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## **Regime type matters: A comparative analysis of the impact of institutions on foreign direct investment inflow**

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# **Regime type matters: A comparative analysis of the impact of institutions on foreign direct investment inflow**

Bachelor Thesis

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Bachelor Project: International Cooperation and the Design of Global Economic Institutions

Instructor: Dr. Michael Sampson

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## 1. Introduction:

Foreign direct investment (FDI) was severely halted during the Covid-19 pandemic. Now that the pandemic is under control, the United Nations Conference on Trade and Development (UNCTAD) has reported that FDI flows have started to return to their pre-pandemic levels of 1.6 trillion (UNCTAD, 2022a). FDI remains an important tool for developing countries to gain access to foreign capital, technology, and new information. Through the increase in business competitiveness, employment, and overall economic activity, FDI can spur economic growth (Jordaan et. al., 2020). However, the political environment and institutional arrangement might have an impact on the attractiveness of FDI. The post-COVID resurgence of FDI warrants a renewed look at the effects of regime type and respective institutions on their inflow of FDI. This research attempts to assess how regime type impacts the inflow of FDI to developing countries.

The study of the international political economy is inherently concerned with the study of the complex interplay between politics and the economy. Different types of regimes ranging from authoritarian to hybrid regimes and ultimately to democracies implement different economic policies which lead to diverging outcomes. Authoritarian rulers are often incentivized to consider only the short-term and the duration of their rule which neglects long-term economic development. Democracies on the other hand are said to uphold transparent institutions which facilitate economic growth (Olson, 1993; Weede, 1996; Przeworski & Limongi, 1993). However, the literature is divided on the exact effect of regime type on the inflow of FDI. Various authors argue that democracies create a trustworthy and encouraging investment climate whereas in authoritarian regimes investors run the risk of receiving unfair treatment and being neglected in favor of domestic producers (Li & Resnick, 2003; Choi & Samy, 2008). The contradictory stances in the literature is addressed by answering the following research question:

**Research question:** How does regime type impact the inflow of foreign direct investment in developing countries?

This thesis seeks to answer the following research question by conducting a qualitative analysis using process tracing to analyze the effect of different regime types on FDI inflow. A most different systems design (MDS) will be adopted to assess this relationship in two countries with different political regimes, Vietnam, and South Africa.

Based on the analysis, this paper concludes that in the case of Vietnam, authoritarian developing regimes can uphold stronger essential institutions which create a stronger and more reliable investment climate that increases inward FDI flows. Developing democracies on the other hand such as South Africa, are subject to less political stability and reliability over time which hinders its attractiveness for FDI. The findings of this paper speak to the broader literature on the relationship between domestic institutions and economic growth. More specifically, it questions how regime type impacts the inflow of FDI. As foreign investment continues to increase following the Covid-19 pandemic, the findings are increasingly relevant and contribute to important policy developments. Economic growth is an essential step in alleviating global poverty and in achieving many of the United Nations' sustainable development goals. Gaining a deeper understanding of the mechanisms that attract FDI in countries of different political regimes is quintessential.

This thesis adheres to the following structure. First, the literature review conceptualizes the concepts central to understanding and reviews the current literature on the relationship between FDI and economic growth, and FDI and regime type. Second, it presents the institutionalist theory of economic development and theory utilized in this thesis. Third, it discusses the methodology, case selection, and operationalization. Following this, an analysis where the main findings are presented. This is complemented by a discussion and conclusion section where the implications of the findings, the limitations of the study, and considerations for future academic research are highlighted.

## 2. Literature review

This literature review will first conceptualize the main variables involved: FDI and regime type. It will then review the academic research surrounding the topics of FDI and economic growth and FDI in different regime types. Furthermore, it will identify the debate in the literature which revolves around the attractiveness of democracies versus autocracies in boasting regime institutions that attract more FDI. While democracies are more transparent and open to cooperation, autocracies boast political consistency and stability as well as efficiency when it comes to implementing policies.

### 2.1: Conceptualization of FDI and Political Regimes

The definition of FDI is taken from the official conceptualization of the UNCTAD which defines FDI as “an investment reflecting a lasting interest and control by a foreign direct investor, resident in one economy, in an enterprise resident in another economy” (UNCTAD, 2022b, p. 1). Schneider & Frey (1985) identify some of the main determinants of attracting inward FDI and argue that it is a combination of economic and political factors. Economic variables such as a country’s level of development, size of the market, and a low balance of payment deficit attract more FDI. Political factors range from the amount of bilateral aid coming from Western countries, political stability, government efficiency, and protection of investment al increase the likelihood of receiving inward FDI flows (Schneider & Frey, 1985).

Political regimes will be classified as the political institutions, norms, and rules which determine how political power is acquired and maintained (Alvarez et. al., 1996). Alvarez et. al., (1996) differentiates between democracies and authoritarian regimes in the following manner. Democracies must have directly elected executives and legislatures as well as the presence of more than one party. In authoritarian regimes, these conditions are not met, and power is held by a single ruler or a small group of people (Alvarez et. al., 1996). Investment in these two regimes differs substantially. In authoritarian regimes, foreign investors may experience government interference in business operations, property contracts, and policy. However, this can be remedied if authoritarian regimes implement policies that prioritize the well-being of their citizens and engage in investment treaties such as bilateral investment treaties which will ensure the rights of the investors are protected (Bastiaens, 2016). Democracies on the other hand are

compiled to provide transparency to the investors, sound policy which leads to capital accumulation, and decisions and property rights that are upheld by the courts. Furthermore, corruption is punishable, and power is constrained through checks and balances which will reduce the chances of expropriation and corruption of foreign investors (Izilein & Mohammed, 2017).

## 2.2: FDI and Economic Growth

The literature on FDI and economic growth finds itself in a debate with findings ranging from a positive effect on economic growth to a weak effect, in some cases even a negative effect on economic growth. The literature is further divided on the direction of the relationship; does FDI lead to economic growth or does economic growth attract FDI (Al-Iriani, 2007)? One side of the debate finds that economic growth can act as a catalyst by providing access to foreign capital and new technologies needed to stimulate development. In this case, the relationship is bi-directional, meaning that FDI leads to economic growth and that economic growth also attracts further foreign investment (Al-Iriani, 2007; Chowdhury & Mavrotas, 2006). Umoh et. al., (2012) contributed to this argument and found that in Nigeria, FDI has led to technology spillovers which led to an increase in productivity and utilization of resources. This led to a further increase in exports resulting from increased capacity and domestic production competitiveness (Umoh et. al., 2012). In turn, this has attracted more foreign investment and economic growth.

On the other hand, various authors pointed to a weak or even non-existent relationship between FDI and economic growth. De Mello (1999) argued that past studies have failed to evade omitted variable bias in their studies. As a remedy, De Mello conducted a time series panel study to find that the relationship between FDI and economic growth relies on country-specific factors such as the time frame of FDI, the technological gap between leaders and followers, and the starting point of development of a given economy. Furthermore, the volume of foreign investment depends on the economy's trade regime, legislation, political stability, and scale factors such as the size and demand in the market for the goods produced via FDI (De Mello, 1999). The author suggested a weaker relationship than the one identified previously, as FDI is mediated and affected by a variety of factors.

Various authors found a null relationship between FDI and economic growth in least-developed countries (LDCs) (Sarkar, 2007; Chakraborty & Nunnenkamp 2006). Through a panel

regression analysis, Sarkar (2007) found that only 10 cases out of their chosen 51 cases observed a positive long-term relationship with economic growth. This comes down to the openness of the economy and the wealth of these countries. Other cases either observed no relationship at all or even a negative relationship (Sarkar, 2007). The dispersed results among positive, negative, and null relationships indicate and reveal the ambiguity in the relationship between FDI and economic growth. Chakraborty & Nunnenkamp (2006) attempted to relieve some of the ambiguity of this relationship. Following a sharp rise of FDI in India, they analyzed the investment scene and economic growth in India. The authors found that the relationship between FDI and economic growth in India is not statistically significant and that FDI has not led to a rise in GDP in a significant manner (Chakraborty & Nunnenkamp, 2006). They support the findings of De Mello (1999) and claim that the effectiveness of FDI is influenced by institutional factors and domestic investment policies such as openness to trade and financial sector development (pp. 31-32). Vu et. al., (2008) went one step further and identify that FDI can also be sector dependent. The authors used sectoral data for Vietnam and China and concluded that FDI only reveals consistent positive growth in the manufacturing sector. In other sectors, the effect on growth is statistically insignificant and, in some cases, even negative. Capital and technology-intensive industries benefit more from the technology and capital received through FDI and exhibit a positive relationship with economic growth (Vu et. al., 2008).

It is clear that studies contradict each other regularly, many studies find a strong positive relationship between economic growth and inward FDI flows, however, others argue that FDI effectiveness is dependent on political circumstances and sector. While the debate is present, the consensus amongst development specialists is that foreign investment can play a crucial role in leading to economic growth as evidenced by the FDI growth success story of the Asian tigers, etc. As a result, this thesis adopts the premise that FDI is beneficial for developing states and attracting FDI should be a primary policy concern.

### 2.3: FDI and Regime Type

The literature is further divided on the effect and determinants of regime type on FDI. The main debate is whether democratic institutions attract more FDI and experience higher economic growth in comparison to authoritarian regimes.

The central argument in favor of democracy in attracting foreign investors is that democracy increases the efficiency and security of interactions between foreign investors and national governments. Property rights are essential in facilitating economic growth. This equally applies to foreign investors. Democratic institutions offer to protect the property rights of firms and individuals in exchange for tax payments. As a result, democratic regimes reduce risk and attract more foreign investment flows. On the other hand, as democratic institutions protect the rights of both MNEs and domestic producers, they limit the monopolistic tendencies of MNEs which may in turn limit FDI flows to democratic regimes (Li & Resnick, 2003). In their study of 53 developing countries, Li & Resnick (2003) found that democratic institutions do indeed increase FDI flows as they provide secure property protection rights. However, on the contrary, they found that increases in democracy also reduce FDI flows as more robust democratic institutions impose constraints on investors and foreign capital (Li & Resnick, 2003). There are both benefits and drawbacks to democratic regimes in terms of attracting FDI. While this study highlighted important aspects of democratic institutions that attract FDI, it neglected the way that regime type mediates the effect of FDI on economic growth. Choi & Samy (2008) provide certain findings which support the theory that democracies attract more FDI as veto powers and checks and balances in the government increase the credibility of the government. This credibility of the government would then lead to security against the expropriation of the investors investing abroad which would increase FDI flows to democracies (Choi & Samy, 2008)

Oneal (1994) complemented the shortcomings of the previous studies by assessing the effect of foreign investors in authoritarian regimes. He attempted to answer the questions and thesis posed by O'Donnell (1978) who argued that authoritarian and autocratic regimes can also lead to economic growth and that under certain circumstances, they are more efficient than democratic regimes (pp. 567-568). Oneal analyzed the flow of US foreign investment flows and its effective rate of return. The studies revealed that US multinational corporations have not always benefitted from investing in autocratic regimes. In both developing and developed democratic regimes, the rate of return on investment has been higher. However, when analyzing South American regimes versus Asian regimes, South American investments have been more profitable (Oneal, 1994). Elkomy, et. al., (2016), addresses one of the shortcomings of past studies analyzing the effect of FDI in transitioning economies, namely the cross-sectional issues. They do this by analyzing 61 transition/developing countries from 1989 to 2013. They find that hybrid and authoritarian regimes

experiencing an inflow of FDI exhibit a positive relationship with economic growth whereas in democracies, the relationship is insignificant. However, they find that it is primarily other macroeconomic drivers of growth such as human capital that are more important to facilitating development, rather than FDI itself (Elkomy, et. al., 2016). This study contradicts previous studies which find that FDI in democratic regimes will thrive due to greater property rights as opposed to authoritarian regimes. These findings are confirmed by Moon (2019) who finds that autocracies can indeed attract more FDI inflow by taking advantage of their relatively high political and macroeconomic stability. Democracies struggle with political constraints such as audience costs in the government which can hinder effective policy implementation to support the institutions such as property rights which will attract investors (Moon, 2019).

The debate in the literature about the effectiveness of democracies versus autocracies in attracting FDI remains ongoing and is centered around the strengths of both regimes in offering a stable investment environment. While democracies may boast a more transparent regime that commits to strong property rights protection, rule of law, and political stability, autocracies can offer political consistency and more stability as the regime is not open to change. Furthermore, autocracies can implement policies and reforms faster and more efficiently.

This debate has yet to be resolved due to a variety of factors, however most prominent are the issues of the complexity of the factors that influence FDI attractiveness and the heterogeneity of cases that are studied. The factors that affect FDI attractiveness are numerous and complex which range from political to economic, and social factors that influence the investment environment. Furthermore, it is difficult to draw substantive conclusions that are generalizable across all cases as each country is different. All countries experience varying levels of institutions and economic development as well as different levels of stability. The complex interactions of these factors are what makes the debate so widespread and contentious. As a result, rather than adopting a quantitative approach, a qualitative approach to studying the complex interplay between these factors is most suitable. Consequently, it will attempt to disentangle the numerous mechanisms at play and illustrate how regime types influence FDI inflows. This thesis will attempt to clear up the ambiguity in this debate by focusing on two countries, one being a democracy and the other being an autocracy.

### 3. Theoretical Framework

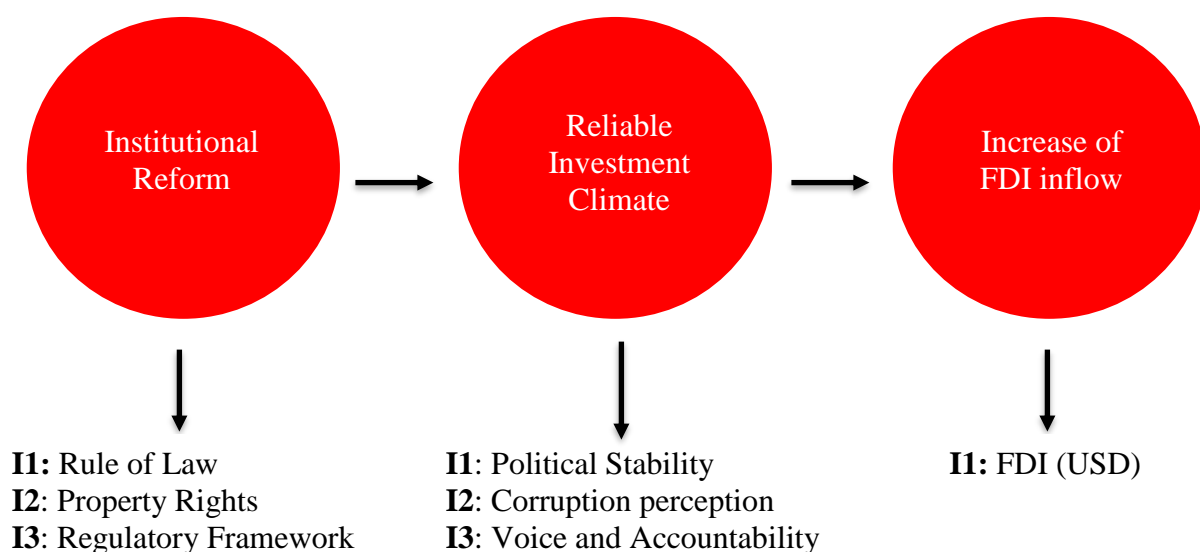
This framework will the relevant theories linking regime type to FDI. The primary of these theories is the institutionalist theory of economic development. The underlying premise and importance placed on institutional quality will be used to develop an underlying basis for the theory used to answer the research question.

#### 3.1 The Institutional Theory of Economic Development:

The institutionalist theory of economic development is an extension of contemporary institutionalist theory, which argues that economic development and strong domestic institutions are inherently interconnected. Ultimately, economic development is influenced by the quality of institutions and influences factors such as investment, innovation, and productivity (Street, 1987). The institutionalist theory of economic development views the state as central to how economies are planned and led. Autocracies may reinforce outdated or inefficient institutions which stunt economic growth. Democracies on the other hand are viewed to be a better foundation for a well-run economy as they promote transparent and fair institutions (p. 1863). Douglass North (1990) contributes to the literature on the importance of incorporating domestic institutions in modern economic growth theory. North defines institutions as the “rules of the game in a society which act as devised constraints that shape human interaction” (p. 3). He derives a theory of institutions and institutional change by assessing formal constraints and informal constraints. Formal constraints include political and judicial rules, economic rules, and contracts. Examples of political and economic rules are the following: the hierarchical structure of the polity, its decision-making structure, and property rights. Informal constraints on the other hand are more difficult to describe and constitute unwritten rules and customs that guide behavior in society. Lastly, North emphasizes enforcement as an essential element of economic growth and argues that enforcement of property rights and contracts is a crucial determinant of development as it promotes a stable and trustworthy investment climate (North, 1990).

The institutionalist theory of economic development introduces the importance of property rights, contract enforcement, and decision-making structure in creating an investment-rich environment. These institutions will be used in this thesis to identify key differences in institutional elements of different regime types and assess their impact on attracting FDI.

This thesis adapts the theoretical concepts and importance of institutions in influencing economic growth and will attempt to apply this to regime types and FDI inflows. To this end, an increase in FDI flows is expected to be a result of various factors such as a strong rule of law, enforcement of property rights, and a transparent regulatory framework. The strengthening of these institutions will lead to a more reliable and stable investment environment characterized by political stability, low perception of corruption, and accountability. These indicators are chosen based off of the determinants of FDI which lead to a more attractive investment destination. This will then be expected to reveal consistent increases in FDI inflow.



Mechanism 1, Institutional reform, will be analyzed using three indicators: rule of law with importance placed on bilateral and multilateral commitments such as BITs, property rights, and regulatory framework. The importance of each of these domestic institutions in creating a reliable investment environment in developing countries is outlined in the theoretical framework. This way, the importance of these institutions and their respective reform will be assessed in terms of their ability in creating a stronger investment environment that attracts foreign investment. Mechanism 2, attracting FDI, will assess how these institutions affect the investment environment by looking at three indicators over time. These are political stability, perception of corruption, and voice and accountability. These three indicators will reveal the potential differences between regime types and how policies are implemented to support or deny these indicators. Mechanism 3:

inflow of FDI, will then be expected to increase in relation to the quality of the institutions determining the investment climate. This will be measured through net FDI flows measured in US\$ as they illustrate the total amount of FDI received. Various authors argue that democratic regimes will attract more FDI as they offer a more transparent and reliable investment climate by illustrating a commitment to effective institutions such as the rule of law and property rights. Through the literature review and theories discussed in the theoretical framework, the following hypothesis is derived:

### 3.2: Hypothesis

**H1:** *Stronger domestic institutions will lead to a more attractive investment climate which will lead to a greater inflow of FDI.*

## **4. Research Design**

### 4.1: Methodology

This thesis conducts a comparative case study using a most different systems design (MDSD). A different system design means this thesis will compare countries together that are different in various aspects except for the variable of interest, in this case, FDI (Halperin & Heath, 2020). The strength of this system is that it allows for control variables such as differences in institutional regulation to be different across cases. This will lead to the observation of the desired effect of the variable of interest, the inflow of FDI (Halperin & Heath, 2020). Process tracing will be used to test the causal mechanisms leading from institutional quality inherent to regime types and its mediating effect on FDI inflow.

Process tracing has the benefit of viewing and assessing the change in the relationship over time. The time 1990-2020 will show the countries of different regime types at the initial stage of attracting and benefitting from foreign investment as well as their development over time. Specific critical junctures in each country such as policies and investment laws will show how domestic institutions are strengthened and made unique to their regime type. The three causal mechanisms are 1. Institutional reform and 2. Attracting foreign investment, and 3. Increase in FDI inflow.

#### 4.2: Case selection:

The cases selected are Vietnam and South Africa. Both countries have received significant inward flows of FDI over the years since the late 1990s, however, they differ in many other regards such as investment policy, domestic institutions, and most importantly, regime type.

**Table 1:** *Illustration of Most Different Systems Design*

	<i>Vietnam</i>	<i>South Africa</i>
<i>Political Regime</i>	Unitary One-party socialist republic	Constitutional Parliamentary democracy
<i>FDI inflow</i>	Attracting significant FDI	Struggling to attract FDI consistently, however, still attracting significant FDI flows.
<i>Institutional Accountability</i>	Moderate	Good

*Note:* Data taken from World Bank, (2023), World Bank in Vietnam; World Bank, (2023) World Bank in South Africa. Data on Institutional Accountability adapted from the BTI Country Reports 2022 – South Africa and Vietnam

Vietnam is an authoritarian one-party state ruled by the Communist Party of Vietnam. This single-party regime means that decision-making is concentrated among very few individuals who make decisions concerning economic governance. Its domestic institutions which affect economic outcomes such as property rights, legal institutions, and political participation and inclusion are often subject to corruption (Malesky, & London, 2014).

In 1968 Vietnam adopted the Doi Moi policy of renovation and economic reform which opened the country up to the possibility of foreign investment (UNCTAD, 2022). Vietnam since then has transformed in terms of attracting FDI. The distribution of FDI in Vietnam by sector has changed over the course of the last three decades. Initially, FDI was concentrated in the oil and gas sector, however, this changed as Vietnam moved from an agriculture-based economy to an industry and services-based economy (UNCTAD, 2022).

The political regime in South Africa differs substantially from Vietnam. South Africa is a constitutional democracy that prioritizes political rights and participation, as well as free and fair elections and an independent judiciary (Freedom House, 2021). Furthermore, its

economic development has fluctuated due to various domestic issues such as electricity supply, and other socio-economic challenges (World Bank, 2023a).

**Table 2:** *Macroeconomic data: 2020*

	<i>Vietnam</i>	<i>South Africa</i>
<i>GDP (US\$)</i>	347 billion \$	337 billion \$
<i>GDP Growth Rate (average)</i>	6.1%	2.3%
<i>FDI USD + % of GDP</i>	15.66 billion \$ (4.6%)	3.15 billion \$ (1%)
<i>Democracy rating</i>	0.12 (rank 143)	0.58 (rank 51)

*Note:* Adapted from World Bank, (2023), Databank: World Development Indicators. Data for democracy rating taken from Democracy Report by the V-Dem Institute (2023)

Table 1 highlights the basic macroeconomic data for both Vietnam and South for the year 2020. FDI inflows are both substantial, however, Vietnam has had a larger inflow both in terms of US\$ and in its percentage of GDP. While they have similar GDPs, GDP per capita is almost four times larger in South Africa than in Vietnam. The most important difference is the democracy rating which is significantly higher in South Africa than in Vietnam. Table 2 illustrates the commitments both cases have made to signing international investment agreements. Vietnam has signed significantly more bilateral investment treaties (BIT) and treaties with investment provisions (TIP) whereas investment-related instruments are similar.

**Table 3:** *International Investment Agreements*

	<i>Vietnam</i>	<i>South Africa</i>
Bilateral Investment Treaties (BITs)	45	11
Treaties with investment provisions (TIPs)	27	11
Investment-related instruments (IRIs)	21	20

*Note:* Data taken from Investment Policy Hub. (2023). International Investment Agreements Navigator for both Vietnam and South Africa

The overview of the international investment agreements highlights the differences between Vietnam and South Africa in terms of the rule of law, property rights, and regulatory framework highlighted in causal mechanism 1. Vietnam is a signatory to more BITs and TIPs, whereas investment-related instruments are for all intents and purposes the same.

#### 4.3: Data Collection

To find data on regime institutions, data will be taken from the Global Economy Database. These indicators provide statistical data over time for both Vietnam as well as South Africa. The Global Economy Database measures the indicators used in the causal mechanisms on a -2.5 (weak) to a 2.5 (strong) scale.

The UNCTAD Investment Policy Hub will be used to access the particular investment policies that both countries have implemented to assess its relationship with the strengthening of domestic institutions and creating a more favorable investment climate. Using these documented investment policies, their effect on critical junctures in each of these countries' respective histories will be compared to their inflows of FDI.

Data on FDI flows are taken from the UNCTAD annual investment reports as well as the IMF investment reports and are lastly quantified using data from the World Bank database. FDI inflow is measured as a total of US\$.

## **4. Analysis:**

### **4.1 Vietnam**

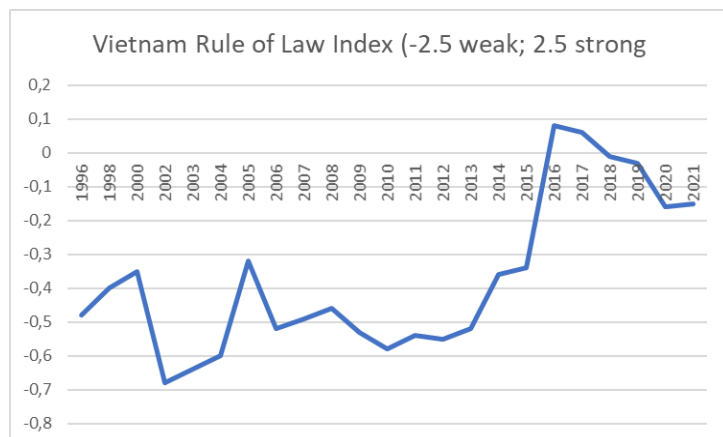
#### Mechanism 1: Institutional reform

##### *Indicator 1: Rule of law*

As an authoritarian state, Vietnam's legal system represents its political system. It follows a top-down structure in which they do not have an independent judiciary and balance of powers between government branches. As a result, foreign investors have had the problem of corruption when it comes to government decisions and rulings as officials are often underqualified, unreliable,

and partial (U.S. Department of State, 2022a). Figure 1 shows the underwhelming rule of law values in Vietnam, which only starts increasing after 2010.

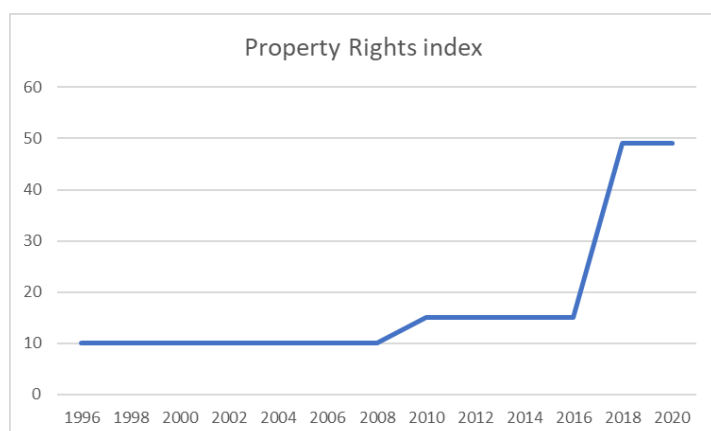
*. Figure 1:*



*Note:* Taken from the Global Economy Database (2021): Vietnam: Rule of Law

### *Indicator 2: Property Rights*

The hypothesis stated that democracies would have stronger domestic institutions which would encourage foreign investment and by extension, economic growth. Property rights in Vietnam have been historically low. In Vietnam, the state collectively owns the land which implies that neither Vietnamese locals nor foreigners can own land to be used for private production or infrastructure development (U.S. Department of State, 2022a). This is a product of the centrally planned economy that has been in place since before the implementation of the Doi Moi policy. Using data from the Economic Freedom Index which provide property rights scores on a scale from 0 to 100, it is established that property rights have become more pronounced and strengthened over the last 20 years. From the years 1996-2008, Vietnam retained a score of 10. From the years 2010 to 2016 this increased to 15. In the years 2017-2019, a drastic change is observed which shows a property rights score of 49 which aligns with the global average.

**Figure 2:**

*Note:* Taken from the Global Economy Database (2021): Vietnam: Property Rights Index

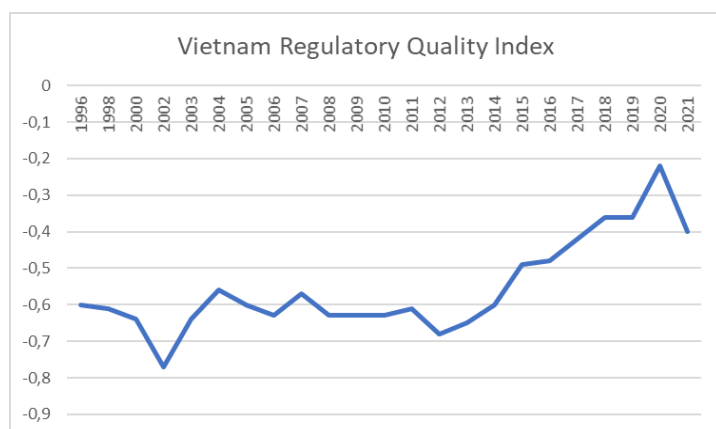
In Figure 2, from the year 2006, a visible increase in property rights is observed. To achieve this Vietnam strengthened its frameworks surrounding property rights such as joining the WTO in January 2007, becoming a signatory to the General Agreement on Trade and Services (GATS), and WTO's trade-related aspects of intellectual property rights (TRIPS). Furthermore, in preparation for WTO accession, Vietnam's intellectual property rights (IPRs) were completely overhauled to become more improved and robust (UNCTAD, 2023). An example of this is found in the 2006 law on intellectual property which covered copyright and copyright-related rights, industrial property rights, and plant varieties. This allowed authorities to implement administrative measures and criminal procedures in cases of infringement of property rights. A more drastic increase in the property rights index is in 2018. This can be explained through various reforms that Vietnam underwent in achieving stronger property rights. In 2018, Vietnam became a signatory of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). Part of this agreement made Vietnam strengthen its property rights regime and implement legislation and laws that would protect property rights for both investors and domestic businesses (U.S. Department of State, 2022a).

### *Indicator 3: Regulatory Framework*

Vietnam's regulatory framework surrounding foreign investment is dictated by its Law on Investment (UNDP, 2020). This law on investment requires foreign investors to have potential projects and investments to be approved by the Prime Minister. Furthermore, it sets out a list of

sectors in which investment is restricted. These sectors include narcotics, chemicals, minerals etc. (UNDP, 2020). The Global Economy reports that on average, Vietnam's average regulatory quality from the period 1996-2021 is -0.56 on a -2.5 (weak) to a 2.5 (strong) scale. While this is relatively low compared to the world average of 0.03, it has been rising consistently during this time period. Vietnam is making steps in making its regulatory framework for foreign investment stronger and more robust to attract more foreign investment. The 2005 Investment law decentralized the authority to provide investment certificates to the provincial level as well. This streamlined the process by which foreign investors could attain certificates to invest in Vietnam (UNCTAD, 2023). On the graph, since 2005, the rating of the regulatory quality index has been increasing consistently. This depicts a similar trend as the other institutions such as rule of law and property rights.

**Figure 3.**



*Note:* Taken from the Global Economy Database (2021): Vietnam: Regulatory Quality Index

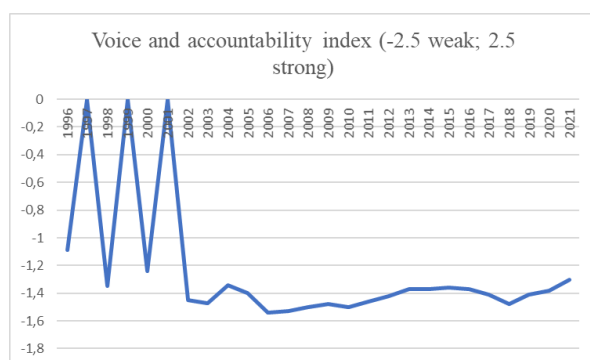
## Mechanism 2: Attracting Foreign Direct Investment

### *Indicators 1 and 2: Political Stability and Voice and Accountability*

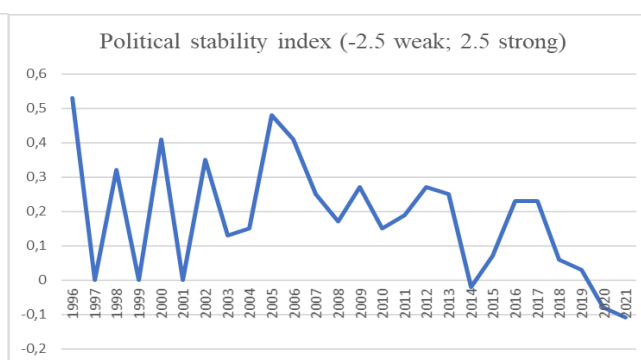
What is remarkable about the inflow of FDI to Vietnam is its relatively stable and consistent increase since the beginning of its experience with FDI. As mentioned previously, Vietnam is a one-party state governed by the Communist Party of Vietnam (CVP). This government was a result of the end of the war in 1975 in which the communist party retained control (BTI, 2022b). Figure 5 shows that while political stability has been slightly decreasing, it has remained relatively stable. The political stability that has been so attractive for foreign

investors largely stems from the one-party autocratic form of leadership that is present in Vietnam. In 2008, a sharp increase was observed in political stability, this in part can be explained by the 2008 “grassroots democracy” measures taken to promote democratic institutions such as people’s inspection boards. This increased transparency and accountability for local officials over their decisions and actions. However, while slight democratic reforms have been implemented such as mandatory voting and freedom of expression are protected in the country’s 2013 constitution, these are often not found in practice (BTI, 2022b).

**Figure 4**



**Figure 5**



*Note:* Taken from the Global Economy Database (2021): Vietnam: Voice and Accountability, Political Stability, and Corruption Perceptions Index

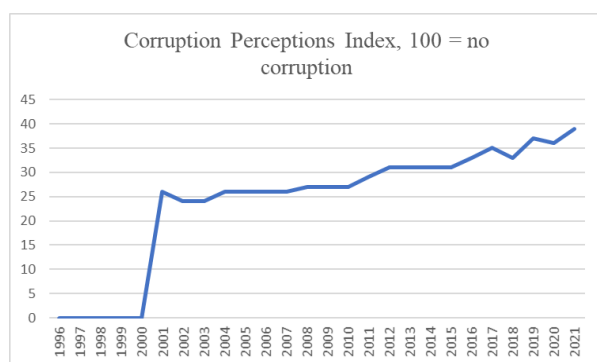
Figure 4 illustrates the political voice and accountability of domestic citizens which is low compared to the world average. During this time, the average was -1.4 on a -2.5 through 2.5 scale (The Global Economy, 2022).

### *Indicator 3: Perception of Corruption*

Corruption simultaneously is seen on the rise consistently since 2000. However, while corruption has been a widespread concern among investors, corruption has not interfered with the high levels of foreign investment. Most of the corruption is concentrated around issues of tax, customs, and land administration. In 2005, Vietnam adopted the first law on Anti-Corruption which required not only government officials to report their assets, but also their close relatives. The law also established a national anti-corruption steering committee to battle corruption (UNCTAD, 2023).

What these indicators show is that while certain elements that may deter foreign investment such as high levels of corruption and low levels of domestic voice and accountability may be present, the political stability in Vietnam has remained intact. The one-party autocratic state that prioritizes economic welfare recognizes the importance of political stability in achieving this. While Figure 6 depicts an erratic relationship, Vietnam boasts an average political stability factor of 0.21 during the period of 1996 -2021 which is higher than the world average (The Global Economy, 2022).

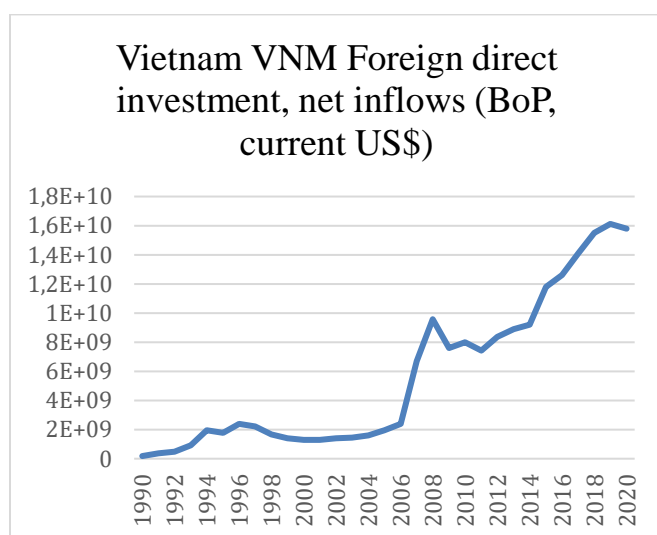
**Figure 6**



*Note:* Data taken from the Global Economy Database (2021), Corruption Perception Index

### Mechanism 3: Increase in FDI

**Figure 7**



*Note:* Data taken from World Bank (n.d.) Foreign Direct Investment, net inflow (US\$)

The third causal mechanism as illustrated by the indicator net inflows of FDI (USD\$) illustrates that since the implementation of the Doi Moi Policy, Vietnam has been consistently attracting inward FDI. 2008 reveals a sharp increase which is unusual for the trend. Otherwise, this graph depicts a positive linear inward flow of FDI. When taking these developments into account, there clear increase in foreign investment in Figure 7 in 2005, which may well be correlated with these improvements in the regulatory framework surrounding foreign investment and anti-corruption mechanisms. The accession to the WTO and other various multilateral agreements occurred in 2006 and 2007 which demanded a certain quality of domestic institutions. This would explain the rise in FDI in 2006.

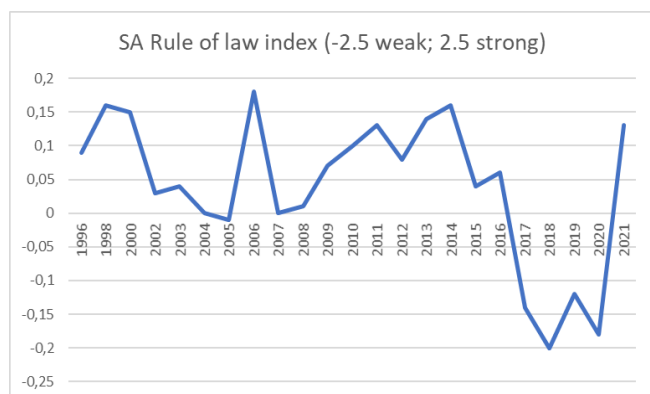
## 4.2 South Africa

### Mechanism 1: Institutional Reform

#### *Indicator 1: Rule of Law*

As an electoral democracy, South Africa boasts a robust legal system that is centered around a predictable and fair rule of law that is balanced by various bodies in the polity. However, this has not always been found in practice. Figure 8 illustrates the volatility of the rule of law index taken from The Global Economy (n.d.), over time. Corruption remains a widespread problem that has interfered with judicial rulings and proceedings, especially for foreign investors. (U.S. Department of State, 2022b). From Figure 8, a general decline in the rule of law is noticed until 2008. Since then, the rule of law has steadily increased up until 2015 when it decreases to a historic low. Since 2018, a sharp increase is noted up until the current value of the rule of law is found.

**Figure 8:**



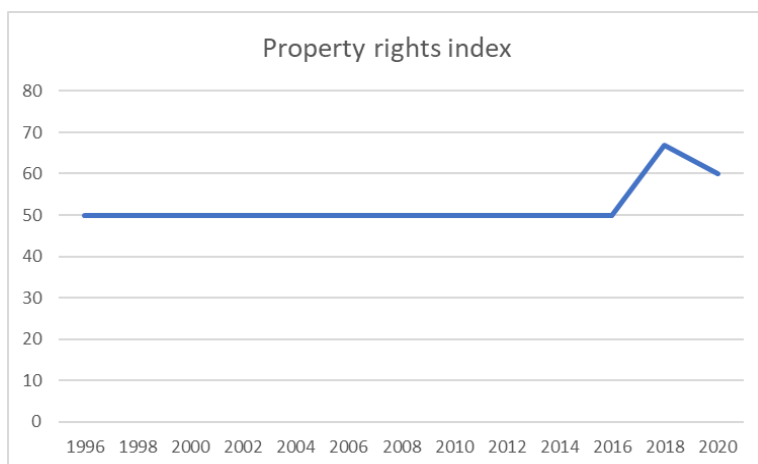
*Note:* Taken from the Global Economy Database (2021): South Africa: Rule of Law

In 2015 South Africa Signed the Promotion of Investment Act which removed the investor-state dispute settlement mechanism that was inherently a part of their bilateral investment treaties (BITs). By terminating their BITs, South Africa sent a negative message to foreign investors which portrayed a hostile investment environment with a high-risk profile (Mossallam, 2015). When comparing these events to Figure 2, a simultaneous decrease in FDI flows is observed. In 2018, the rule of law index increased substantially. An important development was the Competition Amendment Bill which allowed for South African officials to review foreign investments in South Africa (U.S. Department of State 2022b). This bill decreased the chances of price discrimination by larger firms, to promote competition, employment, and employment security (Investment Policy Hub, 2023).

#### *Indicator 2: Property rights*

South Africa does not discriminate between foreigners and nationals when it comes to private property ownership. As a result, foreign investors can own land without any further legal restrictions or complications (U.S. Department of State, 2022b). Figure 9 depicts the stability of the property rights index in South Africa. Its property rights values have remained the same since 1996 at a value of 50. In 2018, this increased to a value of 70 which then slightly decreased again in early 2020.

**Figure 9**

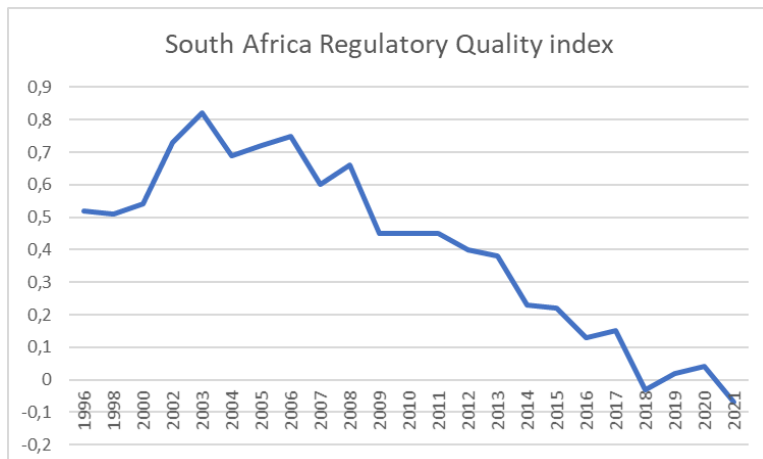


*Note:* Taken from the Global Economy Database (2021): South Africa: Property rights index

Like Vietnam, South Africa is also a signatory to various international agreements when it comes to property and intellectual property rights. The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) is one example of this (U.S. Department of State, 2022b). Furthermore, various reforms and amendments were introduced which made the existing framework even more robust. The draft national policy on the intellectual property of South Africa, A Policy Framework in 2013, and the Intellectual Property Law Amendment Act (2013). These agreements were centered around creating an investment-friendly environment that would protect the knowledge and work of nationals as well as foreign investors (OECD, 2022). However, given the initial strength of property rights in South Africa, these reforms did not lead to drastic improvements in the quality of property rights and merely retained and strengthened them at the level they were previously at.

### *Indicator 3: Regulatory Framework*

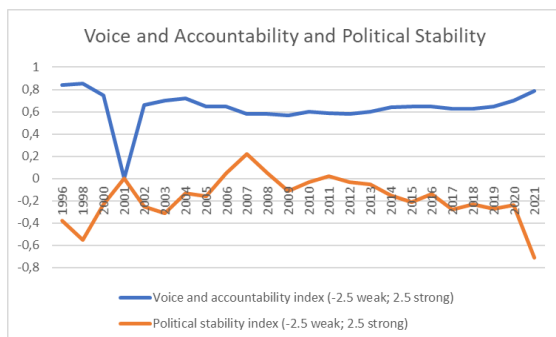
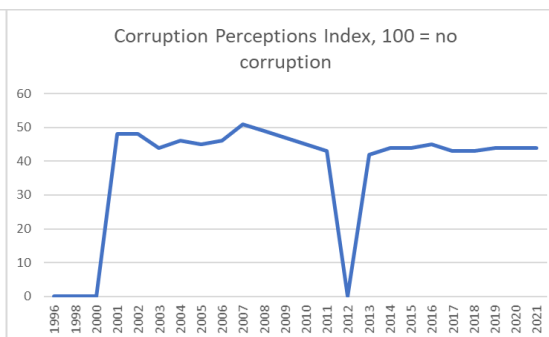
South Africa exhibits a different relationship with the regulatory quality. Since 2002, regulatory quality has been decreasing substantially to a low of 0 in 2021 which is measured on the same scale from -2.5 to 2.5. While historically this has been higher than in Vietnam, it has been decreasing rapidly. One of the reasons for this is the complexity of the framework which makes it more difficult for foreign investors to come to South Africa (Faku, 2022). South Africa restricts and regulates foreign investment within the banking, insurance, broadcasting, and telecommunications sector (Govender & Ngwila, 2022). This limits the entry of various foreign investors. Furthermore, as mentioned previously, South Africa has decided not to enter any more bilateral investment treaties. Under the Investment Act, all investors will act under South African law (Govender & Ngwila, 2022). The regulatory framework surrounding foreign investors is further complicated by the Companies Act of 2008 and the B-BBEE. These acts ensure that the benefits of foreign investments are balanced against the benefits for the South African economy (Global Legal Group, 2020), As a result, the quality of South Africa's regulatory framework has been decreasing. This is in line with similar trends with South Africa's rule of law which has also slowly been decreasing.

**Figure 10**

Note: Taken from the Global Economy Database (2021): South Africa: Regulatory Quality Index

## Mechanism 2: Attracting Foreign Investment

Indicators: Political Stability, Voice and Accountability, Perception of Corruption

**Figure 11****Figure 12**

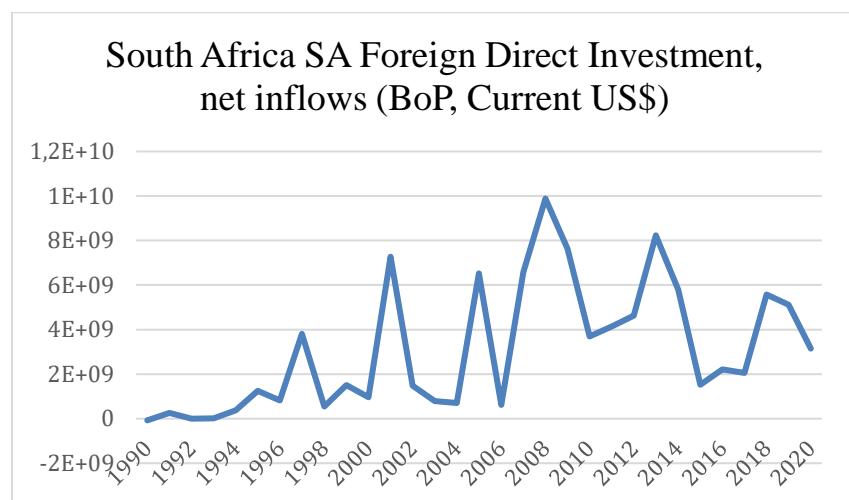
Note: Taken from the Global Economy Database (2021): South Africa: Voice and Accountability, Political Stability, and Corruption Perceptions Index

In terms of attracting foreign investment and creating a stable and predictable environment for FDI, South Africa depicts a different scenario than Vietnam. As an electoral democracy, its voice and accountability of citizens is relatively high compared to Vietnam. It holds a value of 0.66 on a scale from -2.5 - 2.5 during the time period 1996 to 2021. This is contrasted heavily with the political stability in South Africa which averages -0.18 on the same scale (The Global

Economy, 2022). Figure 11 illustrates this relationship and is confirmed by the U.S. State Department which states that corruption and change in government stability has proven to be an issue in generating long-term reliability for investors (U.S. Department of State, 2022b). Furthermore, the interests of labor unions, the private sector, and other traditional leaders influence the legislature that is drafted (BTI, 2022a). As a result, the stability of government decisions and government changes are often in question. This has a disrupting effect on the consistency of foreign investment flows. Furthermore, the perception of corruption in South Africa is substantial. This has proven to a major deterrent of foreign investment due to irregularities and unfair treatment due to corruption (U.S. Department of State, 2022b).

### Mechanism 3: Increase in FDI

**Figure 13**



*Note:* data taken from World Bank (n.d.) Foreign Direct Investment, net inflow (US\$)

Figure 13 shows that inward FDI flows fluctuate significantly over time showing an erratic relationship. During the time 2010-2018, South Africa experienced a significant economic downturn. This is otherwise referred to as “South Africa’s lost decade” which was characterized by economic mismanagement and corruption (U.S. Department of State, 2022b). Figure 2 illustrates the effect this had on FDI flows which report a visible decrease in inward flows. Furthermore, it illustrates the inconsistency of South Africa’s inward FDI flows. There is not a single time period of more than 10 years of consistent growth. The lack of consistency in the

quality of institutions and the political instability observed in figure 11 have resulted in irregular inward FDI flows.

## **5. Discussion**

Using the three causal mechanisms, institutional reform, attracting foreign investment, and inflow of FDI, the analysis has revealed key differences between Vietnam and South Africa. The primary of these are stability, predictability, and reliability of the investment environment which have been found to be stronger in Vietnam than in South Africa. According to the theory, one would expect institutional reform in key institutions such as rule of law, property rights, and regulatory frameworks to lead to a more reliable investment environment. This would be characterized by political stability, low corruption, and accountability. This would then lead to greater inward FDI flows.

Vietnam has witnessed an increase in all three indicators of institutional quality which has resulted in more political stability and a stable investment environment. Corruption and accountability remain a problem in Vietnam. However, the ability of a one-party, autocratic state to implement decisions quickly and efficiently has proven to create an FDI-inducing environment which has led to increases in inward FDI flows. The political environment of South Africa is much more turbulent, and the quality of the essential institutions fluctuates significantly. Political stability and lack of additional investment treaties create an insecure investment environment which has seen it struggle to consistently attract foreign direct investment.

This illustrates that the Vietnamese one-party autocratic system supports the hypothesis that strong domestic institutions lead to greater FDI flows. While democratic institutions may provide a more transparent environment, the *strength* of the institutions plays a more decisive role. Furthermore, Vietnam's commitment to signing bilateral and multilateral agreements such as BITs and becoming a signatory to the WTO, GATT, and TRIPs signalled a trustworthy environment to investors centered around the fair and equitable treatment of investment. Authoritarian regimes are thus able to create a stable environment that is appreciated by investors. In particular, when authoritarian regimes take part in multilateral economic institutions which hold them accountable, investment risk is mitigated. Developing democracies such as South Africa show that in some cases the hypothesis is not supported. Democratic voices and pressures from interest groups and other domestic actors can determine and influence policy outcomes in relation to foreign

investment such as through the B-BBEE policy. Various reforms implemented such as the Investment Act have reduced the quality of the investment framework which has resulted in a weaker and less reliable investment climate.

The findings of the analysis speak to the debate in the literature which is centered around which regime type can offer a more credible and strong investment environment. These findings contradict those of Li & Resnick (2003) who argue that democracies excel at promoting stronger institutions. The findings support the arguments of authors such as Oneal (1994), Elkomy, et. al., (2016), O'Donnell (1978), and Moon (2019) who argue that autocratic regimes are superior at implementing economic policies faster and promoting political stability to promote and attract investment. As a result, the findings of this thesis offer an additional perspective on the debate in the literature which supports the argument that authoritarian regimes, under certain circumstances, are superior to democracies at attracting FDI.

The strengths of these findings are twofold. First, the findings are highly relevant to the current investment trends in developing countries. Developing countries are becoming popular recipients of foreign investment. The findings of this thesis, therefore, have implications for policy developments concerning how investors approach investing in developing countries of different regimes. In particular, the findings point to the potential of a high return on investment in authoritarian regimes due to their political stability. For developing democracies on the other hand, multilateral and bilateral enforcement mechanisms such as bilateral investment treaties can play a complementary role in overcoming the shortcomings of the enforcement mechanisms of domestic institutions and rule of law.

Secondly, the second strength finds itself in the case selection of Vietnam and South Africa. As primary examples of popular recipients of foreign investment, they provide an example to other developing countries in southern Africa and southeast Asia with similar political regimes, domestic institutions, and FDI flows. While every country has characteristics that make them unique such as natural resource concentration or economic policy and history, regime type, and institutional strength remain important factors for attracting FDI.

However, there are various limitations present in this research that must be addressed. First, while South Africa identifies and is labeled as a democracy, it can also be identified as a flawed democracy. Corruption levels are high, and institutions are flawed. As a result, the relationship between democracy, FDI, and economic growth may not be generalizable to all democratic

countries. On the other hand, South Africa's flawed democracy may accurately represent the quality of institutions in developing democratic countries. These are *developing countries*, which implies that the domestic institutional setting is still subject to change and improvement. Secondly, it must be highlighted that while a relationship has been identified between institutional quality, their respective regime types, and attracting FDI, this should not be viewed as an all-encompassing cause of the dependent variable. Current developments in the resurgence of the global value chains have benefitted countries like Vietnam greatly. They are surrounded by other fast-growing, emerging economies which have integrated regional economies. South Africa on the other hand is much more isolated than Vietnam and is not as deeply connected to the global value chains which means it has not yet been as popular with foreign investors (Hollweg, 2019). Future research could delve deeper into this topic by considering geographic proximity to other emerging economies and the role that regime type can have in their respective involvement in the global value chains.

## **6. Conclusion**

This thesis contributes to the broader literature on regime types and FDI with the main findings that authoritarian regimes type mediate FDI inflows by providing more stability and predictability in the investment environment through stronger institutions. A comparative case study using process tracing was implemented to compare the countries of Vietnam and South Africa which have historically differed greatly in their regime type and respective relationships with FDI inflow and economic growth.

The findings in this thesis have various societal implications. While regime type may not have the largest influence on attracting FDI, institutional strength does. This means that developing countries should prioritize making their institutions more robust and creating an environment that induces FDI and by extension economic growth. This can be achieved by strengthening the essential institutions for economic growth discussed in this thesis such as property rights, rule of law, and regulatory framework. Becoming a signatory to multilateral investment treaties is one of the ways in which this can occur.

Furthermore, these findings point to a potential trade-off between democracies and attracting FDI for developing countries. While democracy in itself is a respectable goal for developing countries to pursue, if the quality of the institutions are not able to be supported, this

can have implications for how foreign investors view the investment climate and consequently their willingness to invest. While there certainly are drawbacks to authoritarian rule in terms of transparency, policymakers must keep in mind that these can be overcome if adequate domestic institutions are reinforced properly. Vietnam illustrates that authoritarian leadership has its benefits in terms of foreign investment if approached with the right intentions and end goal of attracting foreign investors.

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