THE ROLE OF INSTITUTIONAL QUALITY IN FOREIGN DIRECT INVESTMENT INFLOWS IN NIGERIA

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ABSTRACT

The study examined the role of institutional quality in foreign direct investment inflows in Nigeria over the period 1996 to 2024. The specific objectives of the study were to find out whether control of corruption (COC), government effectiveness (GOE), political stability (PST), regulatory quality (REQ), and rule of law (ROL) significantly affect foreign direct investment (FDI) in Nigeria. To this end, the fully modified least square (FMOLS) econometric analysis was utilized in the analysis of data. The results obtained revealed that control of corruption (COC) and regulatory quality (REQ) are significantly and positively related to FDI; political stability (PST) and rule of law (ROL) had significant inverse effect on FDI; while regulatory quality (REQ) had a weak inverse relationship with FDI inflow. Based on these outcome, the study concluded that, in the determination of FDI inflow in Nigeria, regulatory quality factors such as control of corruption, regulatory quality, political stability (PST) and rule of law are potent drivers that should be seriously handled by the government and relevant policy makers in the country. The study recommends among others that, the Nigerian government should prioritize regulatory quality by improving the clarity, consistency, and fairness of regulations to reduce uncertainty and costs for foreign investors. This steps will constantly make the domestic economy to be more attractive to foreign investors, ultimately increase FDI inflows.

Keyword: Institutional Quality, Rule of Law, Control of Corruption, Regulatory Quality, FDI

Introduction

Institutional quality is a broad concept that captures law, individual rights and high quality government regulations and law courts that direct the behavior of organization (Scott, 1995). In other words, institutions are the rule that structure economic, legal, political and social interactions and transactions such as laws, regulations and codes of conduct, as well as the mechanism that enforce these rules (North, 1991; World Bank, 2002). Institutions determine the costs and risks of transacting in an economy and therefore the level of productive and economic activities (Alfaro,Areedam Sebnem & Selin, 2018). The most explicit formal institutions are the formal rules and regulations such as the constitution of a country, the extant laws relating to the rule of law and enforcement of contracts, political, and economic equality, right to acquire legitimate property, pecuniary rights and other related property rights (Avellaneda, 2006; Bonnie, Quan & Meenakshi, 2012).   The reason being that good quality institutions significantly enhance foreign capital inflow to the domestic economy; while deficiency in institutional arrangement such as rule of law, corruption control, financial market regulation, political stability, government effectiveness and informal codes of conduct can negatively affect investment inflows (Soh, 2021; Azzimonti, 2019). Institutional quality is very attractive to foreign investor because it decreases transaction costs and make doing business easy in host countries (Cimarron, Moline, & Tamarit, 2021; Donghua, Chen, Xin & Zhou, 2019). Foreign, Investors are unwilling to invest in countries where institutions encourage corruption, nepotism and red-tapism because these factors increase business operational cost (Cicatiello, Simone, Ercolano & Gaeta, 2021; Wang, Lin, Fung & Kao, 2019; Ryan & Tang, 2021).

The question therefore arises as to what actually determines inflow of foreign direct investment to developing countries? There are numerous theoretical and econometric literatures on the determinants of FDI in developing economies but the results are still inconclusive as the evidence provided in empirics are rather untidy and sometimes confusing.

Therefore, poor institutional quality may lead to unnecessary high costs in doing business in a highly corrupt economy. It is therefore crucial to take into cognizance the peculiar rudiments in analyzing the political economy underpinning FDIs. The empirical evidence on the impact of institutional quality in explaining behavior of FDI flows have been relatively limited to Nigeria, despite the high amount of literature that exist on the drivers of FDI. Kaufmann, Kraay & Mastruzzi (2016), however revealed that Nigeria low compared to Ghana and other countries in Africa in various indicators of institutional qualities which include quality of rule of law, quality of regulatory systems and government effectiveness, political stability, freedom from violence and control of corruption.

Therefore, the main objective of this study is to empirically examine the role of institutional quality in foreign direct investment inflows in Nigeria.

Drawing from the foregoing, and considering the strategic positions occupied by Nigeria economy in the ECOWAS sub-region, it becomes imperative to empirically investigate the extent to which institutional quality have influence foreign direct investment in Nigeria.

Conceptual Review

In this section, a comprehensive review of conceptual review, theoretical review and literatures review on the role of institutional quality in foreign direct investment in Nigeria will be conducted.

Concept of Institutional Quality

Institutional quality is a formal rule set by regulatory structure, governmental agencies, and law court that direct the behavior of organization (Scott, 1995). These institutions established by government are basically the rules of the game in an organized society which helps to structure incentives in human exchanges, politically, socially and socially.

Foreign Direct Investment (FDI)

Foreign direct investment (FDI) involves the physical investment and purchases made by a company or individual outside of the home country, typically through the acquisition of shares or the establishment of an investment venture from scratch by opening plants, factories, machines or buying buildings (Luu, 2018).

Corruption control

Corruption is among the highly talked about issues in the global environment by politicians and academics. The increased attention on corruption, partly, can be attributed to the fact that it is very costly. It is estimated that the cost of corruption in the global economy is around US$ 3.6 trillion annually (Johnson,2018).

Regulatory Quality

Quality of regulation captures the ability of the government through its agencies to effectively regulate business (Kaufmann, Kraay & Mastruzzi, 2001). It is the extent to which regulatory policy and environments help or hinder private businesses (Busse & Groizard, 2008). It entails regulation

in capital markets which include proportion of time spent in completing the forms and dealing with the requirements imposed by government regulatory agencies. It also explains cost of licensing and registering business and the manner at which stock market operations are controlled through sanctions and incentives (World Bank, 2015)

Political Stability

According to World Bank (2015), political stability relates to the prospect of the stability of government as well as lack of politically motivated violence and terrorism. It is a situation where members of the society largely restrict themselves to behavioral conduct regarded as being within the confine of usual political role. The absence of such normal political atmosphere, which threatens the stability of government is regarded as political instability.

Government Effectiveness.

Government effectiveness captures perceptions of the quality of public service, the quality of the formulation and implementation, and the credibility of the government commitment to such policies. Countries are evaluated based on the competence of civil service, effective implementations of government decisions and public service vulnerability to political pressure, ability to manage political alternatives without drastic policies changes or interruption in government services. capacity of governments and its agencies to design, formulate, and implement policies and discharge functions in a most effective manner is very low (World Bank 2015).

Rule of Law

The rule of law is a principal of governance in which all persons, institution and entities (public and private) are responsible to law, which is consistent with international human rights norm and standard and which is declared public and equally applicable and independently adjust (Vera institution of Justice, 2008). This also implies the capacity of the judiciary, police force and related agencies to discharge their responsibility in a timely and fair manner (Thomas & Christopher, 2003).

Theoretical Review

Institutional Theory

The theoretical framework for this study hinges on the institutional theory developed by North (1990) as it is still relevant today. According to the theory, institutions exist due to the uncertainty

involved in human interactions. They are constrained devised to structure those interactions. They are less formal shared interactions derived from professions, scripts, and other societal and cultural practices that organizations and individuals are expected to follow (Jepperson, 1991).

Empirical   Review

There are several empirical studies on the relationship between institutional quality and foreign direct investment (FDI) across the globe.

Ibrahim (2019) investigates the impact of institutional quality on foreign direct investment (FDI) in Ghana for the period 1985 -2016, using the autoregressive distributed lag (ARDL) approach. The result establishes a positive significant effect of institutional quality on FDI irrespective of the time horizon. The results also reveal a significance impact of inflation on FDI in both short and long run, while GDP per capital growth and trade are significant determinants only in the short run.

Jilenga and Helian (2017) examines the relationship between institutional quality and foreign direct investment in sub-Saharan Africa for the period 1990 – 2016. The study employed the generalized method of moment and obtained a positive relationship between institutional quality and foreign direct investment in sub-Sahara Africa.

Hayat (2019) investigates the impact of institutional quality on foreign capital flows in 104 countries for the period 1996 -2018. Using the generalized method of moment and the estimated disclosed that institutional quality influences foreign direct investment.

Brown & Ibekwe (2018) investigates the impact of political stability on foreign direct investment for the period 1996-2017. The study adopted the granger causality test and found that political stability has a unilateral predictive effect on foreign direct investment inflows in Nigeria economy. Omodaro, (2019) examines the effect of corruption on foreign direct investment in Nigeria for the period 1995–2017. The study used the ordinary least square method (OLS) and proved that corruption has a significant and positive effect on foreign direct investment.

Methodology

The research design for this study is the ex-post facto or the longitudinal research design, which entails that the data used cannot be altered or manipulated by the researcher because they have already occurred. The population of the study is the Nigerian economy, with special focus on the institutional quality variables such as control of corruption, government effectiveness, political

stability, regulatory quality, and rule of law in relation to foreign direct investment (FDI) inflows from 1996 to 2024.

The data for the study is a time series data covering the period 1996 to 2024. They were sourced from the World Bank Development Indicators (2024).

Theoretical Framework and Model Specification

The theoretical framework for this study is anchored on the push and pull factors theories of foreign capital flows advocated by (Calvo et al (1993). According to these theories, the push-factor theory attribute direction of capital flows to what happens on the international front such as falling international interest rates, business cycles domestic country of the firm and the rising trend toward international diversification (Reinhart et al, 1996; Calvo, 1998). On the other hands, pull- factor theory traces the causes of capital flows to such domestic factors as autonomous increases in the domestic money demand function, increases in the domestic productivity of capital, and increasing integration of domestic capital markets with global capital markets (Agenor & Montiel, 1999). That is to say, econometrically, this relationship is depicted as:

$$FCF = \delta_0 + \delta_1 PulF + \delta_2 PusF \dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots\dots (1)$$

Where:

      FCF = Foreign capital flows

      PulF = Pull factors

      PusF = Push factors

Therefore, in this study, we modified equation 1 above to incorporate institutional quality factors influencing FDI. Thus, we assume that the push factors affecting the direction of capital inflows goes beyond falling international interest rates, business cycles, and rising trend in international diversification; and those of pull-factor attributed to autonomous increases in domestic money demand, increases domestic capital productivity and increasing integration of domestic capital markets to global market. We propose that institutional factors such as control of corruption, government effectiveness, political stability, regulatory quality, and rule of law can also serve as either 'pull or push factors' that effectively influence the direction of capital flow to any country. This relationship is therefore represented in this study in a functional equation as follows:

FDI = f (COC, GOE, PST, REQ, ROL) -- (2)

However, the long run econometric form of the Autoregressive Distributed Lag model (ARDL) model is stated thus:

$FDI = \alpha_0 + \alpha_1 COC_t + \alpha_2 GOE_t + \alpha_3 PST_t + \alpha_4 REQ_t + \alpha_5 ROL_t + u_t$-------------------------(3)

Where:

FDI = Foreign Direct Investment

COC = Control of Corruption

GOE = Government Effectiveness

PST = Political Stability

REQ = Regulatory Quality

ROL = Rule of Law

u_t = Error term

The Apriori expectations of the model are $\alpha_1, \alpha_2, \alpha_3, \alpha_4, \alpha_5 > 0$

Method of Data Analysis

The main method of analysis in this study is the fully modified ordinary least square (FMOLS) which was originally designed in the work of Phillips and Hansen (1990) to provide optimal estimates of co-integrating regressions. The method Fully modifies least squares to account for serial correlation effects and for the endogeneity in the regressors that results from the existence of a co-integrating relationship. The coefficients obtained from the estimation are then used to verify the working hypotheses of the study.

Results

This section is on the empirical analysis of data on the role of institutional quality in foreign direct investment inflows in Nigeria. As earlier stated in the previous section, the fully modified least

square econometric technique was employed to analysis the data. However, some preliminary and post-tests like descriptive statistics, co-integration, and variance inflator factor were also estimated. The software used for the data analysis is the [E-views 10.0.]

Descriptive Statistics

The descriptive statistics for the data is presented in Table 4.1. It shows the average values as well as first and second moments of the data distribution, and all the data are in billions of naira respectively. The mean value of foreign direct investment (FDI) in Nigeria is 3.321 for the entire sample, while the median value is 2.319. The data is positively skewed with coefficient of 0.713, which was a common feature of FDI inflows in the sampled period. The maximum value stood at about 8.849, while the minimum value is -1870.0. With this result, and on average, there seems to be more inflows of FDI to Nigeria within the period. There appeared to be a high variation in FDI inflow as suggested by the high value of the standard deviation (2.63) when compare with the mean value (3.321) This simply suggests a high level of variability of the pattern of FDI into the country. The summary statistics with respect to Jaque-Bera (J-B) statistic value of 2.926 is not significant and Implies that the probability distribution of the sample for the variable is normally distributed.

The mean values of control of corruption (COC), government effectiveness (GOE) and political stability (PST) are -1.164, -1.029 and -1.726 respectively; while their maximum values are -0.901, -0.848 and -0.588. By these results, it becomes glaring that these three institutional quality variables may not have been effective in attracting FDI to Nigeria due to their negative signs even though their corresponding means values are still negative but higher than the maximum values. The three variables (COC, GOE and PST) are positively skewed; and corresponding J-B probabilities are not significant. Therefore, these variables except those of PST are normally distributed.

Descriptive Statistics

	Mean.	Med.	Max.	Min.	Std. Dev.	Skew.	Kurt.	J-B.	Prob.
FDI	3.321	2.319	8.849	-1870.0	2.63	0.713	2.377	2.926	0.231
COC	-1.164	-1.126	-0.901	-1.502	0.130	-0.764	3.450	3.067	0.215
GOE	-1.029	-1.020	-0.848	-1.213	0.103	-0.116	2.073	1.101	0.576
PST	-1.726	-1.861	-0.588	-2.211	0.420	1.532	4.6287	14.55	0.000

REQ	-0.921	-0.922	-0.682	-1.293	0.148	-0.742	3.435	2.891	0.235
ROL	-1.111	-1.120	-0.843	-1.513	0.187	-0.515	2.538	1.538	0.463

Source: Author's Computation (2025)

Unit Root Test Analysis

The Augmented Dickey Fuller (ADF) test was employed to conduct the unit roots test. The results are presented in levels and first difference in Table 4.2. In the result, the ADF test statistic for each of the variables is shown in the second and fifth column, while the 95 percent critical ADF value is shown in the third and sixth column respectively. The result indicates that all the variables are not stationary at levels (see panel 1). However, after the first difference was taken, all the variables were now stationary (see panel 2). This implies that the variables are actually difference-stationary, attaining stationarity after the first differences of the variables. Thus, we would accept the hypothesis that the variables possess unit roots. Indeed, the variables are integrated of order one (i.e. I [1]).

Table 4.2: Unit Root Tests

Variable	At Levels ADF Test Statistic	Panel 1 95% Critical ADF Value	Remark	First ADF Test Statistic	Difference 95% Critical ADF Value	Panel 2 Remark
FDI	-1.696013	-2.971853	Non-Stationary	-6.662078	-2.976263	Stationary
COC	-1.794846	-2.971853	Non-Stationary	-5.158206	-2.976263	Stationary
GOE	-2.949244	-2.971853	Non-Stationary	-6.681898	-2.976263	Stationary
PST	-1.932404	-2.971853	Non-Stationary	-5.462487	-2.976263	Stationary
REQ	-2.695226	-2.971853	Non-Stationary	-6.712442	-2.976263	Stationary
ROL	-1.326290	-2.971853	Non-Stationary	-4.718860	-2.976263	Stationary

Source: Author's Computations (2025)

Co-integration Test

To test for co-integration, we employ Johansen Co-integration Test. The panel tests is based on two main tests statistic (the eigenvalue test (λ-max) and the trace test statistics). As can be seen from Table 4.3, both the eigenvalue test (λ-max) and the trace test statistics indicate that there are five (5) significant co-integrating vectors between institutional quality and foreign direct investment (FDI) in Nigeria. This implies that a long run relationship exists among these variables.

Table 4.3: Johansen Co-integration Tests Results.

Trace Test			*Maximum Eigenvalue Test*	
Null Hypothesis	Trace Statistic	Prob. Value	Max-Eigen Statistic	Prob. Value
r = 0*	123.4107	0.0002	44.79591	0.0137
r ≤ 1	78.61479	0.0084	32.11888	0.0798
r ≤ 2	46.49591	0.0667	18.33168	0.4677
r ≤ 3	28.16423	0.0762	14.85575	0.2991
r ≤ 4	13.30848	0.1040	9.352465	0.2580
r ≤ 5	3.956019	0.0467	3.956019	0.0467

Source: Author's Computations (2025)

Fully Modified Least Square Analysis (FMOLS) Estimation

Table 4.4 presents the fully modified least square (FMOLS) regression estimation of the role of institutional quality in foreign direct investment inflows in Nigeria. Indeed, the diagnostic indicators are very impressive as the R squared value of 0.78 demonstrated a very high predictive ability. This suggests that over 78 % of the systematic variations in direct investment (FDI) is captured by changes in the explanatory variables at any given period. The adjusted R-squared value of 0.73 percent is equally very high and it implies that the model has a good predictive ability.

Now, with respect to the individual explanatory variables in terms of signs and significance, it is seen that control of corruption (COC) has a significant positive relationship with foreign direct investment flows (FDI), as it was significant at the 1 percent level. This means that COC is significant driver of FDI inflows to Nigeria over the period of investigation. This effectively aligns with the findings of Chen and Jiang (2022) who submitted a significant positive relationship between COC and FDI. It further corroborated the finding of Barassi and Ying (2022), that a significant

inverted U-shaped exist between corruption and FDI, indicating that a certain degree of corruption actually attracts FDI inflows. This is because corruption helps to speed up bureaucratic procedures, thus providing an implicit subsidy for firm effective public services that will promote the development of foreign enterprises (Chungshik, 2015).

The coefficient of regulatory quality (REQ) is significantly and positively related to FDI, meaning that it is a relevant determinant of foreign direct investment inflow in Nigeria over the period of investigation. Indeed, it is seen that a unit improvement in regulatory quality (REQ) leads to about 8.33E+09 per cent increase in FDI inflow to the country. This presupposes that the current regulatory policy in Nigeria should either be sustained or be improve on so that REQ will continue to drive FDI positively. The finding agrees with those of Asongu et.al. (2018), Bitar, et.al. (2020), Sadhon, et.al. (2022) who found a significant positive relationship between quality of regulation and FDI.

Table 4.4: Institutional Quality and Foreign Direct Investment in Nigeria (FMOLS)

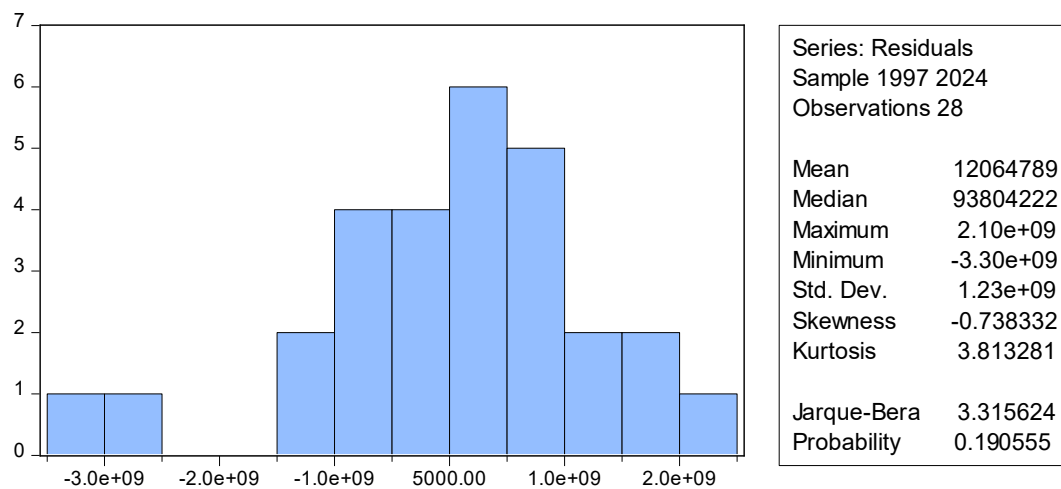| Variable	Coefficient	T-Ratio	Prob.
COC	1.02E+10	3.760025	0.0011**
GOE	-2.30E+09	-0.983171	0.3362
PST	-3.93E+09	-6.452392	0.0000**
REQ	8.33E+09	4.669171	0.0001**
ROL	-1.09E+10	-5.874183	0.0000**
Constant	1.62E+09	0.415255	0.6820
$R^2 = 0.78$	$\bar{R}^2 = 0.73$		

Source: Author's computation (2025) from E-view 10.0   Note: ** sig. at 1% level.

Multi-collinearity Tests

Tests for Stability of Regression

The residuals of the estimated coefficients in the study are expected to be normally distributed for the estimates to be reliable. The normality test is conducted using the Jarque-Bera (J-B) procedure as presented in Figure 4.1. From the results, it is seen that the J-B probability test (0.190555) was not significant, suggesting that the residuals are normally distributed and are statistically stable and effective for long term prediction and analysis.

Fig. 4.1: Test of Normality Results

Source: Author's Computation (2025) from Eview 10.0

Discussion of Findings

Political stability is theoretically adjudged to be potent factor in that demonstrates a country's attractiveness to foreign investors. This is true because, when the political climate of a country is stable, it easily attracts foreign investors to commit capital into the domestic economy, knowing that their investments will not be jeopardized by abrupt policy changes, regulatory inconsistencies, or civil unrest (Holger & Greenaway, 2004; Kunofiwa, 2018). The outcome of this study has demonstrated a significant negative relationship between political stability and FDI. This suggests that the current political environment in Nigeria is not stable enough for FDI to have meaningful impact. One probable reason for this could corruption and bureaucracy, which is often associated with political instability, increase transaction costs and these provide disincentives to investors. It even extends to risk of expropriation, where unstable governments may resort to nationalizing industries or imposing heavy regulations on foreign firms, which further discourages foreign investment.

The significant impact of control of corruption on FDI suggests that the current crusade against corruption in the country is in the positive direction. This is so because, when corruption is significantly controlled, it positively impacts not only FDI but other forms of foreign investment inflows. Therefore, the government and indeed regulatory institution should deliberately engage in creating a more transparent, efficient, and predictable environment that will guarantee certainty of

returns on investment, while at the same time minimize transaction costs. This steps will constantly make the domestic economy to be more attractive to foreign investors, thereby lead to increased FDI inflows.

Conclusion

The study has empirically examined the role of institutional quality in foreign direct investment inflows in Nigeria over the period 1996 to 2024. Institutional quality is believed to be fundamental to driving FDI into domestic economies, especially in emerging economies of Africa. The fully modified least square (FMOLS) was utilized in the analysis of selected institutional quality data such as control of corruption (COC), government effectiveness (GOE), political stability (PST), regulatory quality (REQ), and rule of law (ROL) respectively. The results obtained revealed that control of corruption (COC) and regulatory quality (REQ) are significantly and positively related to FDI; political stability (PST) and rule of law (ROL) had significant inverse effect on FDI; while regulatory quality (REQ) had a weak inverse relationship with FDI inflow. Based on these outcome, the study concludes that, in the determination of FDI inflow to Nigeria, regulatory quality factors such as control of corruption, regulatory quality, political stability (PST) and rule of law are potent drivers that should be seriously handled by the government and relevant policy makers in the country.

Recommendations

Based on the finding of this study, the following specific recommendations are brought forward:

Corruption and FDI inflows, the government and indeed regulatory institution should deliberately engage in creating a more transparent, efficient, and predictable environment that will guarantee certainty of returns on investment, while at the same time minimize transaction costs. These steps will constantly make the domestic economy to be more attractive to foreign investors, ultimately increase FDI inflows.

Nigerian government should wake up to its statutory responsibility of seeking to attract and retain FDI inflow on continuous basis in order to argument limited domestic funds to speed up the pace of economic development. To this end, they should strengthen legal and institutional frameworks by ensuring transparency, rule of law and efficient legal institutions. These will assure investors' confidence and increased inflow of FDI.

The Nigerian government should prioritize regulatory quality by improving the clarity, consistency, and fairness of regulations to reduce uncertainty and costs for foreign investors

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