

## Institutional Quality and Foreign Direct Investment Nexus: The Nigerian Scenario

Abdulsalam S. Ademola<sup>1\*</sup>, Fabiyi.O. Tanimola<sup>2</sup> and Lawal Wasiu. O.<sup>3</sup>

<sup>1,3</sup>Department of Economics and Development Studies, Federal University Dutsin-Ma, Nigeria.

<sup>2</sup>Department of Economics. F.C.E Katsina State.

### \*Corresponding Author

Abdulsalam S. Ademola

Department of Economics and Development Studies, Federal University Dutsin-Ma, Nigeria.

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**Abstract:** The flow of FDI has largely been undermined in the country, this could largely be due to some underpinning factors among which could be the quality of institutions. It is for this reason that this study tries to examine the nexus between institutional quality and Foreign Direct Investment (FDI) in Nigeria, data were sourced from the acknowledged issues of Central Bank of Nigeria (CBN) statistical bulletin (2022), National Bureau of Statistics (NBS,2022) and World Development Indicator. Government Effectiveness (GOEF), Quality of Service Delivery (QSDE) and Political Risk Stability (PRSK) were all used to proxy quality of institutions, while Foreign Direct Investment (FDI) serve as dependent variable. The ARDL model was used as techniques of analysis and after establishing the mix order of integration that is I(0) and I(1). The findings revealed that institutional variables are positively related to (FDI) and statistically significant at 1% in both period, which implies that quality of institution matters if the nation must attract foreign direct investment. Specifically, in long run, a percentage change in quality of services delivery and political stability will lead to 9% and 17% change on FDI respectively and they are all significant at 1%. It is recommended that institutions should be enhanced by away of enforcing discipline into civil service, ensure rule of law take its course and create investment conducive environment in order to attract more foreign investment in Nigeria.

**Keywords:** Foreign Direct Investment (FDI), Institutions, Institutional Quality and Investment.

**JEL Classifications:** EO2, O43.

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## 1. Introduction

Increasing sustainable economic growth and development has been a primary goals and priority of every economy be it developed or developing, and how to achieve it is an issue of concerns to both policy maker, government and researchers in this area of study. It is an issue of concerns because achieving economic growth and development is determined by many factors both economic and non-economic determinants. In terms of economic factors, variables such as investment unemployment, inflation, balance of payment etc plays a vital role in achieving economic growth and development according to macroeconomics theorist, while non-economic factor includes institution such as governance, corruption, rule of law, quality of services delivery of which its significant impact on economic growth has been established according to Acemolgu (2005)

Investment has been described as the bedrock of growth and development most especially Foreign Direct Investment (FDI). According to Classical and Keynesian school of thought, investment is a prime mover of any economic growth most especially in developing countries. It improves level of output, increase productivities, creates more jobs, more income at both

individual and corporate organization level and enhance foreign exchange competitiveness and favourable balance of payment. (FDI) has been described as energy booster in achieving economic growth and development most especially in developing countries (Jindřichovská, et al, 2020). It is cogent ingredient of international integration of emerging economies for some decades, implying that a stringent n feature in the diffusion of knowledge across borders (Alguacil et al., 2011; Dasgupta, 2012). Consequently, FDI is seen as the engine of growth, more capital injection, competition and productivity of local firms through new technologies and human capital development.

Moreover, FDI inflows have been a source of economic advancement in developing countries, of which many of these countries have continuously engaged by creating promotion strategies, offering a several investment incentives and executed policies to abate its inflows and stimulate varying engagement. Sanity in Financial sector, recovery growth plan and partnership in economic dealings are salient examples of these types of programs and policies. Foreign direct investment (FDI) bridge the gap between savings and investment requirements. Endogenous growth theories stressed on the role played by FDI is an important predictor of growth path since it is crucial technical transfer from

industrialized countries to developing countries as a result of international partnership. By strengthening the skills and knowledge of workers in the host country, FDI has the capacity of bringing unemployment to its barest minimum.

Institutions on the other hand according to (North, 1990), refers to “the humanly devised constraints that shape human interaction” – they are “the rules of the game in society”. North explains that “institutions are made up of formal constraints (rules, laws, constitutions), informal constraints (norms of behaviour conventions and self-imposed codes of conduct), and their enforcement characteristics. Together they define the incentive structure of societies and specifically economies” institutional quality on the other hand is defined in terms of its components which includes; quality of governance in such economy, quality of rules of law, quality of service delivery, less corruption, political stability etc.

According to Martins & Latifat, (2015), institutions in recent time has been identified as a determinant factor that drives the transformation agenda of any economy most especially developing economy. Over time institutions have been commonly used recklessly in the political environment by exercising series of control over the society and the utilization of its resources purposely for development.

However, given the benefit and importance of FDI as highlighted above, certain prerequisites must be met in the host country to attract FDI inflow and convert the potential benefits into positive spill-overs (Crespo et al., 2007; Gorodnichenko et al., 2014). One of these prerequisites are the quality of institution in such country which is one of the non-economic determinants of growth. In the previous studies, most of the studies were tented towards economic determinants, while non-economic determinants, including the institutional quality dimension, were seriously downplayed which might have a serious consequence in the validity of inference. A country with strong institutional setting, is usually characterised with good governance, which is expected to increase nation’s FDI absorptive capacity. The most significant debate for foreign investment is that qualitative governance and strong institutions usually reduces transaction costs of investment in a particular country (Brouthers et al., 2008). It is for this reason that this study tends to examine the nexus between institutional quality and foreign direct investment with evidence from Nigeria. Following the introductory section, section two presents the literature review; section three discusses the methodology used in the study. Section four contained data analysis and interpretation, while section five concludes the study.

## 2. Literature Review

### 2.1 Theoretical Literature

Institutional school of thought provides that, the prosperity of a society depends on its economic institutions and this is dated back to Adam Smith (1776) as contained in Ricardian or neo-classical school of thought, who provides an analysis of the role of market in the economic system. The basis of this school of thought is that growth variables can be become largely ineffective due to market imperfections which impose huge transaction cost on economic agents, and induce a country to be stuck in a detrimental equilibrium which is Pareto non-optimal. The view is that the market structure is endogenous and partly determined by adherence

to the rule of the game and the enforcement of property rights, which ultimately impacts on how the gains of the exchange are distributed among the players and ensure equality of opportunity capable of improving long-run economic performance. But with the efficient working institution, market imperfection will be restored and transaction cost will be reduced.

North (1990) provide more robust framework in scope and modification to the neo-classical comparative advantage framework by injecting some dynamics approach into their doctrine, through openness of economy. North’s central argument was that although, the increase in trade, production efficiencies from economics of scales and division of labour have tended to endure, they did not offer a fresh, more comprehensive theoretical approach. He considered institutions as the important channel through which formal and informal constraints determining the rules of exchange such as high transaction cost in the economic system could be reduced. Reduction in transaction cost and openness of economy will attracts Foreign Direct Investment (FDI) which will boost economic activities. This was developed not as an alternative but complimentary approach to address what was considered the inadequacies of the neoclassical paradigm.

### 2.2 Empirical Review

There are many studies on institutional quality and economic growth and so also on foreign direct investment (FDI) with economic growth, Zhang (2001), Makki and Somwaru (2004) and Liu (2008), but empirical literature on institutional quality and FDI in Nigeria is very scanty to the best of our knowledge. There is also mixed reaction of the findings of some available studies. Some studies documented a positive relationship Bucharan BG, & Rishi M (2012), Nguyen Hoa, and Cao Hong Vinh, (2018) and Behera C. & Mishra B. (2020) while others reported an inverse relationship (Juric L., Franc S. and Barisic A., (2020), Bayar et al. (2016).

Bucharan BG, & Rishi M (2012) examined the impact of institutional quality on Foreign Direct Investment (FDI) level and volatility using panel data analysis of 164 countries from 1996-2006. The findings of the study indicates that good institutional quality matters for FDI inflows in the selected countries. The study also provides evidence that institutional quality has a positive and significant effect on FDI., which implies that after controlling for some economic determinants, non-economic determinants like institution matter attracting FDI in such economy, but its effect on FDI volatility is insignificant.

In a related study by Hoa, and Cao Hong Vinh, (2018), on the impact of foreign direct investment (FDI) inflows in Vietnam using fixed effect technique of data analysis on a time series data from 1996-2016. The findings support the positive effects of institutional quality in general on FDI inflows to Vietnam. Furthermore, specifically, political stability, absence of violence, regulatory quality, government effectiveness and control of corruption proves to be the strong determinants factors for attracting FDI in Vietnam. The study therefore recommends strong hold of intuitional quality in Vietnam.

Similarly, Behera et al (2020) examined the impact of institutional quality on FDI inflows for emerging economies from South Asian countries from the period of 2002 to 2018 using Im-Pesaran-Shin (IPS) panel unit root test and ARDL- PMG Model with panel granger causality. The study find out that there exist a long run relationship between institutional quality and FDI. Controlling for

economic determinants such as GDP, globalization, financial development, the study finally find out that institutional quality strongly causes FDI inflow given the economic determinants. The study recommended that policy makers should focus more on institutional quality along with economic determinants such as gross domestic product, globalization, financial development for higher inflows of FDI in the emerging economies.

On a contrary view, Jurcic L., Franc S. and Barisic A.(2020) examined the relationship between non-economic determinants and FDI inflow in Croatia from 1996-2017 using OLS regression technique of analysis. The result of the exploratory study shows that institutional quality including regulatory quality, political stability, government effectiveness, rule of law and control of corruption could not be established as a significant determinant of FDI inflows in Croatia but economic determinants such GDP per capita, average gross wages proves to be a strong determinant of FDI inflows. The study concluded that institutional quality does not matter in attracting FDI and recommended that economic factors should be strengthening in order attract more FDI in Croatia.

In line with above submission by Jurcic L., Franc S. and Barisic A, (2020), Bayar et al. (2016) concluded that control and rule of law do not play any role on FDI inflows. Madr et al. (2015) argued that, the role of political institution including the quality of democracy, political instability and terrorism and the impact of corruption on the inflow of FDI in emerging markets. Their results suggest that the influence of the political environment on FDI is not unambiguous in emerging markets, while political instability and terrorism shows a significant variable.

In the view of Abdella et al. (2017), corruption does not significantly affect FDI flows in the BRIC countries (Brazil, Russia, India, and China), similarly, trade openness and political stability are indicative variables explaining the flow of FDI flows. Peres et al. (2018) investigated the role of institutional quality on FDI in developed and developing countries, their findings implies institutional quality is an important variable explaining of FDI in developed countries having a positive impact, while it is cogent in developing countries due to weak institutional structure.

The available empirical review indicate that the findings of the past studies are mixed up and at time very ambiguous, as some studies

reported positive impact while others negative. Also, the empirical study combining institutional quality and foreign direct investment is also not available in Nigeria context, hence the need for this study.

### 3. Methodology

#### 3.1 Materials and Method

This study employs times series data from 1981 to 2021 using macroeconomic variables such as; Gross Domestic Product per capita as a control variable to minimize specification bias. The dependent variable is FDI which were captured as total inflows as a percentage of Gross Domestic Product (GDP), and independent variable are the non-economic factor (institutional Quality) captured by Quality of Service Delivery (QSDE), which is the degree of labour dedication, responsiveness, reliability and commitment to work, government effectiveness (GOEF), captured by perception of the quality of public services and the degree of its independency from the political pressures, Political Risk/ Stability (PRSK) captured by absence of violence and insecurity in the country and Trade Openness (TOPN) and (RGDP) as a control variables. All the institutional variables indicators are sourced from Word Development Indicator while FDI per capita variables are sourced from central bank of Nigeria (CBN) statistical bulletin and National Bureau of Statistics NBS, (2022)

#### 3.2 Model Specification

Following the model specification by Jurcic et al (2020), the study includes the following institutional quality indicators (independent variables): Government Effectiveness (GOEF), Political Risk/ Stability (PRSK), Quality of Service Delivery (QSDE) and Trade Openness (TOPN) as a control variables, while Foreign Direct Investment (FDI) is the dependent variable. According to Rodrik and Subramanian (2003) in Jurcic et al (2020), they based the independent variables into basically three parts stressing the overall institutional quality QSDE measure the quality of market-creating institutions, GOEF measures the quality of market- regulating institutions while PRSK the quality of market-stabilizing institutions. The regression model exploring the quality of institutions effects on FDI inflows according to Jurcic et al (2020) is explained below:

$$FDI_{pc} = \beta_0 + \beta_1 GOEF + \beta_2 QSDE + \beta_3 PRSK + \beta_4 TOPN + \mu \text{-----}(1)$$

Where;

$FDI_{pc}$  = Foreign Direct investment per capita

$GOEF$  = Government Effectiveness

$QSDE$  = Quality of Service Delivery

$PRSK$  = Political Risk Stability

$TOPN$  = Trade Openness as percentage of GDP

$\beta_0$  = the intercept or constant

$\mu$  = Error terms

$\beta_1, \beta_2, \beta_3,$  and  $\beta_4,$  are the coefficient of independent variable to be estimated. The a priori expectation of all the independent variable is that they are expected to be positively correlated with FDI Variable all things be equal i.e  $\beta_1, \beta_2, \beta_3,$  and  $\beta_4, > 0.$

### 3.3 Model Estimation Technique

The study adopts the Autoregressive Distributed Lag (ARDL) technique by Pesaran and Shin (1999) which was extended by Pesaran, Shin, and Smith (2001) to determine the relationship between institutional quality variables and FDI for the period under consideration. The ARDL method is applicable given that the order of integration of all the variables are mixed up that is I(0) and I(1). This approach is superior to other types of cointegration approach because it has a single-equation set-up and it is easy to interpret. The variables used in the model can be assigned different lag-lengths.

The dynamic short run and long run unrestricted ARDL model are specified as;

$$\Delta[(\ln FDI)_{t}] = \beta_0 + \beta_1 (\ln FDI)_{t-1} + \beta_2 \ln(GOEF)_{t-1} + \beta_3 (QSDE)_{t-1} + \beta_4 (PRSK)_{t-1} + \beta_5 (TOPN)_{t-1} + \sum_{i=1}^p \alpha_1 \Delta \ln(FDI)_{t-1} + \sum_{i=1}^m \alpha_2 \Delta \ln(GOEF)_{t-1} + \sum_{i=1}^n \alpha_3 \Delta \ln(QSDE)_{t-1} + \sum_{i=1}^n \alpha_4 \Delta \ln(PRSK)_{t-1} + \sum_{i=1}^n \alpha_5 \Delta \ln(TOPN)_{t-1} + \varepsilon_t$$

again:

$$\Delta[(\ln FDI)_{t}] = a_0 + \sum_{i=1}^p \alpha_1 \Delta \ln(FDI)_{t-1} + \sum_{i=1}^m \alpha_2 \Delta \ln(GOEF)_{t-1} + \sum_{i=1}^n \alpha_3 \Delta (QSDE)_{t-1} + \sum_{i=1}^n \alpha_4 \Delta PRSK_{t-1} + \sum_{i=1}^n \alpha_5 \Delta TOPN_{t-1} + \sum_{i=1}^n \alpha_6 \Delta Recm_{t-1}$$

## 4. Result and Discussion

### 4.1 Unit Root Test

To ascertain the stationarity properties of the variables used to avoid spurious regression, the study employed the first generation test such as (ADF) and (PP). The unit root results is presented on table 4.1

**Table 4 1: Stationarity Test Result**

Variables	ADF		PP		Order of Integration	Remarks
	Level	1 <sup>st</sup> diff	Level	1 <sup>st</sup> diff		
FDI	-3.4543	-8.7868***	-3.3648	14.3362***	I(1)	Stationary
GOEF	-0.3553**	-3.9262	-0.4194	-4.1014***	I(0)	Stationary
PRSK	-2.7187	-8.2566***	-2.7187**	-8.3486	I(0)	Stationary
QSDE	-2.6451	-6.9392***	-2.6807	-6.9009***	I(1)	Stationary
TOPN	-2.5757	-8.4218***	-2.3833	10.0042***	I(1)	Stationary

Source: Researchers’ computation (2023) using E-view 9

**Notes:** Significance is indicated by \*\*\* \*\* and \* at 1%, 5%, and 10%, respectively. L stands for logarithm, and Lag length is measured by the use of SIC.

The unit root result in Table 4.1 revealed that most of the variables have unit root at their levels, which means they are not stationary. The only exception is GOEF and PRSK at Phillips Perron level which are found to have no unit root at level and hence, are stationary at level or integrated of order zero, i.e. I(0). After taking the first difference of the remaining variables they became stationary, hence, they are integrated of order one I(1).

### 4.2 Cointegration Test

After determined the properties of the variable used, the next is to find out if there exist long run equilibrium among the variables using ARDL Bound Test. Table 4.2 presents the result of the ARDL Bound test conducted.

**Table 4 2: ARDL Bound Test Result**

Test Statistic	Value	K
F-statistic	5.6297	4
Critical Values		
I(0) Bound	I(0) Bound	I(1) Bound
2.427	2.427	3.395
2.893	2.893	4
3.967	3.967	5.455

Source: Researchers’ computation (2023) using E-view 9

The result of the ARDL bounds test for cointegration presented in table 4.2 shows that the computed F-statistics (5.6297) is greater than the upper and lower bound at 1% significant level. This implies that there is a cointegration among the variables.

**ARDL Estimation**

The estimated coefficients of both dependent and independent variables are presented in Table 4.3 panel **a** and **b** for both long and short run.

**Table 4.3: Short and Long Run Results**

<b>PANEL A: Cointegrating Form (Short Run Estimates)</b>				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(GOEF)	0.022856	0.036522	0.625802	0.5367
D(PRKS)	0.095006	0.032751	2.900864	0.0073
D(QSDE))	0.074211	0.039704	1.869114	0.0725
D(TOPN)	-0.044470	0.016562	-2.685071	0.0122
D(TOPN(-1))	-0.037077	0.017433	-2.126749	0.0427
CointEq(-1)*	-0.907435	0.143417	-6.327232	0.0000

R-squared	0.711240	Mean dependent var	0.023424
Adjusted R-squared	0.650496	S.D. dependent var	1.192867
S.E. of regression	0.799758	Akaike info criterion	2.534924
Sum squared resid	20.46761	Schwarz criterion	2.793490
Log likelihood	-42.16356	Hannan-Quinn criter.	2.626920
Durbin-Watson stat	2.177230		
F-Statistic	386.7622		
Prob(F-statistic)	0.000000		

<b>PANEL B: (Long Run Coefficients)</b>				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
GOEF	-1.018082	2.596209	-0.392142	0.6980
PRKS	0.176378	0.055041	3.204482	0.0035
QSDL	0.096500	0.057756	1.670835	0.0063
TOPN	0.007295	0.019860	0.367341	0.7162
C	-4.155178	3.480176	-1.193956	0.2429
EC = FDIN - (-1.0181*GOEF + 0.1764*PRKS 0.0965*QSDL + 0.0073*TOPN -4.1552 )				

Source: Researchers’ computation (2023) using E-view 9

The result of long run estimate indicate that all the variable are rightly signed according to a priori expectation and statistically significant at 1%, except the coefficient of GOEF which is negative and not statistically significant. Specifically. A percentage change in political stability and quality of service delivery will bring about 17% and 9% changes in foreign direct investment. This implies that the more stable a country is politically and the more the quality of service delivery in the country the better the level of foreign direct investment in the country. This finding of the study is similar to the findings by Behera & Mishera, (2020) and Nguyen & Siham (2013) who respectively investigated the effect of institutional quality foreign direct investment in Sub-zaharah African ans Vietnam.

Table 4.3b presents the result of short run estimation of the coefficient of the variables used in the study. Like long run, short run coefficient share similar behaviour with that of long run in terms of signs and magnitude in accordance with a priori expectation. But in the case of short run all institutional variables government effectiveness, political stability and quality of service delivery are positively related to FDI and are statistically significant at 1% except government effectiveness that are not statistically significant. The policy implication of this findings is that the more effective the government of Nigeria are, the better chance of accessing foreign investment and also the more stable the country is and the more quality of services render in the country the better chance Nigeria as a country has in attracting foreign investment. The findings is consistent with the finding of studies such as Nguyen & Cao, (2013), Bounoua & Siham, (2014) and Behera & Mishera, (2020), and it is inconsistent with the findings of Jurcic et al (2020).

**4.3 Diagnostics Test Result**

The study carried out various diagnostic tests to determine the adequacy of the estimates such as the Normality test (Jaque-bera (JB)) for normal distribution of error or the residuals, Serial Correlation (Breusch-Godfrey LM Test) , Heteroscedasticity test (Breusch-Pagan-Godfrey), and Model specification test using Ramsey RESET Test. The results of the diagnostic test are presented in table 4.4 below:

**Table 4.4: Result of ARDL Diagnostic tests**

Tests	F-statistics	Prob. Value
Normality((Jarque -Bera Test Statistics)	3.70707	0.15668
Serial Correlation(Breusch-Godfrey LM Test)	0.68090	0.56262
HeteroscedasticityTest: Breusch-Pagan-Godfrey	1.42325	0.2231
Specification Error (Ramsey RESET Test)	4.2045	0.4505

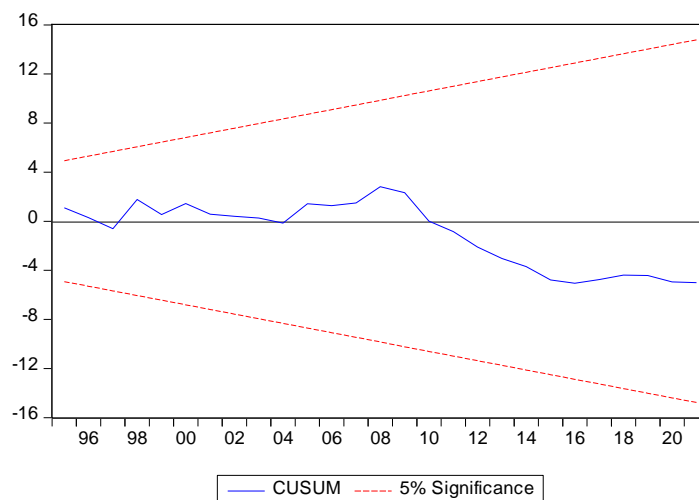
**Source.** Authors’ computations

From the Table 4.4 above, the results of the ARDL diagnostic tests show the Jarque-Bera tests for normality reports 3.70707 and it associates probability value of (0.15668)pass the normal distribution test because the Jarque-Bera probability values are not significant at all levels. Therefore, the error term in the model is normally distributed during the study period. The results of Serial Correlation (Breusch-Godfrey LM Test) indicate the absence of the serial correlation or no autocorrelation as the F-statistic is not significant as indicated by probability value of 0.56262, which means the effect of previous period does not affect the present situation. Besides, the results of heteroskedasticity, also shows the F-statistics is not statistically significant at 5% level, with a probability value of (0.2231) this signifies that there is zero mean and constant residual. Therefore, the model is free from heteroskedascity problem. Meanwhile, the results of Ramsey (1969) Reset test of Misspecification the F-statistic is not also statistically significant indicated by p-value of (0.4505).As expected the test result is considered meaningful because the p-value is not significant at any level of significance and it implies that the residuals in the models are free from any diagnostic problems.

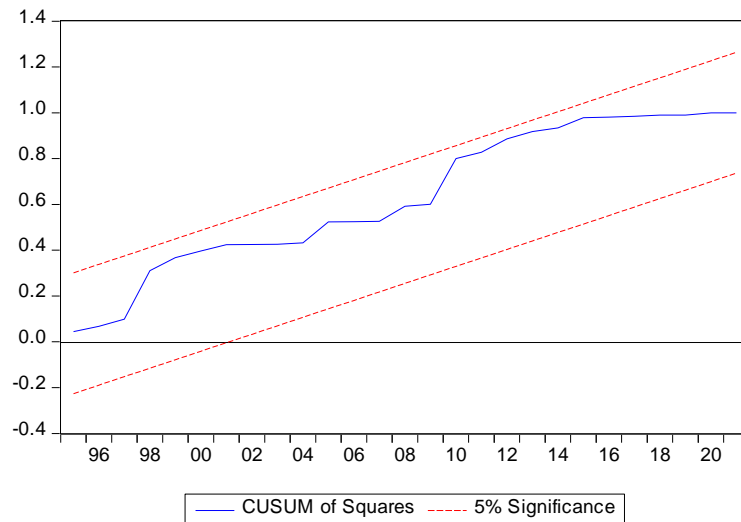
**4.4.1 Stability Test**

The result of the (CUSUM) is presented, If the results are within 5% level of significance, it implies there is stability and significant relationships among the variables. The figures 1 and 2 below presents the result of CUSUM and CUSUM Square

**Figure 1: CUSUM Test Result**



**Figure 2: CUSUM Square Test Result**



Both Figure 1 and 2 shows the result of the stability test which is within 5% level of significant. The results are instructive as it shows no room for spurious regression in both cases because the blue line is in-between the two red lines. Implying that all variables used are stationary and the model is stable over the period of investigation.

### Discussion of Findings

The study investigates the impact of institutional quality on foreign direct investment in Nigeria using second generation institutional indicators. The specific objectives of the study is to investigate the impact and how institutional quality affect economic growth through foreign direct investment. The result of long run estimate indicate that, all the variable are rightly signed according to a priori expectation and statistically significant at 1%, except the coefficient of GOEF which is negative and not statistically significant. The policy implication of this findings is that the more effective the government of Nigeria are, the better chance of accessing foreign investment and also the more stable the country is politically and the more quality of services render in the country the better chance for Nigeria as a country to attracts foreign investment and hence economic growth. This finding of the study is similar to the findings by Behera & Mishera, (2020) and Nguyen & Siham (2013) who respectively investigated the effect of institutional quality foreign direct investment in Sub-zaharah African ans Vietnam and it is inconsistent with the findings of Jurcic et al (2020).

## 5. Conclusion and Recommendations

### 5.1 Conclusion

The study investigates the impact of institutional quality on Foreign Direct Investment (FDI) in Nigeria using time series data covering the period from 1961-2021. ARDL econometric model were used to analyse data sourced from the Central Bank of Nigeria statistical bulletin and World Bank Development indicators. The finding of the study indicate that institutional variables that is political stability, government effectiveness and quality of service delivery are positively related to foreign direct investment and significant at 1% , both in the short and long run. This implies a country that is stable politically, more effective in

terms of governance and deliver quality services will attract foreign direct better than the country with other side of the indicators. The study therefore concluded that institutional Quality have a strong positive relationship with FDI and have significant impact in attracting foreign direct investment in Nigeria which will foster economic growth and development.

### 5.2 Recommendations

The study recommends that, for Nigerian economy to attract more foreign investment, the institutions need to be strengthened. This can be achieved by enforcing discipline in the civil service, by away punishing the offender and reward the dedicated ones, ensure that the rule of law take its course without any interference from government, open up economy to international market so as attracts foreign investors and increase level of output. Conducive investment climate should be created, by addressing the challenges of insecurity in the country and providing incentive like reduction in tax rate or tax holiday to encourage local production in order to encourage investors both local and foreign in Nigeria.

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