dispute resolution, the Arbitration Council (AC), to deal with labor disputes. The transparent and independent functions of AC proved a great success and the exception in the weak and corrupt court system of Cambodia. Various stakeholders have considered it as a role model for the judicial reforms for the country. Detail of the AC is introduced in the following section in details.

5.4.3 FDI and Labor Arbitration Council

As the FDI inflows increased, especially to the garment sector into Cambodia, so did the number of strikes and industrial disputation. And given the ineffective and unreliable court system in the country, a transparent and equitable alternative dispute resolution mechanism was needed. To cope with those needs, the Arbitration Council (AC) was established in 2003 with assistance from ILO-Labor Dispute Resolution Project (LDRP) to resolve labor disputes through conciliation and arbitration mechanism, under the 1997 labor law of Cambodia. IL0-DRP continued to provide financial and technical support to the AC until 2009. From 2009, the World Bank began to finance the AC through its Demand for Good Governance (DFGG) Project, which lasts for a four-year period until the end of March 2013.

This AC is not a court, but it is endowed with legal decision-making authority with regards to labor dispute cases. Awards by the council can be either binding or non-binding, depending on the pre-agreement of the disputed parties. The Arbitration Council was launched in 2003 as an alternative dispute resolution mechanism to promote effective industrial relationships by providing a forum for workers and employers to seek fair and equitable resolutions to labor disputes. At the launch of the Arbitration Council, the then-minister of labor (Mr. Ith Samheng) declared:

"*The Arbitration Council is this country's first modern arbitral institution [and it] will open a new chapter in Cambodia's industrial relations history. With the opening of the Arbitration Council we are witnessing the debut of a new dispute settlement framework which will assist workers and employers in building harmonious workplace relations by providing for the efficient, independent, and expert adjudication of labor disputes.*"[41]

5.4.3.1 Role and Overview of Labor Arbitration Council

The Cambodian Arbitration Council was founded with assistance from ILO to hear all collective labor disputes of rights and interest. Collective dispute refers to dispute that involves one or more employers and a number of their staff. And in order to be classified as a collective dispute, it has to be related to:

1) Working conditions;
2) The recognition of rights of professional organization within the enterprise;
3) Relations between employers and workers; and
4) The dispute must have the potential to jeopardize the effective operation of the enterprise or the social peacefulness. [42]

Regarding the mechanism to resolve collective disputes, disputes are first presented to the Labor Inspector for conciliation (mediation) by the Ministry of Labor, which must review the case within 48 hours of submission. If the case cannot be resolved within 15 days, the Ministry refers it to the AC within 15 days. At the AC, the referred case is heard by a panel of three arbitrators, one chosen by the union, one chosen by the employer, and the chair chosen by the two disputed parties. First, the three arbitrators discuss the case and try to help the parties to resolve their dispute by agreement in an informal voluntary conciliation or

[41] The Arbitration Council Homepage. Accessed Nov. 9, 2010. http://www.arbitrationcouncil.org/Aboutus/TheArbitrationCouncil/HistoryoftheCouncil/tabid/227/language/en-US/Default.aspx

[42] Labor law (1997), Article 302.

mediation. If no settlement can be reached, then the Arbitration Panel proceeds to formal mandatory arbitration, which requires the parties to provide additional evidence to support their case.

Table 5.16: Maximum Time Limits for the Resolution

Process	Interim Steps	Total
Conciliation	Collective dispute reported to labor inspector (Art. 303) *48 hours* Minister appoints conciliator (Art. 304) *15 days*	19 days
	Referral to Arbitration Council	3days
Arbitration	Appointment of Arbitration Panel (Art. 310) *3 days* Arbitration Panel meets (Art. 310) Decision by Arbitration Panel (Art. 313) *Immediate*	15 days
Opposition	Parties have opportunity to lodge opposition	8 days
		45 days

Source: The Arbitration Council[43]

Generally, the Arbitral Award[44] is issued within 15 working days from the date the AC receives the case. All awards are non-binding unless the parties agree otherwise. If the parties agree to a binding award, it is then considered as the final court judgment. If both parties do not agree to a binding Arbitral Award, this signifies that the decision of the AC is not

[43] The Arbitration Council Homepage. Accessed Nov. 10, 2010. http://www.arbitrationcouncil.org/InformationforParties/OverviewoftheArbitrationHearingProcess/tabid/64/language/en-US/Default.aspx

[44] Arbitral Award is the official name for the written decision of the Arbitration Council.

immediately enforceable. Instead, either of the parties can file an opposition to the award within eight calendar days from the date of issuance. If either party files an opposition within the 8-day limit, then the award will not be enforceable. Table 5.16 summarizes the process and mechanism of disputes resolution by the AC.

5.4.3.2 Impact of Labor Arbitration Council on Governance

The Arbitration Council, which was established and designated to deal with collective labor disputes in Cambodia, has positively contributed to the industrial relationship between employers and employees, specifically in the garment sector. According to Zack (2009), approximately 80% of the cases received by the AC come from the garment industry, while a small portion comes from hotel industry. Out of which, about 70% of the cases have been resolved successfully by the council for the disputants. Firm managers also reported a 96% decrease in disputes over the previous five years as well as a 97% decrease in time loss due to disputes (ILO and WB, 2006), suggesting a significant improvement in the industrial relationship in comparison with the situation in the late 1990s.

One of the main factors contributing to this success can be the training given to workers (labor unions) and foreign employers (mainly Chinese). For the workers' side, lack or insufficient knowledge of domestic labor law and distrust to the employers' side had long been the main cause of the problems, adding to the fact that some labor unions were politically motivated. To mitigate the problems, the training provided by the AC includes domestic labor law and mechanisms to resolve problems through peaceful means, providing workers with better understandings of and more confidence to the employers' side. At the same time, training about Cambodian culture/traditions and domestic labor law were also provided to the employers' side. With better understandings of Cambodian culture, foreign employers gradually learn how to work and get along with Cambodian workers, suggesting an improved industrial relationship between both parties.

The existence of the AC can be considered as a positive exception for the judicial system in Cambodia. As the court is generally perceived as corrupt and unreliable, the AC serves as an important and only transparent and relatively reliable mechanism for dispute resolution in the country at the moment. The success of this labor arbitration council is also expected to have very important implications for the commercial arbitration council, which is set to be launched in the near future.

5.4.4 Concluding Remarks

The presence of foreign direct investments in general does not only contribute to economic development, but also to the improvement in governance quality. For example, in the government-private sector forum, where the private sector can directly and publicly communicate with the government, FDI firms play a key role in addressing its concerns primarily on governance issues related with their business operation. Sector-wise, FDI in garment sector also contributes largely to the improvement of governance, especially through its improved labor standard compliance. At first glance, this improvement of labor standard seems to be a burden for manufacturers as it adds more cost in the production process. However, as image-sensitive international buyers, with pressures from their conscience consumers at home, value the labor standards in producing countries. And compliant garment manufacturers are eligible for the export quota to their respective markets, primarily the U.S. and European markets. In addition, the improvement of labor standards itself also positively affects the relationship between the manufacturers and labor unions. Productivity of workers also increased as a result of improvement in working conditions and environment. At the same time, the presence of FDI, which led to the establishment of ILO, also positively contributes to the structural change of other sectors, including the Arbitration Council.

5.5 Conclusion

After decades of civil war, Cambodia was finally able to launch a general election under the supervision of the United Nations in 1993. The long-awaited peace and stability started to be realized with an open economic policy based on attracting foreign investments to perform as the growth engine. From the mid-1990s, FDI firms started to come to Cambodia to take advantage of its generous tax policy and abundant cheap labor. Many of them concentrate in the garment sector.

The presence of FDI firms does not only create economic benefits such as employment for Cambodia, but it also brings about positive change in the institution or governance for the country. The presence of FDI does not automatically lead to the improvement of governance quality. In fact, it would be more precise to say that it is the problems or difficulties faced by the FDI firms that lead to the improvement of governance. For example, it was due to the difficulties encountered by the firms that led to the establishment of G-PSF in 1999 to provide a formal and crucial platform, where the private sector can effectively address its concerns to the government regarding business operations in this sector. In the past, those issues were, in principle, discussed and dealt with behind closed doors with little *transparency*. Although there is room for improvement, the role of FDIs in governance in Cambodia especially for *regulatory quality* through G-PSF can be considered significant.

The impact of FDI in garment sector on governance improvement in Cambodia was also huge. Under the UCTA scheme, a substantial improvement in labor standards was the condition for the increased quota export of garment products to the U.S. market. Under this scheme and through training by the ILO-Labor Dispute Resolution Project (ILO-LDRP), there was a significant improvement in working conditions of workers and industrial relationship in the labor market. Needless to say, the AC also played a crucial part in dispute resolution when it could not be solved internally between the disputed parties. Given the ineffective and corrupt judicial system at the presence, the AC is widely perceived as the most

and only reliable and transparent dispute resolution body in Cambodia. The success of this AC is believed to have significant implications for the country's judicial reform in the future.

Chapter 6: Conclusion

6.1 Purpose and Issues

This dissertation tries to investigate the relationship among governance, FDI inflow and economic performance. A case study on Cambodia is introduced to see the impacts of FDI on governance structure, and aim to explain the bi-directional relationship between the two. To achieve this aim, this dissertation reviews the concept of governance and FDI in details before conducting the analysis on their relationship with economic performance. The concept of governance is gaining popularity in the development community and is considered to have huge impacts on economic development. However, despite its increasing popularity, its definition and usage remain vague. Different international organizations such as the World Bank, IMF, UNDP, ADB, define governance differently, depending on their interests and agendas. Also, the qualitative nature of governance makes it difficult to carry out quantitative analysis, raising an issue of applicability of findings in one country to other countries. The relationship among governance, FDI inflow and economic performance is analyzed by using two-stage least square regression model, in a way trying to capture the marginal effects of governance on economic growth. In this analysis, the sampling countries are classified into three different income groups: low-income, middle-income, and high-income.

On the other hand, numerous studies also suggest the positive impacts of FDI on economic development of recipient countries through its job creation effects, spillover effects, among others. In principle, FDI inflows tend to originate from more developed countries to less developed ones, taking advantage of its superiority in technology and management skill. Countries with better governance tend to attract more FDI than countries with a lower level of governance quality. This dissertation, using Cambodia as a case study, tries to prove that the presence of FDI can also positively affect the governance structure of a country in return, by executing pressure on the government for improvement.

6.2 Key Findings

6.2.1 Governance and Economic Performance

Despite the heightened awareness of the importance of governance, its definition and usage are still vague. Different institutions define governance differently depending on their interests and agendas. The World Bank and the Asian Development Bank define governance as the management of a country's social and economic resources for development. As its main mission is more related with economic issues, the International Monetary Fund's definition of governance is closely related with *economic liberalization*. The United Nations Development Programme includes human aspects such as *participation*, *equity*, *consensus orientation* in governance, as its main mission is human development. Other organizations define governance in a very narrow sense. For example, Transparency International's definition of governance is closely related to *corruption*, while Freedom House emphasizes on *civil liberties* and *political rights*.

Due to its qualitative nature of governance, it is hard to quantify its impacts on other factors of the economy. In addition to the conceptual definition, the operational definition of governance has been created to measure the quality of governance. An operational definition of governance serves as the principle for making governance indicators. In making governance indicators, one needs to comprehend the two core aspects of governance: actual governance and perceived governance. While actual governance refers to the *de jure* rules on the books, perceived governance refers to the *de facto* realities on the ground. Both actual and perceived governance indicators have its strength and weakness. The strength of actual governance indicators includes its transparency of criteria/conditions in the construction of the data, but with a striking weakness, as it does not sometimes reflect the reality. Perceived governance indicators are presently thought to be the best choice, as they reflect the perception of the people and represent the real situation.

A number of governance indicators have been so far established to measure the quality of

governance. Since they reflect the experts' perception, they tend to capture more perceived aspects than actual ones. Among them, the World Bank governance indicator (so called KKZ indicators) is the most composite one, using more than 30 different data sources. Despite the wide coverage of more than 200 countries, the lack of historical data makes KKZ indicators unsuitable for time-series analysis. ICRG governance indicator with the annual data starting from 1984 covering more than 130 countries is now considered the most suitable composite governance indicators for time-series analysis, its only disadvantage being its small coverage of low-income countries. Both ICRG and KKZ governance indicators have six elements: 1) *voice and accountability:* measuring political, civil, and human rights; 2) *political stability*: measuring likelihood of unlawful change in government, including coup d'état or terrorism; 3) *government effectiveness*: measuring the competence of the bureaucracy and quality of public service delivery; 4) *regulatory quality*: measuring the incidence of market-friendliness; 5) *rule of law*: measuring the quality of contract enforcement, the police, and the courts; 6) *control of corruption*: measuring the exercise of public power for private gain.

Given the ICRG indicator's insufficient coverage of low-income countries, the CPIA indicators are used. CPIA indicators were initiated by the World Bank in the 1970s to assess the institutional quality of IDA countries; it is also used as one of the important criteria for providing loans and grants to those countries. CPIA indicator has 16 elements, classified into 4 clusters: *economic management, structural policies, policies for social inclusion/equity, and public sector management and institutions*. Both ICRG and CPIA indicator were later used in the analysis to examine the impact of governance on FDI inflow and economic growth.

Economic governance is considered as a subset of governance related with economic affairs and good economic governance is synonym to sound economic management. Economic governance alone does not always bring desired outcomes, as it is interrelated with other aspects such as culture, social, and politics. However, economic governance is regarded as providing a major impact on economic outcomes in comparison with other aspects. For

example, *regulatory quality*, which measures the market friendliness, is a very important criterion for investors for their investment decision. *Government effectiveness* and *accountability* reflects the government's ability and responsibility for their actions. Without *accountability* and *transparency*, government officials could be prone to favor a certain interest group, which could lead to corruption. *Rule of law* and *control of corruption* are also key elements of governance, which reflect the government's commitment to adhere to the law and is crucial in shaping investors' confidence.

6.2.2 FDI and Economic Performance

As the world economy is getting more globalized, the role of FDI and its impact on the recipient countries is considered greater than ever before. In principle, there are two reasons for this shift in paradigm. First, the recipient countries, which have a shortage of capital and technology at home, are compelled to attract FDI from abroad to help vitalize the domestic economy. The competition of FDI attraction by developing countries has been fierce in the last decade. Various investment incentives are provided to FDI firms in the hope of job creation, technology transfer, and management know-how in the future. However, the excessive investment incentives by recipient countries are also criticized for encouraging a *race to the bottom* and for lowering the bargaining power of a sovereign state to international firms.

Second, the motivation of FDI firms to seek higher returns abroad also contributes to this shift of production base. As also mentioned in Narula and Dunning (2000), the motives of FDI firms to invest abroad include: *natural resource-seeking, market-seeking, efficiency-seeking, and strategy asset-seeking*. Natural resource-seeking FDI tends to go to less developed countries where natural resources are abundant, while market-seeking FDI tends to move to emerging economies where the market size is sufficiently big. Efficiency-seeking FDI often seek to raise cost efficiency by rationalizing their operations,

including the shift of production base to lower cost countries and exploitation of the economies of scale or scope abroad. Strategic asset-seeking FDI is set to augment their assets by obtaining strategic assets abroad such as cutting-edge technology or knowledge that are not available at home.

The impact of FDI on economic development is, in principle, different depending on the stage of development of the recipient country. This is also closely related with the motives of FDI firms to invest abroad. For example, for least developed or low-income countries, as FDI tends to concentrate on natural resources or low-skilled manufacturing, the impact on the economy is considered limited to government revenue (from natural resource) and employment generation (from manufacturing). Middle-income countries, with investment from FDI firms of relatively high technology, are encouraged to change the industrial structure from labor-intensive to a more technology-intensive manufacturing method. For developed countries, in general, the amount of outward FDI exceeds inward FDI. FDI firms to developed countries, in the case of originating for middle-income countries, mainly aim to access the existing large markets and to obtain technology, know-how in order to increase competitiveness at home. However, if FDI firms originate from countries at a similar stage of development their objectives tend to be the efficiency seeking and strategic asset seeking.

Both governance and FDI inflow have been proved by many studies to have a positive impact on economic growth/development in general. However, as countries of different stages of development tend to have different levels of governance quality its impact on economic growth is also considered different. Below are the findings on the impact of governance on FDI and economic growth of countries of different income groups: low-income, middle-income, and high-income. For analysis purpose, CPIA indicator is used as proxy of governance indicator for low-income countries and KKZ indicator is used as proxy for governance indicator for middle-income and high-income countries. Two-stage least square method was employed in the regression, where per capita GDP growth rate, total investment

ratio to GDP, and FDI ratio to GDP are taken as dependent variables, respectively. Furthermore, in order to capture the marginal impact of governance on the above dependent variables in each income group, the country samples are classified by income group. Below are the key analytical regression results.

6.2.3 Governance, FDI Inflow, and Economic Growth in Low-Income Countries

The regression result in low-income countries suggests that the quality of governance is not significantly correlated either with FDI inflow and per capita GDP growth. However, governance is found to have a positive relationship with total investment, which is the summation of domestic investment and foreign direct investment. This result implies that governance factors play a limited role in promoting growth performance, and domestic investment is likely to be more sensitive than foreign investment to governance structure. This is also supported by the fact that in low income economies, domestic investors tend to invest in their own country, while FDI investors have more choices and tend to invest in countries where basic economic conditions are in place, many of which are middle income countries.

On the other hand, the limited impact of governance on growth performance in low-income countries can also be explained by the limited resources (both human and physical resources) embedded or accumulated in this income group. The quality of governance is considered as the effectiveness of management of resources. As resources in low income countries are still at a low level, their impact on growth can also be considered limited. However, this is not to say that the quality of governance is not important for growth. As the country gets more developed with more resources, the importance and impact of governance on growth will increase.

6.2.4 Governance, FDI Inflow, and Economic Growth in Middle-Income Countries

In middle-income countries, most of the governance indicators have a positive correlation

with per capita GDP growth. For example, in the 1986-1993 period analysis, the impact of *political stability* and *regulatory quality* on per capita growth reveal a coefficient of 0.85 (t=3.16) and 1.27 (t=4.44), respectively. In the 1994-2003 analysis, the impact of *political stability*, *regulatory quality*, and *rule of law* on per capita growth show the coefficient of 0.33 (t=1.89), 0.54 (t=2.49), and 0.73 (t=2.83), respectively. This result implies that the political stability and market-friendly policies are important for growth performance, as empirically evidenced in many countries especially in transition economies.

Regarding the relationship between governance and FDI inflow, only *regulatory quality* is found to be positive and significant in both periods (1986-1993: coef=0.631, t=1.92; 1994-2003: coef=0.520, t=1.78). This result also supports many studies indicating that a market-friendly environment is the most important element in attracting FDI inflow. This is also partly because middle-income countries possess the minimum sufficient economic conditions such as basic infrastructure, and human resources. A further implication is that FDI inflow ratio is generally more sensitive than domestic investment to governance indicators, despite the difference in degree among them.

6.2.5 Governance, FDI Inflow, and Economic Growth in High-Income Countries

In high-income economies, governance shows positive correlation with per capita growth in the analyses in both periods (1986-1993 and 194-2003), despite the difference in significance levels. In the first period, although positive, *voice and accountability*, *political stability*, and *rule of law* are not statistically significant. This suggests that the above variables do not seem to play a crucial role in growth performance. However, *government effectiveness*, *regulatory quality*, and *control of corruption* are more significant with coefficient of 0.65 (t=2.01), and 0.88 (t=2.74), 0.57 (t=1.70), respectively. Among them, it should also be noted that regulatory quality, which measures the incidence of market-friendly policies, is likely to play the most important role in explaining the gaps in growth performance. In other words,

countries pursuing a higher level of market-friendly approaches tend to achieve higher growth.

In the second period (1994-2003) analysis, *voice and accountability* (coef=0.90, t=2.19), *political stability* (coef=0.75, t=2.15), *effectiveness of government* (coef=1.99, t=1.96), and *rule of law* (coef=2.47, t=2.27) show positive and statistically significant results, while *regulatory quality* and *control of corruption* are insignificant. The reason why regulatory quality and control of corruption show little influence on growth rate is probably due to the existing high level of market-friendly policies and relatively low level of corruption across countries in this high income group.

Regarding the impact of governance on FDI inflow, only *rule of law* is positive and statistically significant (coef.=0.77, t=2.39) in the first period. In the second period, no significant correlation is found for all the governance variables. This result suggests that governance factors do not play a decisive role in promoting FDI inflow in high-income countries. This is probably because FDI firms coming to invest in high-income nations are generally strong and independent from the influence of the host economies' governance structure.

In conclusion, we can say that governance does not have a clear positive relationship with growth performance in low-income economies. Sound development governance is essentially a good management of accumulation and efficient allocation of the accumulated productive resources. Once the country starts to develop with accumulation of those productive factors, governance factor will become an essential element to promote growth.

6.3 Impact of FDI on Governance Structure in Cambodia

Due to the civil war that lasted for almost three decades, Cambodia's economic foundation has been seriously damaged. The transition toward market economy in 1989, which later led to the establishment of a FDI-friendly law on investment in 1994, prompted Cambodia to

successfully attract FDI into the country. The presence of FDI does not only create economic benefits to the country such as employment or technology spillover, but also brings about institutional change into the country.

Despite the difference in level, governance is, in general, considered to have a positive impact on economic growth. In addition to that, this study found that in Cambodia, the presence of FDI also positively affects the governance structure in the country in return. The impact of FDI on governance can be witnessed in the following channels.

6.3.1 FDI and Government-Private Sector Forum

The establishment of *Government-Private Sector Forum* (G-PSF) in 1999 provided a formal and crucial platform for private investors to effectively address their concerns related with their business operation and directly request for the government to intervene. In the past, those issues were, in principle, discussed behind closed doors with little *transparency*. The requests raised by the private sectors at the forum were primarily the outstanding issues whose solution could not be found at the preliminary and internal consultation in the Working Group WG) with the responsible Ministries. For example, the issues raised at 2006 G-PSF includes: 1) modification, issue or refine the existing *law*; 2) modification, issue or refine *regulation*; 3) dedication of political will, resources to the *enforcement* of existing laws, regulations and institution operating guidelines; 4) change of scope or the establishment of a new government agency or *institution* to deal with the private sector's need; 5) development of existing or new *infrastructure*; and 6) *clarification* and interpretation of existing administrative and legal procedures.

The G-PSF is considered to have had a significant impact on the Cambodian governance structure. Before its establishment, there was no formal channel for the private sectors to directly address their concerns or difficulties to the government in a transparency manner. To satisfy the need, the G-PSF mechanism acts as a foundation for the government to understand

needs and build trust with the private sectors in order to improve the quality of governance and push reforms forwards.

6.3.2 Promotion of Labor Standards in Garment Sector

The garment sector has been playing a very crucial role for Cambodian economy. Its total export reached almost 3 billion USD in 2008, accounting for approximately 70 per cent of the country's total exports. This sector also creates employment for about 280,000 people in 2009, down from its peak of 335,000 people in 2007 due to the global financial crisis. As most of the workers are young women from rural villages, this sector is considered to have a significant impact on the poverty reduction both directly and indirectly through remittances sent to the families in the rural sector.

However, the presence of FDI in the garment sector does not only contribute to the job creation and poverty reduction, but also to the improvement in core labor standard (child labor, forced labor, workplace discrimination, freedom of association and collective bargaining) and modernization of labor market itself. Before the presence of FDI, despite the existence domestic labor code, the implementation was weak and in principle ineffective. This is fundamentally a result of the U.S.-Cambodia Textile Agreement, which was signed in 1999 linking the improvement of labor standards to increased export quota to the U.S. market. To ensure the quality and independence of the monitoring system, ILO was requested and accepted to act as the monitoring body through the establishment of its Better Factories Project (BFP). The success of ILO-BFP which was originally designed for garment sector, also led to the establishment of Arbitration Council to deal with labor disputes across sectors.

6.3.3 Arbitration Council

The Arbitration Council was created with assistance from ILO-Labor Dispute Resolution Project (ILO-LDRP) in 2003 to deal with collective disputes between employers and

employees, primarily in the garment sector. A dispute is, in principle, dealt with through an informal conciliation and if agreement cannot be reached, it will then be forwarded to a mandatory arbitration. At the conciliation stage, it takes only maximum 19 days to find agreement between the disputed parties. However, if the case is sent to the arbitration council, an arbitration panel will be formed with representative arbitrator from each disputed party and one arbitrator from the government, which is approved by both parties to act as chair arbitrator.

The Arbitration Council is considered a very successful case in promoting the industrial relationship between the employers and employees in Cambodia. And given the ineffective and unreliable court system in the country at present, the success of the Arbitration Council is believed to have a significant implication on the country's judicial reform in the future.

6.4 Policy Implication

6.4.1 FDI, Governance, and Economic Performance

The concept of governance is vague and perceived differently among stakeholders depending on their interests and agenda. In general, countries with better governance tend to attract more FDI inflows and promote higher economic growth than countries with a lower level of governance. However, the impact of governance differs depending on each of its elements and on income groups. For example, in middle-income countries, regulatory quality, which measures the market-friendliness policy, seems to have a more significant impact on economic growth than other elements of governance. Therefore, in order to effectively formulate and execute an economic policy, it is necessary that the policy makers properly understand the features of each element of governance. In other words, a lack of proper understanding of the nature of each element of governance may lead to confusion and a reduction in the intended effect of the policy.

6.4.2 Short-term and Long-term Effect of Governance on Economic Performance

The impact of governance on economic performance can be divided into short-term, and middle- and long-term effects. Governance of short-term, in which many of the elements are economic governance, refers to the policy stance of government such as inflation management policy, trade policy, and fiscal deficit management policy. The impact of these elements of governance on growth is, in general, reflected in a few years.

However, the impact of other governance indicators such as voice and accountability, political stability, government effectiveness, rule of law, and control of corruption, tend to take effect in the middle- and long-term. This is because these issues are structurally embedded into the society and cannot be changed in the short-run. Therefore, in order to to effect the smooth implementation of the policy, it is crucial for policy makers to properly understand the time frame of the effect of governance when executing a policy.

6.4.3 Governance in Cambodia

The presence of FDI is considered not only to contribute to economic development in Cambodia through its effect on job creation, transfer of management know-how, tax revenue among others, but also to the improvement of governance quality for the country. For example, the inflow of FDI in the garment sector has led to the establishment of labor unions, labor arbitration council, and improvement of labor standards. The establishment of the Government-Private Sector Forum in 1999 to provide a formal platform for the business sector to address their concerns to the government was also a result of FDI inflows into the countries. The above reasons provide more grounds for policy makers to justify the attraction of FDI into the country.

However, the inflow of FDI does not automatically lead to the improvement of governance. Rather, it is the difficulties or problems faced by the FDI firms that lead to the improvement of governance. In low-income countries like Cambodia where FDI play a key

role in the economic development, it is important that the policy makers are well aware of the impact of FDI on governance and therefore create a mechanism to maximize that impact in order to achieve sustainable economic growth.

6.5 Future Research

This dissertation contributes to the discussions on the relationship among governance, FDI inflow, and economic growth. However, as governance is rather a new and vague concept in development economics, the following areas are suggested for further research:

1) *Inter-Income-Group Analysis:* The quantitative analysis method employed in this dissertation is a two-stage least square with classification samples countries into income group. Despite its strength in capturing marginal impact in each income group, the issue of inter-income group impact still remains. As such, in order to investigate the impact of governance on FDI inflow and economic growth across income group, inter-income group analysis is suggested;
2) *Causality Effect:* This dissertation focuses only on the correlation between governance, FDI inflow, and economic growth. However, in order to see which factor has more influence on the other, a causality test is needed. This could further clarify the relationship between governance and FDI inflow, either one-directional or bi-directional;
3) *Application for other Economic Indicators:* This dissertation mainly focuses on the impact of governance on FDI inflow and economic growth. However, this method can also be applied to other key economic variables such as domestic investment.
4) *Impact of FDI on Governance in other Countries:* As FDI inflow is generally determined by economic factors, rather than general governance factors, a case study is suggested in order to understand the whole picture on the impact of FDI on governance in a certain country. Due to time constraints, this dissertation has focused only on the

case of Cambodia. However, as FDI is increasingly becoming a crucial actor in promoting economic growth especially in developing countries, its influence on the governance structure of in other countries is worth studying in-depth.

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