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# Developing Trust, Developing Economies: The Role of ESG Disclosure in Attracting Foreign Investment

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## ABSTRACT

Legitimacy theory posits that organizations strive to align with societal expectations to gain advantages, yet its focus has primarily been at the company level. The **purpose** of the study is to investigate the global applicability of legitimacy theory by examining the relationship between Environmental, Social, and Governance (ESG) disclosures and Foreign Direct Investment (FDI). In particular, the study sets the **task**: analyze the impact of ESG disclosures on FDI across twenty-eight countries; compare the ESG performance of different nations; and explore the role of regional ESG standards in influencing ESG performance and FDI. The application of the Kruskal-Wallis test revealed the dominant position of Western nations with developed ESG standards. The Bonferroni adjustment post hoc test on World Bank data indicated that countries with well-developed ESG standards act as global investors, trusting the high standards of rapidly improving Western regions. Statistical tests confirmed that countries in the developing stage, with values somewhat similar to the most developed areas, present attractive alternatives for foreign investors. However, the lack of standardized norms hinders the establishment of trustworthy economic relationships. These findings suggest that just as businesses use Corporate Social Responsibility (CSR) to gain legitimacy, countries can adopt ESG practices to align with global norms and attract FDI. Although this transition may be time-consuming, developing regional ESG disclosure norms could serve as an effective stepping stone.

**Keywords:** ESG disclosure; foreign direct investment; legitimacy theory; non-financial report; green finance; development

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## ОРИГИНАЛЬНАЯ СТАТЬЯ

# Развивая доверие, развиваются экономики: роль раскрытия информации по ESG в привлечении иностранных инвестиций

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## АННОТАЦИЯ

Теория легитимности утверждает, что организации стремятся соответствовать общественным ожиданиям для получения преимуществ, однако ее внимание сосредоточено в основном на уровне компаний. Цель данной работы — исследовать глобальную применимость теории легитимности путем изучения взаимосвязи между раскрытием информации об экологических, социальных и управленческих аспектах (ESG) и прямыми иностранными инвестициями (ПИИ). В частности, в исследовании ставится задача: проанализировать влияние раскрытия информации ESG на ПИИ в 28 странах; сравнить ESG-показатели различных стран; изучить роль региональных стандартов ESG во влиянии на ESG-показатели и ПИИ. Применение теста Крускала-Уоллиса выявило доминирующее положение западных стран с развитыми стандартами ESG. Тест post hoc с поправкой Бонферрони на данные Всемирного банка показал, что страны с хорошо развитыми стандартами ESG выступают в роли глобальных инвесторов, доверяя высоким стандартам быстро развивающихся западных регионов. Статистические тесты подтвердили, что страны, находящиеся на стадии развития, с показателями, несколько схожими с наиболее развитыми регионами, представляют собой привлекательные альтернативы для иностранных инвесторов. Однако отсутствие стандартизированных норм

препятствует установлению доверительных экономических отношений. Эти выводы позволяют предположить, что подобно тому, как бизнес использует корпоративную социальную ответственность (КСО) для обретения легитимности, страны могут применять практики ESG, чтобы соответствовать глобальным нормам и привлекать ПИИ. Хотя этот переход может занять много времени, разработка региональных норм раскрытия информации по ESG может стать эффективной отправной точкой.

**Ключевые слова:** раскрытие информации о ESG; прямые иностранные инвестиции; теория легитимности; нефинансовая отчетность; зеленое финансирование; развитие

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## INTRODUCTION

Building trust is crucial for developing economies. ESG (Environmental, Social, Governance) practices play a central role in this process. Strong ESG disclosure reflects commitment to operating ethically and sustainably, fostering trust, and attracting investment. Investors may be more likely to invest in countries with strong ESG practices due to factors such as reduced environmental risk, strong labor practices, and a stable political climate. The concept of non-financial reporting is based on the idea, that traditional financial statements alone do not provide a comprehensive insight into a company's operation. As businesses broaden their influence and border, demand grows for more comprehensive and transparent information about their non-financial performance. The interconnections and globalization further raised the need for a "standardized report". ESG has become a cornerstone of ethical business practices over the past twenty years. With roots in ancient Chinese ethics, the concept was convened by the United Nations (U.N.) in 2004 to promote ethical investment [1, 2].

In 2006, the U.N. initiated the Principles for Responsible Investment (PRI) to help investors integrate ESG considerations into their strategies.<sup>1</sup> The differences in the regulatory frameworks [3–5], cultural norms [6, 7] and even the stage of economic development [8, 9] hinder the standardization of such non-financial reports. Just like financial reports, non-financial reports face manipulation too.<sup>2</sup> The lack of guidelines, audits, and international controlling bodies also set back the unification of the ESG disclosure [10–12]. Despite these shortcomings, according to Deloitte (2020),<sup>3</sup> the share of nonfinancial sustainability reporting within the S&P 500 companies from 2011 to

2018 turned around, making these disclosures widely used. In 2022, 98% of these companies reported ESG information,<sup>4</sup> demonstrating its widespread acceptance and mainstream status.

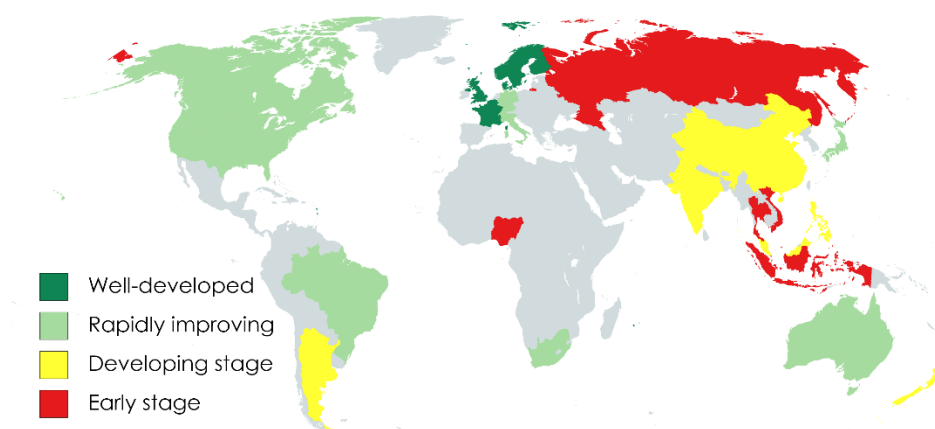
The concept of ESG disclosure has been extensively researched and applied. Many studies analyzed the influence of a solo factor or the whole ESG disclosure on the firm performance [13–15]. Single-industry or country-focused investigations are also widely published [16, 17]. However, the ESG disclosure's differentiating roles on the global level, especially the focus on FDI patterns, has received relatively less attention. This is where the legitimacy theory could become relevant. It posits that organizations seek to align their actions with societal norms, values, and expectations to maintain their legitimacy [18]. This theory suggests that businesses engage in activities such as Corporate Social Responsibility (CSR) to appear responsible and ethical, thereby securing their acceptance and approval from stakeholders and the broader society. Extending legitimacy theory to the international level is relevant because just as businesses use CSR to gain legitimacy, countries can also use ESG practices to align with global norms, thereby attracting foreign investment. By implementing strong ESG disclosure practices, countries can increase transparency regarding their environmental, social, and governance practices, enhancing their legitimacy in the eyes of international investors who value responsible business conduct. This broader application of legitimacy theory underscores that investors find those countries more credible and reliable, which demonstrate strong ESG commitments, similar to how they view individual companies with robust CSR practices. To analyze the hypothetical patterns, first, publications related to the ESG disclosure were reviewed. Then the research database and the applied methodologies are presented. This section is followed by the statistical tests used to compare FDI flows between countries with different

<sup>1</sup> United Nations. Who Cares Wins. 2004.

<sup>2</sup> PRI Association. PRI Reporting Framework Main definitions. 2018.

<sup>3</sup> Deloitte. #DeloitteESGnow — Sustainability Disclosure Goes Mainstream. 2020.

<sup>4</sup> Center for Audit Quality. S&P 500 ESG Reporting and Assurance Analysis.



**Fig. 1. The Analyzed Countries**

Source: Compiled the authors 2024, based on [9].

levels of development in terms of ESG disclosure. The here highlighted findings are particularly significant for the least developed countries and their businesses. The final section contains recommendations and possible actions for development addressed to the above-mentioned actors.

## MATERIALS AND METHODS

To analyze the ESG disclosure potential effect on the FDI, an international ESG disclosure framework was sought. Organizations such as the World Bank and the International Monetary Fund, typically aggregate and analyze ESG data based on a broad range of economic and developmental indicators. These classifications often reflect a country's overall economic status and development level, incorporating data from multiple sources, including self-reported information by the countries themselves. In contrast, the involved study employs a specific framework focused exclusively on the analysis of ESG regulations. This framework uses a structured and objective scoring system to assess the implementation and rigor of ESG practices across different countries. This methodology is designed to provide an unbiased comparison based on well-defined principles and criteria specifically related to ESG factors. This approach allows for a detailed and nuanced understanding of how countries perform in terms of ESG practices, which is particularly relevant for evaluating their attractiveness for FDI.

The work of [9] benchmarked thirty ESG regulations across twenty-eight countries worldwide. The research employed external and practical benchmarking techniques to assess the involved countries according to their ESG regulations. Data on practices and regulations related to ESG factors were gathered from various global sources. Each category was limited to ten regulations for benchmarking purposes. For quantifying

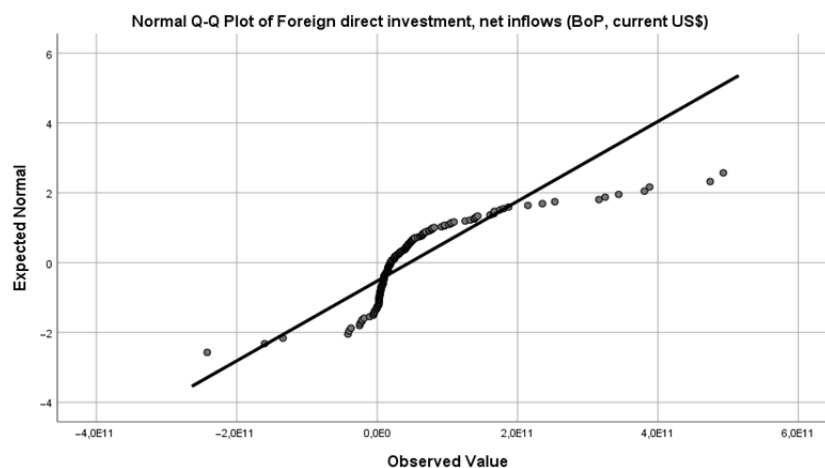
ESG scores, the researchers analyzed the implemented regulations across all countries and assigned scores to each regulation based on its implementation level: three points for fully implemented or mandatory regulations, two points for partially implemented or voluntary regulations, one point for regulations under consideration or forthcoming, and zero points for regulations that were absent. According to this scoring method, the highest achievable score across the three factors was determined to be ninety points, reflecting comprehensive ESG performance. Country scores were calculated by summing the scores of all regulations within the ESG framework. Finally, an overall ESG score was computed by averaging the individual scores of each category (the countries studied are shown in Table in the Appendix.)

The studied countries were divided into four groups (Well-developed, Rapidly improving, Developing stage, Early stage, where the Well-developed countries are the most developed, and the Early stage countries are the least developed) based on the obtained points, which are a measure of their ESG development. The studied nations' geographical location and their final clusters are presented in Fig. 1.

To quantify the net inflows of FDI (BoP, current US\$) the World Bank database was used.<sup>5</sup> Considering the SDGs were adopted in 2016, the current work involved the relevant data for the period 2016–2022 (the UK should be considered a pre-Brexit EU member, given that it was a member for a larger part of the period under review than not a member).

This short time frame could be one of the limitations. The study is based on secondary data that deals with a limited number of countries, in addition, not ESG disclosure is the only factor that can affect the FDI. In

<sup>5</sup> World Bank. DataBank 2024.



**Fig. 2. The distribution of FDI**

Source: Compiled the authors, 2024.

the last years, some extraordinary cases like pandemics, war, and sanctions further complicated the global situation and could distort the outcomes too.

Considering the characteristics of the dataset, Shapiro-Wilk and the Kolmogorov-Smirnov test were run to study the distribution of the variables. These methods were used before running the one-way ANOVA test to check that the conditions were met. The Kolmogorov-Smirnov test is a nonparametric statistical test [19]. It is used to assess whether two populations have the same distribution. The test compares the empirical distribution functions of the samples. This function represents the probability that a random variable from the population will be less than or equal to a given value [20]. The Kolmogorov-Smirnov test defines D-statistic, which is the maximum absolute difference between the two empirical distributions' functions. If the D value is high, then the null hypothesis has to be rejected, which means the two populations do not have the same distribution [21]. The Shapiro-Wilk test similar to the previous one could be used to define the distribution of the studied variables [22]. It is ideal to test a variety of data types. Since it is a nonparametric test, it does not have any assumptions related to the distributions of the studied variables [23]. The Shapiro-Wilk test is generally considered to be a more powerful test of normality than the Kolmogorov-Smirnov. Because it is more likely to correctly identify samples that are not normally distributed [24]. Since both of the tests rejected the normal distribution of the dataset, the prerequisites for one-way ANOVA were not fulfilled. The nonparametric alternative of the Kruskal-Wallis test can be used to compare the medians of two or more independent samples [25]. However, compared to the one-way ANOVA, it does not

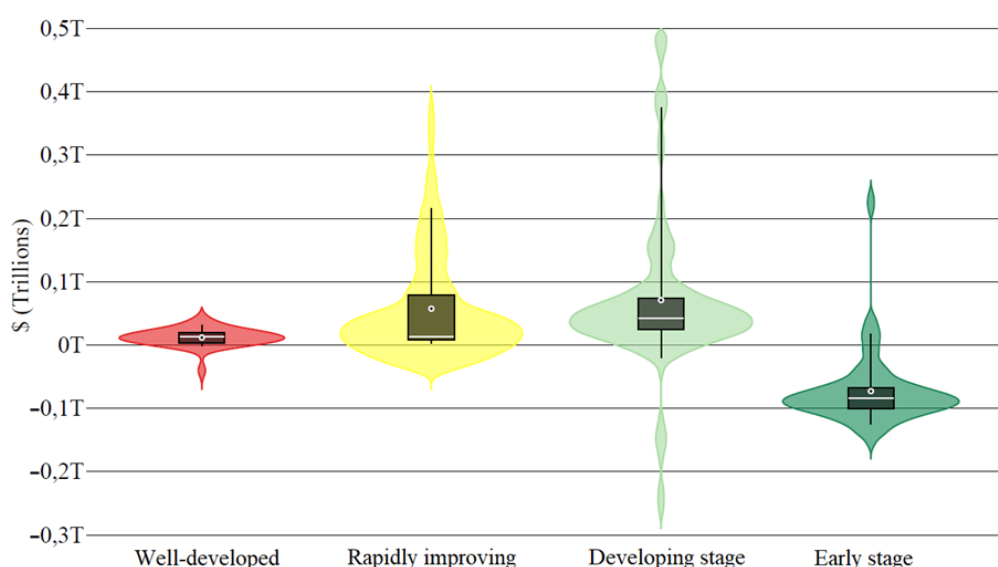
require the normal distribution of the dataset. It can identify the dissimilarities between the samples but cannot indicate the place of them [26]. A Bonferroni adjustment post hoc test was run to point out from the pairwise comparison which groups differ from each other significantly [27]. This method applies adjusted p-values from multiple pairwise comparisons to control the family-wise error rate (FWER). So it is less likely to reject the null hypothesis when it is false [28]. After the differences between the groups are highlighted, the magnitudes of them get studied. For this, Cohen's d test was involved. It quantifies the effect size of a between-group comparison, so we can gain a clearer understanding of the true depth of the differences between the studied cases. The larger its value, the larger the contrast between the groups [29]. It is important to choose the correct form of Cohen's d since it is sensitive to the differences in the standard deviations [30]. To take the right one, we examined the homogeneity of variances by Levene's test. Since it revealed the lack of homogeneity, for the quantification of differences, Cohen's d for Two-Sample with Unequal SD was used [31].

## RESULTS AND DISCUSSION

To identify the potential differences within the clusters, one-way ANOVA could have been applied. However, the necessary prerequisites for the test were not met. Both the Shapiro-Wilk test and the Kolmogorov-Smirnov test indicate that the dataset does not fit a normal distribution, as shown in Fig. 2.

The Kruskal-Wallis test seemed to be the proper nonparametric alternative to the one-way ANOVA since it is not so sensitive to violations of normality. At first,





**Fig. 3. The FDI's Distribution Across the Studied Groups**

Source: Compiled the authors, 2024.

the dataset suitability for this statistical analysis was checked. The scale FDI and the ordinal ESG disclosure variables could be analyzed with it because they fulfill the variables-related requirements of the test. The independence of the group members is also provided. Even though the Q-Q plots have shown some outliers in the dataset, they are valid data points and not errors in the data collection or measurement process.

Based on the Kruskal-Wallis test, we had to reject the null hypothesis, so the distribution of FDI is not the same across the studied groups. *Figure 3* presents the difference in the FDI's distribution within the analyzed clusters. Considering only the violin plots, there is a high probability of differences between the clusters studied.

To identify the statistically significant differences between the four groups, the Bonferroni adjustment post hoc test was applied. It is a conservative adjustment that is less likely to reject the true null hypotheses. The result of the pairwise comparison is presented in *Table*.

The addressed method pointed out differences between the Early stage and Developing stage, Early stage and Rapidly improving in addition to the Well-developed and Rapidly improving nations. The revealed contrasts between the Early stage and Developing stage, Rapidly improving countries reflect the wide gaps regarding the received FDIs, which are probably caused by the different levels of ESG disclosure. In light of these results, it can be argued that even a low level of development also significantly increases the received FDI. The differences highlighted between the two most developed clusters by the Bonferroni adjustment

post hoc test indicate a relevant matter. Even though significant dissimilarities were defined by the test, it cannot be used to measure their magnitude. For this purpose, Cohen's d for Two-Sample with Unequal SD was involved in the research. It has to do so because the use of Levene's test for examining the homogeneity of variances highlighted that the samples are not homogenous. The applied Cohen's d made possible the quantification of the standardized difference between the means. The explored dissimilarities were major in each case. Between the Early stage and Developing stage countries was the highest (0.81), which supports the significant difference between their FDI. The contrast was relatively similar between the Early stage and Rapidly improving regions too. Even though the outliers of the Rapidly improving countries, the difference between the two most developed groups indicated by the high Cohen's d value reflects, that the investor role is definitely played by the well-developed nations.

The findings revealing substantial differences between developed and least developed countries align with several studies that have shown a positive relationship between non-financial disclosure and investor sentiment. According to [32] and [33], investors are inclined to invest in countries and companies demonstrating a commitment to sustainability. Some studies, however, highlight the limited impact of ESG disclosure. For instance, the research of [34] indicates that ESG press releases have an insignificant effect on investors, likening their reaction to routine portfolio rebalancing activities. Conversely, the study of [35] examined the added value of extended ESG disclosure,

The Bonferroni Adjustment Post Hoc Test of the Defined Groups

Pairwise comparisons of group					
Sample 1 – Sample 2	Test Statistic	Std. Error	Std. Test Statistic	Sig.	Adj. Sig.
Early stage – Well-developed	-11.718	12.554	-0.933	0.351	1.000
Early stage – Developing stage	33.167	12.554	2.642	0.008	0.049
Early stage – Rapidly improving	-55.356	11.959	-4.629	0.000	0.000
Well-developed – Developing stage	21.449	11.46	1.872	0.061	0.368
Well-developed – Rapidly improving	43.637	10.805	4.039	0.000	0.000
Developing stage – Rapidly improving	-22.188	10.805	-2.054	0.04	0.24

Source: Compiled the authors, 2024.

specifically looking at the implementation of the EU directive in Italy. This research found that the new element did not provide value-relevant information for investors. It is worth noting that these latter studies focused on well-developed disclosures rather than the mere existence or basic aspects of such reports.

As it is seen, the direct relationship between the ESG disclosure and FDI has not been widely studied. It stresses the novel approach of the research but also hinders putting the results into scientific context. However, the main and subfactors of ESG are broadly researched at the business level. Probably some of these could have an impact on investors' decisions at a higher level too. The political environment is one of the most obvious factors that can be considered by investors [36, 37]. The stable governance and clear regulations build trust and encourage transparency [38, 39]. The economic growth and the development of infrastructure as partial results of the local economic policy could impact the decision-making of the investors too [40, 41]. Taxation is an important issue in all cases, not just for investment [42, 43]. Strong human capital and fair labor practices are key considerations, which can attract green investors [44, 45]. However, the various local norms and business practices could be considered as relevant factors too [46, 47]. The pandemic, running

armed conflicts, and restrictions also can influence the assessment of potential investments [48–53].

Although ESG disclosure is very popular and comprehensively studied, the extension of the legitimacy theory has not been applied to analyze the potential impact of the ESG framework's development on FDI. The current study confirmed that this firm-level approach could be seen at the country level. Within the group of countries studied, it's important to consider the specific role of the European Union member states. These countries share similar values and norms. In addition, the pressure caused by the Green Deal could lead more investors to prefer alternatives from this region. Even countries with less developed regulations can become potential targets for investors in the hope of higher profits. However, those companies located in areas with low ESG standards are generally not preferred by investors. To avoid the investment gap deepening further, the least developed countries' ESG regulations should adapt the Western practices. Notwithstanding, often the less developed nations belong to economic communities (out of the EU), e.g., the Eurasian Economic Union, following higher standards could open new markets for them. Through the adaptation, the governments could enhance the regional and international competitiveness of their

companies. The existence of a standardized ESG disclosure could significantly facilitate the situation of the least developed regions. However, with the current circumstances, the change in the local regulation could take time, so it might be worth it for the companies to go beyond the local standards to enhance their international competitiveness, even though this shift could be costly.

## CONCLUSION

Building trust in business is a priority, especially when partners with diverse norms are involved. As the geographical distance increases, the differences are also likely to grow. In many countries, demonstrating commitment to sustainable development is regulated by the law. While in other regions it is not so. Even though international endeavors for sustainability have an impact on the financial sector too, where green investment gains increasing attention. Through the extension of the legitimacy theory, the work proved, that the enterprise-level approach is applicable at a higher scale. Similar to how businesses leverage CSR to establish legitimacy, countries can implement ESG practices to conform to global standards and attract FDI. The findings revealed significant disparities between the studied groups, aligning with the official

theory. The results highlighted the importance of ESG practices in influencing investment patterns. The leading position of the developed Western countries is unambiguous, but the gap between the countries in their Developing and Early stages is huge. It suggests that the continued rise of green finance could further crowd out firms located in narrowing regions from international investments. The lack of global standards could further deepen the inequalities. To address these concerns, exploring regional ESG disclosure norms as a stepping stone to international ones could be a valuable path forward. While the development of international standards may take time, businesses in less developed economies can take proactive steps to enhance their ESG disclosure practices. By adopting the good ESG practices of the developed Western countries and actively engaging with regional sustainability initiatives, these companies can demonstrate their commitment to responsible growth and attract the attention of foreign investors. As the demand for ESG transparency continues to rise, proactive businesses have the opportunity to become pioneers in their regions, paving the way for a more sustainable and prosperous future. The upcoming works could discover the feasibility of developing regional ESG disclosure norms.

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Appendix

Table

The Analyzed Countries' Classification

Well-developed	Rapidly improving	Developing stage	Early stage
Belgium	Australia	Argentina	Indonesia
Denmark	Brazil	China	Nigeria
Finland	Canada	India	Russia
France	Germany	Malaysia	Thailand
Norway	Italy	New Zealand	Vietnam
Sweden	Japan	Philippines	
UK	South Africa	Singapore	
	Switzerland		
	USA		

Source: Compiled the authors, based on [20].

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