**International Journal of Digital Marketing Science**
**Vol.3 No.2 (2026)**
**ISSN 2961-7367**
**pp. 143-156**

**https://journal.adpebi.com/index.php/IJAMB**

# Tax Expenditures, Regulatory Quality, Rule of Law, and Foreign Direct Investment: Political Stability as Moderator

**Afzal Rezki Ilmani[1], Annathasia Puji Erasashanti [2]**
[1,2,] Faculty of Economics and Business, Institut Keuangan Perbankan dan Informatika Asia Perbanas, Indonesia
Email: [1] ilmaniafzal@gmail.com, [2] erasashanti@perbanas.id

**ARTICLE INFO**

Research Paper

***Article history:***
Received: 5 July 2026
Revised: 10 August 2026
Accepted: 28 August 2026

**Keywords:** tax expenditure, regulatory quality, rule of law, foreign direct investment, political stability

**ABSTRACT**

This study examines the effects of tax expenditures, regulatory quality, and the rule of law on foreign direct investment inflows, with political stability as a moderating variable, across nine developing OECD member countries and key partners during 2016–2022. This study employs a quantitative method using secondary data analyzed via panel data regression using the Random Effects Model (REM) approach. The results of the panel data regression analysis indicate that tax expenditures and rule of law have a positive effect on foreign direct investment, while regulatory quality has a negative effect on foreign direct investment. Furthermore, the results of the moderation analysis show that political stability does not moderate the effects of regulatory quality or rule of law on foreign direct investment. Political stability weakens the effect of tax expenditures on foreign direct investment. These findings imply that OECD developing countries' governments need to formulate and evaluate the effectiveness of tax expenditure policies for foreign investors to increase foreign direct investment and improve overall governance quality by evaluating each regulation, ensuring the rule of law applies to those regulations, and maintaining political stability.



## INTRODUCTION

Countries around the world faced various global dynamics that triggered economic instability throughout the 2016–2022 period. This period began with a recovery from the global economic slowdown of 2014–2015, followed by various shocks, such as the trade war, the COVID-19 pandemic, the supply chain crisis, a surge in global inflation, and the escalation of the conflict between Russia and Ukraine. This series of events heightened uncertainty in global markets and posed significant challenges to economic stability and growth across various countries. The impact was reflected in an economic slowdown marked by a downward trend in foreign direct investment. According to World Bank (2026), the average foreign direct investment (FDI) across 43 OECD member countries and key partners from 2016 to 2022 fluctuated significantly, showing a downward trend as illustrated in Figure 1.

Corresponding: erasashanti@perbanas.id
DOI: https://doi.org/10.54099/ijdms.v3i2.1965

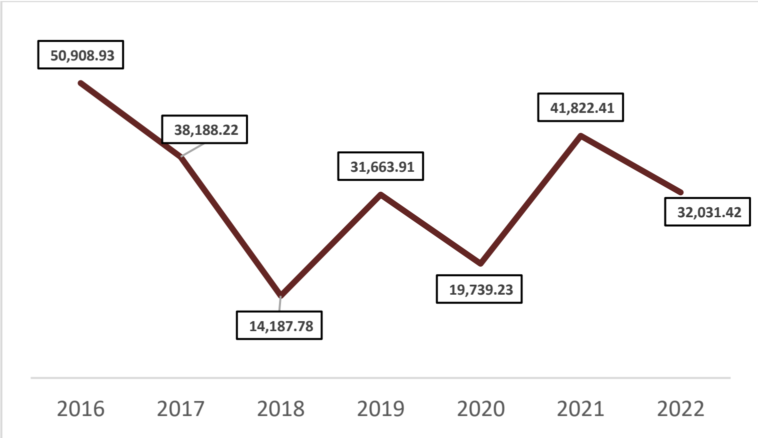


Figure 1 Average Foreign Direct Investment in 43 OECD Member Countries and Key Partners, 2016–2022 (in millions of U.S. dollars)

Capital investment is a strategic element in a country's economic activities. Foreign direct investment not only takes the form of incoming foreign capital flows but also brings about the transfer of information and communication technology, access to global markets, and opportunities for job creation, thereby driving the country's development toward greater progress and modernization (Fauzan & Rahman, 2025). Efforts to attract foreign investment into the country require the government to play an active role in creating a conducive investment climate, thereby enhancing investment appeal and establishing mutually beneficial conditions for both investors and the host country (the investee).

Several previous studies have shown that foreign direct investment is influenced by various factors. Studies by Yahaya (2026), Bella & Yudianto (2021), and Kusumaningtyas & Kalimanzila (2023) found that tax incentives have a positive effect on foreign direct investment. In addition, Mirkovikj et al. (2024) found that improvements in regulatory quality have a positive effect on foreign direct investment. Studies by Drajat (2022) and Akisik (2020) also found that rule of law has a positive effect on foreign direct investment. However, several studies on the effects of tax incentives, regulatory quality, and rule of law on foreign direct investment still show contradictory results. Siregar & Patunru (2021) and Ahmed et al. (2025) found that tax incentives have a negative effect on foreign direct investment. Khan et al. (2024) and Nzeh et al. (2024) found that regulatory quality has a negative effect on foreign direct investment. Meanwhile, studies by Saha et al. (2022) and Le (2025) show that rule of law has a negative effect on foreign direct investment. These inconsistent findings indicate research gaps in explaining the conditions under which fiscal and institutional factors influence foreign direct investment.

Based on empirical phenomena and research gaps, this study aims to analyze the effects of tax expenditures, regulatory quality, and rule of law on foreign direct investment, while also examining the role of political stability as a moderating variable on the effects of these three independent variables on foreign direct investment. The novelty of this study lies in the inclusion of political stability as a moderator variable in the strategic relationship between tax expenditures, regulatory quality, and rule of law—specifically regarding their impact on investors' perceptions of foreign direct investment. This study incorporates political stability as a moderating variable to explain the inconsistencies found in previous research. The inclusion of political stability as a moderating variable is crucial because it can demonstrate the extent to which stable political conditions can reduce the perceived investment risk faced by investors, thereby allowing for a more comprehensive understanding of the relationship between tax expenditures, regulatory quality, and rule of law and foreign direct investment.

## LITERATURE REVIEW

### *Eclectic Paradigm Theory*

The eclectic paradigm theory Dunning & Lundan (2008) explains that there are three factors that determine the behavior of an international company in making direct investments in another country, namely ownership advantages, location advantages, and internalization advantages. Among these three components, location advantages are particularly relevant in explaining why multinational enterprises choose one host country over another. Location advantages relate to the characteristics and attractiveness of the host country in creating a conducive investment climate that provides benefits to investors. Recent studies emphasize that location-specific factors remain important determinants of foreign direct investment location decisions, which can influence the expected benefits and costs of investing abroad. Mihaylova (2020), for example, demonstrates that policy-related location advantages, including the institutional framework, infrastructure, labour-force characteristics, and cost competitiveness, contribute to the attractiveness of host countries for foreign direct investment. Similarly, Jones et al. (2020) show that location-specific characteristics influence the motives and geographical distribution of foreign direct investment across host countries. Islam & Beloucif (2024) show that a number of economic, political, and institutional factors as the significant determinants of foreign direct investment across the world. Therefore, location advantages can be understood as a multidimensional set of host-country characteristics that shape the attractiveness of a country as a destination for foreign investment. In this study, the location advantage perspective provides the theoretical basis for examining how host-country conditions influence foreign direct investment decisions.

### *Foreign Direct Investment*

Foreign direct investment refers to the acquisition of assets or other resources to generate future income through day-to-day operations conducted outside the investor's home country and subject to the laws and regulations of that host country for the purpose of generating income (Ahmed et al., 2025). Foreign direct investment differs from portfolio investment because it generally involves a long-term commitment and a degree of managerial influence over the foreign enterprise (Paul & Feliciano-Cestero, 2021). Foreign direct investment is also an important component of international capital flows because it can facilitate capital accumulation, technology and knowledge transfer, employment creation, and productivity improvements in host economies (Paul & Feliciano-Cestero, 2021). A systematic review by Islam & Beloucif (2024) shows that foreign direct investment is influenced by various host-country characteristics, including market size, trade openness, infrastructure quality, labour costs, macroeconomic stability, human capital, and economic growth prospects. Institutional quality is also considered an important factor in attracting foreign direct investment because effective institutions can reduce uncertainty and create a more predictable investment environment (Khan et al., 2024). From the perspective of multinational enterprises, the objectives of foreign direct investment are to expand markets (market-seeking), acquire resources (resource-seeking), and improve efficiency through business expansion or the integration of business functions (efficiency-seeking) (Jones et al., 2020).

### *Tax Expenditures*

According to the Direktorat Jenderal Strategi Ekonomi dan Fiskal (2025), tax expenditures refer to tax revenue that is lost or reduced due to special provisions that differ from the generally applicable tax system (benchmark tax system). The concept of tax expenditures differs from general government spending (Dewi, 2024). In government spending, the public receives direct, tangible benefits (direct transfers), whereas in tax expenditures, the public does not receive direct, tangible benefits but rather benefits in the form of tax incentives or tax breaks. Forms of tax expenditures include allowances, exemptions, rate relief, tax deferrals, and credits (OECD, 2010). Tax expenditures are part of the location advantages of eclectic paradigm theory that can attract foreign investment to countries offering

tax incentives. Tax expenditures can reduce the cost burden of investment in the form of tax reductions, thereby increasing the rate of return expected by investors. Several previous studies, such as Yahaya (2026), Bella & Yudianto (2021), and Kusumaningtyas & Kalimanzila (2023) found that tax incentive variables have a positive and significant effect on foreign direct investment. Thus, the hypothesis can be defined as follows:
**H1: Tax expenditures have a positive effect on foreign direct investment inflows**

***Regulatory Quality***
In the eclectic paradigm theory (Dunning & Lundan, 2008), location advantages are factors that influence multinational companies to engage in foreign direct investment. Research by Islam & Beloucif (2024) shows that governance indicators influence foreign direct investment. Governance indicators can be measured through regulatory quality (World Bank, 2025). Regulatory quality serves as a governance indicator that reflects the quality of a country's institutions. It reflects a government's capacity to formulate and implement policies (World Bank, 2025). Regulatory quality can be assessed based on public perceptions of regulations that support private-sector development. In the context of foreign direct investment, countries with high-quality and efficient regulations can attract more foreign investment (Contractor et al., 2021). Research by Mirkovikj et al. (2024) found that regulatory quality has a positive effect on foreign direct investment. Thus, the hypothesis can be defined as follows:
**H2: Regulatory quality has a positive effect on foreign direct investment inflows**

***Rule of Law***
Based on the eclectic paradigm theory (Dunning & Lundan, 2008), multinational companies consider location advantages when making foreign direct investments. Research by Islam & Beloucif (2024) shows that governance indicators influence foreign direct investment. The quality of a country's governance can be assessed based on the rule of law (World Bank, 2025). Rule of law refers to the government's oversight of rules or laws and how the government provides rewards (protection) or penalties in the context of enforcing those laws. Rule of law can be measured by the perception of the extent to which individuals and institutions comply with and respect the rules applicable in society, which includes the effectiveness of contract enforcement, protection of property rights, the performance of the police and the judiciary, as well as the likelihood of crime and violence (World Bank, 2025). Countries that provide stronger protection for investors can attract more foreign investment (Contractor et al., 2021). Research by Drajat (2022) found that rule of law has a positive and significant effect on foreign direct investment. Thus, the hypothesis can be defined as follows:
**H3: Rule of law has a positive effect on foreign direct investment inflows**

***The Role of Political Stability in Moderating the Effect of Tax Expenditures on Foreign Direct Investment Inflows***
According to the eclectic paradigm theory (Dunning & Lundan, 2008), multinational companies' decisions to engage in foreign direct investment are influenced by a country's location advantages. One form of such location advantages is fiscal policy that provides incentives to investors, such as tax expenditures. Tax expenditures—such as tax exemptions, adjustments, credits, or deferrals—aim to reduce investment costs, thereby enhancing a country's attractiveness as a destination for foreign investment.

However, the effectiveness of tax expenditures in attracting foreign direct investment is not determined solely by the magnitude of the incentives provided but is also influenced by the investment environment, one aspect of which is political stability. Political stability reflects the perception of the extent to which political power and governance are protected from various forms of destabilization, as well as the likelihood that government authority will be challenged or altered through violent, coercive, or unconstitutional means (World Bank, 2025). Empirical Studies Islam & Beloucif (2024) show that political stability is one of the factors in location advantages that influence the volume of incoming foreign investment. Research (Cuervo-Cazurra et al., 2022) found that institutional quality has the potential to serve as a substitute for fiscal incentives in attracting foreign investment. This suggests that the interaction between the two is not complementary but rather substitutive. In countries with low institutional quality, fiscal incentives are more effective in attracting foreign investment (Cuervo-Cazurra et al., 2022). Thus, the hypothesis can be defined as follows:

**H4: Political stability weakens the effect of tax expenditures on foreign direct investment**

***The Role of Political Stability in Moderating the Effect of Regulatory Quality on Foreign Direct Investment Inflows***

Based on the eclectic paradigm theory (Dunning & Lundan, 2008), location advantages are one of the factors influencing multinational companies' decisions to make foreign direct investment. One factor that contributes to location advantages is the quality of regulations. Regulatory quality can be measured by public perception of regulations that support the development of the private sector. High-quality regulations can reduce administrative barriers, improve licensing efficiency, and provide certainty in the conduct of business activities. These conditions will lower transaction costs and enhance a country's attractiveness as a destination for foreign direct investment.

However, from the perspective of the eclectic paradigm theory, investment decisions are influenced not only by a single locational advantage but by a combination of various characteristics of the host country. In addition to regulatory quality, investors also consider political stability as part of locational advantage because political stability reflects the level of security and sustainability of the investment environment. Regulatory quality and political stability are two indicators for measuring the quality of governance (World Bank, 2025). Political stability is measured by perceptions of the extent to which political power and governance are protected from various forms of destabilization, as well as the likelihood that government authority will be challenged or altered through violent, coercive, or unconstitutional means (World Bank, 2025). Countries with high levels of political stability face a lower risk of disruptions to investment activities (Vasilyeva & Mariev, 2021). This is consistent with research by Islam & Beloucif (2024) showing that indicators of governance and political stability are factors in location advantages that influence foreign direct investment. Thus, the hypothesis can be defined as follows:

**H5: Political stability strengthens the effect of regulatory quality on foreign direct investment**

***The Role of Political Stability in Moderating the Effect of Rule of Law on Foreign Direct Investment Inflows***

According to the eclectic paradigm theory (Dunning & Lundan, 2008), location advantages are one of the factors multinational companies consider when making foreign direct investments. One factor that shapes locational advantages is the rule of law. Rule of law can be measured by the perception of the extent to which individuals and institutions comply with and respect the rules that apply in society, including the effectiveness of contract enforcement, protection of property rights, the performance of the police and the judiciary, and the likelihood of crime and violence (World Bank, 2025). With rule of law, the risks faced by investors are reduced, transaction costs can be minimized, and investor confidence in the investment environment increases. Countries that provide stronger protection for investors can attract more foreign investment (Contractor et al., 2021).

However, based on the eclectic paradigm theory, investment decisions are not determined by a single locational advantage but by a combination of various factors that shape a country's attractiveness. In addition to rule of law, investors also consider political stability as part of location advantages. Rule of law and political stability are two indicators for measuring the quality of governance (World Bank, 2025). Political stability is measured by the perception of the extent to which political power and governance are protected from various forms of destabilization, as well as the likelihood that government authority will be challenged or altered through violent, coercive, or unconstitutional means (World Bank, 2025). Countries with high levels of political stability have lower investment risk (Vasilyeva & Mariev, 2021). This is consistent with research by Islam & Beloucif (2024) showing that indicators of governance and political stability are factors in location advantages that influence foreign direct investment. Thus, the hypothesis can be defined as follows:

**H6: Political stability strengthens the effect of regulatory quality on foreign direct investment**

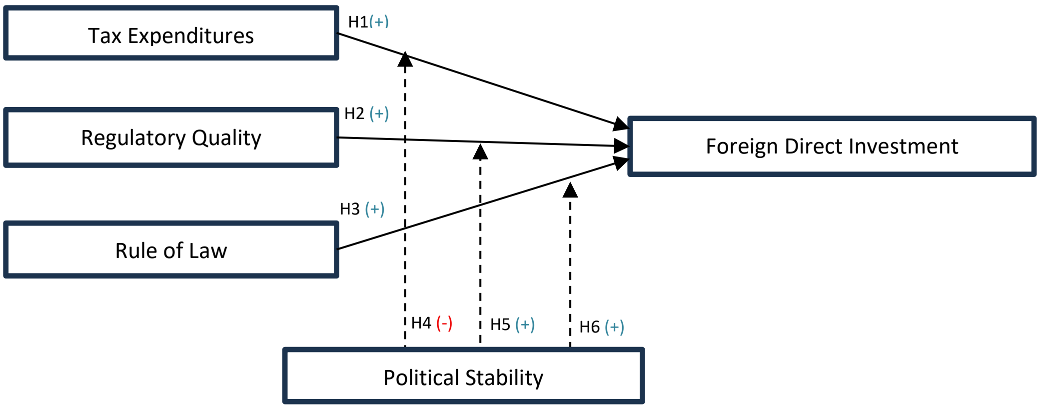


Figure 2 Conceptual Framework

## METHOD

The study is conducted using a quantitative method with secondary data sourced from the Global Tax Expenditure Database (GTED), jointly published by German Institute for Development and Sustainability (IDOS) & Council on Economic Policies (CEP) (2025), World Government Indicator that measured and published by World Bank (2025), and Foreign Direct Investment published by World Bank (2026). The variables used in this study consist of independent variables (tax expenditures, regulatory quality, and rule of law), a dependent variable (foreign direct investment), and a moderating variable (political stability). The population of this study consists of OECD member countries and key partners. The sample is determined using purposive sampling based on specific criteria, including OECD member countries and key partners that meet the criteria for developing countries as defined by International Monetary Fund (2023) and countries that reported tax expenditures for the years 2016–2022. There are 9 countries that qualify for inclusion in the research sample, namely Chile, Colombia, Costa Rica, Mexico, Turkey, Indonesia, India, Brazil, and South Africa. With an observation period of 7 years, the total number of observations processed in this study is 63. Data are collected through documentation of available statistical data.

Data processing and analysis are conducted using E-Views 11. The analytical techniques included descriptive statistical analysis, testing of panel data regression models, panel data regression analysis using Generalized Least Squares (GLS), and hypothesis testing. Hypothesis testing used multiple linear regression and Moderated Regression Analysis (MRA), the coefficient of determination (Adjusted $R^2$), and the t-test with a 5% significance level.

## RESULT

### Descriptive Results

**Table 1 Descriptive Results**

| Descriptive | Tax Expenditure ($X_1$) | Regulatory Quality ($X_2$) | Rule of Law ($X_3$) | Political Stability (Z) | Foreign Direct Investment (Y) |
|---|---|---|---|---|---|
| Mean | 26,750,593,472.487 | 57.938 | 54.699 | 58.375 | 23,928,119,716.658 |
| Median | 18,037,577,712.000 | 56.580 | 53.796 | 55.618 | 13,989,154,028.368 |
| Maximum | 92,910,731,820.995 | 74.989 | 73.990 | 85.471 | 78,183,840,044.980 |
| Minimum | 8,213,148.301 | 50.864 | 38.338 | 35.486 | 2,058,579,911.052 |
| Std, Dev, | 25,492,543,467.275 | 6.165 | 9.338 | 10.799 | 21,123,673,758.472 |
| Skewness | 1.120 | 1.207 | 0.505 | 0.816 | 1.050 |
| Kurtosis | 3.395 | 3.700 | 2.427 | 3.300 | 3.147 |
| Observations | 63 | 63 | 63 | 63 | 63 |

Based on Table 1 above, the variables of tax expenditure, regulatory quality, rule of law, political stability, and foreign direct investment in the nine countries have medians that are smaller than their mean values. This indicates that the data distribution is slightly right-skewed. In terms of the degree of data dispersion, the standard deviations of all variables are smaller than their mean values, suggesting that the data are homogeneous. The kurtosis values for the variables tax expenditure, regulatory quality, political stability, and foreign direct investment are greater than 3 (three), indicating a leptokurtic distribution—meaning the data has a higher peak and thicker tails compared to a normal distribution. Meanwhile, the kurtosis values for the rule of law variable are less than 3 (three), indicating a platykurtic distribution—that is, one with a flatter peak compared to a normal distribution. The skewness values for all variables indicate that the data distribution is slightly skewed to the right (positively skewed), meaning that most of the data tends to cluster around higher values.

**Panel Data Regression Model Test**

***Chow* Test**

**Table 2 Chow Test Result**

| Effects Test | Statistic | d.f. | Probability |
|---|---|---|---|
| Cross-section F | 6.582 | (8.51) | 0.000 |
| Cross-section Chi-square | 44.681 | 8 | 0.000 |

Based on Table 2 The results of the Chow test show that the probability value for the cross-sectional chi-square statistic is 0.000. This probability value is less than 0.05. Therefore, based on the results of the Chow test, the best model selected for this study is the Fixed Effects Model (FEM)

***Hausman* Test**

**Table 3 *Hausman* Test Result**

| Test Summary | Chi-Sq. Statistic | Chi-Sq. d.f. | Probability |
|---|---|---|---|
| Cross-section random | 5.2000 | 3 | 0.1577 |

Refer to Table 3 The Fixed Effects Model (FEM), which was selected in the Chow test, is subsequently subjected to the Hausman test. The results of the Hausman test showed that the probability value for cross-sectional randomness is 0.1577. This probability value is greater than 0.05. Thus, based on the results of the Hausman test, the best model selected for this study is the Random Effects Model (REM).

***Lagrange Multiplier* Test**

**Table 4 *Lagrange Multiplier* Test Result**

| | Test Hypothesis | | |
|---|---|---|---|
| | Cross-section | Time | Both |
| Breusch-Pagan | 24.0134<br>(0.0000) | 2.9446<br>(0.0862) | 26.958<br>(0.0000) |

Refer to Table 4 The Random Effects Model (REM), which was selected in the Hausman test, is subsequently subjected to a Lagrange Multiplier test. The results of the Lagrange Multiplier test showed that the probability value for the cross-sectional random effect is 0.0000. This probability value is less than 0.05. Thus, based on the results of the Lagrange Multiplier test, the best model selected for this study is the Random Effects Model (REM). According to (Gujarati & Porter, 2009, p. 603), the most appropriate method to use for panel data in a Random Effects Model is the Generalized Least Squares (GLS) method.

**Multiple Linear Regression Test**

Based on the results of a multiple linear regression analysis of panel data using Generalized Least Squares (GLS), the following panel data regression equation was:

**FDI = 22,184,761,845.9 + 0.698*TER – 1,116,563,208.15*RQ + 873,119,108.545*RL + [CX=R]**

Note:
FDI = Foreign Direct Investment
TER = Tax Expenditure
RQ = Regulatory Quality
RL = Rule of Law

**Coefficient of Determination Test ($R^2$ Test)**

**Table 5 $R^2$ Test Result**

| Weighted Statistics | |
|---|---|
| R-squared | 0.5103 |
| Adjusted R-squared | 0.4854 |

Based on the results of the coefficient of determination test ($R^2$ test), the adjusted R-squared value is 0.485. The adjusted R-squared value in Table 5, which is 0.485 or 48.5%, indicates that the model's ability to explain the variation in the dependent variable is quite significant. All independent variables collectively account for approximately 48.5% of the variation in the dependent variable, namely realized foreign direct investment. The remaining 51.5% is influenced by other variables not included in the analysis of this study.

**Significance Test for Individual Parameters (t-Test)**

**Table 6 t-Test Result**

| Variable | Coefficient | Std, Error | t-Statistic | Probability |
|---|---|---|---|---|
| Constanta (C) | 22,184,761,845.8891 | 23,487,846,07.4675 | 0.9445 | 0.3488 |
| Tax Expenditure ($X_1$) | 0.6982 | 0.1024 | 6.8207 | 0.0000 |
| Regulatory Quality ($X_2$) | -1,116,563,208.1486 | 541,703,440.7380 | -2.0612 | 0.0437 |
| Rule of Law ($X_3$) | 873,119,108.5455 | 401,580,724.6266 | 2.1742 | 0.0337 |

Based on table 6 the results of the t-test for the variables of tax expenditure and rule of law, the probability values from the test results are less than the significance level (α), and the coefficient values indicate a positive direction; therefore, Hypotheses 1 and 3 are accepted. Thus, both variables have a positive effect on foreign direct investment. For the regulatory quality variable, the probability value of the test results is less than the significance level (α), and the coefficient indicates a negative direction; therefore, Hypothesis 2 is rejected. Thus, the regulatory quality variable has a negative effect on foreign direct investment.

## Moderated Regression Analysis (MRA) Test

**Table 7 MRA Test**

| Variable | Coefficient | Std. Error | t-Statistic | Probability |
|---|---|---|---|---|
| **MRA Test of Political Stability on the Effect of Tax Expenditures on Foreign Direct Investment** | | | | |
| **Variable** | **Coefficient** | **Std. Error** | **t-Statistic** | **Probability** |
| Constanta (C) | 22.003.362.701,3400 | 14.430.506.319,4622 | 1,5248 | 0,1327 |
| Tax Expenditure ($X_1$) | 2,2919 | 0,7162 | 3,2001 | 0,0022 |
| Political Stability (Z) | -280.382.141,1005 | 231.630.678,4708 | -1,2105 | 0,2309 |
| Tax Expenditure ($X_1$) * Political Stability (Z) | -0,0288 | 0,0126 | -2,2870 | 0,0258 |
| **MRA Test of Political Stability on the Effect of Regulatory Quality on Foreign Direct Investment** | | | | |
| **Variable** | **Coefficient** | **Std. Error** | **t-Statistic** | **Probability** |
| Constanta (C) | 343.201.337.975,9310 | 153.008.576.460,5970 | 2,2430 | 0,0287 |
| Regulatory Quality ($X_2$) | -4.461.277.646,1132 | 2.467.333.868,9873 | -1,8081 | 0,0757 |
| Political Stability (Z) | -4.459.897.042,6677 | 2.350.946.158,8540 | -1,8971 | 0,0627 |
| Regulatory Quality ($X_2$)*Political Stability (Z) | 58.209.241,7404 | 36.990.926,4337 | 1,5736 | 0,1209 |
| **MRA Test of Political Stability on the Effect of Rule of Law on Foreign Direct Investment** | | | | |
| **Variable** | **Coefficient** | **Std. Error** | **t-Statistic** | **Probability** |
| Constanta (C) | -29.333.437.182,0891 | 109.585.247.026,7370 | -0,2677 | 0,7899 |
| Rule of Law ($X_3$) | 1.804.226.601,4099 | 1.905.874.480,7482 | 0,9467 | 0,3477 |
| Political Stability (Z) | 470.841.291,1798 | 1.640.287.074,2767 | 0,2870 | 0,7751 |
| Rule of Law ($X_3$) * Stabilitas Political (Z) | -22.260.180,4196 | 27.400.191,0050 | -0,8124 | 0,4198 |

Based on the results of the t-test in the MRA analysis in Table 7, the probability value from the moderation test of the political stability variable on the tax expenditure variable regarding foreign direct investment is smaller than the significance level (α), so Hypothesis 4 is accepted. The t-test results show that political stability weakens the effect of tax expenditure on foreign direct investment. Meanwhile, the results of the moderation test for the political stability variable on the regulatory quality and rule of law variables on foreign direct investment are greater than the significance level (α), so Hypotheses 5 and 6 are rejected. The t-test results show that political stability is unable to moderate the effect of regulatory quality and rule of law on foreign direct investment.

## DISCUSSION

### The Effect of Tax Expenditures on Foreign Direct Investment Inflows

The results of the hypothesis testing on the tax expenditure variable indicate that Hypothesis 1 is accepted. Tax expenditure has a significant positive effect on foreign direct investment. The higher the estimated tax expenditure allocated, the greater the foreign direct investment. This finding has important implications for the government, as the regulator, which needs to formulate effective tax expenditure policies and increase the estimated value of tax expenditure to attract foreign direct investment.

The results of this study support the eclectic paradigm theory. According to the eclectic paradigm theory (Dunning & Lundan, 2008), location advantages are one of the aspects that can influence foreign investment. Location advantages are the benefits investors gain when investing in a host country. Tax expenditures are among the location advantages that can attract foreign investment to countries offering tax incentives. Tax expenditures can reduce the cost burden of investment through tax reductions, thereby increasing the rate of return that investors expect. The results of this study are also consistent with studies Yahaya (2026), Bella & Yudianto (2021), and Kusumaningtyas & Kalimanzila (2023) which concluded that tax incentives have a positive and significant effect on increasing the foreign direct investment. The more companies or investors that are granted tax holiday incentives, the higher the inflow of foreign direct investment.

**The Effect of Regulatory Quality on Foreign Direct Investment Inflows**

The results of the hypothesis testing on the regulatory quality variable indicate that Hypothesis 2 is rejected. Regulatory quality has a negative effect on foreign direct investment inflows. What is interesting about the results of the analysis and testing in this study is that the direction of the effect of regulatory quality on foreign direct investment inflows is negative. This contradicts the eclectic paradigm theory, which, in principle, states that high-quality regulation is a factor in a country's ability to attract foreign direct investment. The results of this study also contradict previous research Mirkovikj et al. (2024) and Contractor et al. (2021) which state that regulatory quality has a positive effect on realized foreign direct investment.

Nevertheless, the results of this study are consistent with the findings of Khan et al. (2024) and Nzeh et al. (2024) which concluded that regulatory quality has a negative effect on foreign direct investment. This negative effect indicates the continued existence of institutional barriers that hinder the smooth flow of resources into the economy (Nzeh et al., 2024). This finding is also supported by the study of Drajat (2022), which states that investors seek comfort and ease in conducting their business. Inflexible policies can reduce foreign investors' interest in investing. A study Ahmed et al. (2005) states that regulatory flexibility is essentially a strategy to encourage capital inflows into a country. Although conceptually, higher regulatory quality is expected to enhance investment attractiveness, improvements in regulatory quality may be accompanied by the implementation of stricter standards, administrative requirements, and compliance mechanisms. These conditions have the potential to increase the compliance costs borne by foreign investors, thereby reducing investment attractiveness, particularly for companies focused on cost efficiency. Therefore, the government needs to evaluate the quality of each regulation to ensure there are no overly strict regulations, convoluted administrative procedures, or requirements that increase compliance costs for foreign investors.

**The Effect of Rule of Law on Foreign Direct Investment Inflows**

The results of the hypothesis testing on the rule of law variable indicate that Hypothesis 3 is accepted. Rule of law has a positive effect on foreign direct investment. These findings support the eclectic paradigm theory (Dunning & Lundan, 2008), which posits that multinational corporations consider location advantages when making foreign direct investment decisions. Research by Islam & Beloucif (2024) also indicates that governance indicators influence foreign direct investment. The quality of a country's governance can be assessed based on rule of law (World Bank, 2025). Effective law enforcement can instill confidence in investors. These findings are also consistent with studies by Drajat (2022) and Akisik (2020), which conclude that rule of law has a positive effect on encouraging foreign investment inflows. High rule of law indicates that the government, as the regulator and administrator of the state, can ensure consistent enforcement of regulations, protection of citizens' rights, and fair and effective dispute resolution, thereby creating an investment climate conducive to foreign direct investment. Conversely, legal uncertainty can impose costs that may reduce investors' interest in investing.

**The Role of Political Stability in Moderating the Effect of Tax Expenditures on Foreign Direct Investment Inflows**

The results of the hypothesis test on the role of political stability as a moderator of the effect of tax expenditures on actual foreign direct investment indicate that Hypothesis 4 is accepted. Political stability weakens the effect of tax expenditures on foreign direct investment. This suggests that the positive effect of tax expenditures on foreign direct investment becomes weaker when accompanied by high political stability.

From the perspective of the eclectic paradigm theory (Dunning & Lundan, 2008), the decisions of multinational corporations are determined by the location advantages of a home country. These location advantages consist of various factors, including tax expenditures and political stability. Investors view tax expenditures as requiring interaction with political stability when making foreign investments.

However, the relationship between the two is not complementary but rather substitutive. A study by Cuervo-Cazurra et al. (2022) found that institutional quality has the potential to serve as a substitute for fiscal incentives in attracting foreign investment. According to World Bank (2025), the quality of governance can be measured, in part, by indicators of political stability. When institutional quality is already at a high level, investors' need for additional compensation through fiscal incentives decreases. In countries with low institutional quality, fiscal incentives are more effective in attracting foreign investment (Cuervo-Cazurra et al., 2022).
Therefore, the government needs to consider that the effectiveness of tax expenditures as a tool for attracting foreign investment depends on the quality of the political climate in each region or during a specific period. In regions or periods where political stability remains fragile, tax incentives can be utilized more strategically as risk compensation to attract investors. Conversely, in politically stable conditions, the government can reassess the magnitude and design of the tax expenditures provided, given that some of these incentives may be redundant and offer marginal benefit in influencing investment decisions.

**The Role of Political Stability in Moderating the Effect of Regulatory Quality on Foreign Direct Investment Inflows**
The results of the hypothesis testing on the variable of political stability in moderating the effect of regulatory quality on foreign direct investment inflows indicate that Hypothesis 5 is rejected. Political stability does not moderate the effect of regulatory quality on foreign direct investment inflows. The eclectic paradigm theory explains that investors evaluate various locational advantages simultaneously. Not all location advantages need to interact in influencing investment decisions. The lack of significance of this moderating effect indicates that political stability is not a variable capable of influencing or altering the relationship between regulatory quality and foreign direct investment. For investors, regulatory quality is viewed as a fundamental, independent indicator. Whether a country's political conditions are stable or not does not significantly alter investors' perceptions regarding foreign direct investment. From the perspective of the eclectic paradigm theory (Dunning & Lundan, 2008), the decisions of multinational companies are determined by location advantages. Regulatory quality and political stability are aspects included in location advantages, and both serve as worldwide governance indicators according to World Bank (2025).

**The Role of Political Stability in Moderating the Effect of Rule of Law on Foreign Direct Investment Inflows**
The results of the hypothesis testing on the variable of political stability in moderating the effect of rule of law on foreign direct investment indicate that Hypothesis 6 is rejected. Political stability does not moderate the effect of rule of law on foreign direct investment. The eclectic paradigm theory explains that investors evaluate various locational advantages simultaneously. Not all locational advantages necessarily interact in influencing investment decisions. The lack of significance of this moderating effect indicates that political stability is not a variable capable of influencing or altering the relationship between rule of law and foreign direct investment. For investors, rule of law is viewed as a fundamental, independent indicator. Whether a country's political conditions are stable or not does not significantly alter investors' perceptions regarding foreign direct investment. From the perspective of the eclectic paradigm theory (Dunning & Lundan, 2008), the decisions of multinational corporations are determined by the location advantages of a home country. Rule of law and political stability are aspects included in location advantages and both serve as worldwide governance indicators according to World Bank (2025).

## CONCLUSIONS
This study examines the effects of tax expenditures, regulatory quality, and rule of law on foreign direct investment inflows, with political stability as a moderating variable, across nine developing OECD

member countries and key partners during the 2016–2022 period. The findings demonstrate that tax expenditures and rule of law have a positive effect on foreign direct investment, while regulatory quality has a negative effect on foreign direct investment. Furthermore, the results of the moderation analysis show that political stability does not moderate the effects of regulatory quality or rule of law on foreign direct investment. Political stability weakens the effect of tax expenditures on foreign direct investment.

## RECOMMENDATIONS

Based on the research findings, the author recommends the government of OECD developing countries to formulate and evaluate the effectiveness of tax expenditure policies for foreign investors in order to increase the realization of foreign direct investment and improve the overall quality of governance by evaluating each regulation and ensuring rule of law regarding those regulations, as well as maintaining political stability.

## RESEARCH LIMITATION AND FUTURE RESEARCH

### RESEARCH LIMITATION

The limitation of this study is the findings cannot be generalized to all countries worldwide. Each country has distinct characteristics in terms of governance, investment climate, and tax policies—particularly regarding tax expenditures. Additionally, the study covers only the period from 2016 to 2022. This period does not fully capture the long-term dynamics of the relationship between tax expenditures, regulatory quality, rule of law, political stability, and foreign direct investment. The decision to use the 2016–2022 period was driven by a data gap after 2022 for the tax expenditure variables of Colombia and Costa Rica.

### FUTURE RESEARCH

It is recommended that future researchers to expand the scope and time period of the study to include all countries worldwide in order to draw comprehensive and thorough conclusions, test and analyze other independent variables to identify additional factors that may serve as sufficient stimuli for the realization of foreign direct investment, and test and analyze other moderating variables that may strengthen or weaken the relationship between macro-institutional factors and tax expenditures on the realization of foreign direct investment.

## REFERENCES


Ahmed, Arezki, R., & Funke, N. (2005). *The Composition of Capital Flows: Is South Africa Different?*

Ahmed, R., Aoyan, S. H., Islam, Md. A., & Khan, S. (2025). Impact of tax incentives on tax revenue, GDP, and foreign direct investment: A study on the Bangladesh economy. *Journal of Business*, *10*(03), 1–10. https://doi.org/10.18533/journal.v10i3.369

Akisik, O. (2020). The impact of financial development, IFRS, and rule of LAW on foreign investments: A cross-country analysis. *International Review of Economics and Finance*, *69*, 815–838. https://doi.org/10.1016/j.iref.2020.06.015

Bella, M. I., & Yudianto, I. (2021). The Impact of Tax Incentives on Foreign Direct Investment: The Case of Tax Holiday and Corporate Income Tax Rates in Indonesia. *Journal of Accounting Auditing and Business*, *4*(2), 34–48. https://doi.org/10.24198/jaab.v4i2.34397

Contractor, F. J., Nuruzzaman, N., Dangol, R., & Raghunath, S. (2021). How FDI Inflows to Emerging Markets Are Influenced by Country Regulatory Factors: An Exploratory Study. *Journal of International Management*, *27*(1). https://doi.org/10.1016/j.intman.2021.100834

Cuervo-Cazurra, A., Silva-Rêgo, B., & Figueira, A. (2022). Financial and fiscal incentives and inward foreign direct investment: When quality institutions substitute incentives. *Journal of International Business Policy*, *5*(4), 417–443. https://doi.org/10.1057/s42214-021-00130-9

Dewi, N. L. P. K. (2024, February). *Mengenal Tax Expenditure : Belanja Perpajakan yang Menguntungkan Wajib Pajak*. Https://Pajak.Go.Id/Id/Artikel/Mengenal-Tax-Expenditure-Belanja-Perpajakan-Yang-Menguntungkan-Wajib-Pajak.

Direktorat Jenderal Strategi Ekonomi dan Fiskal. (2025). *Laporan Belanja Perpajakan 2024* (Vol. 8). Direktorat Jenderal Strategi Ekonomi dan Fiskal Kementerian Keuangan.

Drajat, E. U. (2022). Pengaruh Kualitas Pemerintahan Terhadap Penanaman Modal Asing. *Jurnal Ekonomi Dan Bisnis*, *11*, 24–34. https://doi.org/10.34308/eqien.v11i1.689

Dunning, J. H., & Lundan, S. M. (2008). *Multinational Enterprises and The Global Economy, Second Edition*. Edward Elgar Publishing Limited.

Fauzan, M., & Rahman, A. (2025). Analisis Dampak Investasi Asing Langsung Terhadap Pertumbuhan Ekonomi dan Kesejahteraan Masyarakat di Negara Berkembang. *Economica Insight*, *2*(1), 1–10. https://doi.org/10.71094/ecoin.v2i1.198

German Institute for Development and Sustainability (IDOS) & Council on Economic Policies (CEP). (2025, October 10). *Global Tax Expenditures Database: Version 1.3.2*. Https://Gted.Taxexpenditures.Org/.

Gujarati, D. N., & Porter, D. C. (2009). *Basic Econometrics Fifth Edition* (5th ed.). McGraw-Hill Irwin.

International Monetary Fund. (2023, April). *World Economic Outlook Database Groups and Aggregates Information*. Https://Www.Imf.Org/En/Publications/Weo/Weo-Database/2023/April/Groups-and-Aggregates.

Islam, & Beloucif, A. (2024). Determinants of Foreign Direct Investment: A Systematic Review of the Empirical Studies. *Foreign Trade Review*, *59*(2), 309–337. https://doi.org/10.1177/00157325231158846

Jones, J., Serwicka, I., & Wren, C. (2020). Motives for foreign direct investment location in Europe and EU enlargement. *Environment and Planning A*, *52*(8), 1681–1699. https://doi.org/10.1177/0308518X20916503

Khan, H., Dong, Y., Bibi, R., & Khan, I. (2024). Institutional Quality and Foreign Direct Investment: Global Evidence. *Journal of the Knowledge Economy*, *15*(3), 10547–10591. https://doi.org/10.1007/s13132-023-01508-1

Kusumaningtyas, R. O., & Kalimanzila, J. (2023). The Impact of Tax Incentive on Increase Foreign Direct Investment. *Journal of Sustainable Development and Regulatory Issues*, *1*(2), 51–63. https://doi.org/10.53955/JSDERI.20xx.xxxx

Le, D. K. (2025). Institutional Factors and FDI Inflows in ASEAN-7: A Bayesian Approach. *Journal of ASEAN Studies*, *13*(1), 55–86. https://doi.org/10.21512/jas.v13i1.12399

Mihaylova, S. (2020). Foreign direct investment attractiveness of central, eastern, and southeastern european countries: The importance of policy-related location advantages. *Croatian Economic Survey*, *22*(1), 65–101. https://doi.org/10.15179/ces.22.1.3

Mirkovikj, B. K., Gkasis, P., & Golitsis, P. (2024). Regulatory Quality and Foreign Direct Investment: A Case Analysis of North Macedonia. *Theoretical Economics Letters*, *14*(05), 1883–1913. https://doi.org/10.4236/tel.2024.145095

Nzeh, I. C., Okoli, U. V., Ozoh, J. N., & Ezenwob, F. N. (2024). Regulatory Quality, Rule of Law and Foreign Direct Investment Inflows: Evidence from the Economic Community of West African States. *International Journal of Finance, Economics and Business*, *3*(1), 10–23. https://doi.org/10.56225/ijfeb.v3i1.282

OECD. (2010). *Tax Expenditure in OECD Countries*.

Paul, J., & Feliciano-Cestero, M. M. (2021). Five decades of research on foreign direct investment by MNEs: An overview and research agenda. *Journal of Business Research*, *124*, 800–812. https://doi.org/10.1016/j.jbusres.2020.04.017

Saha, S., Sadekin, M. N., & Saha, S. K. (2022). Effects of institutional quality on foreign direct investment inflow in lower-middle income countries. *Heliyon*, *8*(10). https://doi.org/10.1016/j.heliyon.2022.e10828

Siregar, R. A., & Patunru, A. (2021). The Impact of Tax Incentives on Foreign Direct Investment in Indonesia. *Journal of Accounting Auditing and Business*, *4*(1), 66–80. https://doi.org/10.24198/jaab.v4i1.30629

Vasilyeva, R. I., & Mariev, O. S. (2021). Determinants of Foreign Direct Investment in Developed and Developing Countries: Impact of Political Stability. *Economy of Regions*, *17*(4), 1390–1404. https://doi.org/10.17059/EKON.REG.2021-4-24

World Bank. (2025). *The Worldwide Governance Indicators: Revised Methodology for Measuring Governance Using Perception Data*.

World Bank. (2026, April 10). *Foreign direct investment, net inflows (BoP, current US$)*. Https://Data.Worldbank.Org/Indicator/BX.KLT.DINV.CD.WD.

Yahaya, O. A. (2026). Tax Incentives and Foreign Direct Investment Inflows in Nigeria: A Time Series Analysis. *International Journal of Economics, Public Finance, and Development Studies*, *21*(02), 119–151. https://dx.doi/10819/ijepfds.2026.v21.i2.119