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Do institutions matter for Foreign Direct Investment in Cambodia?[1]

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Abstract

The paper analyzes the relevance of institutions for inward FDI flows to Cambodia over 1995-2014. Using panel data analysis with random effects estimation procedures, we find that institutional quality matters for the enhanced FDI flows. Regulatory quality, rule of law, and voice and accountability are found to be positively associated with a rise of FDI in Cambodia. We also find that trade relations and bilateral investment agreements are important determinants while political risk is a deterrent to FDI in the Kingdom. Resource-seeking is one of the motives of foreign investors. The paper also offers some policy implications which may be relevant for Cambodia as well as for developing countries or transitional economies with similar levels of economic development and institutional quality.

JEL classification: C23; F23
Key words: Foreign Direct Investment; Institutions; Governance; Cambodia

1. Introduction

Foreign direct investment (FDI) has been viewed as one of the key factors driving economic growth and development of many transitional and developing economies. Thus, the governments of these countries prioritize to lure FDI by adopting liberal policies towards foreign investment activities and by promoting inward FDI. There is no exception for the Kingdom of Cambodia. Since after the first-ever general elections of 1993, Cambodia has attracted an increasing amount of realized FDI stocks, reaching more than US$13 billion in 2014, according to the data made available by the National Bank of Cambodia (NBC). The Kingdom has widely liberalized its economy and opened it up to the outside world. It also adopted a very liberal FDI policy, with no restrictions on equity share, greatly simplified registration procedures, and generous fiscal incentives for the implemented FDI projects.[5]

Multinational firms decide to invest in a foreign country if ceteris paribus their expected returns on investment are higher in the host country than elsewhere. These returns depend primarily on the firms' operation costs, which are negatively correlated with the higher quality of the host's institutions, such as economic freedom, state fragility, political rights, and/or civil liberties. (Du, et al., 2008). The current paper empirically investigates the effects of institutions on inward FDI in Cambodia.

The effects of institutions on FDI have received relatively limited attention, while the economic determinants of FDI flows have been well documented (Liu et al., 1997; Wei and Liu, 2001; Cuyvers et al., 2011). Several previous studies especially concentrated on some specific institutional aspects such as corruption (e.g. Cuervo-Cazurra, 2006) and tax regime/fiscal freedom (e.g. Buettner and Ruf, 2007), but few investigated the role of a wider range of institutions (e.g. Pournarakis, and Varsakelis, 2004; Ali et al., 2010). Since the seminal works by Nobel Laureate in economics Douglas C. North (1990, 1991, 1994, 2005), more attention has been devoted to the impact of institutional quality on FDI flows (Li and Resnick, 2003; Daude and Stein, 2007; Tintin, 2013; Ledyaeva et al., 2013; Zeshan and Talat, 2015).

Institutions affect economic performance of an economy through their influence on people's behavior, and transaction and production costs, which in turn determine profitability and feasibility of engaging in economic activities. The differential economic performance over time is influenced by the evolution of institutions over time (North, 1990). It is interesting to mention that Dunning (2006) and Dunning and Lundan (2008) have incorporated institutional factors into the received eclectic paradigm[6] and posited that high quality of host-country institutions,

[5] Hill and Menon (2013) indicate that the fiscal incentive offered by Cambodia for FDI projects is perhaps too generous.
[6] Dunning (2006) incorporates the work of three Nobel Laureates in economics, namely Amartya Sen, Joseph Stiglitz and Douglas C. North, into his seminal eclectic paradigm of ownership, location and internationalization to theorize the determinants of transnational corporations.

enforcement mechanisms and transaction cost effectiveness will encourage multinational firms to engage in FDI in the host economy.

Previous studies on motives of FDI locations have used gravity models and have focused primarily on the conventional economic, geographical and political determinants of FDI (Liu et al., 1997; Wei and Liu, 2001; Zhao, 2003; Asiedu, 2006; Buckley et al., 2007). Recently, some studies have shifted from the traditional FDI-determining factors towards the roles that institutions and governance have played in locational decisions of foreign investors in a host economy, especially in developing and transitional countries (Busse and Hefeker, 2007; Masron and Nor, 2013; Anyanwu and Yameogo, 2015).

This paper contributes to the existing literature on locational determinants of FDI by testing a wider range of institutional factors that may influence the decisions of multinational firms to launch investment projects in Cambodia, a small highly open Southeast Asian country whose institutions, basic infrastructure and human capital were totally destroyed by the genocidal regime of the *Khmer Rouge*, many years of the enduring internal conflict[7] and economic embargos by Western powers.

The remainder of the paper is organized as follows. Section 2 provides a brief review of the literature on the linkages between institutions and foreign direct investment. Section 3 presents some stylized facts of inward FDI flows and institutions in Cambodia. This is followed by the discussion on econometric specification, estimation procedures, and data sources in Section 4. Section 5 offers empirical results and discussion. Finally, Section 6 concludes and offers some policy implications.

2. Nexus between Institutions and Foreign Direct Investment[8]

Institutions are the rules of the game in a society (North, 1990, 1991, 1992). There are several definitions of institutions.[9] They are defined as the humanly devised constraints that shape economic, social and human interactions and set the rules of the game for organizations to follow. Institutions are composed of informal constraints (ethnical norms, customs, traditions and codes of conduct), formal rules (constitutions, laws, and property rights), and characteristics of enforcing those constraints (North, 1992). These formal and informal institutions establish rules and procedures that reduce costs and uncertainty in commercial exchanges as they provide

[7] Cambodia suffered enormously from the atrocities committed by the *Khmer Rouge* regime which was overthrown on 7 January 1979, after which the Kingdom continued to face another economic hardship inflicted mainly by the economic embargoes imposed by the Western super powers. Moreover, Cambodia continued to suffer from enduring internal conflicts until after the first-ever general elections sponsored by the then United Nations Transitional Authority of Cambodia (UNTAC). Only since late 1998 has Cambodia enjoyed full peace, security and national unity, thanks to the *win-win* policy initiated by Samdech Prime Minister Hun Sen.

[8] This section is based largely on Soeng et al. (2016)

[9] To Neale (1987), an institution is 'a mental construct', while institutions refer to 'both the internalized injunctions that people follow and the actions that others will take to enforce the injections or to protect people in the liberties and opportunities that institutions provide'. According to Parto (2005), institutions are defined as 'the set of conventions and rules of action that prevail in the economy and are embedded in the social structure'.

parties concerned with enforcement mechanism (Ali et al., 2010). Young (1994) describes institutions as sets of rules of the game or codes of conduct defining social practices. More broadly institutions are social relations that frame production, consumption and exchanges, acting as a structure within which individual action in the economy takes place (Parto, 2005). Despite a range of definitions of institutions, there seems to be a consensus that institutions are invariably instrumental to the health of an economy.

Institutions affect economic activities through their effects on costs of firms. For instance, bureaucracy, red-tape and lengthy delays in obtaining operation permits or licenses may substantially increase production costs, thus adversely affecting firms' competitiveness. Institutions are found to have impacted upon many economic activities, including long-run economic performance and growth (North, 1990; Acemoglu et al., 2001; Góes, 2016), international trade (de Groot et al., 2004; Cheptea, 2007; Méon and Sekkat, 2008) and foreign direct investment (Li and Resnick, 2003; Nunnenkamp and Spatz, 2004; Aysan et al., 2007; Gani, 2007; Daude and Stein, 2007; Bannaga et al., 2013; Masron and Nor, 2013; Ledyaeva et al., 2013; Saidi, et al., 2013; Tintin, 2013; Zeshan and Talat, 2015).

As to investment, institutional quality matters to foreign investors. Institutions affect both foreign and domestic investment in two broad ways (Daude and Stein, 2007). First, inefficient institutions of a host country raise the costs of doing business for firms as they are regarded as taxes to be 'paid' by the firms. Second, feeble enforcement of contracts may increase uncertainty about the future returns of firms, thus exerting an adverse impact upon private investment. In a similar vein, Henisz (2000) indicates that foreign investors will face two types of risks if their property rights are not sufficiently protected. The first is that the government of a host country may behave in an opportunistic way and appropriate a proportion of the returns on FDI projects or even nationalize them. Second, with better access to local administration authorities, incumbent competitors may win the government's favour at the expense of the new foreign entrants.

Given the important roles of institutions, research has shifted towards the impact of institutional quality on locational determinants of FDI. Knack and Keefer (1995) show that property rights have a positive impact on both investment and growth. Many studies have confirmed the conclusion of Knack and Keefer. Li and Resnick (2003) suggest that property rights in less-developed countries are important to FDI inflows and economic growth. However, Resnick (2001) and Li and Resnick (2003) report that democracy is negatively related to FDI inflows in many developing and transition economies. Seyoung (1996) provides some evidence supporting the hypothesis of a positive association between intellectual property rights protection and FDI flows. A similar finding is reported by Pajunen (2008) who finds that property rights have played a significant role in business, in both domestic and international contexts. Seyoum (2009) shows that the quality of institutions is a strong, significant determinant of FDI for 84 developed and developing countries.

Using a large data set from both developed and developing or transitional economies, Goberman and Shapiro (2002) find that good governance has a relatively large positive effect on FDI in developing or transitional economies. Similarly, Gani (2007) finds that institutional quality is positively associated with inward FDI in the Asian, Latin-American and the Caribbean regions. However, Méon and Sekkat (2007) conclude, in their study of the relationship between governance and FDI, that good governance is weakly associated with FDI inflows over 1990-2000 in a sample of almost 100 countries. In turn, Asiedu and Lien (2011) find for 112 countries over 1982-2007 that the effect of democracy on FDI depends on the share of natural resources in host countries' total exports. Democracy tends to facilitate FDI in countries with a low share of natural resources in their exports, but a negative relationship between democracy and FDI is found for host countries the total exports of which are dominated by natural resources. Using a panel data set from 164 countries over 1996-2006, Bunchanan et al. (2012) confirm a positive association between FDI and governance. They also find that quality of institutions has a significant, positive effect on the volatility of FDI in the countries under investigation. Okada (2013) investigates how institutional quality affects international capital flows for 112 countries over 1985-2009 and finds that institutions play an important role in facilitating FDI inflows for these countries.

Ledyaeva et al. (2013) empirically study the effects of corruption and democracy on locations of FDI activities in Russian regions, using firm-level panel data over 1996-2007. Their findings suggest that countries with similar levels of institutional quality tend to have more business relations with each other. The results suggest that FDI from less corrupt and more democratic countries tends to flow to the regions with less corruption and strong democratic practices, and that foreign investors from more corrupt and non-democratic countries prefer to invest in the regions with high corruption and weak democracy. These findings seem to explain why countries with high corruption and non-democratic host countries receive negligible amounts of FDI from rich countries with high quality of institutions. Using data at sectoral level, Shah et al. (2016) find for Pakistan that institutional quality does matter to inward FDI flows to Pakistan's services and manufacturing sectors.

Yet, several studies find that poor governance does not deter, but encourage FDI inflows in both developing and transitional economies (Bellos and Subasat, 2012a, 2012b). More recently, Subasat and Bellos (2013) confirm their earlier results for transitional countries and Latin America. They argue that, under certain circumstance, poor governance could affect FDI positively as it could allow firms to circumvent poorly designed regulations in these countries which are under institutional transition. Cuervo-Cazurra (2006) points out that the effects of corruption on FDI depend primarily on the commonality shared by the host and home countries. Host countries with high corruption attract less FDI from home countries with strong legal systems against bribery abroad, but receive more FDI from countries with high corruption practices. Méon and Sekkat (2007), based on the earlier works of Leys (1965) and O'Donnell

(1978), indicate that bribes could incentivize bureaucrats to speed up the application approvals for the establishment of new investment projects, in an otherwise sluggish administration. Positive effects of corruption have also been indicated in a series of publications (Huntington, 1968; Leff, 2002; Rose-Ackerman, 2002). They indicate that corruption helps speed up transactions and procedures than would otherwise be the case, thus solving the principal-agent problems and enhancing efficiency. These views are shared by other researchers, such as Bailey (1966) who contend that perks may attract able civil servants who would otherwise have opted for employment in private businesses, non-governmental organizations or international organizations where salaries are much higher.

The results of the studies presented in the above literature review as to how institutions affect FDI flows between countries are far from clear-cut. Of course, general descriptions need to be analyzed in more detail. Econometric specification need to be formulated and vigorous analyses are to be systematically made before any sound policy implication and conclusion can be made.

3. Some stylized facts of FDI inflows and institutions in Cambodia

Cambodia is a very highly open economy. It is a small Southeast Asian country that is home to the famous Angkor Wat temples and the Temple of Preah Vihear—both world heritage sites - and was once the center of the Khmer empire (Tully, 2005; Hill and Menon, 2013). The last 150 years was a protracted troubled period for Cambodia. During 90 years, the country was under French colonial rule (1863-1953).[10] It also experienced unpleasant regime changes brought about by coups d'état,[11] was dragged into the Indochina war and severely affected by the U.S. bombardments during U.S.-Vietnam war, and, more recently, suffered dramatically from the genocidal *Khmer Rouge* regime during which time nearly two million people were killed or died of starvation, forced overwork or disease. This brutal *Khmer Rouge* rule and the enduring civil wars caused enormous destructive damage, not only to the Kingdom's basic infrastructures, many institutions, and financial and health systems, but, more importantly, to the country's human capital and human resources,[12] which are indispensable for the post-conflict reconstruction and development of the conflicts-ridden Cambodia.

[10] France concluded a so-called 'protectorate' treaty with Cambodia in August 1863 (Slocomb, 2010). Despite relative stability and peace, the Cambodian people during the French colonization period were desperately poor and, even worse, were forced to pay their taxes, otherwise they would have little access to the French administration contact, which came in the form of education and health care. Corruption was widespread and land distribution was highly skewed to foreigners (perhaps mostly French investors) under concessions and substantially benefited the few rich. Social indicators were critical, with very high infant mortality. Existing institutions were left intact under the French colonial rule.

[11] Cambodia was briefly at peace and stability, and enjoyed a fair share of prosperity brought about by economic development during the *Sangkum Reastr Niyum* (People's Socialist Community), the post-independence period of 1953-1969 (Slocomb, 2010). Unlike during the French colonial administration, *Sangkum Reatr Niyum* spent heavily on the most two important sectors, health and education, as these sectors were believed to be the key to modernization and healthy economy (Tully, 2005; Slocomb, 2010).

[12] Tully (2005) reports that many Cambodian intellectuals abroad were lured by a *Khmer Rouge* leader Thiounn Mumm to return home, with a promise of a role in the reconstruction of the country. They were executed upon their arrival in Cambodia. In 2004, a hybrid court, known as the Extraordinary Chambers in the Courts of Cambodia, was established between the Royal Government of Cambodia and the United Nations to bring the top *Khmer Rouge* leaders to justice for their crimes against humanity committed during the *Khmer Rouge* regime during which an estimated 1.7 million people were killed.

After the demise of the *Khmer Rouge* regime, Cambodia continued to be decimated by the international imposition of embargo and isolation. This came to an end after the conclusion of the 1991 Paris Peace Accord which paved the way for the arrival of the United Nations Transitional Authority (UNTAC). The Kingdom held its first general election in 1993 under the auspices of the United Nations, with the formation of a legitimate coalition government with two prime ministers.[13] Since then, Cambodia has widely liberalized its economy by adopting a highly open policy towards foreign direct investment and trade with the rest of the world. The investment law was drafted and approved by the National Assembly in 1994, with the Council for the Development of Cambodia being charged with reviewing and approving investment applications. The 1994 law on investment was amended in 2003 to further simplify investment application procedures, and approved investment project became eligible for generous incentives on a non-discriminatory basis.

At the beginning of its opening up, Cambodia received FDI from three Asian neighbours, namely Indonesia, Singapore and Thailand, with a total amount of US$67.67 million.[14] This amount noticeably increased to around US$1.58 billion in 2000, and to US$6.16 billion in 2010, reaching US$16.35 billion by the third quarter of 2016.[15] According to Table 1, Cambodia was highly attractive to FDI from Asian countries, representing more than 70% of total inward FDI stocks in 2014, with “Greater China” (China, Taiwan, Hong Kong, Macao) accounting for more than 43%, followed by the ASEAN countries (26%), South Korea (9.14%) and Japan (3.48%). Although the triad (the European Union, the United States and Japan) have been the largest international investors, their combined FDI stocks in Cambodia represented only 12.60% of total inward FDI stocks in 2014.

[13] Prince Norodom Ranariddh, President of FUNCINPEC Party, served as the first Prime Minister and the second prime ministerial position went to Samdech Techo Hun Sen, the current Prime Minister of the Kingdom of Cambodia.
[14] This was probably because of the political instability and insecurity posed by frequent armed attacks and fighting between the *Khmer Rouge* guerrilla militias and the Cambodian Royal Armed Forces. The country enjoyed unprecedented peace in late 1998 when the *Khmer Rouge* organization was completely dismantled with the *win-win* strategy of the Royal Government of Cambodia.
[15] The amounts are FDI stocks in Cambodia, based on the data made available by the National Bank of Cambodia.

Table 1: Inward FDI Stock in Cambodia by Country of Origin, 2014

Economy	Inward FDI Stock (US$ million)	% of Inward FDI Stock
ASEAN	*3,383.44*	*25.98*
Vietnam	1,207.48	9.27
Malaysia	1,004.44	7.71
Singapore	629.96	4.84
Thailand	524.84	4.03
Indonesia	10.00	0.08
Brunei	4.68	0.04
Philippines	2.04	0.02
Greater China	*5,610.67*	*43.08*
China	4,047.59	31.08
Taiwan	970.26	7.45
Hong Kong	591.86	4.54
Macao	0.96	0.01
European Union	*859.77*	*6.60*
United Kingdom	292.99	2.25
France	207.93	1.60
Netherland	132.27	1.02
Luxembourg	61.78	0.47
Belgium	45.90	0.35
Denmark	32.43	0.25
Norway	25.22	0.19
Germany	17.76	0.14
Ireland	12.73	0.10
Other EU Member States	30.76	0.24
South Korea	1,190.33	9.14
Japan	453.78	3.48
United States	331.03	2.54
Australia	232.48	1.78
Russia	117.28	0.90
Saudi Arabia	144.32	1.11
Canada	51.00	0.39
Others	650.87	5.00
Total	13,024.97	100.00

Source: National Bank of Cambodia

FDI flows to Cambodia take two main modes of entry, either joint ventures or wholly-owned enterprises (Cuyvers et al., 2009). Initially, Cambodian-foreign joint ventures appeared to be more popular, which might be due to several factors such as foreign investors being unfamiliar with some important local characteristics, risk sharing, and perception of being better treated by

the host government when linking up with a domestic investor. However, the joint ventures systematically declined since 1995.

Table 2 presents the sectoral distribution of inward FDI in Cambodia. The industrial sector was the most popular sector, having attracted 44.24% of the total FDI stocks, with garments and footwear representing almost half of the industrial share. Cuyvers et al. (2009) indicated that the success of the garments and footwear sector may be attributed to Cambodia being the beneficiary of the most favoured nation (MFN) treatment and the generalized system of preferences (GSP) of the United States, the European Union and other advanced countries. Undeniably, Cambodia is also well endowed with a large reserve of relatively low-cost, low-skilled labour that is highly suitable for a labour-intensive industry such as garments and footwear.

Table 2: Sectoral Distribution of Inward FDI Stocks in Cambodia, 2014

Sector	Inward FDI Stocks (US$ Million)	% of Inward FDI Stocks
Agriculture	*2,021.69*	*15.52*
Industry	*5,762.72*	*44.24*
Mining and quarrying	167.23	1.28
Beverages	183.33	1.41
Footwear	369.42	2.84
Garments	2,480.39	19.04
Packaging	149.69	1.15
Petroleum Products	80.63	0.62
Tobacco	48.08	0.37
Wood Processing	102.88	0.79
Construction	273.46	2.10
Hydropower	1,907.61	14.65
Services	*4,121.62*	*31.64*
Hotels and Restaurants	1,211.63	9.30
Finance	2,257.50	17.33
Telecommunications	520.17	3.99
Real Estates	132.33	1.02
Others	*1,118.93*	*8.59*
Total	13,024.97	100.00

Source: National Bank of Cambodia

Since its deep economic transformation and wide-ranging reforms initiated in the 1990s, Cambodia has made remarkable achievements—impressive economic growth and rapid economic development. It has maintained high economic growth rates for the past decades,[16] except in 2009 when the narrowly-based economy of the country was severely affected by the global financial and economic crises originating in the United States.[17] It has enjoyed prosperity and unprecedented peace since late 1998. Despite these successes, Cambodia has faced a number of challenges, especially the quality of institutions that are largely shaped by its history (Hill and Menon, 2013).[18] During the French colonial rule for 90 years, social institutions were practically left intact (Slocomb, 2010). They were relatively modernized during the post-independence *Sangkum Reastr Niyum*'s period of 1953-1969, but these institutions were virtually destroyed during the genocidal *Khmer Rouge*'s time of nearly four years (Hughes and Un, 2011).

Since full peace and relative political stability have been secured, the Cambodian government has devoted its meagre resources to improving good governance within the country's bureaucracy (Hughes and Un, 2011). The commitments to good governance are also explicitly shown in a number of policy agendas, such as the Governance Action Plans and a series of the Rectangular Strategy updates. However, recently Hill and Menon (2013; 2014) reported that Cambodia's formal institutions are weak despite the fact that the Cambodian economy grew faster than many post-conflict economies for a much longer period in the recorded history.

[16] For the past decades, Cambodia recorded impressive growth rate of 7 percent per annum, lifting up the status of Cambodia from low-income country to lower-middle income country (while some countries fell back) by the World Bank in 2016. With the average growth rate of 7%, Cambodia's income will double every 10 years! On the basis of this success, the Asian Development Bank in 2016 predicted that Cambodia would become the new Asian Tiger economy. However, this high economic growth does not seem to benefit the poor much, especially those residing the rural areas, as economic development is seen to be uneven and over-concentrated in Phnom Penh and other downtown areas (Cuyvers et al. 2009), encouraging migration of workers from the rural to urban areas. Urban-rural inequality appears to have been widened, which is also seen in many developing and advanced economies alike.

[17] The Cambodian economy depends heavily on few economic drivers, namely agriculture, garments, real estate and tourism; three of which are vulnerable to external shocks such as global downturns and crises.

[18] Efforts were made to rebuild basic infrastructures and formal institutions that were abolished by the *Khmer Rouge* regime, in the 1990s during which Cambodia was relatively at peace. After full peace materialized in late 1998, more reforms have continually been introduced, leading to the drafting of the long-awaited anti-corruption law that was approved and subsequently promulgated in 2010.

Table 3: Governance Indicators for CLMV (Percentile Ranks, %)

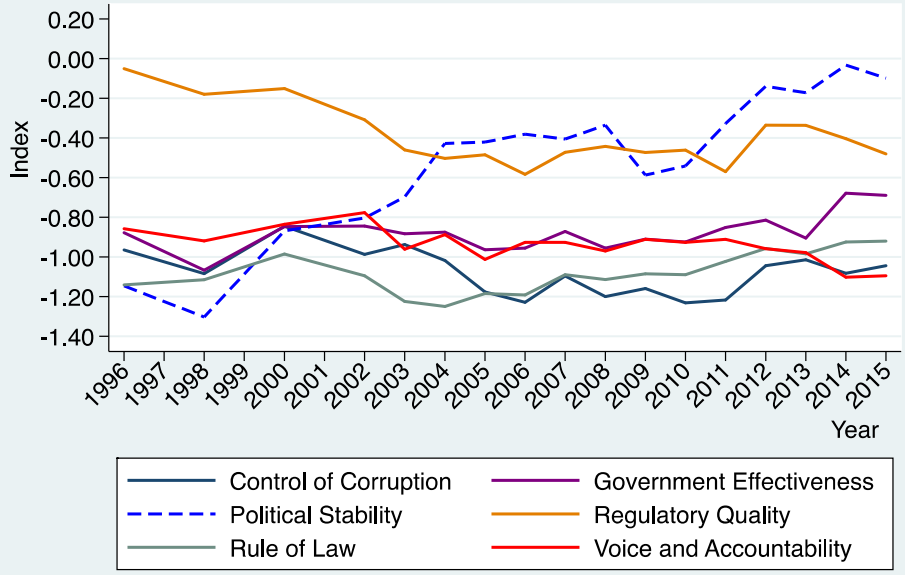
	1996	*2000*	*2004*	*2008*	*2012*	*2013*	*2014*	*2015*
Cambodia								
Control of Corruption	17	21	14	7	14	16	13	13
Government Effectiveness	19	19	18	16	23	20	25	25
Political Stability	14	20	30	32	41	40	45	44
Regulatory Quality	50	43	32	37	41	40	37	35
Rule of Law	14	19	9	12	17	15	18	17
Voice and Accountability	21	24	23	21	20	21	18	19
Lao PDR								
Control of Corruption	36	25	9	6	15	20	25	20
Government Effectiveness	28	20	13	18	22	27	39	37
Political Stability	54	26	26	45	47	49	60	60
Regulatory Quality	11	7	9	14	23	23	22	24
Rule of Law	18	21	14	22	23	26	27	25
Voice and Accountability	20	16	7	5	6	5	4	4
Myanmar								
Control of Corruption	3	4	1	1	11	12	17	17
Government Effectiveness	6	8	4	3	3	5	9	10
Political Stability	10	7	18	14	18	13	11	10
Regulatory Quality	4	3	0	0	2	5	6	7
Rule of Law	7	10	3	4	6	10	9	8
Voice and Accountability	1	0	0	0	4	7	9	13
Vietnam								
Control of Corruption	40	32	24	26	36	36	38	39
Government Effectiveness	35	39	41	47	45	46	52	55
Political Stability	58	58	51	50	55	55	44	49
Regulatory Quality	28	22	30	30	28	29	30	34
Rule of Law	37	42	38	41	39	40	45	46
Voice and Accountability	17	12	9	8	9	12	10	11

Note: The data are each country's percentile ranks, with a score of 100% being the highest.
Source: World Bank's Worldwide Governance Indicators.

Table 3 reports for CLMV (Cambodia, Lao PDR, Myanmar and Vietnam) the governance quality, which is often used as proxy for institution quality. Since 1996, global governance indicators have been assessed for the World Bank's member countries, covering six aspects of governance, namely control of corruption, regulatory quality, governance effectiveness, rule of law, political stability and absence of violence or terrorism, and voice and accountability. Each country is ranked, using percentile, for each governance dimension.

According to the percentile rankings, CLMV on average scored below the 50 % percentile rank for almost all dimensions over 1996-2015. Cambodia has improved in terms of political stability, rule of law, and government effectiveness. For political stability, Cambodia's percentile ranks have steadily increased from 14 % in 1996, to 20 % in 2000, to 32 % in 2008, reaching 44 % in 2015. Compared to CLMV, Cambodia enjoyed far more political stability relative to Myanmar that was ranked well below the CLMV average for all dimensions, but less than its Indochina neighbors, Lao PDR and Vietnam. Similarly, in 1996 Cambodia's percentile rank for rule of law was 14 % and 19 % for government effectiveness and its percentile ranks increased to 17 % and 25 % for these two dimensions respectively, in 2015. Interestingly, the rankings for voice and accountability for Cambodia have not improved over 1996-2015, but the Kingdom were ranked well above Lao PDR, Myanmar and Vietnam, but below the more advanced ASEAN member states (Appendix A). Singapore was ranked the highest among the World Bank's memberships for all dimensions, except voice and accountability.

Figure 1: Evolution of Cambodia's Institution Quality, 1996-2015



Source: World Bank's Worldwide Governance Indicators

Figure 1 depicts the evolution of Cambodia's institutional quality over 1996-2015. The estimated score for each dimension ranges from -2.5 to +2.5, with a score of 2.5 being the highest. Although Cambodia scored below the average for all aspects of governance indicators, it has performed better on some of the governance dimensions—political stability, rule of law, and government effectiveness—during the period under investigation. However, regulatory quality and control of corruption experienced downward trends over 1996-2015, with the latter being identified as the most problematic factor for doing business (Hill and Menon, 2013, 2014; World Economic Forum, 2016, 2017).

4. Specification, estimation procedures and data

4.1 Specification and estimation procedures

Since 1994, Cambodia has attracted a large amount of FDI, in particular from its neighbouring Asian developing countries. FDI from advanced economies such as Japan, the EU, and the U.S. has been very small, with Japan being a very recent phenomenon. However, the factors that may affect FDI inflows to Cambodia have not yet been well studied, especially with respect to the effects of institutions on FDI flows to the Kingdom. This paper seeks to fill the research gap by testing a broader set of institutional factors that may influence FDI flows to the Cambodian economy over the period of 1995-2014. On the basis of the analysis, it will provide some policy implications which may be relevant for Cambodia as well as for other transitional and developing countries with similar levels of institutional quality and economic development.

In the light of the conceptual discussion presented above, the relationship between FDI and institutions in Cambodia is modelled as follows:

$$LFDI_{ict} = \beta_0 + \beta L(institution)_{ct} + \alpha L(control\ variables)_{ict} + \varepsilon_{ict} \quad (1)$$

$i = 1, 2, \ldots, N$ and $t = 1, 2, \ldots, T$ (from 1995 to 2014, inclusive)

The subscripts i, c and t refer to the FDI home country, Cambodia and time, respectively. ε_{ict}, denoting a composite error term, is equal to $\alpha_i + u_{ict}$, where α_i is country-specific, accounting for the unobserved heterogeneity among the home countries, and u_{ict} is a white noise error term. Both the dependent variable and the explanatory variables are in logarithms and are denoted by *L*. The use of the variables in logarithms has three advantages. First, it makes it relatively easy to interpret the estimated slope parameters of the explanatory variables. The coefficients of the logged explanatory variables are the elasticities of the dependent variable with respect to a one percentage change in the explanatory variables (except the coefficients of binary variables). Second, the use of logged values can reduce the problem of outliers. Third, log-transformation linearizes a non-linear relationship between the included variables.

Due to the inappropriateness and inefficiency of estimation with time series and cross-sectional estimation alone, it was decided to opt for a panel data set, i.e. the data containing time series of a number of individuals, in the estimations of econometric specification (1). Panel data have several advantages over the usual cross-sectional or time series data (Hsiao, 2003, 2005, 2007; Plasmans, 2006). Plasmans (2006) has shown that panel data are more efficient with respect to random sampling and ease of identification, present less multicollinearity and are better for aggregation as the aggregation may vary over time. Similarly, Hsiao (2005) has indicated that

an important advantage of panel data is that it allows to control for the effects of omitted variables and contain information on the inter-temporal dynamics, and also that the individuality of the entities allows the effects of missing or omitted variables to be controlled for. Wei and Liu (2001) have argued that the use of panel data takes into account the diversity and the specificity of unobservable behaviors of different investors, which are not shown in the specification (1).

Panel data sets allow us to use three estimation procedures: pooled OLS, fixed-effects (FE), or random effects (RE) estimations. If the assumption holds that the unobservable individual country-specific effects are not very different, pooled OLS estimations are the most efficient and simplest method. The FE estimator allows for the unobservable country heterogeneity, and is always less efficient than the RE estimator, but the latter may suffer from endogeneity bias (based on the Hausman test) so that the FE estimator is preferred in that case. However, the use of a fixed-effects model will drop the time-invariant variable, and will make FE estimations less efficient than the RE estimation counterpart. Like the FE model, RE estimations take into consideration the unobservable country heterogeneity effects, but incorporate these effects into the error terms, which are assumed to be uncorrelated with the explanatory variables.

To choose the appropriate model for the panel data set from these three competing models, three tests are available (Plasmans, 2006): the F-test, the Hausman specification test (Hausman, 1978), and the Lagrange multiplier test (LM test) (Breusch and Pagan, 1980). The F test is used to carry out a test for the FE model against the pooled OLS. The null hypothesis of the F test is that all individual effects are equal (pooled regression), or algebraically, $H_0: \alpha_1 = \alpha_2 = \alpha_3 = \cdots = \alpha_N = \bar{\alpha}$, with the F test statistic for the joint significance of the individual effects as follows:

$$F_{N-1,NT-N-K+1} = \frac{(R^2_{FE} - R^2_{pooled})/(N-1)}{(1-R^2_{FE})/(NT-N-K+1)}, \qquad (2)$$

where N is the number of FDI-investing countries, and K is the number of explanatory variables. A large value for *F* will lead to the rejection of the null hypothesis in favour of the FE model. The Hausman test is for testing the appropriateness of the FE model against the RE model. The Hausman test statistic is computed as follows (Verbeek, 2004):

$$\psi_H = \left(\hat{\beta}_{FE} - \hat{\beta}_{RE}\right)' \left[\hat{V}\{\hat{\beta}_{FE}\} - \hat{V}\{\hat{\beta}_{RE}\}\right]^{-1} \left(\hat{\beta}_{FE} - \hat{\beta}_{RE}\right) \qquad (3)$$

where $\hat{V}_s$ denote estimates of the true covariance matrices. Under the null hypothesis that the explanatory variables and α_i are uncorrelated, the Hausman test statistic ψ_H is asymptotically χ^2 distributed with *K* degrees of freedom, where *K* is the number of slope coefficients in the

random effects model. A large value of ψ_H leads to the rejection of the null in favour of the fixed effects model.

Since the regression equation (1) contains both time-variant and time-invariant variables, the use of FE estimation is deemed inappropriate as it will drop the time invariant variables. Therefore, this paper will opt for the estimation of pooled OLS and RE models. One model against the other model will be tested using the LM test. If individual country-specific effects do not exist, the pooled OLS model is known to deliver the best linear unbiased estimators (BLUE), while RE estimators are not efficient. The opposite is true if individual country-specific effects do exist in the panel data set.

The pooled OLS model assumes that the individual specific effects, α_i, are equal and different from zero, while the RE model assumes that they follow a random, independently and identically distributed stochastic process; that is, $\alpha_i \sim iid(0,\sigma_\alpha^2)$; u_{it} is assumed to be normally distributed with zero mean and constant variance, that is, $u_{it} \sim iid(0,\sigma^2)$. It has been shown by Breusch and Pagan (1980) that, under the null hypothesis $H_0: \sigma_\alpha^2 = 0$ against the alternative hypothesis $H_1: \sigma_\alpha^2 > 0$, the *LM* test statistic is as follows:

$$LM_{BP} = \frac{NT}{2(T-1)}\left[\frac{\sum_{i=1}^{N}\left(\sum_{t=1}^{T}\hat{e}_{it}\right)^2}{\sum_{i=1}^{N}\sum_{t=1}^{T}\hat{e}_{it}^2} - 1\right]^2, \qquad (4)$$

which is asymptotically χ^2 distributed with one degree of freedom; $\hat{e}_{it}$ denotes OLS residuals obtained under H_0 (pooled regression). A large value for the LM test statistic will reject the null hypothesis in favour of the RE model.

Additional tests such as collinearity and heteroskedasticity tests are carried out. The collinearity check is based on the variance inflation factor (*VIF*), which has been shown to be equal to $1/(1-R_i^2)$, where R_i^2 is obtained from the multiple correlation coefficient of an explanatory variable X_i regressed on the remaining explanatory variables. Evidently, a higher VIF_i indicates R_i^2 to be near unity and therefore points to collinearity. The commonly-used rule of

thumb states that if *VIF* < 10, there is no evidence of damaging multicollinearity (Baum, 2006).[19] Greene (2012) proposes a test for groupwise heteroskedasticity, which is based on the Wald statistic. Under the null hypothesis of common variance, the Wald test statistic is shown to be of the following form: $W = \sum_{i=1}^{N} \frac{(\hat{\sigma}_i^2 - \sigma^2)^2}{var(\hat{\sigma}_i^2)}$, where *W* is χ^2 distributed with N degrees of freedom.

Failure to reject the null indicates the absence of groupwise heteroskedasticity.

4.2 Data

The econometric specification (1) is estimated by using FDI data, which are obtained from the Cambodian Investment Board (CIB) and the National Bank of Cambodia (NBC), for the period over 1995-2014.[20] Data for the explanatory variables are from the international organizations, such as the International Monetary Fund, the World Bank, and the United Nations[21]. Institution data are from the World Bank's Worldwide Governance Indictors database online[22] and political risk data are from Ducroire.[23]

The World Bank's worldwide governance indicators provide six dimensions of governance, covering more than 200 countries and territories since 1996.[24] The six aspects of good governance include voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Kaufmann et al. (2010) define the six governance indicators as follows: *voice and accountability (VA)*, measuring perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association, and a free media; *political stability and absence of violence (PS)*, measuring perceptions of the likelihood that the government will be destabilized or overthrown by unconstitutional or violent means, including politically-motivated violence and terrorism; *government effectiveness (GE)*, measuring the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies; *regulatory quality (RQ)*, capturing perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development; *rule of law (RL)*, capturing perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts,

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[19] Baum (2006) argues that we can safely ignore near-collinearity that does not affect key parameters.
[20] The CIB was created after Cambodia's first-ever national election in 1993, and data on inward FDI in the Kingdom of Cambodia became available from August, 1994 onwards. As FDI data in 1994 cover only a few months and home countries, that year is therefore excluded from the analysis.
[21] Since some observations, such as the inflation rate, show negative numbers, we follow Busse and Hefeker (2007) in transforming the variable using the following procedure: $y = \ln\{x + \sqrt{(x^2 + 1)}\}$, in order for the logarithm of the variable to be meaningful.
[22] The global governance index is between -2.5 and 2.5, with a higher score being better governance quality. Since log of a negative value is not meaningful, we transform the index to a range of 1-6 scales, following Meon and Sekkat (2008).
[23] Political risk data are available at *http://www.delcredereducroire.be*
[24] The worldwide governance indictors have been made available on a biannual basis over 1996-2002, and from 2003 onwards these data are available on an annual basis.

as well as the likelihood of crime and violence; and *control of corruption (CC)*, measuring perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as 'capture' of the state by elites and private interests.

Geographical distance data is from CEPII's GeoDist database,[25] and data on bilateral investment agreements and minimum wage rates are from Cambodia's investment board and Cambodia's Ministry of Labour and Vocational Training, respectively. The definitions of all included variables and descriptions of the data, as well as their sources are provided in Appendix B.

5. Empirical results and discussion

Before discussing the empirical results, we present and discuss the basic statistics—the correlation matrix and variance inflation factor (VIF) values—for all the included explanatory variables in our regression analysis. Table 4 shows that correlation values for some variables are relatively high. These are confirmed by the VIF values[26] of exceeding 10 for several institutional variables such as control of corruption, regulatory quality, and rule of law, which gives rise to the concerns about multicollinearity. The presence of multicollinearity reduces the stability of the estimated coefficients for the variables presented in the specification (1).

Table 5 provides empirical results for inward FDI flows to Cambodia over 1995-2014. Diagnostic tests, such as the autocorrelation and heteroskedasticity tests were carried out and are also reported in Table 5. The autocorrelation test statistics of between 1.52-2.20 are insignificant at the conventional significance level, indicating the absence of autocorrelation problems. The LM statistics for all specifications presented in Table 5 are highly significant at the 1% level, suggesting that the RE model is statistically superior to OLS model. By excluding the time-invariant geographical distance variable, we also carried out the Hausman test to choose between FE vs. RE models. The Hausman statistics are insignificant for all columns 1-7, confirming that the RE model is statistically preferred. Thus, estimation results and discussion are based on the RE estimation method. From Table 5, the test for group-wise heteroskedasticity shows that the null hypothesis of homoscedasticity is strongly rejected at the 1% level. This suggests that heteroskedasticity is present in the data set. Therefore, our econometric specification above is estimated with heteroskedasticity-robust standard errors.

[25] GeoDist is developed by Mayer and Zignago and is available at http://www.cepii.fr
[26] It is often accepted that VIF > 10 is the indication of high collinearity (Baum, 2006)

Table 4: VIF Statistics and Correlation Matrix for Explanatory Variables

Variable	VIF	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
1.GROWTH	4.44	1.00														
2.LTRADE	1.41	0.04	1.00													
3.LPOLRISK	3.11	0.01	-0.14	1.00												
4.LOME	6.63	-0.44	0.33	0.01	1.00											
5.LWAGE	5.67	-0.14	0.50	-0.02	0.47	1.00										
6.LEXCH	2.02	4×10^{-3}	0.02	0.70	0.02	0.02	1.00									
7.LDIST	1.82	0.00	-0.17	0.62	0.00	0.00	0.47	1.00								
8.INFLA	2.61	0.20	0.07	0.35	0.30	0.03	0.25	0.10	1.00							
9.BIA	1.35	0.01	0.19	-0.38	0.20	0.19	-0.22	-0.36	-0.17	1.00						
10.LCC	10.45	0.01	-0.24	0.03	-0.53	-0.14	-0.02	0.00	-0.35	-0.21	1.00					
11.LRQ	12.44	-0.33	-0.32	0.02	-0.30	-0.13	-0.02	0.00	-0.12	-0.27	0.68	1.00				
12.LGE	6.17	0.01	0.19	0.02	-0.38	0.60	5×10^{-3}	0.00	-0.29	0.11	0.31	-0.02	1.00			
13.LPS	5.64	0.33	0.46	9×10^{-3}	0.57	0.68	0.03	0.00	0.02	0.33	-0.38	-0.70	0.46	1.00		
14.LRL	12.53	-0.30	0.26	-0.02	0.24	0.68	0.01	0.00	-0.19	0.12	0.09	0.27	0.50	0.28	1.00	
15.LVA	4.77	-0.21	-0.33	0.03	-0.61	-0.62	-0.02	0.00	-0.31	-0.16	0.35	0.36	-0.15	-0.57	-0.20	1

Notes: Definitions of all variables and descriptions of the data, as well as their sources are provided in Appendix B

The estimated coefficient on trade is, *a priori,* positive and is significant at the 5% significance level for Columns 1-7, suggesting that trade relations between Cambodia and FDI-home countries positively affect FDI flows from the latter to the former. This finding is consistent with the previous studies by Wei and Liu (2001) for China and Cuyvers et al. (2009, 2011) for Cambodia. FDI activities were found to have imported raw materials, semi-finished goods, and machinery from their home country for use in the final production in Cambodia. The final output was destined especially for the third countries' markets, namely the US and the EU which have provided preferential treatment and 'everything but arms' accesses to Cambodia's exports to help this post-conflict country in its reconstruction and development efforts. The imports of these materials are also encouraged by generous fiscal incentives made available according to Cambodia's investment law, which eliminates the import taxes on intermediate goods for FDI projects, and also by the lack of these necessary inputs in the Kingdom.

Table 5: Econometric Results for FDI Inflows to Cambodia

Variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)
Constant	-1.69 (16.88)	-4.78 (21.56)	6.98 (16.33)	2.70 (17.54)	23.60 (14.57)	-7.07 (18.05)	-3.28 (18.09)
GROWTH	0.06 (0.13)	0.06 (0.12)	0.05 (0.11)	0.09 (0.13)	0.09 (0.11)	0.51*** (0.16)	0.15 (0.16)
LTRADE	0.93** (0.42)	0.93** (0.42)	0.98** (0.45)	0.83* (0.45)	0.82** (0.41)	0.85** (0.40)	1.07** (0.51)
LPOLRISK	-4.56 (3.54)	-3.36 (5.92)	-10.92*** (2.97)	-7.38* (4.38)	-8.11** (3.33)	-13.77*** (5.02)	-6.06* (3.34)
LOME	0.46* (0.25)	0.45 (0.30)	0.53** (0.23)	0.56** (0.28)	0.44** (0.22)	1.29*** (0.31)	0.59** (0.30)
LWAGE	1.92 (1.50)	2.27 (2.53)	-0.78 (1.45)	1.07 (1.47)	-4.30*** (1.19)	1.47 (1.38)	3.29 (2.04)
LEXCH	0.59 (0.47)	0.60 (0.47)	0.56 (0.46)	0.59 (0.48)	0.54 (0.47)	0.59 (0.48)	0.58 (0.46)
LDIST	-0.46 (0.68)	-0.47 (0.68)	-0.41 (0.66)	-0.48 (0.67)	-0.45 (0.64)	-0.50 (0.67)	-0.41 (0.69)
INFLA	-0.50 (0.40)	-0.56 (0.35)	-0.11 (0.32)	-0.44 (0.44)	-0.01 (0.42)	-0.59 (0.41)	-0.38 (0.33)
BIA	1.79* (0.93)	1.75** (0.88)	1.91** (0.90)	1.77* (0.94)	1.76** (0.86)	1.56** (0.79)	1.82** (0.91)
LCC		-1.60 (7.53)					
LRQ			17.31*** (4.47)				
LGE				13.51 (12.54)			
LRL					23.43*** (5.53)		
LVA						55.16** (23.12)	
LPS							-6.57 (5.88)
No. of Obs.	195	195	195	195	195	195	195
Overall R^2	0.231	0.229	0.262	0.234	0.284	0.260	0.243
Autocorr. stat.	2.137	2.109	2.132	2.159	2.194	1.521	1.842
LM stat. $\chi^2(1)$	96.45***	93.69***	95.60***	96.39***	102.90***	109.20***	95.30***
Hausman	3.87	4.09	2.75	4.19	3.29	4.82	3.28
Wald stat.	3269***	2925***	3350***	2326***	1061***	1566***	3063***

Notes:

1. L demotes values in logarithms
2. *, **, and *** denote that the slope parameter estimates are statistically significant at the levels of 10%, 5%, and 1%, respectively
3. Standard errors are group-wise heteroskedasticity robust standard errors in parentheses

The political risk variable has the expected negative sign and is significant at the 5% level. This implies that an improvement in the political risk situations (lower risk score) of the country relative to the FDI home countries positively affects inward FDI flows to Cambodia from these home countries. The estimated coefficient is large in terms of both economic and statistical significance. This result appears to be in line with what have been suggested by the data on Cambodia. Cambodia's peace maintenance and relative political stability, combined with the large pool of young, low-cost labour, does not only retain existing FDI as evidenced in the significant increase in FDI stocks over time, but it is also makes the Kingdom increasingly attractive to higher quality FDI with long-term commitments, especially that from advanced countries such as Japan who invested a negligible amount of FDI in Cambodia over 1994-2004 (Cuyvers et al., 2009).

By conventional wisdom, FDI from advanced countries tends to bring in more advanced technology to their affiliates and produce products embodying higher technology in the host country. For instance, Japan's large manufacturers including Minebear have commenced their operations in the early 2010s in Cambodia, producing products such as wiring harnesses for cars, touch screens, micro actuators, different types of motors, and other electrical tools. European companies were also reported to invest in the Kingdom in an increasing number. This may also help promote technological diffusion in Cambodia, is the country being in an urgent need to move up the higher value chain ladder, as well as to diversify its highly narrowly-based economy.

The minimum wage does not seem to have a significant impact on FDI flows to Cambodia over the period under study, but it becomes highly statistically different from zero when rule of law is introduced into the model. The limited impact of the minimum wage is not surprising for the case of Cambodia. Although minimum wage rate has increased in recent years,[27] it has risen at a slower rate and is still much lower than in China or Thailand (Mizuho Research Institute, 2014).

The estimated coefficient on the natural resource endowments variable retains its high statistical significance for all columns 1-7. This provides strong evidence that resource-seeking is another significant motive that entices foreign investors to launch their investment projects in Cambodia. The finding is in line with a number of previous studies (Aseidu, 2006; Dupasquier and Osakwe, 2006; Mohamed and Sidiropoulos, 2010; Anyanwu and Yameogo, 2015; and Soeng et al., 2016).

The estimate of the investment agreements variable is positive and statistically significant in all columns, with or without the introduction of the institution variables. This indicates that these investment agreements are positively associated with an increase of inward FDI flows to Cambodia from the signatories of the bilateral investment agreements. This is an expected

result as bilateral investment agreements are considered as a 'FDI guarantee', thus providing a predictable, friendly environment for FDI from the parties in agreements. Our result is consistent with the previous findings of Egger and Merlo (2007), Crotti et al. (2010) and Bhasin and Manocha (2016).

The results for the institutional variables—the variables of our interest and focus in the present paper—are interesting. The estimated coefficient on the regulatory quality is, as expected, positive and is statistically significant at the 5% level. This evidently suggests that regulatory quality has played a significant and positive role in determining the location of inward FDI flows to Cambodia. The finding is in line with the empirical study by Rammal and Zurbruegg (2006) who investigated the impact of regulatory quality on intra-FDI flows in ASEAN and a more recent study by Soeng et al. (2016) who empirically test some aspects of institutional factors over a longer time span and conclude that regulatory quality matters for inward FDI in the ten ASEAN member states.

Rule of law, which is one of the important aspects of institutions, is found to be a significant determinant of FDI in Cambodia, suggesting that an improvement in the country's rule of law is positively associated with a rise of inward FDI flows to the Kingdom. Our result for rule of law is consistent with many earlier studies by Oliva and Rivera-Batiz (2002), Gani (2007), Naudé and Krugell (2007), Mengistu and Adhikary (2011), Masron and Nor (2013) and Agyemang et al. (2016). This implies that impartial and transparent legal systems that secure protection of legal property and the rights of individuals as well as effective enforceability of contracts, tends to encourage inward foreign investments, especially those with long-term commitments in the host country. The same is also true for domestic investments. Strong rule of law also secures the protection of intellectual property rights, which is instrumental in a successful promotion of innovations and the creation of new ideas and products. Foreign investors may be reluctant to bring in superior technology to their affiliates in the host country if the rule of law in the host is perceived to be weak, due to high risks of being copied.

The estimate of voice and accountability is positive and significant at the 5% level, implying that more popular participation in political processes and institutions that facilitates citizens in the government actions, as well as media independence, seems to positively affect inward FDI in Cambodia. The positive effect of voice and accountability on FDI occurs because it helps promote democratic institutions and provides 'checks and balances' on the government actions, reducing the risks of arbitrary interventions and policy reversals by the host government (Asiedu and Lien, 2011). Other variables such as exchange rate, geographical distance and inflation do not seem to be relevant to FDI flows to Cambodia over the period under investigation.

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[27] Cambodia's monthly minimum wage was US$40 in 1997. It rose to US$50 during 2000-2006, to US$66 in 2011, to US$128 in 2014 and to about US$168 in 2016.

6. Concluding remarks

This paper examines the effects of institutions on inward FDI flows to Cambodia, using panel data analysis over 1995-2014. We empirically test a broader set of institutional factors, controlling for other factors that may be relevant to FDI flows to Cambodia. Statistical tests were carried out to search for the most appropriate estimation model, and the random effects method is found to be the most suitable model for estimating our econometric specification.

Our econometric results provide strong support for the importance and relevance of institutions as factors of attraction of FDI in the case of Cambodia. We find that institutions—regulatory quality, rule of law, and voice and accountability—positively affect FDI flows to Cambodia over the period under investigation. We also find that trade relations and bilateral investment agreements are positively associated with an increase of FDI in Cambodia while political risk is a significant deterrent to the country's inward FDI. In addition, our results suggest resource-seeking is an important motive of foreign investors to launch their direct investment activities in the Kingdom.

The findings of the current paper offer some policy implications. As institutions are significantly relevant for Cambodia, the continued improvements of the country's institutional framework will enhance Cambodia's attractiveness to foreign investors, especially quality FDI with long-term commitments. This may help contribute to the Royal Government's efforts to move up the higher value chain ladder and to diversify the narrowly-based economy, through innovations, inventions, and technology transfers brought in by foreign investors. These are the key to sustained growth and development. Likewise, improvement of institutional quality is also likely to promote domestic investments.

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APPENDIX A:
Governance Indicators for more advanced ASEAN member states (Percentile Ranks)

Country	*1996*	*2000*	*2004*	*2008*	*2012*	*2013*	*2014*	*2015*
Brunei Darussalam								
Control of Corruption	72	69	70	73	73	74	72	73
Government Effectiveness	83	80	65	79	75	75	82	82
Political Stability	87	93	97	92	76	86	95	92
Regulatory Quality	95	81	84	75	85	82	80	77
Rule of Law	67	64	62	65	74	69	70	67
Voice and Accountability	27	26	23	21	32	32	29	26
Indonesia								
Control of Corruption	31	19	17	34	28	31	34	38
Government Effectiveness	37	45	44	47	46	47	55	46
Political Stability	13	3	4	15	28	29	30	25
Regulatory Quality	57	42	25	44	44	46	50	47
Rule of Law	40	29	25	31	34	37	42	40
Voice and Accountability	24	34	40	47	52	49	51	52
Malaysia								
Control of Corruption	71	66	70	58	65	68	68	66
Government Effectiveness	76	82	85	83	77	79	84	77
Political Stability	62	47	57	47	44	48	56	54
Regulatory Quality	73	68	67	62	71	73	76	75
Rule of Law	65	61	68	61	66	65	75	72
Voice and Accountability	50	40	41	31	39	38	38	36
Philippines								
Control of Corruption	51	40	30	25	34	43	40	42
Government Effectiveness	50	50	49	57	59	59	62	58
Political Stability	30	11	5	8	14	17	21	21
Regulatory Quality	60	57	46	52	52	52	52	53
Rule of Law	51	38	34	36	37	42	43	42
Voice and Accountability	56	53	50	45	47	48	53	52
Singapore								
Control of Corruption	97	97	99	98	97	97	97	97
Government Effectiveness	100	100	96	100	100	100	100	100
Political Stability	85	81	86	96	97	97	92	93
Regulatory Quality	100	100	99	99	100	100	100	100
Rule of Law	89	88	95	92	96	95	95	97
Voice and Accountability	55	54	49	38	54	53	45	43
Thailand								
Control of Corruption	50	55	52	42	47	49	42	44
Government Effectiveness	63	61	68	63	61	62	65	66
Political Stability	58	60	23	12	12	9	17	16
Regulatory Quality	58	67	63	58	59	58	62	63
Rule of Law	64	65	57	51	51	52	51	54
Voice and Accountability	61	63	53	31	37	34	25	24

Note: The data are each country's percentile ranks, with a score of 100 being the highest.
Source: World Bank's Worldwide Governance Indicators.

APPENDIX B: Definitions and Data Sources

Variable Name	*Definitions and Data Source*
LFDI	Logarithm of FDI inflows into Cambodia from 1995-2014. *Sources: Cambodian Investment Board and National Bank of Cambodia.*
GROWTH	Economic growth rate of Cambodia over 1995-2004. *Sources: United Nations' National Account Database online*
LTRADE	Logarithm of total trade of Cambodia (imports plus exports). Sources: *IMF's Direction of Trade Statistics*
LPOLRISK	Logarithm of the ratio of long-term political risk scores of Cambodia to those of FDI-home countries. The scores range from 1 to 7, with the score of 7 being of the highest risk. *Source: http://www.delcredereducroire.be*
LWAGE	Logarithm of minimum wage rate for Cambodia (in US$). Source: *International Labour Organization's Database online and Cambodia's Ministry of Labour and Vocational Training.*
LEXCH	Logarithm of ratio of Cambodia's exchange rate between riels and U.S. dollar to FDI-home country's exchange rate between national currency and U.S. dollar. Source: *United Nations' National Account Database online*
LDIST	Logarithm of distance between Cambodia's capital city and that of FDI-home country. Distance is measured in kilometers and is taken from the Centre D' etudes Prospectives et d' Informations Internationales (CEPII). Source: *CEPII's GeoDist database*. Available at http://www.cepii.fr
LINFLA	Logarithm of ratio of Cambodia's inflation rate to FDI-home country's inflation rate. Source: IMF's World Economic Outlook Database. Available at https://www.imf.org
LOME	Logarithm of the ratio of ores and metals exports to total merchandise. Source: *World Bank's World Development Indicators*
BIA	Bilateral investment agreements (BIA) between Cambodia and respective FDI-home country. It is binary variable taking the value of 1 for years when BIA was signed and implemented and 0 otherwise. *Source: Cambodian Investment Board*
LCC	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home
LRQ	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home
LGE	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home

LRL	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home
LVA	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home
LPS	Logarithm of regulatory quality index, which ranges from -2.5 to 2.5, with a score of 2.5 being of the highest quality. Following Meon and Sekkat (2008), the index is rescaled to between 1 and 6, in order for logarithm to be meaningful. Source: *World Bank's Worldwide Governance Indicators*, developed by Kaufmann, Kraay and Mastruzzi. Available at http://info.worldbank.org/governance/wgi/index.aspx#home

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