

**Does Institutional Development attract Foreign Direct Investments in Sub-Saharan Africa?  
A Dynamic Panel Analysis**

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**Abstract**

This study focuses on institutional development in 45 sub-Saharan African countries as an integral part towards attracting FDI in the region. To control endogeneity of variables, the study used the system Generalized Method of Moment (GMM) estimator for the data collected from 1986 to 2015. Institutional development is represented by six governance proxies (i.e. Voice and accountability, regulatory quality, rule of law, political stability and absence of violence, corruption, and government effectiveness). The findings show that only the rule of law and government effectiveness (i.e. institutional development) indicators have positive and statistically significant effects in attracting FDI inflows in sub-Saharan Africa. Further, trade openness and market size continue to play a strong and major impact in sub-Saharan Africa's ability to attract FDI inflows. Institutional Theory and Institutional FDI Fitness Theory are also supported by the study's findings. The study suggests that the region should maintain a high level of rule of law and government effectiveness in order to continue attracting FDI inflows.

**Keywords:** FDI; Institutions development; GMM

**JEL Classification Codes:** F35, B23, C01, C23

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## **1. Introduction**

Investors assess the investment environment before and after making an investment decision (Bartels et al., 2009). In order to build an investment environment, one must consider the composition of institutions that govern investors as well as the investors' behavior. Services such as protecting property rights and enforcing contracts, provided by government agencies, tend to foster market expansion and attract investors as a result of their credibility. According to Rodrik (2008) and Dixit (2009), these activities assist to generate order, lower production costs and uncertainty in the business environment. This provides an atmosphere conducive to market functioning and ensures the reliability and safety of foreign investors in a country. Another factor that may impede FDI growth is institutional flaws linked to sudden changes to rules and regulations as well as inefficiency in public administration (Kersan-Škabic, 2013).

The level of institutional development of a country is determined by the effectiveness of these institutions and its enforcement of the rules and regulations that have been established. For instance, according to Yeboua (2020), institutional development is essential for attracting foreign direct investment (FDI) inflows that facilitate the development and long-term growth of the host country. Burdekin & Langdana (2015) pointed out that most African countries are in the process of developing and need capital to pursue investment opportunities that will lead to economic growth. When it comes to attracting FDI, Khondoke and Kaliappa (2010) pointed out that developing countries have a low rate of domestic saving and a high demand for investment. Thus, there is a clear need to increase domestic savings and investment that can expand the economy and reduce poverty level (Ajayi, 2006).

There are different reasons for studying the effect of institutional development on foreign direct investment (FDI) in sub-Saharan Africa (SSA) countries. First, businesses in developing countries have seen a dramatic shift in business environment since the 1980s as a result of technology transfer and market liberalization (Ullah and Khan, 2017). Changes in policy in developing countries, such as liberalization, ease of doing business, and regulation of foreign direct investment, also contributed to this shift. Second, the level of FDI in developing countries began to rise as these changes were designed to provide favorable environment for foreign and domestic investors. For Sub-Saharan Africa, for instance, there were US\$11 billion worth of FDI in 2001, and US\$36 billion in 2006, due to the availability of opportunities such as natural resources, and rapidly growing economies (Bartels et al., 2009). Angola, Mozambique, Nigeria, and Ghana were the leading recipients of FDI in 2015, accounting for 43 percent of total FDI directed in the SSA region (Rodríguez-Posea and Colsb, 2017). Third, during the year 2019, the region experienced a decrease of 10% of FDI to US\$ 32 billion caused by a decrease in investment flows in South Africa, Nigeria, and Ethiopia (UNCTAD, 2020). Fourth, most developing countries continue to receive insufficient FDI, limiting their ability to accelerate economic development (Neise et al., 2021). Fifth, it has been suggested that a weak institutional framework in developing countries, especially the SSA, and the existence of political and economic risks are some of the reasons for the decline in FDI (See, Ezeoha and Cattaneo, 2011). Further, it has been suggested by Alfaro *et al* (2008) that countries with poor institutional quality are more likely to attract slower capital flows from developed countries. Lastly, SSA has remained the least recipient region of global FDI share. To this end, our study will address the question why some countries can attract large amounts of foreign direct investment (FDI) while others cannot. Therefore, using the system GMM

estimator, this study fills a gap in the literature by assessing the influence of institutional development on FDI in the sub-Saharan Africa countries (SSA).

Our preliminary results show that rule of law and government effectiveness (i.e. institutional development) have positive and statistically significant effect in attracting FDI inflows in sub-Saharan Africa countries from 1986 to 2015. Further, trade openness and market size continue to play a strong and major impact in sub-Saharan Africa's ability to attract FDI inflows.

The rest of the paper is organized as follows: Section 2 examines the theoretical and empirical literature; section 3 examines the methodology and data sources; section 4 deals with result and discussion while the final section concludes.

## **2. Literature Review**

### **2.1 Institutional theory**

To better understand the role that institutions play in attracting foreign direct investment, institutions theory was developed. In Central and Eastern Europe, the transition to a market economy had resulted in this. The theory begins by stating that firms normally operate in a complex, uncertain environment. Foreign investments may be affected by institutional forces within a location if firms are likely to reduce uncertainty on their operations.

Government regulations and incentives have an impact on foreign investment decisions, as they may affect their strategies and performance on international markets (Assuncao *et al.*, 2011). As institutions influence social development, economic openness, and state of economic development, and portray the type of governance regulators in the economy, their importance has risen (Popovici, 2014). Assuncao *et al.* (2011) suggested that, attracting foreign direct investment is a competition between governments, in which both foreign investors and governments are participants, and foreign investment is a game they play. It has also been noted that developed and developing countries are increasingly competing for foreign direct investment (FDI). Governments and states are responsible for creating an enabling environment for investors. Musonera *et al.* (2014) cite this as the role of the state in attracting economic development. To attract FDI, each government develops policies, such as favorable tax policies, subsidies and financial and fiscal incentives such as lowering corporate taxes and free tariff incentives (Faeth, 2009). Once there is quality in institutions, policy formulation and institutional quality should be the key predictors of FDI (Kinoshita and Campos, 2006). Economic growth, economic openness, and governance style are all influenced by institutional development, which is necessary for a country to attract foreign investors (Dunning and Lundan, 2008).

### **2.2 Institutional FDI fitness**

"Theory" of institutional FDI fitness developed by Wilhelms and Witter (1998) focused on governments' responsibilities in undertaking economic measures and having public policies that foster an environment that encourages foreign investment. For instance, a country's ability to attract, absorb, and retain foreign investments is based on its ability to create an environment that attracts investors when their requirements and expectations are met (Makoni, 2015). Musonera *et al.* (2014) viewed institutional fitness as a product of political environment, financial, and economic factors. Government stability, democratic accountability, socioeconomic conditions, investment profile, internal and external conflict, government corruption, and the rule of law all influence a country's political climate while financial factors include foreign debt and foreign debt

services, liquidity and exchange rate stability (Musonera et al., 2014). A majority of vast literature has shown contradictory and inconsistent findings between institutional variables and FDI inflows. For instance, institutional variables and FDI inflows can have a positive association (See, Globerman and Shapiro, 2002; Jadhav, 2012; Dang, 2013; Yang and Zhang, 2015). However, some research such as (Subasat and Bellos, 2011; Pourshahabi et al., 2011; and Demir, 2016) all showed that there is a negative and insignificant relationship between institutional variables and FDI inflows.

### **3. Methodology and Data Sources**

The study included 45 countries within SSA (sub-Saharan African) region from 1986 to 2015. Data were extracted from International sources such as the World Development Indicators (2017) published by the World Bank and World Governance Indicators. The study's time duration was decided by the availability of data since governance data are only available up to 2015. Likewise, during the 1980s various countries within SSA region implemented various reforms to attract foreign investors. Reforms such as privatization, development of policies, economic liberalization, the establishment of government investment agencies, and offering tax holidays were implemented to attract foreign investment. Six governance proxies were used to represent institutional development in the study area with indices ranging from -2.5 (weak) to 2.5 (strong). All six governance proxies were obtained from World Governance Indicators (<https://datacatalog.worldbank.org/dataset/worldwide-governance-indicators>). These include Voice and Accountability (VAC), Regulatory Quality (REQUAL), Rule of Law (ROL), Political stability and Absence of violence (PSAV), Level of Corruption (CORR), and Government effectiveness (GEFF) as explanatory variables affecting dependent variable FDI. The study's control variables were the GDP and the trade openness sourced from World Bank Development Indicators (2017).

To explain the effect of institutional development on attracting FDI, we applied an unbalanced panel regression model, using six governance indicators. Economic indicators such as trade openness and GDP per capita were used as control variables. However, due to large number of countries (N= 45) and the small time period (T=30) the system GMM (Generalized Method of Moments), was used to control endogeneity of variables (See, Kinyondo *et al.*, 2021; Byaro, 2021a, Byaro and Mpetta, 2021c; Byaro et al., 2021d). The following model was used:

$$LFDI_{i,t} = \alpha_0 + x_1LFDI_{i,t-1} + x_2LGDP_{i,t} + x_3LOPEN_{i,t} + x_4Insti_{i,t} + \varepsilon_{i,t} \quad (1)$$

Where

$LGDP_{i,t}$  = Natural logarithm of GDP

$LGDP_{i,t-1}$  = Natural log of one period lagged value of GDP

$LOPEN_{i,t}$  = Natural log of trade openness

$LFDI_{i,t}$  = Natural log of Foreign Direct Investment

$Insti_{i,t}$  = Rule of law, governess effectiveness, political stability, control of corruption, regulatory quality and voice and accountability.

$x$  = Estimated coefficient of parameters

$\alpha_0$  = intercept

$\varepsilon_{i,t}$  = Idiosyncratic error (error term for country  $i$  and time  $t$ ) obtained by

$\varepsilon_{i,t} = u_i + \gamma_t$ , where  $\gamma_t$  = time specific fixed effects,  $\mu_i$  = is the country specific fixed effects constant in time

$i = 1, \dots, N$  (Countries),  $t = 1, \dots, T$  (time)

Given that countries have different legal origins, types of laws and economic development levels, institutional variables have been proposed by Buchanan *et al.* (2012) as endogenous variables. Therefore the system Generalized Method of Moment (GMM) was used in this analysis for two main reasons. First, to eliminate the specific fixed effects for countries ( $\mu_i$ ) and overcome the endogenous of variables by using instrumental approach as proposed by Roodman (2009); Kinyondo *et al.* (2021) and Byaro *et al.* (2021d). The second reason is that the system GMM can handle dynamism between institutional quality and FDI as literature has confirmed that they have bilateral relationship. The high correlation between institutional indicators led us to treat each institutional indicator in sub-Saharan Africa in a separate model while controlling for GDP and trade openness in order to avoid multicollinearity (multiple correlation). The validity of instruments used in GMM was checked and assessed using Hansen Test as suggested by Hansen (1982) where the p-value required should be greater than 10 percent to conclude that the instruments are orthogonal to errors (statistically independent from errors). We employed the Roodmans' (2009) estimator *xtabond2* and applied the collapse command to ensure that the number of instruments does not exceed the the number of countries (See, Byaro , 2021a; Byaro *et al.*, 2021d).

#### 4. Results and Discussion

All institutional indicators show that SSA countries are poorly perceived in terms of institutional development as Voice and Accountability (VAC), Rule of Law (ROL), Government effectiveness (GEFF), Political stability and Absence of violence (PSAV), and Regulatory quality (REQUAL) are all having a minimum of above negative 2 indices. In terms of control of corruption, countries within SSA show a great improvement as it has a lower mean index (-1.87) as compared to the other institutional indicators as indicated in Table 1. Overall, the summary statistics concerning institutional development structures in SSA is poor as all the indicators have shown to have means values below the midpoint of the ranges signaling that institutional development is still perceived to be low by foreign investors.

**Table 1: Summary statistics of Institutional variables**

Variable	Mean	Standard Deviation	Minimum	Maximum
VAC	-0.632	0.710	-2.23	1.01
ROL	-0.747	0.663	-2.45	1.08
CORR	-0.663	0.591	-1.87	1.22
GEFF	-0.770	0.638	-2.45	1.28
PSAV	-0.552	0.881	-2.49	1.2
REQUAL	-0.696	0.641	-2.45	1.13

Source (Authors computation, 2021).

The results of a correlation analysis between FDI and institutional variables (See Table 2) revealed that FDI is positively correlated with all institutional variables except for Level of corruption, Political stability and Absence of violence. In other words, as corruption and political instability in the region increase, FDI will be hindered. Other institutional variables have a positive relationship with FDI, which means that as the country's institutional development is maintained and developed, it will benefit foreign direct investment by increasing investors' trust in allocating resources and making long-term investment decisions.

**Table 2: Correlation Matrix between FDI and Institutional Variables**

<b>Variables</b>	<b>FDI</b>	<b>VAC</b>	<b>ROL</b>	<b>CORR</b>	<b>GEFF</b>	<b>PSAV</b>	<b>REQUAL</b>
<b>FDI</b>	1.0000						
<b>VAC</b>	0.1149	1.0000					
<b>ROL</b>	0.0313	0.8157	1.0000				
<b>CORR</b>	-0.0041	0.6762	0.8664	1.0000			
<b>GEFF</b>	0.0904	0.7398	0.8870	0.8388	1.0000		
<b>PSAV</b>	-0.1153	0.6739	0.7783	0.6849	0.6502	1.0000	
<b>REQUAL</b>	0.1214	0.7727	0.8588	0.7304	0.8513	0.6376	1.0000

Source (Authors computation, 2021).

Table 3 shows the results of the two step system GMM estimator for the effects of institutional development on FDI in 45 chosen sub-Saharan Africa countries from 1986 to 2015.

**Table 3: Regression Results**

<b>Variables</b>	<b>Model 1</b>	<b>Model 2</b>	<b>Model 3</b>	<b>Model 4</b>	<b>Model 5</b>	<b>Model 6</b>
In FDI (-1)	0.42*** (0.09)	0.38*** (0.10)	0.40*** (0.01)	0.40*** (0.10)	0.39*** (0.12)	0.43*** (0.11)
In Trade openness	0.74 (0.55)	1.02* (0.59)	0.72 (0.58)	1.01* (0.58)	0.84 (0.67)	0.87 (0.73)
In GDP	0.27*** (0.09)	0.35*** (0.11)	0.33*** (0.10)	0.36*** (0.12)	0.32** (0.13)	0.29** (0.11)
Voice and accountability	0.34 (0.30)					
Rule of Law		0.56* (0.31)				
Corruption			0.55 (0.36)			
Government effectiveness				0.60* (0.34)		
Political stability					0.22 (0.32)	
Regulatory quality						0.24 (0.32)
Constant	-7.25*	-10.43**	-8.81**	-10.44**	-9.14*	-8.04*
Number of observation (N)	545	545	545	545	545	545
Number of instruments used	11	8	14	11	11	11
Number of Groups/countries	45	45	45	45	45	45
Hansen Test p value	0.21	0.17	0.32	0.22	0.20	0.13
AR(2) p value	0.44	0.41	0.40	0.41	0.42	0.40

**Note:** \*\*\*  $\rho < 0.01$ , \*\*  $\rho < 0.05$ ; \*  $\rho < 0.1$ ; Robust standard errors in paranthesis ( ); dependent variable = FDI.

In= natural logarithm

The high correlation between institutional indicators led us to treat each institutional indicator in sub-Saharan Africa in a separate model results (in Table 3) while controlling for GDP and trade openness in order to avoid multicollinearity. The results from system GMM shows that rule of law and government effectiveness have positive and significant effect in attracting FDI in sub Saharan Africa. This implies that as corporate governance in the region is upheld, it influences FDI positively. By considering the magnitude of coefficient sign, the rule of law (ROL) and government effectiveness (GEFF) has strong significant impact on attracting FDI. Institutional development indicators cannot be considered as having an influencing effect on FDI only. GDP as a proxy for the economy's market size shows positive and significant effect in attracting the FDI. Likewise, when rule of law and government effectiveness are used in the model, trade openness has positive and significant effect in attracting FDI. This means that the more a country is open to trade, the more incentives it creates and the more FDI it attracts. These findings are consistent with those of Asiedu (2006), Kok and Ersoy (2009), Kersan-Škabic (2013), Villaverde and Maza (2015), Karau and Mburu (2016), Sabir et al., (2019). Generally our results clearly shows that rule of law and government effectiveness matters and have a significant influence on the decisions of foreign investors towards directing their capital into the country in form of FDI. In our findings both the Hansen Test and second order serial correlation test (AR2) are all valid as shown in Table 3. This means that the instruments employed are orthogonal to errors and there is consistence in

parameter estimates as in all models as we have failed to reject the null hypothesis since the  $\rho$  - values are greater than 0.1 or 10 percent.

These findings are in line with findings derived by Asiedu (2006); Mishra and Daly (2007); Njoroge (2016); Karau and Mburu (2016) who posited that better institutional functions will attract foreign direct investments. In the same vein, our results vindicate the findings by Ullah and Khan (2017) who also found a positive and significant effect of governance index on FDI in the ASEAN and Central Asian Countries. Apart from government stability and reliability of legal system, Stein and Daude (2001) further added the quality of regulation and policies as another important corporate governance indicator that positively influences FDI. Talamo (2011) agreed that for African countries to increase its rate of FDI, they need to establish fair and transparent judicial system.

The rule of law refers to a scenario in which “the laws are public awareness, explicit in meaning, and apply equally to everyone” (Carothers, 1998), all of which are positive characteristics for increasing FDI inflows. A dependable legal system fosters investor trust and thus acts as a motivator to attract FDI within the country by protecting property rights and contract enforcement entered during the investment process. The investment climate created by the rule of law is more likely to appeal to investors. According to World Bank survey conducted in Brazil and Argentina, firms operating in locations with better legal systems will have easier access to finance (Ndao et al., 2004). Transparent legislation, fair laws, predictable enforcement and government’s accountability are the mechanisms through which the rule of law promotes or hinders FDI attraction. The rule of law has been identified as one of the predictors of a country's FDI attraction in previous studies (Campos and Kinoshita, 2003; Dam, 2006). Similarly, Mishra and Daly (2007) argue that justice in the legal system and respect for people's rights have an impact on FDI in OECD and Asian host countries.

On the other hand, government effectiveness measures the credibility of government policy commitments, such as the quality of policy formulation and implementation, as well as the quality of public services and the degree of independence of civil servants who deliver those services from political pressure. Although Rodriguez-Posea & Colsb (2017) indicated that the process requires patience and takes time, having an effective government will assure favorability of government policies established and implemented for the benefits of investors, thereby attracting FDI in a country. Generally, countries with effective government structures are more likely to have a reliable judicial system (i.e. effective rule of law), and more likely to attract FDI than countries with ineffective governance structures. This means that as countries in sub-Saharan Africa upgrade and improve their institutional structures, they will attract more FDI inflows as investors gain confidence in the investment environment. This will lead to an increase in regional investment. The positive relationship between FDI inflows and GDP suggests the increased market potential in the sub-Saharan Africa countries are important in attracting FDI inflows. These findings are consistent with those of Asiedu (2006), Suleiman (2018), Woldemichael et al., (2019), Vagadia and Solanki (2014), and Week (2017), all of which found a positive relationship between FDI and GDP. When other variables are considered, it appears that international investors are attracted to the size of the African market, as GDP has become a prominent component in all models.

## **6. Conclusion**

The main aim of this study was to examine whether institutional development attracts FDI inflows in sub-Saharan Africa from 1986 to 2015 while controlling for economy's market size represented by GDP and trade openness. Our empirical findings showed that only rule of law and government effectiveness (i.e. institutional development) indicators are positive and strongly significant factors attracting FDI inflows in the region. But also our findings support the Institutional theory and Institutional FDI Fitness which all emphasize on the role of institutions within the country in creating favorable investing environment. Due to these findings it can be concluded that countries within sub-Saharan Africa that continues to uphold its institutional frameworks such as rule of the law and government effectiveness attract more FDI inflows as good governance or good enough governance to attract growth of foreign investments. In turn, the market size of the economy (GDP) and trade openness are still regarded as influential factors towards attracting FDI inflows in sub-Saharan Africa. The study suggests that the region should maintain a high level of rule of law and government effectiveness in order to continue attracting FDI inflows.

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