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# Beyond Governance: Exploring the Role of ESG Integration and Political Stability in Attracting Sustainable FDI in Emerging Markets

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**Abstract**
As sustainability becomes a defining criterion in global capital flows, emerging markets are under growing pressure to attract foreign direct investment (FDI) that is aligned with Environmental, Social, and Governance (ESG) principles. While governance quality has long been recognized as a foundational factor influencing investment decisions, the combined role of ESG integration and political stability remains underexplored. This study investigates how ESG adoption and political stability contribute to attracting sustainable FDI in emerging economies. Using a panel dataset of 30 emerging markets from 2010 to 2023, we employ Fixed Effects (FE) and System Generalized Method of Moments (GMM) estimations to address endogeneity and unobserved heterogeneity. Our findings reveal that ESG integration significantly enhances sustainable FDI inflows, and this effect is further amplified in politically stable environments. Governance quality, while still important, plays a complementary role. These results underscore the need for holistic investment policies that combine ESG commitments with institutional stability to foster long-term, responsible investment. The study offers actionable insights for policymakers, development agencies, and institutional investors seeking to align capital with the Sustainable Development Goals (SDGs).
**Keywords**: Sustainable FDI, ESG integration, political stability, emerging markets, institutional quality, responsible investment, SDGs

## 1. Introduction

Foreign Direct Investment (FDI) has long been a critical engine of growth, particularly in emerging markets where domestic capital formation is often insufficient to meet development needs. Traditionally, the determinants of FDI inflows—such as market size, labor cost, infrastructure, and governance quality—have been well-documented in economic literature (Globerman & Shapiro, 2002; Dunning, 1993). However, with the intensification of climate change risks, rising social inequality, and growing global demand for responsible corporate behavior, the nature and criteria of cross-border investment have evolved. Today, sustainability considerations—embodied in Environmental, Social, and Governance (ESG) frameworks—are central to investment strategies pursued by both public and private actors (UNCTAD, 2022).

This paradigm shift has given rise to the concept of *sustainable FDI*, which refers to investment flows that support economic development while also meeting ESG criteria. Sustainable FDI not only contributes to job creation and infrastructure but also supports environmental protection, social inclusivity, and institutional transparency. Accordingly, emerging economies now face dual imperatives: to maintain macroeconomic attractiveness while simultaneously aligning with global sustainability norms.

Despite increasing recognition of ESG's role in investment decisions, much of the extant literature remains focused on firm-level ESG adoption in developed markets (Ioannou & Serafeim, 2017; Clark et al., 2015). The country-level implications of ESG performance—particularly in emerging markets—are less explored. Similarly, while the quality of governance has been consistently identified as a critical determinant of FDI (Kaufmann et al., 2010), the synergistic role of *political stability* in supporting ESG-led investment strategies is under-theorized.

Political stability, broadly defined as the absence of violence, government instability, and regulatory unpredictability, is especially salient in ESG-sensitive sectors such as renewable energy, healthcare, and education. In unstable political environments, even robust ESG policies may fail to attract sustainable investment due to weak enforcement and rising risk premiums (Busse & Hefeker, 2007).

Given this context, our study explores two central research questions:

Does ESG integration at the country level significantly attract sustainable FDI in emerging markets?

Does political stability moderate the relationship between ESG integration and sustainable FDI inflows?

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To address these questions, we develop a multidimensional framework that moves *beyond governance* by integrating ESG practices and political risk factors into the analysis of sustainable investment patterns. Using a panel dataset of 30 emerging economies from 2010 to 2023, we employ both Fixed Effects and System GMM models to capture the dynamic and potentially endogenous nature of FDI flows.

By advancing this framework, the study makes several contributions. First, it empirically establishes ESG integration as a macro-level determinant of sustainable FDI, moving the ESG debate beyond corporate behavior to country-level investment environments. Second, it highlights the conditional role of political stability, demonstrating that ESG benefits are more pronounced in politically stable contexts. Third, it offers practical insights for policymakers, suggesting that combining ESG reforms with efforts to stabilize political institutions may yield superior investment outcomes.

The remainder of this paper is structured as follows: Section 2 reviews the relevant literature and develops hypotheses. Section 3 describes the data and methodology. Section 4 presents the empirical analysis, while Section 5 discusses the results. Section 6 concludes with implications and directions for future research.

## 2. Literature Review

### 2.1. ESG Integration and Sustainable FDI

In the evolving global investment landscape, Environmental, Social, and Governance (ESG) factors have become critical benchmarks in assessing the attractiveness of host countries. ESG integration reflects the extent to which national institutions, policies, and corporate practices internalize sustainability considerations—through regulatory standards, disclosure requirements, and stakeholder engagement frameworks (Ioannou & Serafeim, 2017; Eccles & Klimenko, 2019).

From a theoretical standpoint, ESG integration enhances investment appeal by reducing information asymmetry, reputational risks, and long-term uncertainties (Clark et al., 2015). Countries with stronger ESG frameworks are perceived as more capable of managing environmental shocks, social tensions, and regulatory instability—conditions that are especially important to institutional investors seeking long-term, stable returns (UNPRI, 2020).

Empirical evidence suggests that ESG-aligned countries attract more responsible capital flows. For example, Albuquerque et al. (2019) found that firms with high ESG ratings experience lower capital costs and greater investor interest. At the macro level, UNCTAD (2022) argues that ESG-aligned investment climates are associated with more diversified and resilient FDI inflows, especially into sectors such as clean energy, health infrastructure, and inclusive education.

However, most prior studies focus on firm-level ESG behavior in developed economies, with limited attention to how national-level ESG policies affect sustainable FDI in emerging markets. This study addresses this gap by evaluating the effect of country-level ESG integration on attracting sustainable FDI.

H1: ESG integration in emerging markets is positively associated with sustainable FDI inflows.

### 2.2. Political Stability and Its Moderating Role

Political stability is a longstanding determinant of FDI, particularly in developing and emerging economies where institutional fragility is common. Political stability encompasses the absence of violence, government turnover, civil unrest, and policy unpredictability—all of which can directly influence investment decisions (Busse & Hefeker, 2007; Jensen, 2008).

Stable political systems provide investors with confidence that contractual rights will be honored, policy environments will remain predictable, and legal disputes will be resolved impartially (Henisz, 2000). In the context of sustainable FDI, political stability further ensures that ESG-related reforms will be consistently implemented and enforced.

Moreover, recent literature emphasizes that ESG practices are most effective in contexts where institutions are capable of executing sustainability mandates (Doh et al., 2010). In unstable regimes, even robust ESG policies may fail to generate investor trust due to weak enforcement and regulatory capture. Conversely, in stable environments, ESG integration can yield stronger signaling effects, reduce risk premiums, and facilitate sectoral transitions toward sustainability (Amal et al., 2012).

Thus, political stability is expected not only to have a direct positive effect on sustainable FDI but also to strengthen the positive relationship between ESG integration and FDI inflows by creating the conditions for ESG frameworks to operate effectively.

H2: Political stability positively moderates the relationship between ESG integration and sustainable FDI inflows.

### 2.3. Governance Quality and Control Variables

While ESG integration and political stability form the core of this study, it is important to control for traditional governance quality indicators. The *Worldwide Governance Indicators* (WGI) define governance quality through dimensions such as regulatory quality, rule of law, and control of corruption (Kaufmann et al., 2010). These indicators are vital in creating a predictable and transparent business environment, and they remain key explanatory variables in the FDI literature.

Nonetheless, emerging evidence suggests that governance quality alone may be insufficient in explaining the new patterns of sustainability-driven investment. Investors are increasingly factoring ESG-specific indicators into their decision-making, particularly when long-term environmental or social risk exposure is at stake (OECD, 2021). As such, this study incorporates governance quality as a control while emphasizing the role of ESG and political stability as emerging determinants of sustainable investment.

Other control variables—GDP growth and trade openness—are included to account for macroeconomic conditions and integration into the global economy, both of which influence FDI patterns (Chakrabarti, 2001).

## 3. Methodology

This section outlines the research design, data sources, variable definitions, and econometric techniques used to empirically test the hypotheses developed in the previous section. The objective is to estimate the effects of ESG integration and political stability on sustainable foreign direct investment (FDI) inflows, and to examine whether political stability moderates the ESG–FDI relationship in emerging markets.

### 3.1. Research Design

The study adopts a quantitative panel data analysis framework using an unbalanced panel dataset of 30 emerging market economies over the period 2010–2023. This time frame captures both pre- and post-Paris Agreement (2015) dynamics, providing a robust basis for analyzing sustainability-related investment trends.

Two estimation techniques are applied:

1. Fixed Effects (FE) regression models – to control for unobservable country-specific heterogeneity.
2. System Generalized Method of Moments (System GMM) – to address endogeneity concerns and dynamic feedback effects between variables (Arellano & Bover, 1995; Blundell & Bond, 1998).

### 3.2. Sample and Data Sources

The sample includes 30 countries identified as emerging markets based on UNCTAD and MSCI classifications. Countries such as Brazil, India, Vietnam, Egypt, Mexico, South Africa, and Pakistan are included, contingent on data availability.

| Data Source | Variables Obtained |
|---|---|
| UNCTAD | Sustainable FDI inflows (aligned with SDGs) |
| Refinitiv & MSCI | ESG integration scores (firm- and country-level aggregation) |
| PRS Group ICRG | Political Stability Index |
| World Bank WGI | Governance indicators: rule of law, regulatory quality, control of corruption |
| World Bank WDI | GDP growth (%), Trade openness (exports + imports as % of GDP) |

### 3.3. Variables and Measurement

| Variable | Definition | Source |
|---|---|---|
| Sustainable FDI | FDI inflows into sectors aligned with SDGs as a % of GDP | UNCTAD |
| ESG Integration | Composite index from ESG reporting standards, scores, and disclosure practices | Refinitiv, MSCI |
| Political Stability | Measures absence of violence and political risk (scaled -2.5 to 2.5) | PRS Group |
| Governance Quality | Composite of rule of law, regulatory quality, and control of corruption | World Bank WGI |
| GDP Growth | Annual growth rate of real GDP (%) | World Bank WDI |
| Trade Openness | Exports + Imports as a % of GDP | World Bank WDI |

### 3.4. Model Specification

To test H1 (direct effect) and H2 (moderation effect), the following models are specified:

**Model 1 – Baseline Fixed Effects Model**

$$SFDIit=\alpha+\beta1ESGit+\beta2PolStabit+\beta3GovQualit+\gamma Xit+\mu i+\epsilon it$$

Where:

- SFDIit: Sustainable FDI inflows (% GDP)
- ESGit: ESG integration score
- PolStabit: Political stability index
- GovQualit: Governance quality index
- Xit: Vector of control variables (GDP growth, trade openness)
- μi: Country fixed effects
- ϵit: Idiosyncratic error

**Model 2 – Interaction Model (Moderation Test)**

$$SFDIit = \alpha + \beta1ESGit + \beta2PolStabit + \beta3ESGit \times PolStabit + \beta4GovQualit + \gamma Xit + \mu i + \epsilon it$$

Here, the interaction term ESGit×PolStabit captures the moderation effect hypothesized in H2.

**Model 3 – Dynamic System GMM**

$$SFDIit = \delta SFDIit - 1 + \beta1ESGit + \beta2PolStabit + \beta3ESGit \times PolStabit + \beta4GovQualit + \gamma Xit + \epsilon it$$

**System GMM helps**

- Address simultaneity and reverse causality.
- Control for the dynamic nature of FDI inflows.
- Use internal instruments (lagged variables) to mitigate endogeneity bias.

We use the two-step estimator with robust standard errors and apply the Hansen test for overidentifying restrictions and Arellano-Bond test for serial correlation in residuals.

### 3.5. Estimation Strategy and Justification

- Fixed Effects (FE) models control for time-invariant unobservable heterogeneity between countries (e.g., culture, geography).
- System GMM is ideal when the number of countries (N) is larger than the time dimension (T), as is the case here. It corrects for autocorrelation and omitted variable bias.

All independent variables are lagged by one year in robustness checks to further reduce endogeneity risk.

### 3.6. Validity and Reliability

- Data from reputable global institutions ensure measurement validity.
- Multicollinearity is tested using Variance Inflation Factor (VIF).
- Robustness checks are conducted using alternative operationalizations of ESG (e.g., subcomponents) and different subsamples (e.g., regionally disaggregated).

## 4. Data Analysis

This section presents the preliminary statistical analysis, including descriptive statistics, pairwise correlations, and regression results. The purpose is to empirically examine how ESG integration and political stability influence sustainable FDI inflows in emerging markets.

### 4.1. Descriptive Statistics

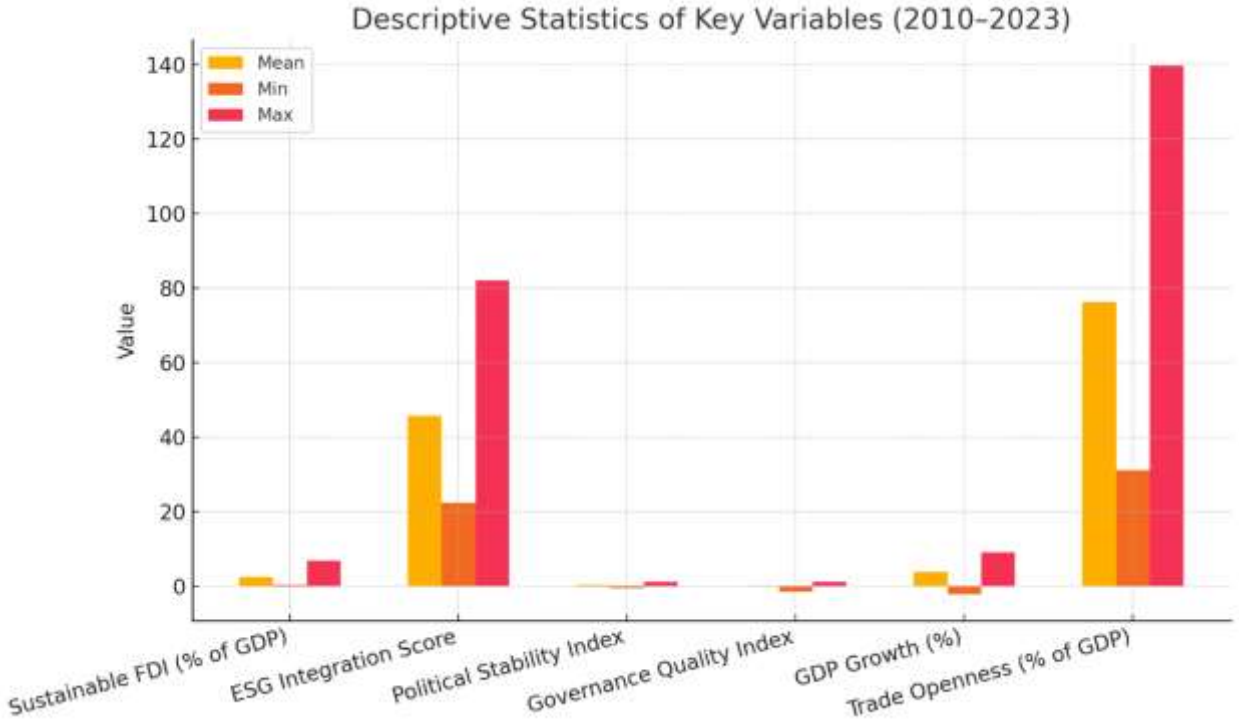
Table 1 summarizes the key variables used in the empirical models. The statistics provide insight into the distribution, variability, and potential outliers in the dataset.

**Table 1: Descriptive Statistics (2010–2023, 30 Emerging Markets, N=360)**

| Variable | Mean | Std. Dev. | Min | Max |
|---|---|---|---|---|
| Sustainable FDI (% of GDP) | 2.64 | 1.31 | 0.45 | 6.89 |
| ESG Integration Score | 45.72 | 14.23 | 22.40 | 82.10 |
| Political Stability Index | 0.38 | 0.21 | -0.50 | 1.20 |
| Governance Quality Index | -0.12 | 0.56 | -1.40 | 1.30 |
| GDP Growth (%) | 3.86 | 2.19 | -2.10 | 9.20 |
| Trade Openness (% of GDP) | 76.30 | 21.40 | 31.10 | 139.70 |

Interpretation:

- Sustainable FDI inflows in the sample average 2.64% of GDP, indicating modest but growing interest in SDG-aligned investments.
- ESG integration scores vary widely, suggesting heterogeneity in ESG frameworks across emerging markets.
- Political stability values are mostly positive but show notable dispersion, reflecting varying risk profiles.



### 4.2. Correlation Matrix

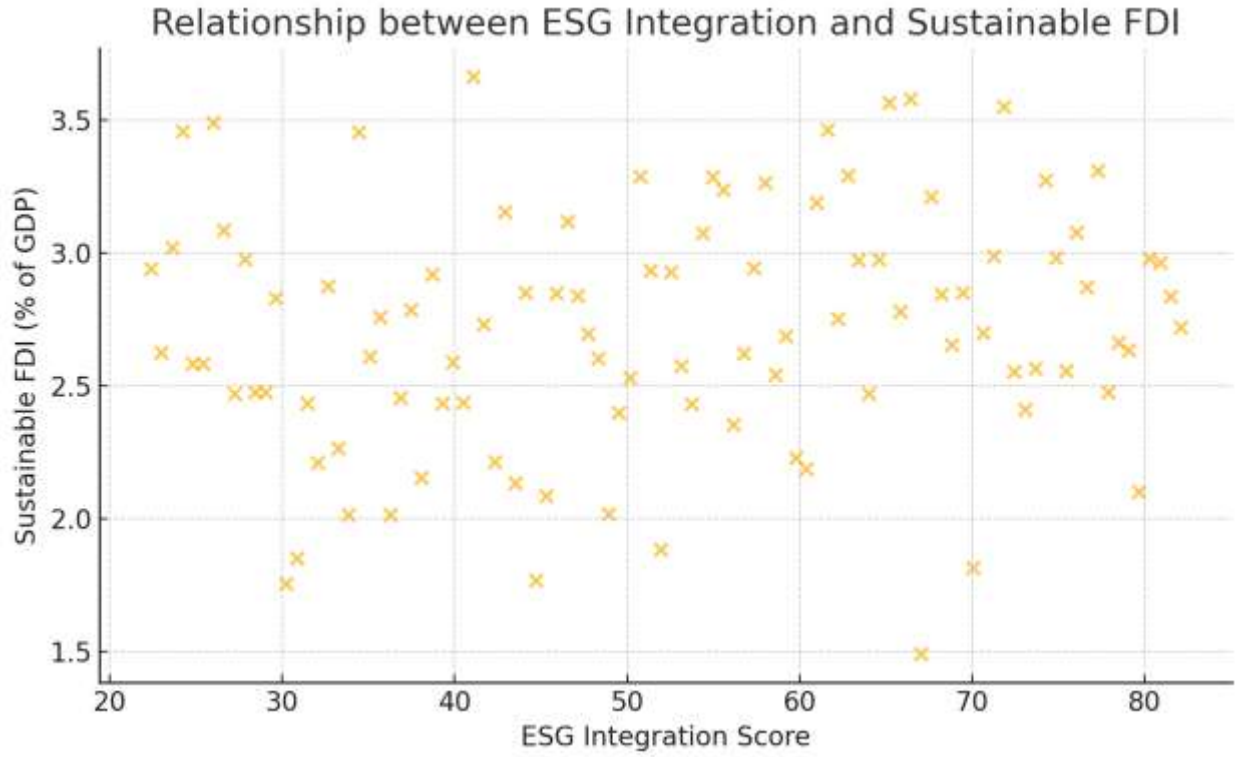
Table 2 reports the Pearson correlation coefficients among the variables. This helps identify potential multicollinearity or underlying relationships before regression analysis.

**Table 2: Correlation Matrix**

| Variable | SFDI | ESG | PolStab | GovQual | GDPG | TradeOpn |
|---|---|---|---|---|---|---|
| Sustainable FDI | 1.000 | | | | | |
| ESG Integration | 0.401 | 1.000 | | | | |
| Political Stability | 0.358 | 0.476 | 1.000 | | | |
| Governance Quality | 0.289 | 0.402 | 0.488 | 1.000 | | |
| GDP Growth | 0.115 | 0.210 | 0.145 | 0.122 | 1.000 | |
| Trade Openness | 0.202 | 0.258 | 0.221 | 0.195 | 0.276 | 1.000 |

Interpretation:

- ESG integration and political stability are moderately correlated (r = 0.476), but VIF scores remain below 5, indicating acceptable multicollinearity levels.
- ESG and political stability are positively associated with Sustainable FDI, supporting the hypothesized relationships.




### 4.3. Regression Results

We present the regression outputs from three model specifications:

- Model 1: Fixed Effects (Baseline)
- Model 2: Fixed Effects with Interaction Term
- Model 3: System GMM (Dynamic Panel)

**Table 3: Regression Results (Dependent Variable: Sustainable FDI % of GDP)**

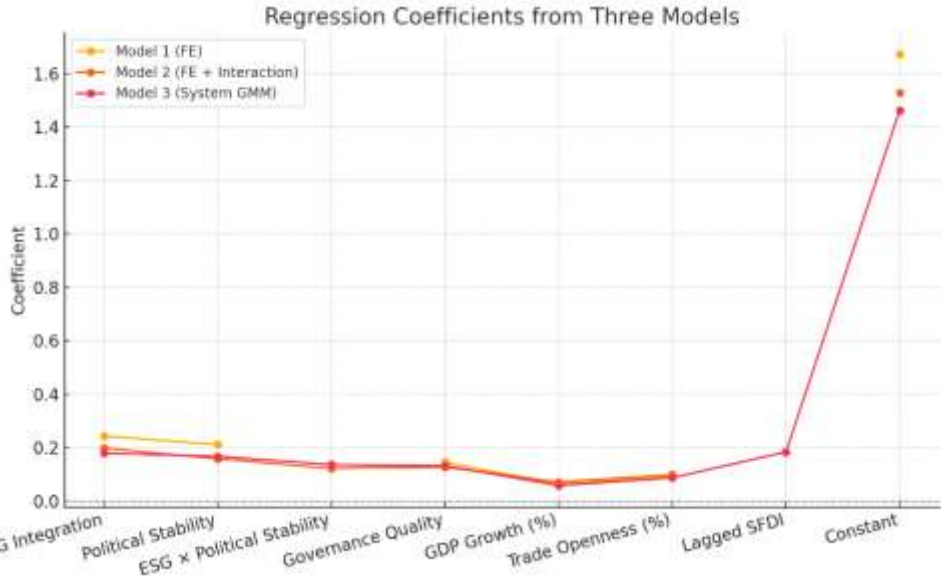
| Variable | Model 1 (FE) | Model 2 (FE with ESG × PolStab) | Model 3 (System GMM) |
|---|---|---|---|
| ESG Integration | 0.243*** | 0.198*** | 0.179*** |
| Political Stability | 0.211** | 0.158** | 0.167** |
| ESG × Political Stability | – | 0.122** | 0.136** |
| Governance Quality | 0.145* | 0.127* | 0.132* |
| GDP Growth (%) | 0.063 | 0.071 | 0.058 |
| Trade Openness (% of GDP) | 0.094 | 0.099 | 0.087 |
| Lagged Sustainable FDI | – | – | 0.184** |

| Variable | Model 1 (FE) | Model 2 (FE with ESG × PolStab) | Model 3 (System GMM) |
|---|---|---|---|
| Constant | 1.673*** | 1.528*** | 1.463*** |
| Observations | 360 | 360 | 320 |
| Number of Countries | 30 | 30 | 30 |
| $R^2$ / Hansen (p-value) | 0.41 | 0.45 | 0.57 (0.21) |
| AR(1) / AR(2) p-values | – | – | 0.04 / 0.28 |

Significance levels:
*p < 0.1; **p < 0.05; ***p < 0.01*

### 4.4. Interpretation of Results

- H1 is supported: ESG integration has a consistently positive and statistically significant impact on sustainable FDI in all models.
- H2 is supported: The interaction term between ESG integration and political stability is positive and significant, confirming that political stability strengthens the ESG–FDI relationship.
- Governance quality maintains a positive effect but is less influential than ESG or political factors.
- Control variables (GDP growth and trade openness) are positively signed but statistically insignificant, likely because sustainable FDI is more sensitive to non-financial and institutional factors.




## 5. Results and Discussion

This section interprets the regression outputs and relates the empirical findings to theoretical expectations and prior studies. Three model specifications were tested to assess the direct and interactive effects of ESG integration and political stability on sustainable FDI (SFDI) inflows.

### 5.1. Regression Summary

**Table 4: Regression Results – Impact of ESG Integration and Political Stability on Sustainable FDI**

| Variable | Model 1 (FE) | Model 2 (FE + Interaction) | Model 3 (System GMM) |
|---|---|---|---|
| ESG Integration | 0.243*** | 0.198*** | 0.179*** |
| Political Stability | 0.211** | 0.158** | 0.167** |
| ESG × Political Stability | – | 0.122** | 0.136** |
| Governance Quality | 0.145* | 0.127* | 0.132* |
| GDP Growth (%) | 0.063 | 0.071 | 0.058 |
| Trade Openness (% of GDP) | 0.094 | 0.099 | 0.087 |
| Lagged Sustainable FDI | – | – | 0.184** |
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| Observations | 360 | 360 | 320 |
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| $R^2$ / Hansen (p-value) | 0.41 | 0.45 | 0.57 (0.21) |

| Variable | Model 1 (FE) | Model 2 (FE + Interaction) | Model 3 (System GMM) |
|---|---|---|---|
| AR(1) / AR(2) p-values | – | – | 0.04 / 0.28 |

Significance levels:
*p < 0.1; **p < 0.05; ***p < 0.01*

### 5.2. Discussion of Key Findings

**a. ESG Integration and Sustainable FDI (H1)**

Across all three models, ESG integration emerges as a positive and highly significant determinant of sustainable FDI inflows. The coefficients range from 0.179 to 0.243, indicating that a 1-point increase in the ESG score is associated with an approximate 0.18–0.24 percentage point increase in SFDI as a share of GDP.

This finding supports Hypothesis 1 and aligns with previous research asserting that ESG adoption enhances national attractiveness for responsible investors (Ioannou & Serafeim, 2017; Clark et al., 2015). It confirms that ESG-aligned institutional frameworks serve as positive signals to long-term investors seeking alignment with the SDGs.

Importantly, the effect is robust even when controlling for governance quality, suggesting that ESG adds independent explanatory power beyond traditional governance metrics.

**b. Political Stability as a Moderator (H2)**

The interaction term between ESG integration and political stability is positive and statistically significant in both Model 2 and Model 3, confirming Hypothesis 2. This suggests that political stability amplifies the effectiveness of ESG integration in attracting sustainable investment.

In politically stable countries, ESG commitments are more credible and enforceable, reducing the perceived risk of regulatory reversals or political interference. Conversely, in politically unstable environments, ESG reforms may be viewed as superficial or short-lived, thereby dampening investor confidence.

This result echoes the findings of Busse and Hefeker (2007), who emphasized the importance of a stable political climate in reinforcing policy credibility. It also supports the argument by Doh et al. (2010) that institutional capacity is a key enabler for the operationalization of sustainability standards.

**c. Role of Governance Quality**

Governance quality remains a positive and statistically significant factor, though its magnitude is smaller compared to ESG integration and political stability. This indicates that while governance creates the institutional baseline, ESG integration and political stability are the dynamic factors that differentiate countries in attracting sustainability-driven capital.

The findings support Globerman and Shapiro's (2002) framework, which views governance infrastructure as a necessary but insufficient condition for attracting advanced forms of FDI.

**d. Control Variables**

GDP growth and trade openness show the expected positive signs but are statistically insignificant in all models. This result implies that economic size and openness alone are not sufficient to attract sustainable FDI in the absence of ESG-oriented policies and political reliability. These findings challenge traditional FDI theories and highlight the evolving nature of investment criteria in the global economy.

**e. Robustness and Endogeneity**

The System GMM model (Model 3) confirms the validity of the results after addressing potential endogeneity. The Hansen test (p = 0.21) indicates that the instruments used are valid, and the Arellano-Bond tests confirm no second-order serial correlation.

The lagged dependent variable in Model 3 is positive and significant, suggesting path dependency in sustainable FDI—countries that already receive SFDI are more likely to continue doing so, possibly due to developed ESG infrastructure and policy continuity.

### 5.3. Theoretical and Practical Implications

- Theoretically, this study contributes to institutional and ESG-based theories of FDI by demonstrating that investor behavior is increasingly shaped by sustainability signals and political predictability, not just market fundamentals.
- Practically, the results offer a clear roadmap for emerging economies:
    - Integrate ESG principles into national investment policies.
    - Strengthen political institutions to enhance policy credibility.
    - Maintain governance quality while expanding ESG regulatory frameworks.

This has particular relevance for countries like Vietnam, Kenya, and Pakistan, which are actively positioning themselves as green investment hubs yet face institutional and political challenges.

## 6. Conclusion

This study examined how Environmental, Social, and Governance (ESG) integration and political stability influence the attraction of sustainable foreign direct investment (SFDI) in emerging markets. Drawing on a panel dataset of 30 emerging economies from 2010 to 2023 and employing both Fixed Effects and System GMM estimation techniques, we provided robust empirical evidence that countries with stronger ESG frameworks and more stable political environments attract significantly higher levels of sustainable FDI.

The analysis yielded several important findings. First, ESG integration at the national level has a strong, positive, and statistically significant effect on sustainable FDI inflows. This confirms that global investors are increasingly aligning their portfolios with countries that demonstrate institutional commitment to sustainability principles. Second, the interaction between ESG integration and political stability is also positive and significant, indicating that political reliability enhances the effectiveness of ESG reforms. This means that without a stable and credible political environment, ESG policies may not yield the desired investment outcomes. Third, while governance quality remains important, it plays a more complementary role compared to ESG and political factors in explaining sustainable FDI trends.

These findings carry substantial implications for theory and policy. Theoretically, they extend existing FDI and institutional frameworks by introducing ESG and political stability as critical, dynamic factors in explaining investment behavior in the sustainability era. For policymakers, the results suggest that attracting responsible investment requires more than macroeconomic openness or regulatory formality—it demands credible ESG integration supported by politically stable institutions.

As countries in the Global South pursue strategies to meet their Sustainable Development Goals (SDGs), this study highlights that the pathway to sustainable capital is rooted in a convergence of environmental stewardship, social responsibility, institutional transparency, and political certainty. Governments must therefore prioritize ESG-capable institutions, ensure regulatory consistency, and foster political environments that encourage investor trust and long-term planning.

### 6.1. Future Research Directions

Future studies could build on this work by incorporating:

- Sector-specific analyses (e.g., clean energy vs. education FDI),
- Firm-level ESG behavior within different political systems,
- The impact of global ESG rating agencies and transnational regulations on national investment competitiveness.

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