

4. Governance quality and investment attractiveness: Empirical evidence from OECD countries

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Abstract: Institutional quality becomes the lens through which this chapter studies investment attractiveness across OECD countries. Using Worldwide Governance Indicators for 2004–2023, the authors construct a synthetic governance-quality index, apply hierarchical clustering, compare EU and non-EU OECD members to link governance dimensions with inward FDI stock as a share of GDP. Scandinavian and selected Western European economies occupy the strongest positions, whereas Colombia, Mexico and Türkiye show the weakest scores. EU members within the OECD display less dispersion, suggesting that integration may foster institutional cohesion. Overall, governance quality and all six WGI dimensions are positively associated with investment attractiveness, with some variation between EU and non-EU groups. The chapter underlines that transparent, effective and accountable institutions remain decisive for attracting foreign capital.

Keywords: governance quality, investment attractiveness, FDI, OECD countries.

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Introduction

Over the past few decades, FDI worldwide has increased significantly. Average annual global FDI inflow rose from approximately 992.8 bln USD between 2000 and 2004 to about 2043.9 bln USD between 2015 and 2019, representing an increase of around 106% (Bothner, 2024). In 2020, the COVID-19 pandemic caused an unprecedented collapse in global FDI (886.2 bln USD), which reached volumes of 1834.5 bln USD and 1466.6 bln USD in the following two years. In 2023, FDI flows decreased to 1364.2 bln USD, continuing a downward trend and staying below levels recorded before the pandemic for the second year in a row (OECD Statistics, 2025). According to IMF data and the IMF's Coordinated Direct Investment Survey, which provides detailed information on direct investment positions between countries, FDI between advanced economies grew by 880 bln USD (3.6%). In contrast, those from advanced economies to emerging markets and developing economies rose by 538 bln USD (7.6%) (IMF, 2025).

High-income countries continue to receive the largest share of global FDI; however, their dominance is decreasing, e.g. the share of non-OECD economies in global capital inflows surpassed that of OECD economies for the first time in 2012 (Dellis, 2024). Nevertheless, when considering FDI inflows from 2010 to 2022, the top 10 host countries still mainly consist of developed economies, including seven OECD members (Figure 4.1).

Capital flows, particularly in the form of FDI, are crucial for the economy, as they influence GDP and exports, indirectly contributing to job creation, and supporting local market development (Chipalkatti et al., 2021). FDI can accelerate economic growth (Emako, 2022; Paul & Feliciano-Cestero, 2021), although some studies show that the relationships between FDI and economic growth are far from stable (Bénétrix et al., 2023). The final effects depend on the domestic conditions of the host country, e.g., human capital, economic and technological conditions, degree of openness of its economy (Forte & Moura, 2013), economic stability (Alguacil et al., 2011), development of financial markets (Alfaro & Chauvin, 2020), and better-developed institutions (Baiaashvili & Gattini, 2020). Institutional factors positively mediate the relationship between FDI and economic growth within different country income groups. Specifically, countries with better-developed institutions than their income group counterparts experience a significantly positive impact of FDI on growth.

To attract FDI, a country should strive to improve the investment climate. Traditional location advantages, such as low labour costs and the availability of raw materials, remain important; however, the country's credibility, political and economic stability, and effective tax policy and legal regulations significantly

determine its investment attractiveness. All these factors create what is known as *good governance*, which ensures transparency in the operation of institutions, increases their efficiency, supports the economy's competitiveness, and builds trust among entrepreneurs. Governance is the responsible, accountable, and transparent exercising of power, based on the principles of efficiency, legitimacy, and consensus (Munshi, 2004, p. 51).

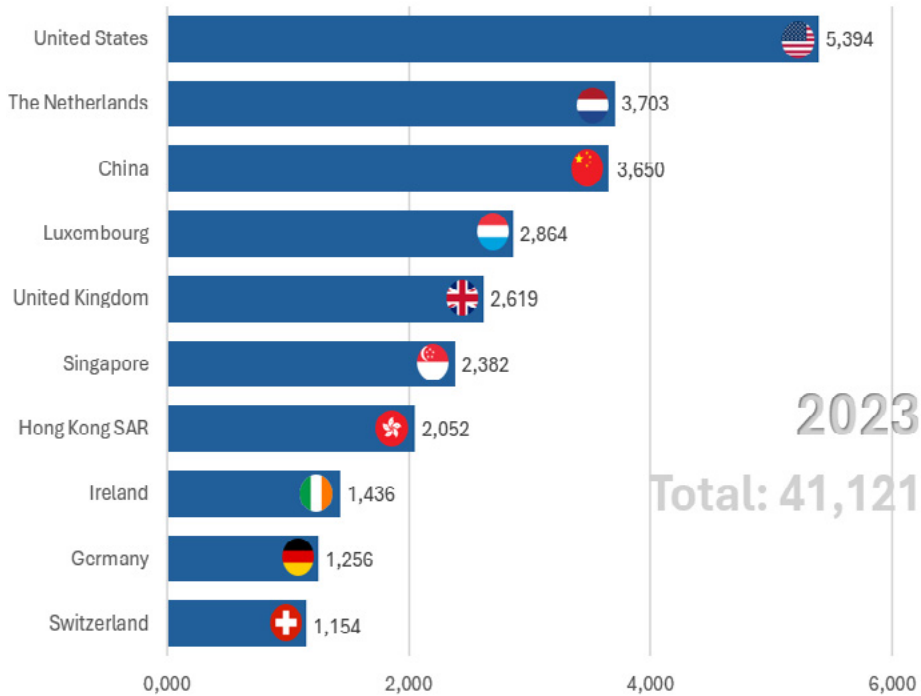


Figure 4.1. Top 10 FDI recipients (2010–2022; bln of USD)

Source: (IMF, 2025).

Many authors equate governance with institutional quality (Huther & Shah, 1999; Kaufmann et al., 2003; Zhuang et al., 2010), with institutional quality measures reflecting the quality of governance and institutions in a country. According to Kaufmann et al. (1999, p. 1), governance is “the traditions and institutions by which the authority in a country is exercised.” Kaufmann and Kraay (2007) use the terms “governance”, “institutions”, and “institutional quality” interchangeably throughout their discussion.

The relevance of good governance is considered an element of the investment attractiveness of a country, and numerous empirical studies have demonstrat-

ed that countries with strong institutions attract more FDI (Belfqi et al., 2021; Buchanan et al., 2012; Dobrowolska et al., 2020, 2021, 2023; Dorożyński et al., 2024; Globerman & Shapiro, 2002; Hayat, 2019; Jadhav, 2012; Khan et al., 2024; Peres et al., 2018; Sabir et al., 2019; Tabash et al., 2024). Therefore, as North posited, “institutions matter” (North, 1990). Extensive literature shows that strong governance structures marked by political stability, high regulatory quality, and effective control of corruption greatly enhance the inflow of FDI, with an optimal level of institutional development being essential for “the materialization of the growthenhancing effect of FDI” (Yeboua, 2020, p. 2). Many findings support the viewpoint that higher-quality institutions foster the transmission channels from FDI to the host economy via technology transfer or knowledge diffusion, while poor institutional quality results in increased uncertainty (i.e. higher cost of doing business) (Guenichi & Omri, 2024). While most studies focus on the macro scale, some are conducted at the firm level. For example, Haddad and Verriest (2025) indicate that more substantial property rights, better regulatory quality, and more developed financial markets lead to increased investment from MNCs. A stable and business-friendly environment may support spillovers from FDI because it affects the business operating conditions and can potentially determine how efficiently FDI resources are employed (Baiaashvili & Gattini, 2020).

On the other hand, some studies find a negative and insignificant relationship between institutional factors and FDI inflows (Nondo et al., 2016; Subasat & Bellos, 2013). Poor institutions act like a tax, raising investment costs and thus impeding foreign investment (Buchanan et al., 2012). This is why governments should carefully “adjust policies and institutions”, otherwise, they may adversely affect not only the size of FDI inflow but “can also be detrimental to economic growth” (van Bon, 2019).

Researchers examining the effect of institutional quality on FDI inflows usually focus on developing, emerging and transition economies (Busse & Hefeker, 2007; Dorożyński & Kuna-Marszałek, 2016; Hossain & Rahman, 2017; Kurul & Yalta, 2017; Wernick et al., 2009), or compare developing and developed countries (Buchanan et al., 2012; Khan et al., 2024; Qureshi et al., 2020; Sabir et al., 2019). Developed countries are rarely examined in this context.

Given this backdrop, the chapter attempts to answer the following questions: Is there any relationship between the quality of governance and FDI inflow? What is the role of governance in stimulating FDI inflows into the OECD, which consists of countries differentiated by their economic development? Which of the six dimensions of governance quality impacts the most FDI inward stock as a per cent of GDP in OECD members? Do EU countries that are members of OECD differ in institutional quality from non-EU OECD countries? This last question is important to our analysis because EU Member States (both “old” and “new”)

have been the focus of our research on multiple occasions (i.e. Dobrowolska et al., 2021, 2023; Dorożyński et al., 2024). Comparing some EU countries with a group of other advanced economies can also offer valuable insights. Moreover, distinguishing this group of countries is related to the book's theme, which focuses on EU countries.

Hence, the principal goal of the chapter is to assess the governance quality in OECD countries and to examine the relationship between GQ and FDI inward stock as a per cent of GDP. Various statistical methods are used, such as hierarchical cluster analysis, contingency analysis, synthetic index values, and descriptive statistics. We used Worldwide Governance Indicators to assess the QG in the OECD members for 2004–2023. WGI captures the GQ in six dimensions: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law, and control of corruption. Many researchers commonly use them in institutional analysis as a measure (e.g., Ajide & Raheem, 2016; Khan et al., 2022; Shah & Afridi, 2015).

The choice of OECD countries as an example is motivated by two reasons. Firstly, OECD countries generally have highly effective and inclusive institutions that promote political stability, the rule of law and the mitigation of corruption. These strong institutions might play a vital role in attracting FDI by ensuring regulatory stability, protecting property rights, and enhancing transparency. Strong governance frameworks in OECD countries have contributed to lower perceived risks and increased attractiveness for investors. Secondly, OECD countries attract a substantial share of global FDI inflows. The US, UK, Japan, Germany, and France are among the largest destinations for FDI, reflecting their market size and investment-friendly policies. OECD countries have historically been both significant sources and recipients of FDI, and this dual role has both shaped the economic landscape of member countries and has contributed to global supply chains.

4.1. Governance quality based on the Worldwide Governance Indicators

Governance quality and its components have been assessed for many years by different institutions and international organisations. The most popular measure of GQ based on aggregate data and international comparative studies include rankings published by the World Bank, the European Central Bank, the International Institute for Management Development, and the World Economic Forum. Unfortunately, institutional quality indicators are usually highly correlated

(Buchanan et al., 2012; Globerman & Shapiro, 2002; Ullah & Khan, 2017). To avoid this problem, we used aggregate and individual governance measures, such as the Worldwide Governance Indicators.¹ The WGIs report aggregates and individual governance indicators for over 200 countries and territories over the period 1996–2023 for six dimensions of governance:

1. *Voice and Accountability* captures perceptions of the extent to which a country's citizens can participate in selecting their government, as well as freedom of expression, freedom of association, and a free media.
2. *Political Stability and Absence of Violence and Terrorism* measures perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism;
3. *Government Effectiveness* captures perceptions of the quality of public services, the quality of the civil service, and the degree of its independence from political pressures. It also encompasses the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies;
4. *Regulatory Quality* measures the perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and foster private sector development;
5. *Rule of Law* captures perceptions of the extent to which agents have confidence in and abide by the rules of society, in particular, the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence;
6. *Control of Corruption* measures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption and the “capture” of the state by elites and private interests.

These aggregate indicators combine the opinions of numerous enterprises, citizens, and expert survey respondents in developed and developing countries. They are based on over 30 individual data sources comprising various surveys, experts, non-governmental organisations, international organisations, and companies' opinions.²

¹ WGI were initiated by Kaufmann and Kraay in 1999 and developed by Zoido and Mastruzzi.

² These data sources are rescaled and combined to create the six aggregate indicators mentioned above, using a statistical methodology known as an *unobserved components model*. A key feature of the methodology is that it generates margins of error for each governance estimate. These margins of error need to be taken into account when making comparisons across countries and over time (Kaufmann et al., 2010).

4.2. The relationship between the GQ and FDI inflow to the OECD Countries

Based on the findings of studies assessing the quality of governance in the OECD Member States and published in the Worldwide Governance Indicators Reports, in the first step of our analysis we used hierarchical cluster analysis methodology³ to identify countries that represent similar GQ. With Ward's method,⁴ we obtained a dendrogram which shows a hierarchical structure arranged in order of descending similarities between the components in the set (see Figure 4.2).

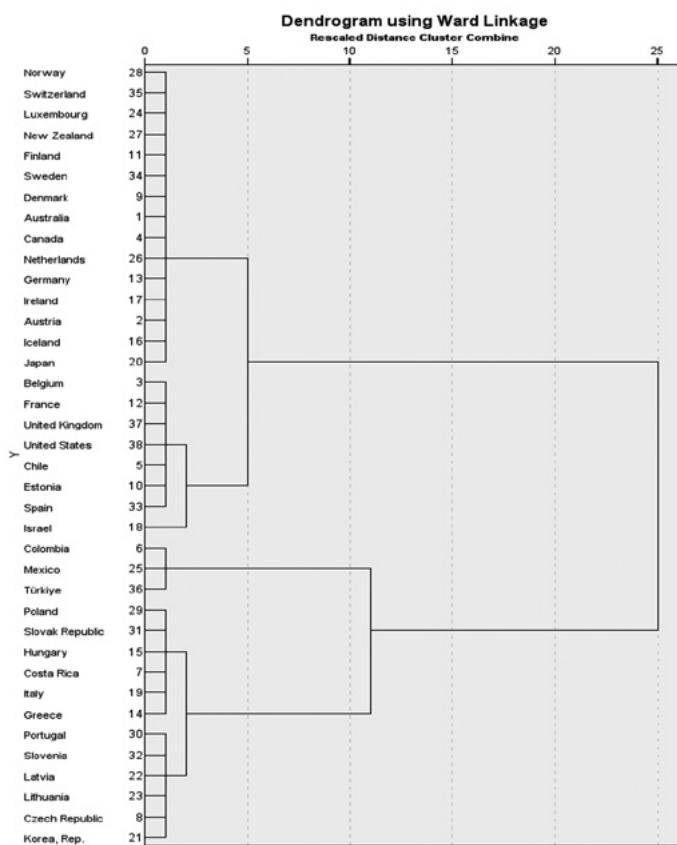


Figure 4.2. Dendrogram for the OECD countries based on Ward's linkage method

Source: own compilation using PS IMAGO.

³ Hierarchical cluster analysis is used to identify homogenous groups of elements based on selected characteristics in a given set of data (Lasek, 2002; James et al., 2014).

⁴ Ward's method is one of the agglomeration methods used in hierarchical cluster analysis.

This allowed us to divide all of the OECD Member States into five groups that represent similar levels of GQ:

- Group 1_{gq}: Norway, Switzerland, Luxembourg, New Zealand, Finland, Sweden, Denmark, the Netherlands, Australia, Canada, Germany, Ireland, Austria, Iceland, Japan;
- Group 2_{gq}: Belgium, France, United Kingdom, United States, Chile, Estonia, Spain, Israel;
- Group 3_{gq}: Colombia, Mexico, Türkiye;
- Group 4_{gq}: Poland, the Slovak Republic, Hungary, Costa Rica, Greece, Italy;
- Group 5_{gq}: Portugal, Slovenia, Latvia, Lithuania, the Czech Republic, the Republic of Korea.

Although hierarchical cluster analysis helped distinguish five groups of countries with similar GQ, it failed to identify which group performs better. Hence, in the second step, we compared the quality of governance among the five groups of countries. We constructed a synthetic index of governance quality for each OECD country based on the data from 2004 to 2023. This measure is the sum of percentile ranks⁵ for the countries published by the WGI for six governance dimensions over the period in question. The overall ranking of the OECD countries based on the synthetic index is presented in Figure 4.3.

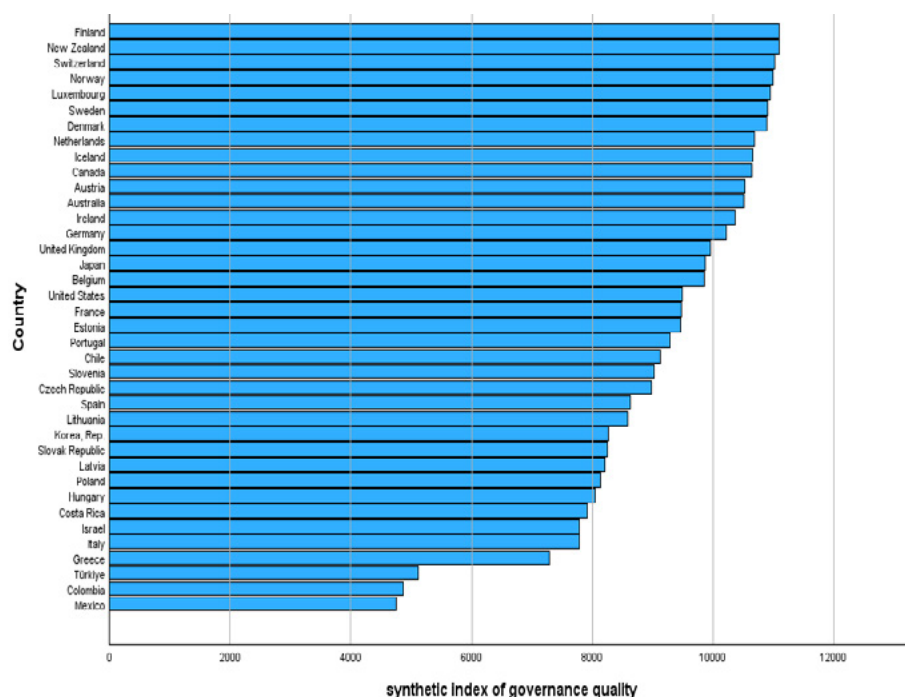


Figure 4.3. Synthetic index of governance quality in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

⁵ Percentile ranks from 0 (the lowest) to 100 (the highest).

Using the synthetic index of governance quality, we calculated the index's mean value for the five countries groups (see Table 4.1).

Table 4.1. The mean value of the synthetic index of governance quality for the OECD Member States, 2004–2023

Group	Country	Mean of the synthetic index of governance quality
Group 1 _{gq}	Norway, Switzerland, Luxembourg, New Zealand, Finland, Sweden, Denmark, Netherlands, Australia, Canada, Germany, Ireland, Austria, Iceland, Japan	10701.93
Group 2 _{gq}	Belgium, France, United Kingdom, United States, Chile, Estonia, Spain, Israel	9229.12
Group 3 _{gq}	Colombia, Mexico, Turkiye	4908.05
Group 4 _{gq}	Poland, Slovak Republic, Hungary, Costa Rica, Greece, Italy	7907.78
Group 5 _{gq}	Portugal, Slovenia, Latvia, Lithuania, Czech Republic, Republic of Korea	8727.80

Source: own compilation using PS IMAGO.

The ranking revealed that the highest GQ was reported by countries from Group 1_{gq}: Norway, Switzerland, Luxembourg, New Zealand, Finland, Sweden, Denmark, Netherlands, Australia, Canada, Germany, Ireland, Austria, Iceland, and Japan. At the other extreme is Group 3_{gq}: Colombia, Mexico and Turkiye, where investors can expect the lowest governance quality. We also examined the relevance of the six dimensions of GQ. The results are presented in Figures 4.4–4.9 and confirm the institutional quality leadership of New Zealand and North European Countries. Mexico, Colombia and Turkiye rank lowest in five of the six individual categories. The exception is political stability and absence of violence partial ranking, in which Israel is one of the worst. The so-called EU-13 new Member States occupy the second part of the ranking, which implies a significant distance to the governance quality of OECD leaders.

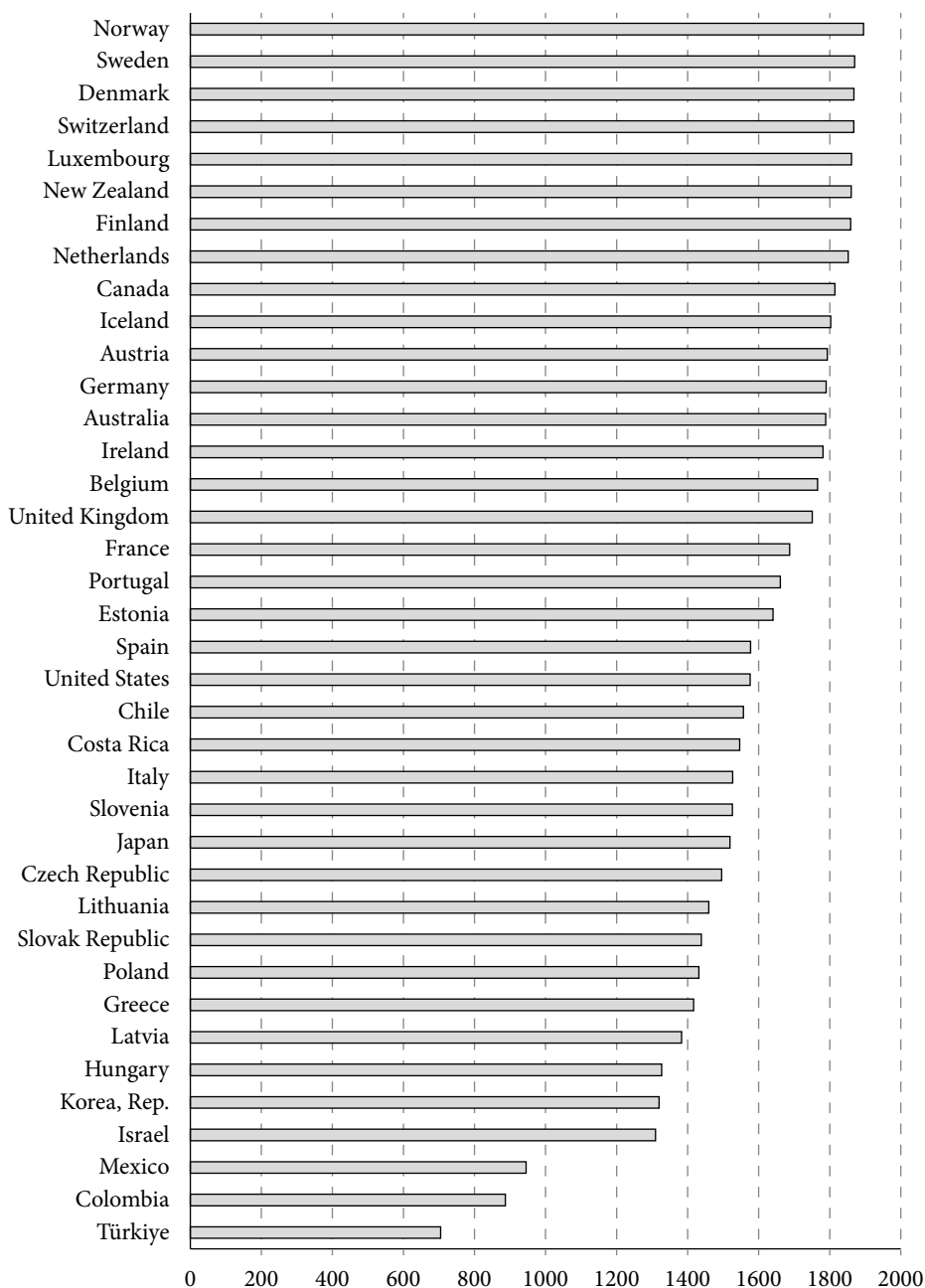


Figure 4.4. SIGQ ranking for a voice and accountability in the OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

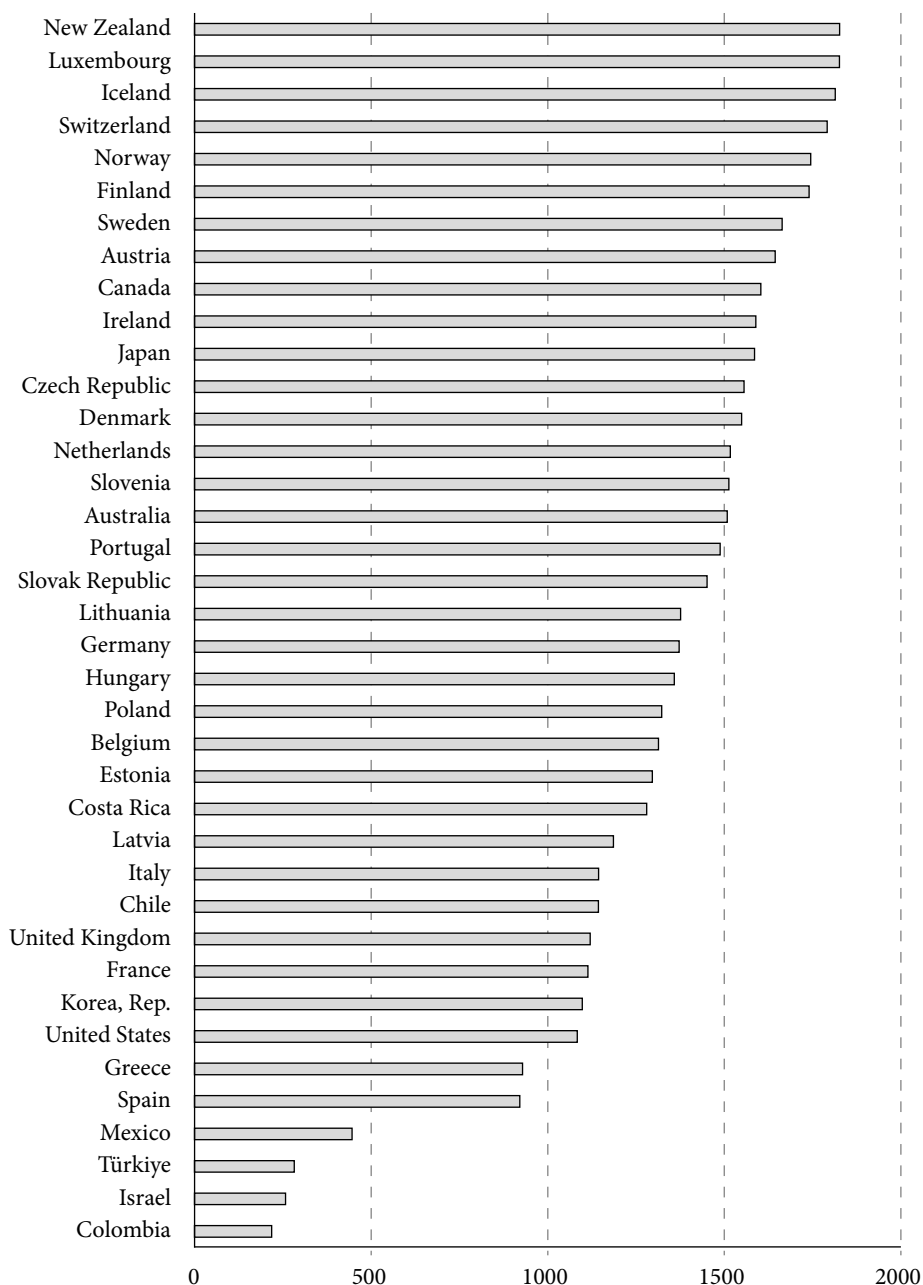


Figure 4.5. SIGQ ranking for political stability and absence of violence in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

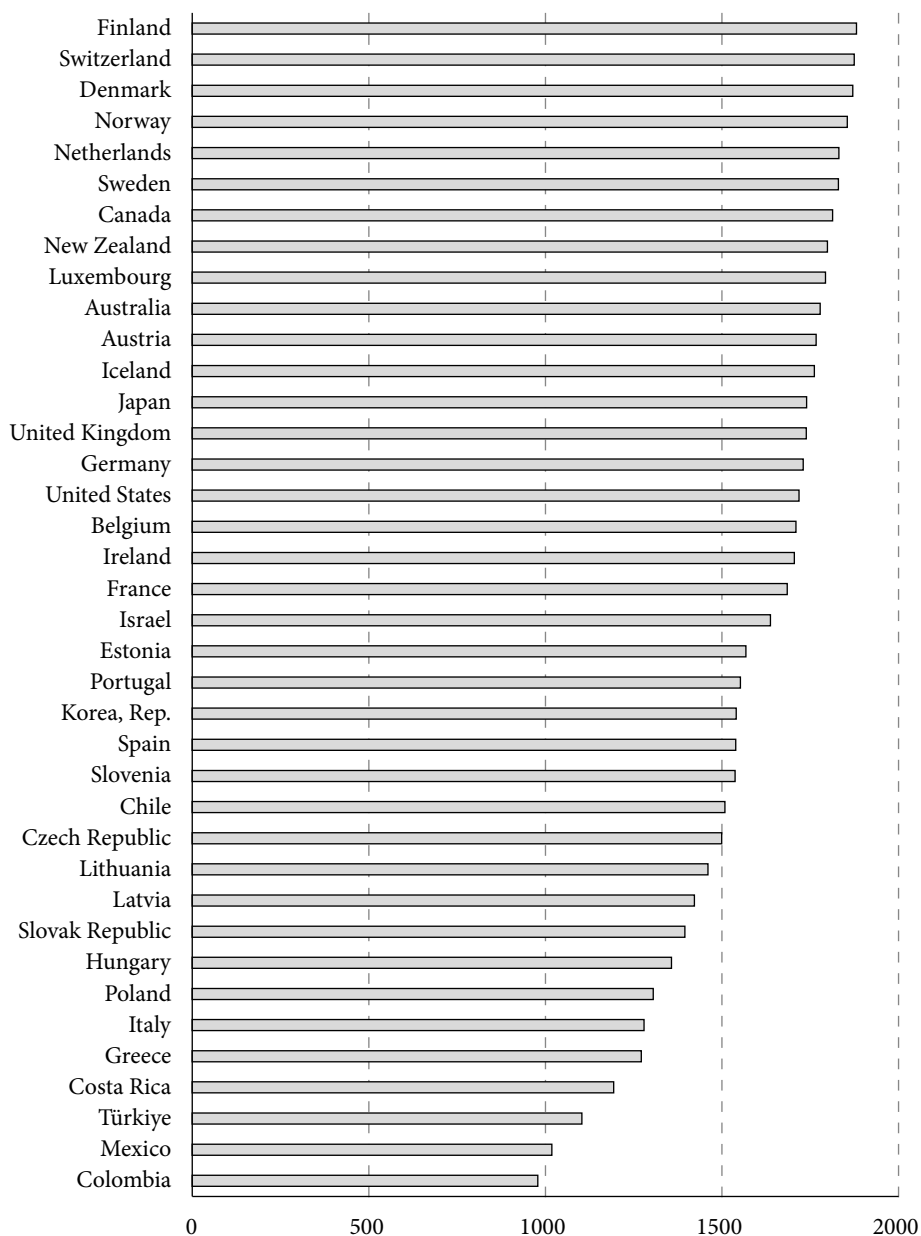


Figure 4.6. SIGQ ranking for government effectiveness in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

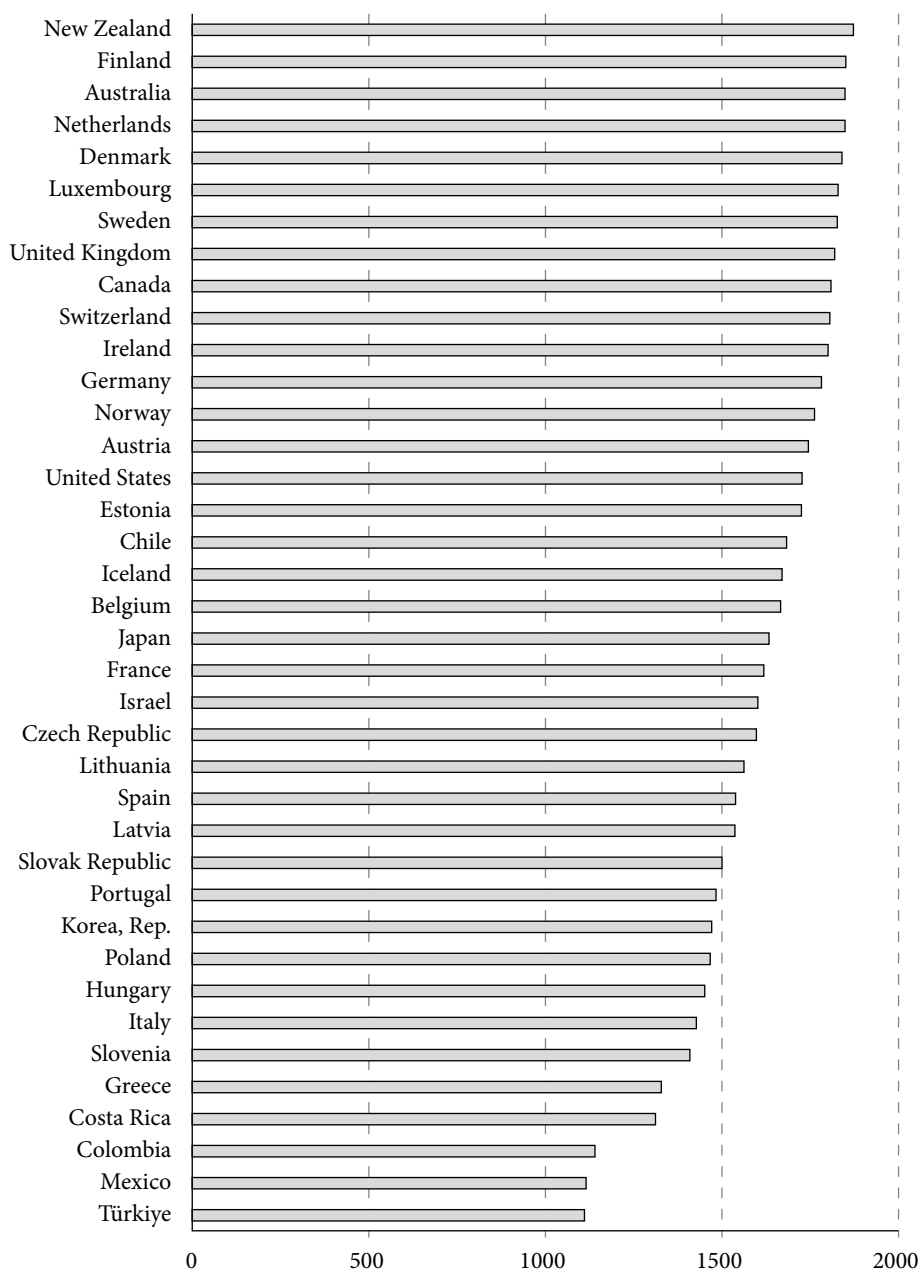


Figure 4.7. SIGQ ranking for regulatory quality in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

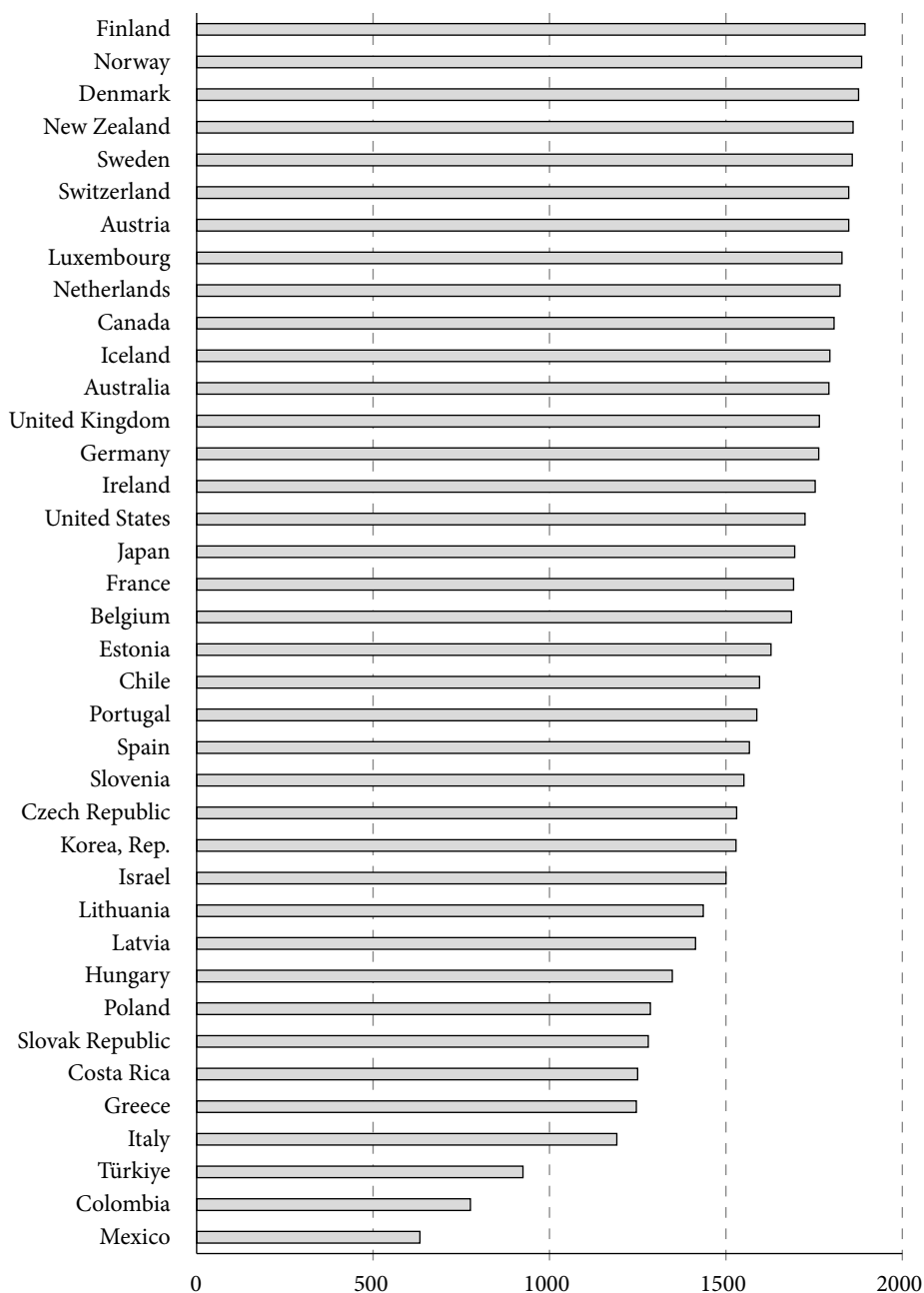


Figure 4.8. SIGQ ranking for rule of law in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.



Figure 4.9. SIGQ ranking for control of corruption in OECD countries, 2004–2023

Source: own compilation using PS IMAGO.

Table 4.2 presents the descriptive statistics of FDI inward stock as a per cent of GDP for the OECD Member States at the end of 2023. It is clear from the table that the data are highly variable, skewed, and exhibit high kurtosis. The 5% trimmed mean and M-estimators differ significantly from the mean, indicating heterogeneity in the examined population. The minimum value was recognised for Japan, while the maximum value was for Luxembourg.

Table 4.2. Statistics for FDI inward stock as a per cent of GDP in the OECD at the end of 2023

Descriptives	Statistic	Standard error
Mean	96.49	
95% Confidence Interval for Mean – Lower Bound	24.45	
95% Confidence Interval for Mean – Upper Bound	169.53	
5% Trimmed Mean	59.72	
Variance	48 039.01	
Standard deviation	219.18	
Minimum	5.89	
Maximum	1 375.81	
Range	1 369.92	
Interquartile range	39.11	
Skewness	5.68	0.383
Kurtosis	33.66	0.750
Percentiles 20	30.77	
Percentiles 40	43.52	
Percentiles 60	58.63	
Percentiles 80	82.38	
M-Estimators		
Huber's M-Estimator ^a	51.56	
Tukey's Biweight ^b	47.45	
Hampel's M-Estimator ^c	48.88	
Andrews' Wave ^d	47.46	

Notes: a. The weighting constant is 1.339.

b. The weighting constant is 4.685.

c. The weighting constants are 1.700, 3.400, and 8.500.

d. The weighting constant is $1.340 \cdot \pi$.

Source: own compilation using PS IMAGO.

Given the circumstances, in the third step of our analysis, we divided the countries into five groups arranged in ascending order of FDI inward stock as

a per cent of GDP based on measures of position such as quintiles. We transformed the FDI inward stock as a per cent of the GDP variable measured on a numerical scale into a variable measured on an ordinal scale. As a result, we produced the following groups of countries:

Group 1_{fdi}: Belgium, United Kingdom, Estonia, Switzerland, Netherlands, Ireland, Luxembourg;

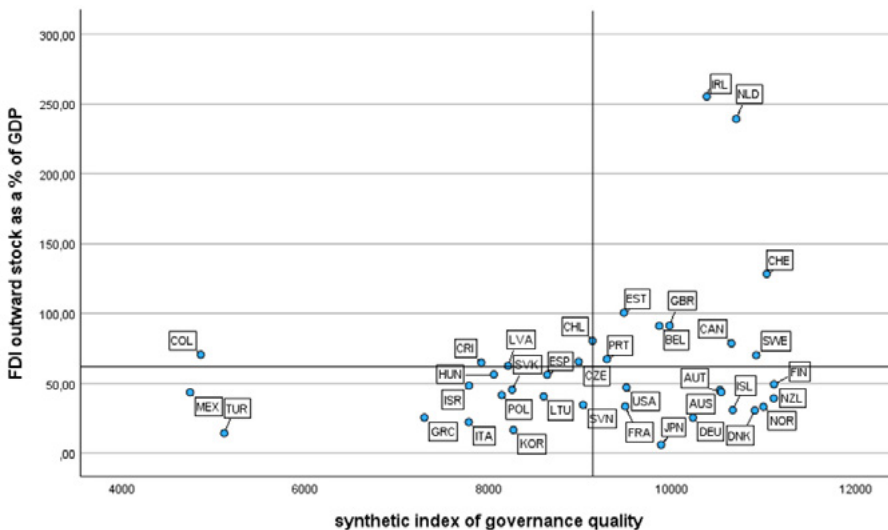
Group 2_{fdi}: Latvia, Costa Rica, Czech Republic, Sweden, Portugal, Colombia, Canada, Chile;

Group 3_{fdi}: Austria, Australia, Slovak Republic, United States, Israel, Finland, Spain, Hungary;

Group 4_{fdi}: Lithuania, Poland, Mexico, New Zealand, Slovenia, France, Norway, Iceland;

Group 5_{fdi}: Greece, Italy, Germany, Denmark, Korea Rep., Türkiye, Japan.

In the fourth step, we assessed the relationship between the OECD countries GQ from 2004–2023 and FDI inward stock as a per cent of GDP at the end of 2023. The correlation analysis started with drafting a scatterplot for the variables (Figure 4.10).

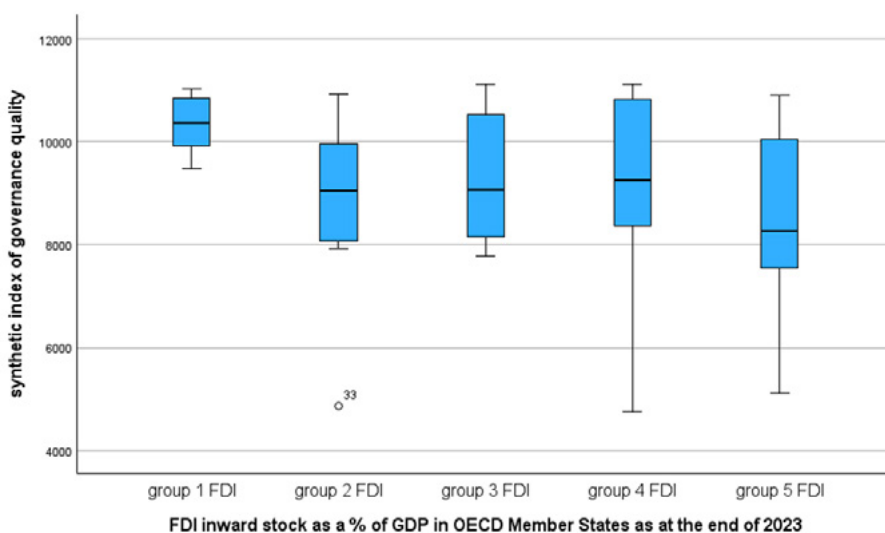


Note: Due to the extreme outlier, we omitted Luxembourg from the Figure.

Figure 4.10. Scatterplot for the SIGQ and FDI inward stock as a per cent of GDP

Source: own compilation using PS IMAGO.

The scatterplot confirms the conclusions drawn in the previous step, suggesting a huge differentiation of FDI inward stock as a per cent of GDP among the OECD Member States, which is largely due to the values of this variable for Luxembourg. For this reason, we decided to assess the degree to which the synthetic index of governance quality differs across the five distinguished groups of OECD countries arranged in ascending order of FDI as a per cent of GDP based on the measures of position such as quintiles (see Figure 4.11).



° number 33 – Colombia.

Figure 4.11. Boxplot for the SIGQ in groups of countries based on the FDI inward stock as a per cent of GDP at the end of 2023

Source: own compilation using PS IMAGO.

The highest median of the synthetic index of governance quality among the OECD Members was reported for Group 1_{fdi}, which means that the countries with the largest inflows of FDI inward stock as a per cent of GDP are those offering the highest institutional quality to potential investors. The median values are lower in Group 2_{fdi} and Group 3_{fdi}, which comprise countries with moderate levels of FDI inward stock as a % of GDP. The results for Group 4_{fdi}, which contains countries reporting the lowest levels of FDI inward stock as a per cent of GDP, are coherent with the SIGQ values.

In the next step of our analysis, we evaluated the SIGQ for all OECD countries by EU and non-EU members. Figure 4.12 shows that EU Member States within the OECD structure have a higher average SIGQ value than non-member

countries. In addition, non-EU countries are characterised by a wide diversity of the quality of governance. A markedly low quality of governance applies to three countries: Colombia, Mexico, and Turkiye.



Figure 4.12. Violin graph for the SIGQ by EU and non-EU OECD Countries

Source: own compilation using PS IMAGO.

A detailed analysis individual dimensions of governance quality also shows that OECD EU countries perform better than OECD non-EU countries. The largest differences between SIGQ averages are recognised in the three following areas: political stability and absence of violence, a voice and accountability and the rule of law (see Table 4.3).

Table 4.3. The mean value of individual dimensions of SIGQ for OECD EU and non-EU countries, 2004–2023

Name	Mean value of SIGQ for OECD		
	EU countries	non-EU countries	total
Synthetic index of governance quality	9424	8810	9182
A voice and accountability	1642	1493	1583
Political stability and absence of violence	1391	1179	1307
Government effectiveness	1597	1554	1580
Regulatory quality	1637	1571	1611
Rule of law	1602	1508	1565
Control of corruption	1556	1505	1536

Source: own compilation using PS IMAGO.

In the last step of the study, we assessed the relationship between the GQ for EU and non-EU OECD countries from 2004 to 2023 and FDI inward stock as a per cent of GDP as of the end of 2023. The correlation analysis started with drafting the scatterplot for the variables (see Figure 4.13 and 4.14).

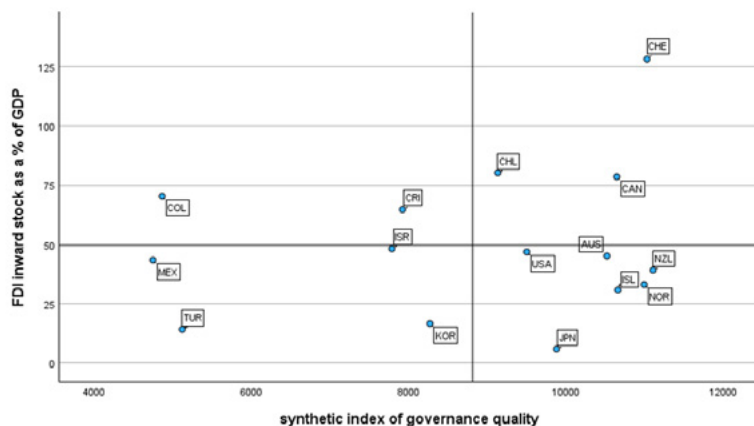
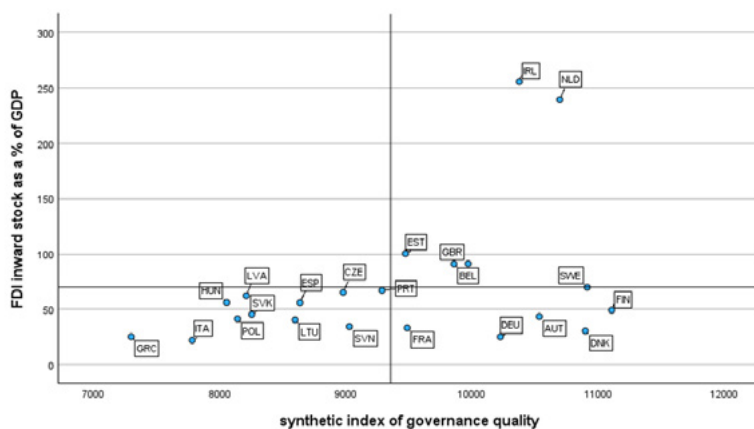


Figure 4.13. Scatterplot for the SIGQ and FDI inward stock as a per cent of GDP for OECD non-EU countries

Source: own compilation using PS IMAGO.



Due to the extreme outlier, we omitted Luxembourg from the Figure.

Figure 4.14. Scatterplot for the SIGQ and FDI inward stock as a per cent of GDP for OECD EU countries

Source: own compilation using PS IMAGO.

We used the contingency coefficient to assess the strength of the correlation between the overall value and six dimensions of GQ and FDI inward stock as a per cent of GDP (Table 4.4). Its value for the six dimensions of GQ for EU and non-EU OECD countries shows a significant, positive correlation between the GQ and FDI inward stock as a per cent of GDP. It is worth noting that the relationship is stronger for non-EU OECD countries.

Table 4.4. Contingency coefficients between the six dimensions of GQ and FDI inward stock as a per cent of GDP

Dimensions of GQ	Contingency coefficient values	
	EU countries	non-EU countries
Voice and accountability	0.606	0.732
Political stability and absence of violence	0.555	0.766
Government effectiveness	0.705	0.742
Regulatory quality	0.666	0.660
Rule of law	0.645	0.725
Control of corruption	0.701	0.685
Overall SIGQ value	0.687	0.704

Source: own compilation using PS IMAGO.

Conclusions

The principal goal of the chapter was to assess the governance quality in the OECD countries and to examine the relationship between the GQ and FDI inward stock as a per cent of GDP, reflecting the investment attractiveness of different countries. The literature review and our statistical analysis lead us to the following conclusions:

1. Most economists and IB researchers agree that institutional quality is one of the primary determinants of investment attractiveness. Numerous theoretical and empirical studies confirmed that higher levels of GQ encourage MNEs. In contrast, weak and ineffective organisational, legal and procedural environments discourage foreign investors due to political and legal instability, bureaucracy, lack of accountability and transparency, inactive mechanisms to reduce corruption and other formal and informal constraints.
2. The OECD countries differ significantly in terms of the overall governance quality, as measured by the WGI and its six main dimensions. At the same time, we found that the countries covered by the study can be divided into

several groups representing similar quality of governance. Using hierarchical cluster analysis, we selected five groups. The countries in these groups show similar characteristics, e.g., political stability, rule of law and control of corruption. Statistical analysis revealed a positive correlation between governance quality and foreign direct investment inflow.

3. Among OECD EU countries, the values of the contingency coefficients between the six dimensions of governance and FDI as a per cent of GDP indicate that government effectiveness, control of corruption and regulatory quality exert the biggest influence on FDI. In turn, among OECD non-EU countries, the quality of governance measured with political stability and absence of violence, government effectiveness, voice and accountability and rule of law is most strongly correlated with investment attractiveness.

To sum up, governance quality is a key factor influencing investment decisions, as confirmed by analyses based on Governance Quality Indicators (WGI). Higher governance quality translates into greater attractiveness for foreign investors, which can increase the inflow of foreign direct investments. As GQ plays a crucial role in shaping a country's investment landscape, policymakers should prioritise governance reforms to enhance their competitiveness in the global market and maximise the potential benefits of FDI inflows. Moreover, it can also be assumed that European integration promotes convergence in institutional quality. This is facilitated by multiple channels: policy harmonisation, financial support, knowledge sharing, and economic interdependence (it compels governments to adopt compatible governance structures to facilitate trade, investment, and economic cooperation). Testing this thesis requires further in-depth research.

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