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Impact of Good Governance on Domestic Investment: Empirical Study for Pakistan

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Abstract: Governance is a procedure of endeavoring basic leadership and implementations. It is a tool of managing national affairs through economic, political and administrative perspectives. Good Governance refers to the effective and efficient working of state machinery. In recent times good governance is considered as a key indicator that can empowers a country's economic health. The current study aims to assess the impact of good governance on domestic investment in case of Pakistan by using time series data. All the series are tested for the unit root through Augmented Dicky-Fuller (ADF) and Phillips-Peron (PP) tests. The ADF and PP tests shows that variables are integrated at first difference. The study employed co-integration techniques such as Johanson co-integration to find the long-run co-integration among variables. Furthermore, the long run coefficients of the variables the study employed the fully modified least square. The results shows that control of corruption, government effectiveness, voice and accountability and regularity quality have significant positive impact on domestic investment. It is suggested that government has to work on good governance to encourage domestic investment to sustain sound and long term economic growth.

Keywords: Good governance, Domestic investment, Economic development, Corruption control, Inflation, Economic growth

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INTRODUCTION

Governance is a procedure of basic leadership and implementations. It is a tool of managing national affairs at each level through economic, political and administrative perspective (Awan et al., 2018). Governance is a broad concept that has many dimensions and dynamics. It is a mechanism through which the economic, political and administrative affairs are managed. The concept of governance that is widely used across the world, which consists upon the elements of government effectiveness, rule of law, political stability, control of corruptions, voice and accountability and regularity quality of the state, together these elements effect the economic health of a country and indicates the good governance as well (Akanbi, 2010). Governance is a broad concept, and there are many scholars and institutes likes United Nations Development Program "UNDP" and World Bank who provided various definitions of Governance. According to the World Bank the governance means the "rule by the rulers". Recently this concept that has captured the eye of the globe and is being considered as the indicator which describes the overall health of the economy is good governance. Good Governance has many dimensions at which the intensity of governance is measured (Stojanovic, Ateljevic & Stevic, 2016). First comes the rule of law, it is about following the constitutions and other legal provisions that is defined by the legislations. The second dimensions is the political stability which refers to the stable political circumstances in economy. Another important dimension in the context of Good Governance is the control of corruptions. Corruptions refer to the financial mismanagement in an economy and its control refers to the management of financial capital in a systematic way (Ogbeidi, 2012). The other dimensions include voice and accountability, regularity quality and government effectiveness which all together indicates the governance health of an economy (Zubair & Khan, 2014). In recent times Good Governance "GG" is considered as a key indicator that can empowers a country's economic health and also refers to the effective and efficient working of state machinery (Houngbo et al. 2017; Khan et al., 2012). Good governance requires sound and

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stable political system in a country, once political stability is achieved the economic growth of a country becomes inevitable that shows the importance of governance at macro level (Jam et al., 2013; Khan & Zubair, 2014).

Investment is widely considered as the driver of economic growth and development (Habibi, & Sharif Karimi, 2017). It is a tool that can enhance the level of growth, increase employment and decrease poverty in economy (Iheonu, 2019). Investment can improve the production facilities by acquiring efficient and new equipment which leads to increase the labor productivity and thus can enhance the overall growth of economy, it can also result an incline in the aggregate demand by providing employment opportunities and wage rate as well (Ouedrago & Kouaman, 2014). Good governance is one of the key factors that can enhance the level of investment in an economy (Iheonu, 2019). Most of economic history of Pakistan is centered on the low rate of investment and savings. As compared to the other South Asian countries Pakistan has never been comparable to those economies in this regard. Fundamentally Pakistan seems like it has been trapped in this low-rate investment and savings. This low investment rate makes the growth of Pakistan economy unsustainable and thus generates a low growth pattern as well (Ali, 2016).

Investment is a key factor that can enhance the economic growth as it is used to scrutinize a country economic growth. Investment is the main source of producing goods that can be used to produce other goods as well (Berman, 2012). Investment is a phenomenon of using time, money and efforts in order to gain the profit. A country's economic growth depends upon the investment as it enhances the capacity of production and technological advancement as well. Total domestic investment can be divided into two categories, private and public investment (Shabbir et al., 2020; Setyowati & Hakim, 2022). There is large theoretical and empirical literature that highlights the relationship of governance and investment. This relationship is contemporary and unusual as governance not only enhances the investment rate in a country but generally it is necessary for countries across the world to enhance and improve the governing quality in order to attract the domestic investors to invest. It is argued that the overall investment is higher in countries having a higher good governance rate, while political instability, corruption and legal uncertainty has a significant and negative impact on the domestic investment. Furthermore, it is also argued that the country with poor governance quality receives a lower investment, so this indicates that the good governance can enhance the investment rate in a country and thus it can contribute to the overall growth and development (Al Muhaissen & Alobidyeen, 2022; Yao & Drama, 2019).

The current study considers the relationship of good governance and Investment in the case study of Pakistan which will provide further evidence in the literature of the current context. The current study tries to establish the long run relationship between domestic investment and good governance indicators in Pakistan it also specifies the governance categorically that will provide insights for the Government of Pakistan to work on those dimensions. Previously Yao and Drama (2019) conducted a study in order to establish a link between the Governance, Foreign Direct investment (FDI) and domestic private investment for the western African economies, in a similar context Iheonu (2019) conducted a study to establish a link between governance and investment for the country of Africa, Akanbi (2010) also explored this relation for a much smaller economy of Nigeria but none of the study has made an attempt to analyze this relation of good governance and domestic investment in the case of Pakistan which makes the current study unique and thus highlights the available research gap. The objective of this study is to investigate the impact of Governance on the domestic investment in Pakistan. The variables included the domestic investment as dependent variable to test it against the independent variables that are the indicators of good governance, the study also employed the per capita GDP and inflation as control variables.

LITERATURE REVIEW

Numerous studies have examined the impact of governance on domestic investment, highlighting its significance for economic development. Recent research by Khan and Ahmed (2022) underscores the positive relationship between good governance and domestic investment inflows. Effective governance mechanisms, such as transparency, accountability, and protection of property rights, foster a favorable investment climate. Conversely, weak governance characterized by corruption, bureaucratic inefficiencies, and political instability inhibits domestic investment. The findings align with previous research by Jansson and Shleifer (2021) and Aitken et al. (2020), emphasizing the importance of strong governance systems for attracting domestic investment and promoting economic growth.

According to Zubair and Khan (2014) governance is a wide range concept, which is the observing tool of managing the national affairs at economic, political and administrative levels, while good governance is the process of running state machinery efficiently and effectively. This study examined that a country economy would experience a persistent economic growth if a country had achieved high level of good governance indicators like, persistent political stability, procedure for voice of accountability prevailed, check and balance on control of corruption and rule of law. With the help of this literature, the current study will try to establish relationship between mentioned good governance indicators and economic growth (GDP). In this study, time series data is used from 2001-2011. GDP is taken as a dependent variable and independent variables are political instability, voice of accountability, control of corruption, rule of law. Different tests have been used for the estimation of the results, Shapiro-Wilk test is used for data normality, after using spear's rho correlation and regression, researcher have observed that political stability is highly contributing factor to economic growth among the four mentioned indicators of good governance. This conclude that, if the political situation of an economy is stable then, country will incline toward the high level of economic growth.

According to Zia and Haq (2009) governance is one of the most important phenomena in the recent time for a country economic development and its economic policies. Good governance is well thought-out the most influential factor for the economic growth. Many studies have suggested that main factor contributing to the low level of investment and economic growth is poor governance quality. In fact, poor governance result too many problems like, low growth, poverty, income inequality and poor infrastructure fails to attract investment, unfortunately it exists specially in case of Pakistan. The main question of this study which is, does governance contribute to pro-poor growth? Experience showed that just economic growth is not enough for poverty reduction, but good governance is also important for alleviating the poverty. In this study data have been taken from 1996 to 2005. Simple interpolation technique has been used and taken the growth in trend between two points in time. Poverty and inequality are taken as dependent variable, and control of corruption, political stability, regulatory quality voice, accountability and rule of law. The study suggested that governance indicator have low in ranks and percentage wise as compared to the other countries. The pro-poor growth, which consist of inequality, poverty, and growth dimensions, indicates that money goes to elite class of the country and there is high level of inequality. To overcome this problem, government of Pakistan should implement the policies in good manner, to get good results in their good government dimensions.

Akanbi (2009) to examine the effect of good governance on domestic investment in Nigeria, for this purpose the study used the path of domestic investment which is bound with supply side of Nigeria. The current paper used the time series data from 1970 to 2006 with the analysis of Johnson techniques. The study concluded that financial development has significant relationship with domestic investment in Nigeria, after the econometrics techniques the study revealed that well stabilize structured and stabilize socio economic investment will pump the domestic investment over the period of long run. Results of this study shows the significant relationship between good governance and domestic investment, which will boost up the economic condition in the direction of positive response to the economy. Another study in the similar context of assessing the impact of Good Governance on domestic investment for the case study of Nigeria was conducted by Ajide (2013). The study adopted the methodology of autoregressive distributive lag model (ARDL), bound testing cointegration approach. The findings of this methodology affirmed a significant difference in short run and long run on domestic investment. The trade openness, inflations and good governance indicators were all having a significant impact on the domestic investment. While on the other hand political stability, voice and accountability appeared to be the dominant factors that can influence the domestic investment, but their impact was negative. Savings, real GDP, degree of openness, real interest rates, inflation rates and governance measures are strong determining variables of domestic investment.

Awan et al. (2018) conducted a study in the similar context, according to this study Governance is not precisely described by the scholars and researchers, but according to UNDP (United Nations Development Program), governance is handing country's affairs at each in every stage through economical administrative and political aspects. In the study corruption is defined as, getting monitory and non-monitory benefits for private advantages. Panel data of SAARC countries including, Pakistan, Nepal, Bangladesh, Sri Lanka and India have been taken from 1996 to 2014. For panel data estimation, fixed effect method was used based upon Hausman specification test findings. Specific cross section coefficient was employed on fixed effect model. Results revealed that, two government institutional indicator consisting political stability and government effectiveness have a positive and significant association with economic growth (GDP) among the selected SAARC countries, while corruption has inverse effect on economic growth in mentioned SAARC countries in the given time frame. The results suggested and concluded that, SAARC countries should effectively implement their policies, in order gain economic growth. They should have control over the corruption, which cause inverse effect on the economic growth including all SAARC countries.

Iheonu (2019) examined the effect of good governance on domestic investment in selected African countries with the help of well modified panel data over period 2002-2015. The study found that all good governance indicators positively affect the domestic investment in Africa except government effectiveness as it has insignificant influence on domestic investment. The study also concluded that voice accountability and control of corruption shows the more influence on domestic investment.

It can be deduced from the literature discussed above that good governance is one of the indicator of influencing domestic investment in a region or an economy as most of the research studies find positive effect of good governance indicators on domestic investment. Moreover, the study on the nexus between good governance and domestic investment can be carried out in panel as well as on time series data for a single economy.

METHODOLOGY

Domestic investment is vital factor that can contribute to economic growth but in order to increase the domestic investment the governance quality needed to be established as well. The current study uses the domestic investment as dependent variable for which the proxy of gross fixed capital formation as is used. Furthermore, the study uses the governance indicators which includes political stability, regularity quality, rule of law, control of corruption, government effectiveness and voice and accountability as the independent variables for which data is collected from world Governance Indicators, World Bank (2022). Furthermore, the study uses per capita GDP and inflation as control variable for the analysis. The time period for which the data is collected is 1996-2020. Augmented Dicky Fuller (Dickey & Fuller, 1979) and Phillips-Peron tests (Phillips & Peron, 1988) are being applied to determine order of integration and to determine whether any time series data is possessing unit root or not. After order of integration determination, this study will apply Johansen's cointegration test (Johansen, 1989) to determine cointegration vectors among variables. This cointegration vector (s) will enable us to testify long run relationship among variables. This step in methodology will be followed to by fully modified ordinary least square method (Phillip and Hansen, 1990) for long run results estimates. The current study uses the domestic investment as a dependent variable against the independent variables of good governance indicators and control variables of GDP per capita and inflation rate of Pakistan. The general function that has been proposed for the study is given below.

$$DI_t = f\left\{PS_t, CC_t, GE_t, RQ_t, RL_t, VA_t, GDP_t INF_t\right\} \tag{1}$$

The empirical model in statistical representation is given in Eq. 3 below:

$$\begin{aligned} \ln DI_t = \beta_0 + \beta_1 PS_t + \beta_2 CC_t + \beta_3 GE_t + \beta_4 RQ_t + \beta_5 RL_t + \beta_6 VA_t + \beta_7 \ln GDP_t + \\ \beta_8 \ln INF_t + u_t \end{aligned} \tag{2}$$

Here in the above model "DI_t" stands for the domestic investment in Pakistan at time "*t*", PS_t depicts the political stability at time "*t*"; CC_t shows the dimensions of corruption control for good governance at time "t"; GE_t stands for the government effectiveness at time "*t*"; RQ_t shows the regularity quality of the governance at time "*t*"; RL_t shows the rule of law at time "*t*"; VA_t stands to indicate the voice and accountability which is also an indicator for the good governance whereas ln represents natural log of respective variables. Furthermore, the control variables include the GDP_t which shows the per capita gross domestic product for Pakistan at time "*t*" and INF_t stands for the inflation at time "*t*" in Pakistan.

Table 1: Variables Description

Variables	Abbreviations	Description	Sources
Dependent Variable			
Domestic Investment	DI	Gross fixed capital formation	World Bank
Independent variables			
Political Stability	PS	Political Stability and Absence of Violence/Terrorism	World Bank
Corruption	CC	Control of Corruption Estimate	World Bank
Government effectiveness	GE	Estimate of Government Effectiveness	World Bank
Regularity quality	RQ	Estimate of Regularity quality	World Bank
Rule of Law	RL	Estimate of Rule of Law	World Bank
Voice and Accountability	VA	Estimate of Voice and Accountability	World Bank
Per Capita	GDP	GDP per capita	World Bank
Inflation	INF	CPI Annual percentage	World Bank

RESULTS AND DISCUSSION

Results based on research techniques discussed in research methodology sections are interpreted and discussed in this section. Table 2 shows the unit root testing of the proposed variables through the Augmented Dicky fuller (ADF) test. In the current testing the ADF equation includes both trend and intercept into the general model. First the variables are tested on level, the results have shown insignificancy of all the variables which concludes that neither of the included variables has shown stationarity on level and thus the data was carrying the unit root problem. After this, the first difference of ADF test with inclusion of both trend and intercept have shown significance thus; all the variables are integrated of first order. Now the variables have satisfied the first assumption of the cointegration testing. All the variables are stationary at 1% significance level except for domestic investment which is stationary at 5%.

Table 2: ADF Unit Root Test Results

Variables	Trend and Intercept (At level)		Trend and Intercept (1st difference)		Integration
lnDI	-0.88	0.7742	-3.33	0.0253**	I(1)
PS	-0.38	0.4022	-15.22	0.0000*	I(1)
CC	-0.37	0.1180	-4.69	0.0014*	I(1)
GE	-1.61	0.4588	-4.33	0.0029*	I(1)
RQ	-0.35	0.6610	-6.63	0.0000*	I(1)
RL	-0.32	0.3610	-5.17	0.0005*	I(1)
VA	-0.30	0.4053	-7.23	0.0000*	I(1)
lnGDP	-1.74	0.7052	-4.69	0.0043*	I(1)
lnINF	-0.34	0.1120	-7.19	0.0000*	I(1)

Note: * and ** show significant levels of 1% and 5% respectively.

Table 3 contains the results of PP unit root test. Like the ADF test here both the trend and intercept is included in the PP econometrical model. First the time series is checked for integration at level, but the results are insignificant at level which means that data is not stationary at level. After checking the time series data for unit root at level the first difference is applied, and results shows that all the time series variables have become stationary at first difference. So now the PP test have cross checked the data for unit root and integration at first difference for the time series has fulfilled the assumption of co-integrations. In the above table all the variables have become stationary with the probability value less than 0.01 (significant at 1%) except the dependent variables of domestic investment whose probability value is less than 0.05 (significant at 5%).

Table 3: PP Unit root test Results

Variables	Trend and Intercept (At level)		Trend and Intercept (1st difference)		Integration
lnDI	-1.12	0.6899	-3.34	0.0253**	I(1)
PS	-0.31	0.3905	-12.82	0.0000*	I(1)
CE	-0.37	0.1170	-13.22	0.0000*	I(1)
GE	-1.61	0.4588	-4.33	0.0029*	I(1)
RQ	-0.35	0.6610	-7.21	0.0000*	I(1)
RL	-0.32	0.3406	-7.80	0.0000*	I(1)
VA	-1.04	0.4630	-8.27	0.0000*	I(1)
lnGDP	-1.74	0.7052	-4.59	0.0053*	I(1)
lnINF	-1.38	0.2204	-8.46	0.0000*	I(1)

Note: * and ** show significant levels of 1% and 5% respectively.

Table 4 shows the results of Johansen Cointegration test. The results show that the null hypothesis of "no cointegration" is rejected on the basis of four cases in case of trace statistics and is rejected on the bases of two cases in case of maxi-eigen statistics. Each statistical value rejects the null hypothesis of no cointegration and accept the alternative hypothesis. Thus; it is deduced from these results that there are two cointegration vectors. From the Table 4, it can be drawn that there is a long run association among variables.

Table 4: Johansen's Cointegration Test

No. of Cointegration	Trace Statistic	Critical Value	Maxi-Eigen Statistics	Critical Value
None	272.16*	197.37	67.55*	58.4
At most 1	204.61*	159.52	58.42*	52.36
At most 2	146.18*	125.61	44.99	46.23
At most 3	101.19*	95.75	39.37	40.07
At most 4	61.81	69.82	24.23	33.87
At most 5	37.57	47.85	18.52	27.58
At most 6	19.05	29.79	11.68	21.13
At most 7	7.37	15.49	7.36	14.26
At most 8	0.007	3.84	0.007	3.84

Note: * confirms cointegration vectors

Table 5 shows the results of the FMOLS model in which the domestic investment as capital stock has been taken as a dependent variable against the independent variable of good governance indicators and control variables of GDP per capita and inflation. The study aim was to explore the impact of the good governance on domestic investment of Pakistan. In the above results the variable of political stability does not have any relation with the domestic investment of Pakistan as its coefficient value is insignificant but the nature of relationship between two variables is positive. The insignificant nature of political stability is because domestic investment is more sensitive with the financial management rather than the political situations of Pakistan. The second important dimension of good Governance is control of corruption, which has high significant relation with the domestic investment as its coefficient is significant at 1%. The control of corruption is referred to the financial management of an economy so this relation means that if the financial system of Pakistan is free from corruption this will encourage the domestic investments and thus will lead to the economic prosperity. The nature of the relationship between them is positive which means that by exerting pressure on corruption the domestic investment will increase significantly this result was previously confirmed by Akanbi (2010) that a well-structured financial system which is free from corruption will encourage the domestic investor to invest and thus it will lead to a good economic performance as well. The government effectiveness carries a positive relation with domestic investment and their long run relationship is also significant at 5%. This concludes that the more effective is the policies and action of government the more will the domestic investment which actually girds up the economic situations of a country towards prosperity as according to the Iheonu (2019), who states that increase in the domestic investment led to create employment opportunities and higher wages as well. This nature of relationship between government effectiveness and investment was previously found by Awan et al (2018). Furthermore, there is a long run relationship found between the regularity quality and domestic investment as the coefficient of the regularity quality is also significant at 5%. The regularity quality shows the effectiveness of governing different sectors effectively it has also been considered as an important dimension of good governance which depicts that how the government regularities are effective. The above results confirmed that more effective the regularity quality of the governance of Pakistan will encourage the domestic investment to incline. The rule of law indicator of good governance has not established any relation with domestic investment as its coefficient is not significant. There is also a long run relation established between domestic investment and voice and accountability as the coefficient value of voice and accountability is significant at 10%. Their nature of relationship is also positive which concludes that by enhancing the voice and accountability the domestic investment does increase as well. Through the above results it can be concluded that good governance Pakistan will encourage domestic investment with itself so the objective of the study is fully acknowledged. This relationship of good governance and domestic investment is previously confirmed by Akanbi (2010), Iheonu (2019) and Ajide (2013) that good governance does have a positive and a significant impact on domestic investment. The control variables which include per capita GDP and inflations are insignificant factors for the domestic investment of Pakistan.

Table 5: FMOLS Results

Variable	Coefficient	Std. Error	*t*-Statistic	Prob.
Constant	2.71***	1.40	1.93	0.0734
PS	0.01	0.03	0.28	0.7820
CC	0.28*	0.09	2.98	0.0098
GE	0.32**	0.13	2.43	0.0290
RQ	0.47**	0.16	2.81	0.0138
RL	-0.11	0.13	-0.87	0.3975
VA	0.22***	0.11	2.01	0.0652
lnGDP	-0.23	0.23	-1.00	0.3192
lnINF	0.02	0.03	0.62	0.5417

CONCLUSION

Governance plays a pivotal role in influencing domestic investment. Countries with transparent and accountable governance systems tend to attract higher levels of domestic investment (Smith & Johnson, 2023). Good governance practices, such as strong legal frameworks, efficient regulatory systems, and protection of property rights, instill confidence among investors and create a conducive environment for business growth. Conversely, nations with weak governance structures often experience lower levels of domestic investment due to uncertainty, corruption, and lack of investor protection (Smith & Johnson, 2023). The study emphasizes the importance of effective governance in promoting domestic investment. The aimed of the current study is to explore the impact of good governance on domestic investment in Pakistan and utilized time series data and technique for said purpose. The variables included the domestic investment as dependent variable to test it against the independent variables that are the indicators of good governance, the study also employed the per capita GDP and inflation as control variables. As the study employed time series data so it is necessary to examine the series for unit root, for this purpose the study used ADF and PP test which yielded that all the variables used in this study were integrated at first difference. After testing the series for unit root, the Johansen's cointegration test was applied which yielded long run cointegration vectors in the proposed relations of good governance indicators and domestic investment. In order to find out the magnitude and individual long run coefficients the study used the methodology of FMOLS. Results indicate that all indicators of good governance are significant factors of domestic investment except rule of law Iheonu, 2019). The significant indicators of good governance positively affect domestic investment in Pakistan. The results of the FMOLS yielded a long run relation of control of corruption with domestic investment; government effectiveness with domestic investment; regularity quality with domestic investment and voice and accountability also affects the domestic investment in Pakistan in long run. The results of the study also similar with the results of the studies conducted by Farla et al., (2016) and Meyer, (2022). Further the study concludes that that good governance in Pakistan will encourage domestic investment henceforth; it is advised that government should work on good governance to provide sound environment for the domestic investment and henceforth, sound and sustainable economic growth can be sustained in Pakistan.

Governance has a significant impact on domestic investment; however, the case of Pakistan highlights certain limitations. While research suggests that transparent and accountable governance systems attract higher levels of domestic investment, Pakistan has faced challenges in this regard (Smith & Johnson, 2023). The country has struggled with issues such as corruption, bureaucratic red tape, and a lack of enforcement of property rights. These limitations create an environment of uncertainty and deter potential investors, impacting domestic investment. Furthermore, political instability and weak institutions in Pakistan have also hindered the effectiveness of governance reforms. Despite efforts to improve governance, these limitations continue to pose challenges to enhancing domestic investment in the country (Smith & Johnson, 2023).

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