# GOVERNANCE QUALITY AND HUMAN CAPITAL AS DETERMINANTS OF FDI INFLOWS: EVIDENCE FROM ASEAN ECONOMIES

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**Abstract:** ***Foreign direct investment (FDI) plays an important role in promoting economic development and industrial transformation in emerging economies. In ASEAN, improving governance quality and human capital has become increasingly important in attracting foreign investors amid growing global competition. Drawing on the OLI paradigm developed by John H. Dunning and Transaction Cost Theory associated with Oliver E. Williamson, this study examines the impact of governance quality and education expenditure on FDI inflows across eight ASEAN countries from 2002 to 2021. Using panel data from the World Bank and UNCTAD, the study estimates fixed-effects regression models to examine the relationships among control of corruption, education expenditure, and FDI inflows, while controlling for key macroeconomic variables. Robustness checks using random-effects and pooled OLS estimations are also conducted. The empirical findings show that better control of corruption significantly increases FDI inflows in ASEAN economies. Education expenditure also has a positive and statistically significant effect, suggesting that human capital development enhances a country's investment attractiveness. The study highlights the importance of institutional reform and investment in education in attracting high-quality FDI, with significant policy implications for Vietnam and other emerging ASEAN economies.***

• Keywords: *foreign direct investment, governance quality, human capital, ASEAN, Vietnam.*

*Date of receipt: 24th Feb., 2026*
*Date of delivery revision: 28th Feb., 2026*
*Date of receipt revision: 26th Mar., 2026*
*Date of approval: 04th Apr., 2026*

*DOI: https://doi.org/10.71374/jfar.v26.i3.69*

## 1. Introduction

Foreign direct investment (FDI) has long been recognized as an important driver of economic development, particularly in emerging economies. By increasing productive capacity, generating employment, promoting industrial expansion, and facilitating the transfer of technology and managerial knowledge, FDI contributes significantly to productivity improvement and long-term economic growth. In addition, FDI can strengthen domestic human capital through training, skill development, and knowledge spillovers, thereby enhancing the competitiveness of host economies.

However, attracting and sustaining foreign investment has become increasingly challenging for developing countries. While traditional advantages such as low labor costs, abundant natural resources, and market size remain relevant, they are no longer sufficient to secure sustainable and high-quality FDI. Multinational enterprises increasingly consider broader location-specific factors, including political stability, institutional transparency, regulatory effectiveness, infrastructure quality, and workforce skills. As a result, governance quality and human capital have emerged as two critical determinants of investment attractiveness.

Governance quality plays a central role in shaping the business environment. Effective governance reduces uncertainty, lowers transaction costs, strengthens property rights protection, and improves investor confidence. In particular, stronger control of corruption can create a more predictable and transparent investment climate by limiting informal payments, bureaucratic inefficiencies, and policy-related risks. Conversely, weak governance and corruption may discourage foreign investors by increasing operational costs and undermining trust in public institutions.

Alongside governance quality, human capital is also essential in attracting FDI. As global production becomes increasingly knowledge-intensive and technology-driven, foreign investors require a skilled and adaptable workforce capable of supporting advanced production processes and innovation activities. Countries with stronger education systems and higher labor productivity are therefore better positioned to attract efficiency-seeking and knowledge-intensive investment. Investment in education is particularly important because it reflects a government's

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long-term commitment to improving workforce quality and national competitiveness.

This study focuses on ASEAN, one of the most dynamic and rapidly developing regions in the global economy. Since the 1990s, ASEAN economies have experienced substantial transformation through trade liberalization, export-oriented industrialization, and deeper integration into global value chains. The establishment of the ASEAN Economic Community has further promoted regional cooperation, investment liberalization, infrastructure connectivity, and institutional reform. Nevertheless, despite ASEAN's overall success in attracting FDI, substantial differences remain among member countries in terms of institutional quality, corruption control, human capital development, and investment performance.

These disparities raise an important question: to what extent do governance quality and human capital influence FDI inflows across ASEAN economies? To address this question, this study examines the effects of control of corruption and education expenditure on FDI inflows in eight ASEAN countries over the period 2002-2021. By focusing on these two determinants, the research contributes to the literature on FDI in developing economies and provides policy implications for ASEAN governments seeking to improve institutional quality, strengthen human capital, and attract sustainable, high-quality foreign investment.

**2. Literature review**

Foreign direct investment (FDI) has been widely recognized as an important driver of economic growth and structural transformation in developing and emerging economies, particularly in ASEAN. Through capital inflows, technology transfer, managerial knowledge, and participation in global value chains, FDI contributes to productivity improvement and long-term development. Therefore, identifying the determinants of FDI inflows has become a central concern in international economics and development studies. Existing literature generally emphasizes the role of institutional quality, macroeconomic conditions, and human capital, although empirical findings remain context-specific and sometimes inconsistent.

From a theoretical perspective, FDI determinants can be explained through Dunning's Eclectic Paradigm and Transaction Cost Theory. According to Dunning (1980, 1988), multinational enterprises invest abroad when ownership, location, and internalization advantages are present. In this framework, governance quality and human capital are important location-specific advantages, as countries with stronger institutions, lower corruption, and more skilled labor forces are more attractive to foreign investors. Similarly, Transaction Cost Theory argues that firms prefer operating in environments where uncertainty and transaction costs are minimized. Weak governance, corruption, and regulatory inefficiency increase business risks through bureaucratic delays, informal payments, and policy uncertainty, whereas stronger corruption control and transparent institutions enhance investor confidence and FDI attractiveness (Williamson, 1985).

A substantial body of empirical research confirms the importance of institutional quality in attracting FDI. Institutions influence the investment climate by reducing uncertainty, protecting property rights, and improving regulatory efficiency. Hayat et al. (2023) show that the impact of governance indicators on FDI varies across countries and institutional dimensions, with regulatory quality generally having a positive effect. In ASEAN, Kezya and Rossanto (2021) find that institutional quality significantly affects FDI inflows in developing member countries, although the direction and magnitude differ across governance indicators. Kuswara et al. (2025) further identify regulatory quality as one of the most robust governance-related determinants of FDI in ASEAN economies.

Macroeconomic conditions also play an important role in explaining FDI inflows. Jagadish et al. (2021) find that financial sector development and natural resource endowments are key drivers of FDI in ASEAN. Liberty and Ruben (2025) report that economic growth and trade openness positively affect FDI inflows, while inflation and financial development produce mixed results depending on model specifications. Their findings also suggest that institutional quality may moderate the effects of macroeconomic variables, indicating that sound governance can strengthen the role of economic fundamentals in attracting foreign investment.

In addition to institutions and macroeconomic factors, human capital is increasingly viewed as a crucial determinant of FDI. A skilled workforce improves labor productivity, supports technology absorption, and enhances the attractiveness of host countries for knowledge-intensive investment. Ibarra-Olivo et al. (2024), in their study of Vietnam and Indonesia, show that the relationship between FDI and human capital is heterogeneous and depends on the type of investment and the host country's position in global value chains. Greenfield FDI in logistics and services tends to increase demand for skilled labor, whereas production-intensive FDI may generate different effects on technical skill demand. This suggests that

the relationship between FDI and human capital is bidirectional and sector-specific.

Despite the growing literature, several research gaps remain. First, many studies use aggregated governance indices and do not sufficiently examine specific dimensions of institutional quality, particularly control of corruption, as an independent determinant of FDI. This issue is especially relevant in ASEAN, where corruption levels and enforcement capacity vary significantly across countries. Second, although human capital is widely discussed, most studies measure it through education outcomes such as years of schooling or skill levels, while relatively few consider government education expenditure as a direct policy instrument for human capital formation. Third, institutional quality and human capital are often examined separately, whereas their combined influence on FDI remains underexplored. In particular, stronger corruption control may improve the efficiency of public education spending, thereby strengthening human capital and increasing FDI attractiveness.

Therefore, this study addresses these gaps by examining the effects of control of corruption and education expenditure on FDI inflows in ASEAN countries over the period 2002-2021. By integrating governance quality and human capital investment into a unified analytical framework, the study provides more specific and policy-relevant evidence on the determinants of FDI in developing economies. Its contribution lies in offering updated empirical evidence from ASEAN and highlighting how institutional reform and education investment can jointly enhance foreign investment attractiveness.

## 3. Research methodology

### *3.1. Research Objectives and Research Questions:*

This study aims to identify the roles of institutional quality, human capital, and macroeconomic factors in determining the attractiveness of foreign direct investment (FDI) in ASEAN countries over the period 2002-2021. In particular, the study examines how governance quality, as measured by control of corruption, and human capital development influence FDI inflows in the region.

Accordingly, this study addresses the following research questions:

1) To what extent does control of corruption influence FDI inflows in ASEAN countries from 2002 to 2021?

2) What is the impact of human capital quality, measured through education expenditure, on FDI inflows in ASEAN countries during the period 2002-2021?

### *3.2. Research Hypotheses*

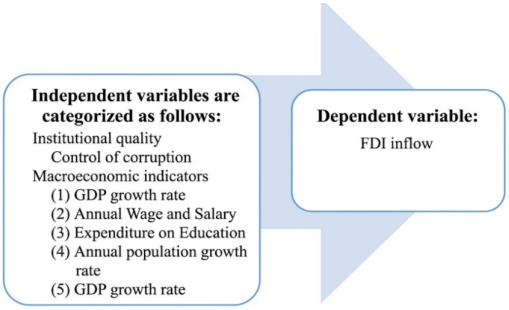
Based on the theoretical framework and empirical literature, the following hypotheses are developed:

H1: Higher institutional quality, measured by stronger control of corruption, is positively associated with FDI inflows in ASEAN countries.

H2: Higher human capital quality, measured by education expenditure, leads to greater FDI inflows in ASEAN countries.

### *3.3. Model Specification*

**Figure 1: Conceptual for FDI inflow**




To examine the determinants of FDI inflows, this study employs a panel data regression model. The baseline specification is as follows:

$$FDI_{it} = \beta_0 + \beta_1 COC_{it} + \beta_2 AWS_{it} + \beta_3 EOE_{it} + \beta_4 POP_{it} + \beta_5 GROWTH_{it} + \alpha_i + \gamma_t + \varepsilon_{it}$$

Where:

$FDI_{it}$: Foreign direct investment inflows in country i at time t

$COC_{it}$: Control of corruption index (institutional quality variable)

$AWS_{it}$: Annual wage and salary (labor cost proxy)

$EOE_{it}$: Government expenditure on education (human capital proxy)

$POP_{it}$: Population growth rate

$GROWTH_{it}$: GDP growth rate

$\alpha_i$: Country-specific fixed effects

$\gamma_t$: Time-fixed effects

$\varepsilon_{it}$: Error term

The coefficients $\beta_1$ to $\beta_5$ capture the marginal effects of explanatory variables on FDI inflows.

This study applies a fixed effects (FE) panel regression model as the baseline estimation technique. The fixed effects model is appropriate as it controls for unobserved time-invariant heterogeneity across countries, such as geographic characteristics, historical institutions, and structural differences that may affect FDI inflows. To ensure robust and reliable results,

additional estimation techniques are employed, including pooled Ordinary Least Squares (OLS) and random-effects (RE) models. Comparing these models allows for a more comprehensive assessment of coefficient stability and consistency across different specifications (Wooldridge, 2010).

To ensure the reliability of estimated coefficients, this study conducts a multicollinearity diagnostic test using the Variance Inflation Factor (VIF). Multicollinearity occurs when two or more independent variables are highly correlated, which can inflate standard errors and reduce the statistical reliability of coefficient estimates.

Following Gujarati (2009), the interpretation of VIF values is as follows:

• VIF < 5: No serious multicollinearity problem

• 5 ≤ VIF < 10: Moderate correlation; variables should be reviewed carefully

• VIF > 10: Severe multicollinearity; variables may need to be excluded or transformed

This procedure ensures that the regression model remains statistically robust and that coefficient estimates are reliable and interpretable.

To enhance the validity of empirical results, robustness checks are conducted by estimating the model using pooled OLS, fixed-effects, and random-effects specifications. Comparing results across different models allows for verification of the consistency of estimated relationships between FDI inflows and explanatory variables. This approach strengthens the empirical credibility of the findings and reduces potential model-specific bias.

The dataset covers ASEAN countries over the period 2002-2021, depending on data availability. The dependent variable is foreign direct investment inflows (FDI), while the explanatory variables are grouped into two categories:

• Institutional quality: Control of corruption (COC)

• Human capital: Education expenditure (EOE)

• Macroeconomic indicators: GDP growth, population growth, and labor cost (annual wage and salary)

Data are collected from internationally recognized sources such as the World Bank's World Development Indicators (WDI) and Worldwide Governance Indicators (WGI).

## 4. Results and discussion

### *4.1. Results*

#### *4.1.1. Multicollinearity check - VIF*

As presented in Table 1, most Variance Inflation Factor (VIF) values are below the conventional threshold of 5, indicating no serious multicollinearity concerns among the majority of explanatory variables. However, the variables control of corruption and annual wage and salary exhibit relatively higher VIF values, exceeding 7.

Despite these elevated values, both variables are retained in the model for several important reasons. First, control of corruption is a key indicator of institutional quality and plays a central role in assessing the investment climate across ASEAN countries. Excluding this variable would significantly weaken the model's ability to capture the governance dimension, which is theoretically and empirically critical for explaining FDI inflows. Moreover, although its VIF is relatively high, it remains below the commonly cited critical threshold of 10, suggesting that multicollinearity is not severe enough to warrant exclusion.

Second, the annual wage and salary variable represents both labor cost and labor market conditions, which are essential determinants of foreign investors' location decisions. This variable captures efficiency-seeking and skill-oriented FDI motivations, making it highly relevant to the model specification despite its moderate multicollinearity. Therefore, retaining this variable ensures that the model adequately captures key labor-market dynamics influencing FDI inflows.

**Table 1: Multicollinearity check - VIF**

| Variable | VIF | 1/VIF |
|---|---|---|
| Control of corruption | 7.57 | 0.132 |
| Annual wage and salary | 7.15 | 0.139 |
| Expenditure on education | 1.44 | 0.693 |
| Annual population growth Rate | 1.07 | 0.934 |
| GDP growth rate | 1.04 | 0.959 |
| Mean | 3.66 | |

#### *4.1.2. The panel regression results*

**Table 2: Combined regression outputs for OLS, Random Effects, and Fixed Effects for FDI attractiveness**

| Variables | Ols | Reandom effects | Fixed effects |
|---|---|---|---|
| GDP growth rate | 422.0** (193.0) | 648.3 (569.5) | 650.3*** (183.7) |
| Annual Salary (current US$) | 1.752*** (0.125) | 1.688*** (0.451) | 2.380*** (0.0764) |
| Control of Corruption | 4,793*** (1,564) | 4,087 (5,694) | 10,858** (3,362) |
| Annual Population Growth Rate | -6,101*** (732.7) | -5,660*** (1,140) | -5,888*** (477.7) |
| Expenditure on Education (% GDP) | 668.4 (598.0) | 991.3 (1,723) | 1,147* (599.2) |
| Constant | 2,494 (3,290) | -1,062 (11,730) | -895.5 (2,920) |
| Observations | 149 | 149 | 149 |
| R-squared | 0.876 | | 0.855 |
| Number of countries | | 8 | 8 |

*Standard errors in parentheses*

**** p<0.01, ** p<0.05, * p>0.1*

Firstly, robustness checks are conducted using three estimation techniques: pooled Ordinary Least Squares

(OLS), random effects (RE), and fixed effects (FE). Across all specifications, the key explanatory variables, GDP growth rate, annual salary, population growth rate, and control of corruption, generally exhibit consistent directional effects on FDI inflows. This consistency across models suggests that the estimated relationships are relatively stable, thereby enhancing the reliability of the empirical findings.

As shown in Table 2, the fixed-effects model yields an R-squared of 0.855, indicating strong overall model fit. This implies that approximately 85.5% of the variation in FDI inflows can be explained by the selected explanatory variables, demonstrating the model's strong explanatory power.

In terms of individual coefficients, all explanatory variables in the fixed effects specification are statistically significant at conventional levels, with varying p-values. At the 1% significance level, GDP growth rate and annual salary are found to have positive, statistically significant effects on FDI inflows, whereas population growth shows a negative relationship.

Specifically, a 1% increase in GDP growth rate is associated with an increase of approximately USD 650.3 million in FDI inflows. This finding is consistent with previous research by Rajah, James, and Ibrahim (2017), which also identifies GDP growth as a key determinant of FDI attractiveness in ASEAN economies. The positive effect of GDP growth reflects the importance of market expansion and economic stability in attracting foreign investors.

Similarly, a one-unit increase in annual salary is associated with approximately USD 2.38 million in additional FDI inflows. This result is particularly interesting, as higher wages are often interpreted as a potential deterrent to cost-sensitive investors. However, in this context, higher wages may signal higher labor productivity and skill levels, thereby attracting efficiency-seeking and knowledge-intensive FDI rather than discouraging investment.

In contrast, the population growth rate is found to have a negative, statistically significant effect on FDI inflows. This may be explained by rapid population growth, which can place pressure on public services and government expenditure, potentially reducing the quality of infrastructure and institutional capacity. This finding is consistent with Asiedu (2006), who argues that population size alone is insufficient to attract FDI unless it is accompanied by improvements in human capital and governance quality.

At the 5% significance level, control of corruption is also found to be statistically significant and positively associated with FDI inflows. Specifically, a one-unit improvement in the corruption control index is associated with an increase of approximately USD 10,858 million in FDI inflows. This result can be explained by the fact that stronger control of corruption enhances transparency, reduces hidden transaction costs, and increases investor confidence in the fairness and predictability of the business environment. This finding is consistent with earlier studies by Habib and Zurawicki (2002) and Busse and Hefeker (2007), which emphasize the importance of institutional quality in attracting foreign investment.

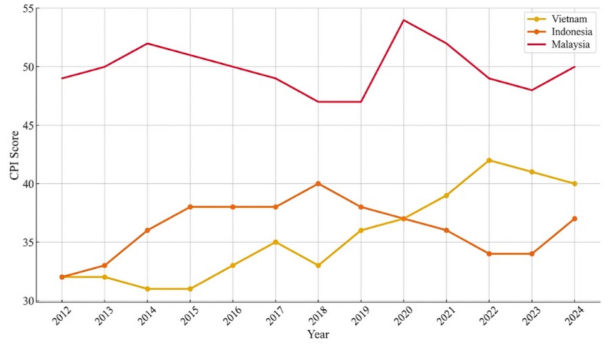
Finally, education expenditure is found to be statistically significant at the 5% level, with a positive effect on FDI inflows. A 1% increase in education expenditure is associated with approximately USD 1,147 million in additional FDI inflows. This suggests that greater investment in education enhances the quality of human capital, thereby strengthening the country's attractiveness to foreign investors. Moreover, this result supports the view that the quality of human capital reinforces labor market competitiveness, complementing the effect of wage levels. This finding is consistent with Delevic and Heim (2024), who argue that human capital quality is crucial for attracting high-quality, knowledge-intensive FDI.

### *4.2. Discussion*

The empirical findings of this study confirm that institutional quality, particularly control of corruption, plays a significant role in attracting foreign direct investment (FDI) inflows in ASEAN countries. The regression results indicate that improvements in corruption control are positively associated with higher FDI inflows, suggesting that governance quality is not merely a supporting condition but a key economic determinant of multinational enterprises' location decisions. This relationship is further reinforced by the observed evolution of governance indicators in Vietnam, Indonesia, and Malaysia over the period 2005-2024.

The trends from the Corruption Perceptions Index (CPI), the World Bank's Control of Corruption indicator, and the Rule of Law index reveal that institutional quality in ASEAN remains highly uneven across countries. Malaysia consistently records stronger governance performance compared to Vietnam and Indonesia, maintaining relatively stable and positive institutional indicators throughout the period. In contrast, Vietnam and Indonesia continue to face governance challenges, though both countries have shown gradual improvements over time. These differences highlight the diverse institutional trajectories within ASEAN despite the region's increasing economic integration.

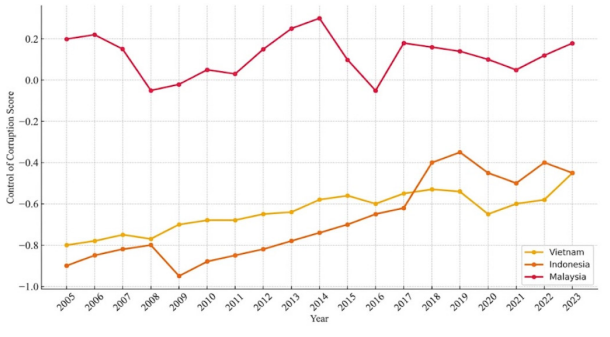
**Figure 2: Corruption Perception Index in 3 selected countries (2012-2024)**




*Source: Transparency International*

A first key observation is that institutional quality in ASEAN remains highly heterogeneous, both across countries and over time. As shown in the CPI trends (2012-2024), Malaysia consistently performs at a significantly higher level compared to Vietnam and Indonesia. Malaysia's CPI score remains relatively stable at 47-54, indicating a moderately strong perception of corruption control and institutional transparency. In contrast, Vietnam and Indonesia remain at lower levels, although both show gradual improvement over time. Vietnam's CPI score increases steadily from around 31-32 in the early 2010s to above 40 in recent years, while Indonesia exhibits a more fluctuating but overall upward trend. This divergence highlights that while ASEAN economies share a regional integration framework, their institutional trajectories remain highly uneven.

**Figure 3: Control of corruption index in 3 selected countries (2005-2023)**




*Source: World Bank*

A similar pattern is observed in the World Bank Control of Corruption index (2005-2023). Malaysia consistently records positive governance scores, reflecting relatively effective institutional enforcement and lower perceived corruption risks. Vietnam and Indonesia remain in negative territory for most of the period, although both countries show gradual improvement over time. Vietnam demonstrates a clear upward trend from approximately -0.8 in the mid-2000s to around -0.4 in recent years, suggesting gradual institutional strengthening. Indonesia also improved after 2016, although the trajectory is less stable due to policy reversals and inconsistent reforms.

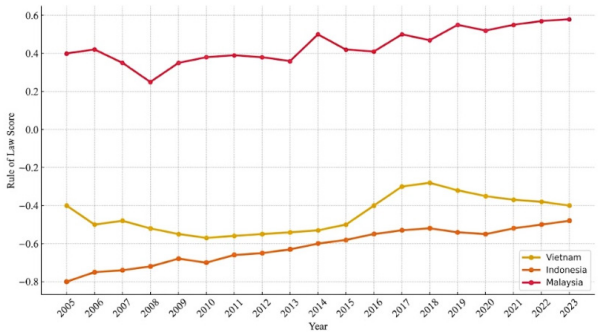
These patterns are consistent with the regression results of this study, which show a positive and statistically significant effect of control of corruption on FDI inflows. Stronger anti-corruption controls reduce transaction costs, improve policy predictability, and increase investor confidence, all of which are important for multinational enterprises making long-term investment decisions. Empirically, improvements in governance indicators in Vietnam and Indonesia correspond with rising FDI attractiveness, particularly in manufacturing and export-oriented sectors.

Vietnam illustrates how gradual institutional reform can improve investment attractiveness even without high governance scores. The 2005 Anti-Corruption Law, subsequent amendments, and the establishment of the Central Steering Committee for Anti-Corruption demonstrate increasing political commitment to governance reform. More recently, the "blazing furnace" campaign intensified enforcement efforts and strengthened institutional credibility. Although Vietnam still records relatively weak governance indicators compared to regional peers, the upward trend suggests improving investor confidence.

Indonesia presents a more complex trajectory. The establishment of the Corruption Eradication Commission (KPK) after the 1998 democratic transition initially improved governance credibility and investor confidence. However, legal amendments such as Law No. 19/2019 weakened the KPK's independence and raised concerns regarding enforcement effectiveness. As noted by Badry and Basir (2022), these reforms may reduce anti-corruption efficiency through additional bureaucratic constraints. This institutional inconsistency is reflected in Indonesia's fluctuating governance performance.

Malaysia, by contrast, represents a case of relatively stronger institutional stability but also demonstrates how governance shocks can damage investor perception. Despite generally stronger corruption-control indicators, the 1MDB scandal significantly weakened institutional credibility and international reputation. As documented by Tan (2021), the scandal exposed major governance failures involving high-level political actors and financial mismanagement. In response, the government introduced the National Anti-Corruption Plan and the National Anti-Corruption Strategy (NACS 2024-2028) to restore institutional credibility and reinforce governance integrity.

**Figure 4: Rule of law index in 3 selected countries 2005-2023**




*Source: World Bank*

The Rule of Law indicators further complement this interpretation. As shown in Figure 17, Malaysia consistently outperforms Vietnam and Indonesia, maintaining relatively stable and positive scores over time. Vietnam and Indonesia, although improving gradually, remain in negative territory, indicating persistent challenges in legal enforcement, judicial independence, and contract security. This divergence is particularly important for FDI decisions, as the rule of law is closely linked to investor protection and the efficiency of dispute resolution.

## 5. Conclusion

This study examines the determinants of foreign direct investment (FDI) inflows in ASEAN countries over the period 2002-2021, with a particular focus on institutional quality and human capital development. Using panel data regression analysis, the findings reveal that both control of corruption and education expenditure play significant roles in shaping FDI attractiveness in the region. In addition, macroeconomic factors such as GDP growth, average salaries, and population growth are found to influence foreign investment inflows. The empirical results indicate that stronger control of corruption has a positive and statistically significant effect on FDI inflows. This suggests that improvements in transparency, accountability, and governance quality create a more predictable and reliable business environment for multinational enterprises. The findings are further supported by institutional developments in Vietnam, Indonesia, and Malaysia, where anti-corruption reforms and governance initiatives have gradually strengthened investor confidence, though effectiveness varies across countries.

Furthermore, the study finds that education expenditure positively affects FDI inflows, highlighting the importance of human capital development in attracting foreign investors. Increased investment in education contributes to a more skilled and productive labor force, which is particularly important for efficiency-seeking and knowledge-intensive FDI. This finding reinforces the view that ASEAN countries must prioritize long-term human capital development to enhance their competitiveness in global value chains.

In conclusion, this research contributes to the existing literature by focusing specifically on control of corruption and education expenditure as key determinants of FDI inflows in ASEAN economies. The findings suggest that sustainable FDI attraction depends not only on economic growth but also on institutional credibility and the quality of human capital. Therefore, ASEAN governments should continue strengthening anti-corruption frameworks, improving governance effectiveness, and investing in education systems to create a more competitive and investment-friendly environment for long-term economic development.

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