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The nexus of FDI, trade, and institutional quality: a panel data analysis of RCEP countries

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Abstract: Studies have shown that the quality of institutions or public governance significantly impacts economic growth. However, the literature on international political economy continues to debate the factors that determine institutional quality and the effects of institutional quality on economic development. There is a dearth of evidence on how international political economy - such as trade, investment, and foreign aid - influences economic and political institutional change. This study examines the relationship between global trade, investment, and public governance using data collected from the 15 Regional Comprehensive Economic Partnership (RCEP) economies from 2014 to 2023. Using a dynamic panel data approach based on the Two-Step System-GMM estimator, findings show that trade openness improves the quality of economic institutions by encouraging regulatory reforms, transparency, and competitiveness. FDI produces mixed results: it boosts economic institutions in the short term but can weaken them when linked to rent-seeking and weak law enforcement environments. However, both FDI and trade have less significant or negative impacts on political institutions, emphasizing uneven democratic accountability and elite capture in several RCEP countries.

Keywords: RCEP, China, USA, ASEAN, Trade, Investment

Introduction

Studies have shown that institutional quality (e.g., measured by public governance indicators) plays a significant role in economic growth (Acemoglu et al., 2001, 2005; Acemoglu et al., 2019; Acemoglu & Robinson, 2013; Coase, 2013; Cook & Levi, 1990; North, 2016; Rodrik et al., 2004; Williamson, 2000). For example, studies usually examine how institutional quality affects trade and FDI. Scholars argue that interventionist trade policy regimes (tariffs and import quotas) undermine trade and investment (Bhagwati, 1980; Bhagwati & Srinivasan, 1980; Buchanan et al., 1980; Krueger, 1974). However, few examine how international

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political economy, such as trade and FDI, affect institutional quality, though it is central to scholarship in international relations and international political economy to understand how international factors, such as trade, investment, and foreign aid, influence economic and political institutional change (Koning, 2016; Olsson, 2020). Drawing on the framework of institutional economics, this study investigates the impact of trade and investment on political and economic institutions.

The research constructed a panel dataset using data collected from the World Bank Governance Indicators, the Heritage Foundation, the International Country Risk Guide (ICRG), and the Fraser Institute to examine the impact of FDI and trade on institutions. The findings will serve as a key reference for scholars, policymakers, and the public seeking to understand the institutional effects of foreign economic presence. The present study could also provide essential insights for governments and international organizations, which must be aware of the benefits and potential risks and take proactive steps to manage them, while promoting a sustainable and equitable trade and investment environment.

The rest of the paper is organized as follows: Section 2 reviews related literature, followed by a description of models and methodology in Section 3. Section 4 analyzes the data and the causal relationships among two international factors: FDI and global trade (TRADE), as well as the quality of institutions. The following section examines the model-based estimates of economic and political institutions. The final section provides concluding remarks.

1. Review of literature

Two strands of research merit attention. The first focuses on the impact of institutional factors on FDI, trade, and economic development. Research has demonstrated that the varying quality of institutions has historically placed countries in either advantageous or disadvantageous positions (Acemoglu et al., 2001, 2005; Rodrik et al., 2004). According to North (1990), institutions consist of a set of formal (e.g., rules, laws) and informal constraints (norms, codes of conduct) along with their enforcement characteristics. They create a societal incentive structure that, in turn, affects economic performance through political and economic institutions.

To clarify further, Levchenko (2004) suggests that more essential institutions in northern hemisphere countries may contribute to the comparative advantage in North-South trade. Regarding investments, Daud and Stein (2007) found that the impact of institutions on domestic and foreign investments faces two challenges. The first is that poor institutions increase the cost of doing business, often viewed as a kind of taxation. Second, future returns become uncertain when contracts are inadequately enforced due to weak institutions, thereby hindering investment levels. Similarly, Mauro (1995) conducted the first empirical study on how corruption affects the total and private investment ratios as percentages of gross domestic product, ultimately discouraging economic growth. Sabir et al. (2019) empirically

examined the impact of institutional quality on foreign direct investment across high-, upper-middle-, lower-middle-, and low-income countries from 1996 to 2016. The study found that institutional quality positively influences FDI across all groups studied. Xu and Wu (2021) also demonstrate the significant impact of taxation and public governance on FDI.

Additionally, multinational corporations prefer investing in democratic countries because the risk of nationalization is low (Ahlquist, 2006), suggesting that strong institutions can encourage FDI in these nations. Asiedu (2006) presents evidence from 22 African countries studied between 1984 and 2000 showing that stable infrastructure, low inflation, an educated population, openness to FDI, reduced corruption, political stability, and a reliable legal system suggest that good institutions are key in fostering FDI. By establishing developed institutions and policy environments, countries can promote FDI even if they are small or lack natural resources.

On the other hand, UNCTAD (2018) found that political risk and institutional quality have decreased FDI in Africa. Evidence from Brazil shows that corruption has a statistically significant relationship with FDI and promotes regional economic activity (Onody et al., 2022). However, another study by Wellalage and Thirakawala (2021) found empirical evidence from Latin American firms that confirms corruption is widespread in a weak institutional environment and can harm firm-level innovation. Another study by Bayar and Diaconu (Maxim) in 2022 examines the nexus of FDI inflows, human development, and export for EU transition economies.

Theoretical and empirical research shows that increased trade engagement or greater trade openness can enhance the quality of institutions. This happens because it promotes foreign competition, supports reform-minded groups, and reduces artificial rents caused by trade barriers (Ades & Di Tella, 1999; Do & Levchenko, 2009; Sandholtz & Koetzle, 2000).

The second strand of literature demonstrates the impact of FDI and trade on institutional quality. Do and Levchenko (2009) interpreted institutional quality as a fixed production cost. They further theorized that preferences over entry costs vary across firm sizes to deter competition, and that these costs are endogenously determined. For countries open to trade, foreign competition encourages a preference for better institutions. Moreover, as large firms expand through trade and smaller firms' contract, political power shifts to favor the large firms. Since these firms want institutions to be inefficient, the political power effect eventually leads to a decline in institutional quality. Do and Levchenko (2009) argue that, when a large country has a small and insignificant share of global trade, the foreign competition effect dominates the political power effect, leading to improved institutions. Consequently, even though large firms gain political support, they still prefer good institutions after trade opening. Conversely, institutions tend to decline when a country is smaller than others but holds a significant share of international trade.

The literature further shows that power tends to concentrate due to openness to trade, leading to a decline in institutional quality. Caribbean countries in the 1700s saw an increase in international trade, which grew with the rise of slave societies and oligarchic regimes (Engerman & Sokoloff, 2002; Rogozinski, 2000). Additionally, in the 1880s, fruit-exporting companies became more influential and helped destabilize the government in favor of regimes that supported their business interests (Woodward, 1999). In Nigeria's case, Sala-i-Martin and Subramanian (2013) found that the exploitation of natural resources, such as oil, has caused weak institutions, unequal wealth distribution, and poor long-term economic performance.

However, the literature examining the effects of trade on institutional quality is limited. Acemoglu et al. (2005) argue that between 1500 and 1850, Atlantic trade in Western European countries helped develop a merchant class interested in a strong system of enforceable contracts. This shows how trade expansion prompted institutional improvements. Wei (2000) found that countries with more open economies tend to have lower corruption levels and often invest in building effective institutions. Consequently, strong institutions attract foreign producers, and countries with open economies see this as motivation to reduce corruption and develop a solid bureaucratic system. Ades and di Tella (1999) found that countries that protect domestic industries from foreign competition tend to have higher levels of corruption. In contrast, countries engaged in international trade generally experience lower corruption levels.

Building on previous discussions of existing studies, the current research proposes two hypotheses:

H1: *FDI and trade are positively linked to the recipient countries' economic institutional quality.*

H2: *FDI and trade are positively linked to the political institutional quality of recipient countries.*

2. The model specification

This paper examines the quality of both economic and political institutions as crucial aspects of public governance. It also assumes that foreign direct investment (FDI) and foreign trade are two external factors (international determinants) that influence the quality of both economic and political aspects. Two models are developed to evaluate how each determinant separately affects the economic and political dimensions.

$$ECO\_INS_{i,t} = \alpha_0 + \alpha_1 FDI_{i,t} + \alpha_2 TRADE_{i,t} + \alpha_3 z_{i,t} + \varepsilon_{i,t} \quad (1)$$

$$POL\_INS_{i,t} = \beta_0 + \beta_1 FDI_{i,t} + \beta_2 TRADE_{i,t} + \beta_3 z_{i,t} + \varepsilon_{i,t} \quad (2)$$

Where *ECO_INS* represents the quality of economic institutions, *POL_INS* also indicates the quality of economic institutions, *FDI* refers to foreign direct

investment, *TRADE* denotes international trade, and *z* includes a set of control variables such as real per capita gross domestic product (GDPPC), global value chain (GVC), and natural resource rent (NNR). The subscripts *i* and *t* indicate the panels (countries) and the time (years).

The following variants of the basic models are also estimated to examine the separate effects of FDI and TRADE on the quality of economic and political institutions.

$$ECO\_INS_{i,t} = \alpha_0 + \alpha_1 FDI_{i,t} + \alpha_2 z_{i,t} + \varepsilon_{i,t} \quad (3)$$

$$POL\_INS_{i,t} = \beta_0 + \beta_1 FDI_{i,t} + \beta_2 z_{i,t} + \varepsilon_{i,t} \quad (4)$$

$$ECO\_INS_{i,t} = \alpha_0 + \alpha_1 TRADE_{i,t} + \alpha_2 z_{i,t} + \varepsilon_{i,t} \quad (5)$$

$$POL\_INS_{i,t} = \beta_0 + \beta_1 TRADE_{i,t} + \beta_2 z_{i,t} + \varepsilon_{i,t} \quad (6)$$

Equations (1) and (2) include both FDI and TRADE simultaneously to assess their joint impact on political and economic institutions. To further validate these findings, equations (3) to (6) were estimated separately to explore the individual contribution of each variable. This modeling will help identify which factor—FDI or TRADE—has a greater influence on the two institutional indices and avoid potential collinearity, providing a robustness check for the baseline models.

Given the larger number of panels (countries) than periods (years) in the data sample, an essential consideration when selecting an estimation method is endogeneity in the right-hand-side regressors and the bias it can cause in estimates. Due to the correlation between the error term and the lagged impact of institutions, traditional panel estimation methods would be biased and inconsistent. Another appropriate estimation technique in this situation is the first difference-GMM estimator with instrumental variables proposed by Arellano and Bond (1991).

The first difference-GMM estimator addresses endogeneity by using GMM-type moment conditions and standard moment conditions as instruments, assuming that the error term is serially uncorrelated and that the explanatory variables are weakly exogenous. To eliminate fixed effects and estimate the model with the two-step GMM estimator—which yields more efficient estimates, in theory—Arellano and Bond (1991) suggested transforming the model into first differences.

Blundell and Bond (1998) and Arellano and Bover (1995) note that lagged levels in the two-step GMM estimator perform poorly when the autoregressive process is highly persistent. Blundell and Bond (1998) developed the Two-Step System-GMM estimator, which combines the moment conditions from the level and differenced models to address this issue. Therefore, the estimation method used in this work is the two-step System-GMM estimator. The validity of the instruments and the serial correlation of the disturbances are tested using the Arellano-Bond serial correlation test and post-estimation Hansen tests, respectively. While the two-step System-GMM estimator accounts for potential endogeneity, future research

could further refine causal relationships by using time-lagged independent variables. The limited sample size also limits generalizability. However, this warrants cautious interpretation of the results and encourages the use of broader datasets in subsequent studies.

3. Analysis

As stated above, this study uses annual data from 15 countries spanning 2014 to 2023. Table 1 presents the data sources, while Table 2 lists the countries. Tables 3, 4, 5, and 6 display the results of the data analysis conducted before estimating the two models described in the previous section.

Table 1. Variables for the Regression Models

Variable	Measured by	Source
Political Institutions (POL_INS)	Composite of the Good Governance Indicators	Worldwide Governance Indicators
Economic Institutions (ECO_INS)	Index of Economic Freedom	The Heritage Foundation
Foreign Direct Investment (FDI)	Foreign Direct Investment, net inflow	World Development Indicators
International Trade (TRADE)	Sum of goods and services as a percentage of Gross Domestic Product	World Development Indicators
Global Value Chain (GVC)	Log value of goods and services exported by a sector or a country that crosses more than one border.	World Integrated Trade Solution
Per Capita Income (GDPPC)	Log of Real Per Capita Gross Domestic Product	World Development Indicators
Natural Resources (NRR)	Total natural resources rents are included sum of oil rents, natural gas rents, coal rents, mineral rents, and forest rents as a percentage of Gross Domestic Product	World Development Indicators

Source: authors' representation

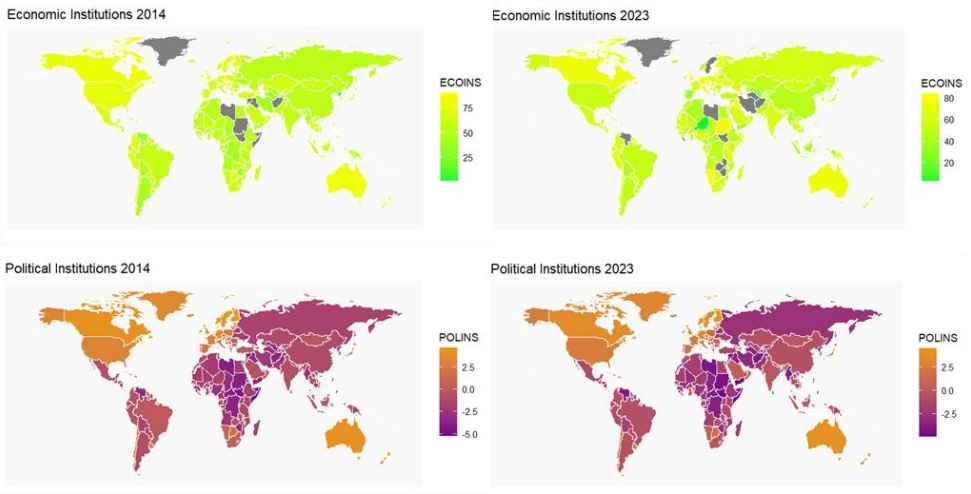
Table 2. List of countries

Country List
Australia, Brunei, Cambodia, China, Indonesia, Japan, Lao PDR, Malaysia, Myanmar, New Zealand, Philippines, Singapore, South Korea, Thailand, Viet Nam

Source: World Development Indicators

Based on the above countries' performances in economic institutions, political institutions, official development assistance, foreign direct investment, and trade, Choropleth maps were generated to depict the behavior of these variables across countries from 2014 to 2023.

Figure 1. Choropleths of the Economic Institutions and Political Institutions during the years 2014-2023

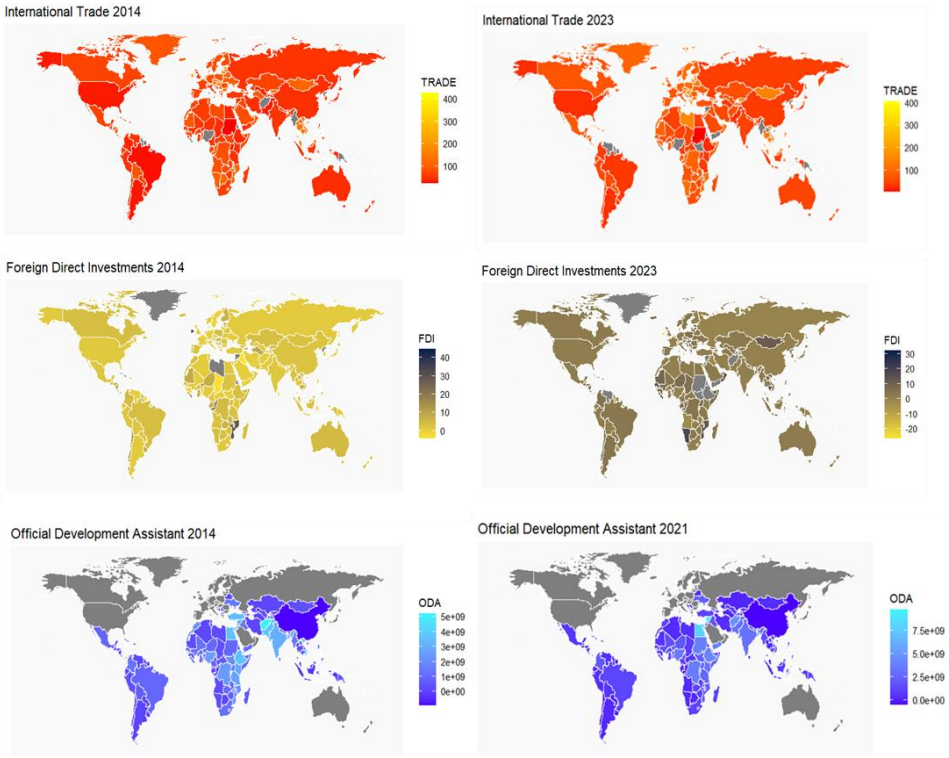


Source: authors' representation

According to the maps above, the economic institutions in the global scenario show that Hong Kong achieved the highest scores in 2014, at 90.1, and Seychelles achieved the highest score in 2023, at 83.9, respectively. This indicates that Hong Kong and Seychelles can maintain such a position, thereby establishing a strong institutional framework for a more resilient global economic infrastructure. However, Singapore could also have held the second position during this period. When evaluating country-by-country performance, the index showed that many countries underperformed their economic institutions index during that period. The performances of the political-institutional indices in New Zealand, Denmark, Switzerland, and Finland remained unchanged during this period, fostering a healthy political environment in their respective nations. Nevertheless, the indices' performance showed slight declines in scores, while their rankings remained the

same. Specifically, New Zealand scored 4.62 on the composite estimates in 2014, while Denmark scored 4.44 in 2023.

Figure 2. Choropleths of the Foreign Direct Investment and International Trade during the years 2014-2023



Source: authors' representation

Figure 2 shows the global FDI and trade from 2014 to 2023 in the worldwide context. According to the figure, the highest net inflow of FDI was 44.55 and 32.01, recorded in 2014 and 2023, respectively, by Hong Kong. However, Singapore remained among the top five throughout this period. The trade performance shows that Hong Kong and Luxembourg led in 2014 and 2023. Hong Kong's trade as a percentage of GDP was 425% in 2014 and 353% in 2023, while Luxembourg's trade as a percentage of GDP was 333% in 2014 and 404% in 2023.

Table 3 presents the summary statistics for the variables used in the study. POL_INS and ECO_INS show the index values for the dependent variables, while the FDI and TRADE represent the summary statistics of the leading independent variables. Then, the GVC and GDPPC are shown in log form, and other variables, such as control-variable ratios and percentages, represent NRR. According to the results, ECO_INS shows higher variance than POL_INS, with the average index

value for the selected countries' economic institutions at 67.99, a considerably higher score than its mid value. When considering the trade values, the deviation was somewhat high, with a reported value of 76.79 for the countries. The FDI shows a considerable gap between countries, ranging from -1.74 to 33.30, whereas the GDPPC gap is lower, ranging from 7.00 to 11.13.

Table 3. Summary statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
POL_INS	150	0.149	2.148	-4.508	3.571
ECO_INS	130	67.994	11.176	48	89.7
FDI	150	4.563	6.292	-1.739	33.304
TRADE	133	102.411	76.792	31.310	360.467
GVC	125	17.790	2.111	13.215	20.683
GDPPC	150	9.174	1.314	7.002	11.130
NRR	120	3.824	4.959	0.000	24.280

Source: authors' representation

Table 4 presents the correlation coefficients for all the variables included in the models. The correlation coefficients reported in the table show that the TRADE and FDI variables are positively correlated with the indices of economic and political institutions. When considering the correlation between TRADE and FDI, results indicate that increases in trade flows are strongly correlated with FDI inflows, suggesting that the two independent variables should be included separately in regression models to address multicollinearity.

Table 4. Correlation matrix of variables

	POL_INS	ECO_INS	FDI	TRADE	GVC	GDPPC	NRR
POL_INS	1.000						
ECO_INS	0.8008	1.000					
	(0.000)						
FDI	0.1275	0.3123	1.000				
	(0.1201	(0.000)					
TRADE	0.0346	0.2868	0.8589	1.000			
	(0.692)	(0.001)	(0.000)				
GVC	0.5326	0.3865	0.0407	0.0136	1.000		
	(0.000)	(0.000)	(0.652)	(0.886)			
GDPPC	0.9588	0.8379	0.1333	0.1047	0.4756	1.000	
	(0.000)	(0.000)	(0.104)	(0.230)	(0.000)		
NRR	-0.1017	-0.1029	-0.1554	-0.0488	-0.4924	0.0339	1.000
	(0.268)	(0.303)	(0.090)	(0.618)	(0.000)	(0.713)	

Source: authors' representation

All model variables, except NRR, show negative correlations with indicators of economic and political institutions. GDPPC is only positively associated with NRR. Interestingly, both TRADE and FDI inflows are positively related to the global value chain variable.

4. Results

As stated in Section 5, the model equations for economic and political institutions are estimated using the GMM. The estimated results from the Two-Step System GMM are reported in Table 5 for the equations of economic institutions and in Table 6 for the equations of political institutions. Regarding model validity, the diagnostic results confirmed that eight models were estimated for both economic and political institutions. Initially, the number of instruments reported by the results is lower than the number of groups created by the estimation, because the estimation results have met the requirement for an efficient model. The F-statistic results for all the models are (0.000 < 0.05), indicating that all models are correctly specified and are significant. Then the lag value of the dependent variables in the models is substantial, since the lagged value of the dependent variable affects the current value of FDI and TRADE.

The Arellano and Bond test AR (1) for first-order serial correlation is lower than the threshold value (0.000<0.05), indicating the presence of first-order serial correlations was significant. Reject the null hypothesis. So, there is first-order serial correlation with residual values. Then, AR (2) second-order correlation statistics are greater than the threshold value (>0.05), as set by the fact that there is no second-order serial correlation; the results are significant. To meet the over-identification restrictions, we used the set of instruments that are valid if the p-value is greater than the results. The Hansen test provides evidence for unbiased results. These tests of exogeneity for the instrument subset results exceed the threshold (p-value < 0.05), indicating that the instruments are exogenous.

The following results in Table 5 report the Model (1), which was the estimated impact of FDI and TRADE against economic institutions, while Model (2) and Model (3) show the individual impact of FDI and TRADE on economic institutions. The main results reported in Models 1 and 2 show that the coefficients for all variables, except GVC and NRR, are statistically significant at the 5% level or better in all equations. Among the two external factors of focus — FDI and TRADE—are positively related to the quality of economic institutions in separate model estimations. Thus, H1 is supported**.** Among the control variables, NRR negatively affects institutional quality when significant, while GDPPC and GVC show insignificant effects on institutional quality. Model 3 of Table 5, as a robustness check, indicates that increases in TRADE lead to improvements in the quality of economic institutions. In contrast, increases in FDI are associated with declines in the quality of economic institutions.

Table 5. Estimated results for equations of economic institutions

Variables	Model 1	Model 2	Model 3
L.ECO_INS	0.3525***	0.3180***	0.8629***
	(2.15)	(1.87)	(24.33)
FDI	0.1323**		-0.3441***
	(1.99)		(-2.01)
TRADE		0.0137***	0.0300***
		(1.99)	(2.22)
GDPPC	4.7426***	4.6563***	1.0318***
	(3.93)	(3.78)	(3.16)
GVC	0.0654	0.7213	0.2093
	(0.19)	(0.84)	(1.50)
NRR	-0.2886	-0.1933***	-0.0886
	(-5.88)	(-4.71)	(-3.39)
Observations	50	48	48
Diagnostic Tests			
F-statistics	0.000	0.000	0.000
Hansen Test	0.281	0.314	0.394
AR 1	0.316	0.072	0.096
AR 2	0.060	0.070	0.624
No of Groups	13	12	12
No of Instruments	12	11	12

Note: The statistical significance of the estimated coefficients was assessed using t-statistics. *** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level
Source: authors' representation

The following results in Table 6 report the Model (4) estimated FDI and TRADE against political institutions, and Model (5) and Model (6) report the individual impact of FDI and TRADE on political institutions. The main results reported in Models 4 and 5 show that the coefficients of FDI and TRADE are statistically significant at the 5% level. The two external factors of focus —FDI and TRADE—are significantly and negatively related to the quality of political institutions in models 4 and 5. The control variable, GDPPC, is substantial in all models and has a significant, positive impact. At the same time, NRR shows a significant negative impact, and GVC is insignificant in all the models, with a negative coefficient. Among the other variables, GVC is not significant. Overall, results indicate that increases in FDI and TRADE undermine the quality of political institutions.

Table 6. Estimated results for equations of political institutions

Variables	Model 4	Model 5	Model 6
L.POL_INS	0.4214***	0.7443***	0.7025***
	(4.16)	(7.55)	(4.63)
FDI	-0.0115**		0.0068
	(-1.92)		(0.74)
TRADE		-0.0005***	-0.0009
		(-2.40)	(-0.94)
GDPPC	0.9353***	0.4281***	0.6448**
	(6.17)	(2.67)	(1.98)
GVC	0.0016	-0.0003	0.0004
	(0.03)	(-0.03)	(0.05)
NRR	-0.0400	-0.0137***	-0.0134
	(-4.85)	(-2.22)	(-1.71)
Observations	50	53	67
Diagnostic Tests			
F-statistics	0.000	0.000	0.000
Hansen Test	0.281	0.481	0.252
AR 1	0.316	0.049	0.148
AR 2	0.060	0.206	0.225
No of Groups	13	13	14
No of Instruments	12	12	13

Note: The statistical significance of the estimated coefficients was assessed using t-statistics. *** Significant at the 1% level; ** Significant at the 5% level; * Significant at the 10% level
Source: authors' representation

6. Discussions of the results

When discussing the derived results from both institutional dimensions, more FDI inflows in RCEP countries could enhance economic institutions, while discouraging the political institutions; however, in the isolated estimations, both economic institutions (0.1326, t = 1.99) and political institutions (-0.0115, t = -1.92) were improved, and the inflow of FDI has happened. It can be understood that when FDI entered countries, it brought capital, technology, managerial expertise, and global standards. As a result, foreign investors demand better economic institutions to protect their investments. Specifically, when multiple multinational corporations invest, they bring international corporate governance practices that may spill over to local firms through supplier relationships, labor mobility, and joint ventures. Specifically, Emerging Economies Multinational Enterprises have increased the importance of the quality of the host countries' economic institutions (Dorakh, 2022).

Our results also indicate that trade has strengthened economic institutions (0.0138, t = 1.99; 0.0300, t = 2.22) and has discouraged political institutions (-

0.0005, t = -2.40) among RCEP countries in both individual and overall models. Recognizing the positive impact of trade on the economy, governments must bolster property rights, improve regulatory quality, and implement administrative reforms to reduce corruption, enhance contract enforcement, and ensure transparency in regulations. Additionally, they need to integrate into the global value chain by establishing specialized institutions to protect intellectual property and by developing dispute-resolution mechanisms. This finding aligns with previous studies that suggest institutional reforms are crucial for promoting free trade among countries and increasing trade flow (Hassan 2001; Tupy 2005). Furthermore, Akpan and Atan (2016) also found that the positive effect of trade openness on growth depends on effective economic institutional reforms.

Regarding political institutions, we found that both FDI and trade are negatively associated with institutional quality. FDI shows a negative and significant association with political institutional quality. One case is Chinese FDI in Africa. When bringing FDI into a host country, the Chinese government and MNEs have been criticized for neglecting human rights and supporting corruption (Shan et al., 2018; Tull, 2006). Similarly, another study by Saleem et al. (2021) found bi-directional causality between institutional quality and FDI in Pakistan.

Regarding trade, some scholars argued that reliance on trade may demote the political institutions. Because trade may be handled by a small elite or a politically connected group, this could weaken democracy and the checks and balances of the countries, as Rodrik (2007) notes: "When the winners of globalization entrench themselves, it may undermine democratic institutions". In this scenario, except for the developed nations, many developing countries' political institutions have been unimproved in the last few decades while trade has significantly increased. Further, there may be an uneven distribution of trade gains due to institutional distrust across economies, while rent-seeking in strategic sector exports results from a weak rule of law. Nevertheless, Acemoglu and Robinson (2006) indicate that trade shocks can either strengthen or weaken institutions, depending on the level of political inclusiveness.

GDP per capita has improved both political and economic institutions. Though the rent-seeking behaviour of elites influences economic productivity, which in turn leads to corruption and weak institutions, increased GDP per capita is linked to economic growth, technological progress, and higher living standards. However, scholars argue that it may help to counterbalance the negative consequences and lead to better institutions. When GDP per capita rises, government revenue may increase, as the government has invested in institutions to resist rent-seeking. Countries with higher GDP per capita tend to have better governance with lower corruption, since wealthier countries have more resources to invest in strengthening institutions (Kaufmann et al., 2011). Ross (2012) indicates that as GDP per capita rises, reliance on natural resources decreases, thereby significantly reducing rent-seeking behavior. In another way, when GDP per capita increases, it generally leads to improvements

in education and civil society participation, which in turn leads to better governance. There is a strong correlation between higher GDP per capita and greater democratic accountability and effective institutions (Knack & Keefer, 1997). Resource-rich countries with higher GDP per capita were able to reduce the harmful effects of rent-seeking by diversifying their economies (Mehlum et al., 2006).

Regarding the results of GVC and NRR, their impact on political and economic institutions is positive, except for one model. When MNEs are concerned with global standards on labour, accounting, or the environment, they are only concerned with the firm level for their own satisfaction. Since governments in developing countries expecting FDIs may not be able to reform national institutions, this may lead to weak legal enforcement, resulting in window-dressing reforms. Syed et al. (2024) note that Bangladesh has experienced a tremendous economic boom driven by the garment industry. However, there is a significant disparity between current labor welfare policies under the ILO-recommended labor law and industry practices. MNEs and local firms may be involved in GVC often from strong export lobbies that can influence trade policies, labor laws, and tax incentives. In that scenario, regulations that block and weaker political reforms have increased the cost due to biased policymaking and imbalanced representation. Arnold and Hess (2017) found that firms with political connections to military and government officials suppress labor protests and preserve production, revealing state capture by elite interests rather than democratic responsiveness (Calabrese & Balchin, 2021).

The negative impact of natural resource rents on political institutions may be linked to a complex of domestic rent-seeking and corruption. Typically, resource rents are large, non-taxed, and centralized in an economy. Corruption in licensing and exports is common and weakens checks and balances. Leite and Weidmann (1999) noted that natural resource rents have increased corruption, which adversely affects long-term growth, thereby constituting a natural resource curse —the institutional impact of natural resource rents (Sala-i-Martin & Subramanian, 2013). Another explanation is that when public revenue relies heavily on resource rents, governments' accountability may decrease. Moreover, authoritarian regimes may have used resource rents to strengthen power, repress dissent, and avoid democratic reforms. Camerer et al. (2013) noted that significant oil reserves can boil down to policy in case studies of Nigeria and Norway.

Conclusion

This paper examines the effects of two external factors —foreign direct investment and international trade —on the quality of economic and political institutions. Using the panel data estimation method of Two-Step System GMM, the models of the quality of economic and political institutions incorporating external factors are developed and estimated using data from 100 countries. Interestingly, FDI inflows and international trade demonstrate different associations with political

and economic institutions: foreign investment and international trade show significant, positive associations with economic institutional quality; however, FDI and international trade show negative associations with political institutions.

The study demonstrates that international political-economic factors are significant determinants of the quality of economic and political institutions. Increases in foreign investment inflows and international trade flows lead to improvements in the quality of economic institutions but deterioration in political institutions. The negative impact of engagement with global trade and receiving FDI on the quality of political institutions has not been widely acknowledged. This study suggests that the national government should be aware of the negative impact of the international political economy on efforts to improve political institutions. FDI and trade could promote economic institutions that facilitate economic development. However, more research could be conducted in specific contexts before any government imposes limits on FDI and controls trade. Another interpretation of the positive association between GDP per capita and institutional quality is that the long-term impact of FDI and trade on income growth could eventually differ across political institutions. Trade and FDI may have different long-term consequences (e.g., different lagged values of FDI and trade could be examined). The longer-term relationship merits further study. Future research could also examine these propositions using different country groups and new control and instrumental variables.

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