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Institutional factors: Their Significance on Foreign Direct Investment inflows in Selected Former British Colonies in Africa

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Abstract

Research on the relationship between foreign direct investment and institutional factors has gained momentum. Conflicting views exist with some literature suggest that foreign direct investment inflows are influenced by institutional factors while others suggest institutional factors improve when foreign direct investment increases. The current study uses data from a panel of fifteen former British colonies to test whether institutional factors attract foreign direct investment inflows. Using Fully Modified Ordinary Least Squares method, findings indicate that the aggregated component of institutional quality improves inflows of foreign direct investment in the selected countries. For disaggregated institutional quality components, some components have negative effects on foreign direct investment inflows. The study recommends that improving on the control of corruption and the rule of law may attract more foreign direct investment in the fifteen selected former British colonies.

JEL Classification: F, F21, F23,

Introduction

Attention on institutional factors as attractors of foreign direct investment (FDI) is on the rise. Particular attention has been paid to the effects of institutional factors on FDI inflows. Of importance is the role of property rights to FDI (Aziz, 2018). Aziz (2018) further notes that institutions are very important especially in countries with limited fiscal space. As such institutional reforms help in raising the necessary and much needed capital.

Literature suggests that inflows of foreign direct investment are heavily depend on institutional factors. Some institutional factors, especially in former colonies, depend on the former colonisers' institutional issues instilled in these countries. This study uses fifteen former British colonies to study the effects of institutions on FDI inflows. In the category of British colonies, the study includes countries that were categorised as protectorates as well. The interesting thing about the countries studied is that at one point they had one colonial master, Britain. But after their independence there has been a tendency for some of these countries to trail behind others in terms of attracting foreign capital and the attendant growth rates. This study, therefore, proposes to find out whether the institutional factors play a role in differences in inflows in these countries. The results will assist governments of the selected countries to reconsider institutional factors when deciding on policies to attract FDI. Since they somehow share almost the same history, it is also easy for them to learn from each other in this context.

While some studies on the effects of institutional factors exist, those on the chosen countries still remain scarce. For example, Yildirim and Gokalp (2016) studied 38 developing countries from across the world and only included two African states. Given the position of Africa in terms of its poverty levels and institutional issues, Africa was underrepresented in that study. Also, the possibility of inertia due to colonial history was not included. Phung (2017) also noted the scarcity of studies on institutions and FDI relationship in developing countries in general.

The objectives of this study are to determine the role of institutional factors on FDI inflows in 15 former British colonies. This has been necessitated by the arguments by Yildirim and Gokalp (2016) who noted that political institution, among others, is a key determinant of retarded growth in Africa. So by extension, results of this study will explain one potential source of the retarded economic growth in these countries. This is because Afonso (2020) indicated that the effects of institutional quality on growth may not be that direct. Additionally, Siddica and Angkur (2017) noted that FDI accelerates economic growth. The study aims to add more information to the existing debate about the effects of institutional quality on FDI, by using data from the 15 former British colonies, since Mahmood et al. (2019) noted that this debate has existed for long while Seth (2018) also argued that few studies exist on the role played by institutional quality in attracting FDI.

The rationale for studying this topic lies in the globalisation wave. Many countries and firms are placing themselves on the global map because the world has become a global village. As such each country intends to market itself to attract as much FDI as possible. The same may apply to regions. Several advantages of FDI over other models of entry exist which make countries willing to attract FDI. The size of FDI flows in Africa is generally lower than other regions (Ajide & Raheem, 2016). Ajide and Raheem (2016) also noted that FDI helps reduce the savings–investment gap that generally exist in most African countries. Of significance also is that quality of institutions are very important variables in countries with limited fiscal space like Malawi, Zambia and Zimbabwe.

Literature review

North (1990) is among the first authors to argue that the efficacy of institutions affects economic growth and performance. Since then a plethora of studies have been done with mixed findings. According to North (1990, p.3) “[i]nstitutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction”. The author goes on to argue that institutions affect performance of economies. However, North (1990) acknowledged the scarcity of existing appreciation of how institutions affect these economies.

Ali et al. (2010) and Mahmood et al (2019) noted that combining the eclectic paradigm by Dunning (1973, 2002) and North’s (1990) work on institutions provides the link between institutions and FDI. The understanding is that a firm is most likely to be motivated to internalise the location advantage, as noted by Dunning (1973), in the foreign country if the quality of institutions in that country are in line with the firm’s expectations.

In countries with strong quality institutions, low transactions costs may motivate foreign companies’ entry. This is because, where quality institutions exist, regulatory frameworks will be adhered to and people will be guided by the set down laws. Property rights will also be clear and adhered to. Therefore, uncertainty reduces. However, where property rights are not well defined and adhered to, uncertainty is high and, therefore, transaction costs, such as legal costs, will increase. This has the potential to reduce inflows of FDI.

Many scholars have researched on how institutions affect economic growth. However, mixed findings among these studies exist (Eicher & Leukert, 2009; Ali, et al, 2010; Bhattacharjee, 2020; Peres, Ameer & Xu, 2018). One group of scholars argue that favourable institutional quality affects growth positively and these include Afonso (2020), Mahmood, et al, (2019), Peres et al. (2018), Siddiqui and Ahmed (2013) and Aziz (2018). This positive relationship has been attributed to the effect of institutional quality on transaction costs. For example, Yildirim and Gokalp (2016) argue that transaction costs reduce economic performance. The authors argue that transactions costs in countries with poor institutions are usually high because of high uncertainty and low trust. Also poor definition of property rights retards growth because it increases uncertainty. The other explanation identified is the promotion of initiatives. Afonso (2020) argues that only in countries with institutions that promote initiatives will growth be enhanced by strong institutions. Therefore, Siddiqui and Ahmed (2013) indicated that favourable institutions positively affect growth. They also show that in developing countries, institutional and policy rents are more important as determinants of growth.

Another possible link between FDI and growth is when institutional quality acts as a moderating variable. Islam et al. (2020) found the moderating role of institution on FDI and financial development in 79 Belt and Road Initiative partner countries. Therefore, when used as a moderating variable, institutional quality will lead to an indirect effect between FDI and economic growth.

Variations in effects of institutions on FDI have sometimes been attributed to differences in measurements of institutions (Bhattacharjee, 2020; Dorozynsk et al., 2019; Ali et al., 2010). This difference in measurements may be attributed to the difficulty in measuring institutions as noted by Dorozynsk, et al (2019). Afonso (2020) indicate that only institutions that promote private initiatives will promote growth. This supports the argument that well defined property rights lead to increased growth, since Yildirim and Gokalp (2016) indicated that the relationship between property rights and economic growth is through transaction costs. Since transaction costs are affected by institutional quality, it implies that institutions are very important in the growth of an economy.

A certain group of authors view institutional quality as insignificant in affecting FDI and growth. Among these authors are Eicher and Leukert (2009), Phung (2017) and Peres, Ameer and Xu (2018). For example, using the sum of control of corruption and rule of law indicators as measures of institutional quality, Peres, Ameer and Xu (2018) noted that institutions do not necessarily affect FDI inflows in developing countries. Eicher and Leukert (2009) noted that the results on the FDI and institutional quality relationship depend on the sample used because the production functions of different countries also differ. Among SADC and ECOWAS states, Bopkin, Mensah and Asamoah (2017) found that institutional quality on its own cannot explain FDI inflows. Among Sub-Saharan African countries covering a period of twenty years, that is 1996 to 2016, Asamoah et al. (2019) found an insignificant relationship between institutional quality and FDI inflows. Therefore, while in some countries institutional quality may affect FDI and economic growth, in some it may not.

The third group of authors is that which belongs to those who think institutional quality is improved by FDI inflows, that is, they argue that causality runs from FDI to institutional quality. In China, Long, Yang and Zhang (2015) noted that in some regions, institutional quality improved because of existence of foreign firms. This is because the foreign firms may demand certain conditions that have external impacts on domestic firms. Long, Yang and Zhang (2015) argue that foreign investors focus attention on institutional quality because a good business environment is in their interest. As such, governments are placed in a position to improve institutional quality to attract FDI. Therefore, existence of such MNCs will continuously improve the institutional quality of countries since the incumbent and new entry foreign firms will continuously demand more improvements. Analogous to this view is that good policies lead to better institutional quality. Glasser et al (2004) noted that, for poor countries, good policies precede improvements in quality of institutions.

A counter-argument on the effects of institutional quality and growth may be brought via the effects of corruption being viewed as oil or sand. If corruption, as an institutional quality indicator, can oil the economic activity through facilitating, say foreign company registration, FDI inflows may increase thereby increasing economic growth. Therefore, economic performance will be enhanced despite the poor institutions because bureaucratic processes will be avoided. However, corruption can also retard inflows of FDI because it increases the costs of doing business. Alongside this argument might be the findings by Contractor, Dangol, Nuruzzaman and Raghunath (2019) that at times MNCs may trade one institutional quality for another. For example, one MNC may be prepared to pay the bribe in exchange of other institutional quality indicators that may improve its existence in the country concerned. Contrary to the arguments by Contractor, Dangol, Nuruzzaman and Raghunath (2019), Dorozynski et al (2019) noted that investors usually base their decisions on overall institutional indicators than on an individual indicator.

Using institutional stability as a measure of institutional quality and the ARDL methodology, Mahmood et al., (2019) found that FDI and institutional stability are correlated in Canada. However, they indicated that in some cases, the relationship does not always hold. The authors also argued that quality institutions improve FDI by disciplining economic behaviour of agents. This is done by reducing or limiting opportunism and therefore improving confidence by foreign investors.

Shah et al. (2015) investigated the causality between institutional quality and sectoral FDI. Using the ARDL methodology and data from Pakistan, their results confirm existence of bidirectional long run causality between institutional quality and FDI in the services and manufacturing sectors. The study, however, failed to find long run causality between institutional quality and FDI in the primary sector.

Sabir et al. (2019) used a system GMM method to study the impact of institutional quality and FDI in developed and developing countries. Covering a period of 20 years, they found that quality of institutions has a significant impact on FDI in all groups of countries studied. However, the magnitude of coefficients was biased in favour of developed countries meaning that institutional quality factors have more effect on FDI in developed countries.

Methodology

Following previous research in the area of study, like Mahmood et al., (2019) and Sabir et al (2019), this study avoided use of OLS methodology. Unlike Mahmood et al., (2019) who used the ARDL, the current study uses the Fully Modified Ordinary Least Squares (FMOLS) Model developed by Phillips and Hansen (1990). The FMOLS is one superior cointegration estimation technique for certain reasons. Moh'd Hemed and Suleiman (2017) and Bouchoucha and Yahyaoui (2019) noted that FMOLS generates consistent estimators of parameters and controls for endogeneity and the problem of simultaneity bias. Two FMOLS models are estimated in this study *viz*, one with disaggregated institutional quality components and the other with the aggregated variable.

A balanced panel data was used in this study. Fifteen countries were selected from the former British colonies and protectorates. The selected countries are Botswana, Egypt, Eswathini, Gambia, Ghana, Kenya, Lesotho, Malawi, Nigeria, Sierra Leone, South Africa, Sudan, Uganda, Zambia and Zimbabwe. The data used stretched from 2007 to 2022. Absence of some recent data made it impossible to use most recent data. Also some countries had no data for some periods prior to 2007. Data used was obtained from the World Bank's World Development Indicators (WDI) and the World Governance Indicators (WGI) developed by Kaufman (2004).

In line with Sabir et al., (2019), the study used FDI inflows as a dependent variable. Control variables include GDP per capita, terms of trade and inflation. To proxy market size, the study used GDP Growth (GDP) while Terms of Trade (TOT) was used to represent market seeking behaviour of FDI in the manner in which Sabir et al., (2019) used it. Inflation, proxied by GDP deflator (GDPD) was used as a measure of macroeconomic stability. For institutional quality, the following variables were used: government effectiveness (GE), control of corruption (CC), political stability (PS), rule of law (RL), voice and accountability (V) and regulatory quality (RQ).

Variable measurements and creation

This section highlights the relevant variables used in this study. It also indicates the source of variables, measurement of these variables and where possible how these variables were created.

FDI Inflows (FDI)

Like Moh'd Hemed and Suleiman (2017) and Bouchoucha and Yahyaoui (2019), this study used net FDI as a percentage of GDP to measure FDI. Net FDI is the difference between FDI inflows and outflows. Net FDI, therefore, is a good measure of FDI because it shows the relative components between inflows and outflows.

Institutional Variables

The role of institutions in determining economic growth and FDI remains debatable. Dorozynski, Dobrowolska and Kuna-Marszalek (2019) noted that the debate on the sign of the coefficient mostly emanates from different measures of institutional quality and FDI. Voigt (2009) also raised concerns about measuring institutions. Despite these arguments, research findings still support evidence of the positive relationship between institutions and FDI. North (1990) is well known for noting that quality institutions positively affects economic growth. Among those who found a positive empirical relationship between institutions and FDI are Ajide and Raheem (2016), Aziz and Mishra (2016), Siddica and Angkur (2017) and Aziz (2018). Eicher and Leukert (2009), Phung (2017) and Peres, Ameer and Xu (2018) are among those authors who find contrasting evidence to the notion that institutions improve growth and FDI. Peres, Ameer and Xu (2018) found that institutions are not a significant determinant of FDI inflows in developing countries. Despite these debates, this study hypothesises that better institutional quality attracts FDI into the countries studied.

As proxies of institutional quality, several studies have used, control of corruption, government effectiveness, political stability, regulatory quality, rule of law and voice and accountability. In line with Bouchoucha and Yahyaoui, (2019) this study uses these components as measures of institutional quality. Besides the disaggregated measures of institutional quality, in line with Bopkin, Mensah and Asamoah (2017), this study uses a composite measure of institutional quality where institutional quality is measured as the average of the six components; control of corruption, government effectiveness, political stability, regulatory quality, rule of law and voice and accountability. The statistics were obtained from World Governance Indicators.

Control Variables

In line with the previous literature, such as Phung (2017) and Ali, Fiess and MacDoNald (2010) who also studied a similar topic, the control variables used in this study are: inflation, GDP and Terms of Trade. The measurement of these variables is explained in this section.

Inflation (GDPD)

The inflation rate in a country discourages inflows of FDI. As an economic variable, inflation represent macroeconomic stability (Ali, Fiess and MacDoNald, 2010, Siddica & Ankur, 2017). Stable economies are more likely to attract FDI inflows than less stable economies. From the perspective of the weak-currency area theory, high inflation leads to a depreciated currency. The depreciated currency attracts more FDI because foreigners will use fewer units of their own currency to invest in the destination country. Therefore, the two views lead us to assume that the coefficient of inflation on FDI is uncertain. In this study, inflation is proxied by the GDP deflator. This was chosen over CPI because of data availability. Some years studied had missing data for CPI for certain countries.

Gross Domestic Product Growth (GDPG)

To attract FDI inflows, a country needs to have the potential to consume the good produced by the foreign firm. One good proxy for market potential usually used by researchers is GDP growth (Ali, Fiess & MacDoNald, 2010; Siddica & Ankur, 2017). Economies experiencing high economic growth rates are more likely to attract more FDI than economies with low economic growth rates. This is because economic growth is viewed as a proxy of future market size.

Trade openness (TOT)

In this study, Terms of Trade represent trade openness as was done by Phun (2017) and Siddica and Ankur, 2017). Trade openness is a good measure of trade liberalisation by host countries and somehow indicates the propensity to export by foreign companies. A more open country is likely to attract more FDI inflows than one which is less open. In another way, TOT shows the market seeking behaviour of FDI (Sabir et al, 2019). The TOT variable is expected to have a positive effect on FDI. Data for TOT was taken from WDI. The TOT index used in this study is the merchandise terms of Trade (% of GDP) found in the WDI.

Findings

For the purposes of this study, results presentation starts with diagnostic tests followed by the FMOLS results themselves. Panel unit root, panel cointegration and multicollinearity tests are among the major diagnostic tests presented.

Panel Unit root test results

To test for unit root problems, three tests were applied, viz, Levin, Lin, Chu test, the ADF test and the Philips Perroni test. Results are presented in Table 1.

Table 1
Panel Unit Root Test

Variable	LLC	ADF	PP
FDI	0.0000*	0.0163*	0.0000*
GDPG	0.0000*	0.0000*	0.0000*
GDPD	0.0000**	0.0000*	0.000*
TOT	0.000**	0.000**	0.000**
ISQUAL			
CC	0.0000**	0.0000**	0.0000**
GE	0.0000**	0.0007**	0.0000**
PS	0.0000**	0.0000**	0.0000**
RL	0.0000**	0.0000**	0.0000**
RQ	0.0000*	0.0000*	0.0000*
V	0.0000**	0.0000**	0.0000**

** integrated of order zero, I(0). ** integrated of order one, I(1).*

LLC- Levin-Lin- Chu test, ADF-Augmented Dickey Fuller test, PP- Philips Perroni Test.

Table 1 indicates that all variables were found to be stationary, $p < 0.001$. While all variables were found to be stationary, they are integrated of different orders. The majority are integrated of order one, as indicated by the asterisk *. The difference in order of integration justifies the use of FMOLs in this study.

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Panel Cointegration

The Pedroni (2004) and Kao (1999) cointegration tests were used to test for panel cointegration. Table 2 reports the Pedroni (2004) and Kao (1999) cointegration tests results.

Table 2
Panel Cointegration

Pedroni (2004) Test				
	Statistic	**P-value**	**Weighted statistic**	**P-value**
Within dimension				
Panel V statistic	-4.970915	1.0000	-4.970915	1.0000
Panel rho statistic	2.673662	0.9962	2.673662	0.9962
Panel PP statistic	-36.15529	0.0000*	-36.15529	0.0000*
Panel ADF statistic	-9.555979	0.0000*	-9.555979	0.0000*
Across dimension				
Group Rho statistic	4.191954	1.0000		
Group PP Statistic	-39.63567	0.0000*		
Group ADF statistic	-9.694775	0.0000*		
Kao (1999**) Test**				
T-statistic	-21.60672	p-value	0.0000	

From Table 2, looking at the Pedroni panel PP and ADF statistics and their respective weighted statistics, one observes that they are all less than 5% implying that there is cointegration (Bouchoucha & Yahyaoui, 2019; Ogbuagu, Iwegbu & Saibu, 2021). Again Table 2 reports Pedroni eleven *p*-values. The eleven *p-values* are grouped into four within dimensions statistics which are further divided into eight values. There are three across dimension values. The majority, about 55% of the eleven statistics in Table 2 indicate that there is cointegration within the panels given that $p < 0.001.$ This approach of testing for cointegration, that is looking at the majority of statistics, was also used by Nasir, Huynh and Tram (2019). The Kao test results in Table 2 also indicate that there is cointegration among the variables with the ADF t- statistic of -21.60672, $p < 0.001$. These two cointegration tests indicate that there is a long run relationship among the variables in the model thereby justifying the use of FMOLS model in this study (Bouchoucha & Yahyaoui, 2019).

Multicollinearity

For multicollinearity test, the study used correlation matrix. The results are reported in Table 3.

Table 3
Correlation Test Results

FDI	FDI	GDPD	GDPG	TOT	ISQUAL
	1.000000				
GDPD	0.506099	1.000000			
GDPG	0.105464	-0.38857	1.000000		
TOT	0.285484	0.096137	0.327143	1.000000	
ISQUAL	0.122202	-0.06656	0.458342	0.351536	1.000000

Results in Table 3 indicates that the highest correlation across variables is about 0.51. Using the rule of thumb that there is no multicollinearity if the cross correlations between any two variables is less than 0.8, the study concludes that there is no strong multicollinearity problem among the variables used in the study.

Fully Modified Ordinary Least Squares Results

The study evaluated the role of institutional quality on FDI inflows using two models; one containing the aggregated components of institutional quality and the other for disaggregated components. Tables 4 and 5 show results for the disaggregated and aggregated models, respectively.

Table 4
Disaggregated Model Results

Variable	Coefficient	T-statistic	P-value
GDPD	0.258859	25.40955	0.0000
GDPG	0.572344	18.31981	0.0000
TOT	0.101817	13.59857	0.0000
CC	0.127252	10.02706	0.0000
GE	-0.275768	-15.34259	0.0000
PS	-0.099164	-8.298773	0.0000
RL	0.374865	12.17714	0.0000
RQ	-0.328573	-13.03749	0.0000
V	-0.214912	-14.46877	0.0000

Table 5
Aggregated Model Results

Variable	Coefficient	T-statistic	P-value
GDPD	0.235913	21.03684	0.000
GDPG	0.448898	9.134498	0.000
TOT	0.059841	7.663178	0.000
ISQUAL	0.083429	3.312174	0.0011

From the disaggregated model (Table 4), all institutional quality components are significant at 5% level of significance. Additionally, two of the six components of the institutional variable are positively and significantly related to FDI inflows. Control of corruption and rule of law are positively related to FDI inflows while government effectiveness, political stability, regulatory quality and voice and accountability are negatively related to FDI inflows. All control variables are positively related to FDI inflows.

Table 5 shows results where institutional quality variables are aggregated. Findings in Table 5 show that institutional quality has a positive and significant effect on FDI inflows just like what Ali, Fiess and MacDoNald (2010) and Siddica and Ankur (2017) found. A percentage increase in institutional quality is likely to lead to about 8% increase in FDI inflows in the selected African countries, $p < 0.05$. This result shows that, overally, better institutions quality attracts FDI in the selected former British colonies.

In line with the argument by Ali, Fiess and MacDoNald (2010), political stability was found to positively impact FDI inflows. This implies that, economies that are politically stable are attractive to FDI inflows possibly because of the low possibility of expropriation.

GDP growth has a significant, $p < 0.001$ and positive effect on FDI inflows for both the aggregated and disaggregated models. Thus, the market potential is reflected by these coefficients in African countries. For the disaggregated model, Table 4 shows that a percentage increase in GDP growth in the selected African countries will lead to about 57% in FDI inflows, $p < 0.001$. To corroborate this, Table 5 shows that after aggregating institutional quality variables, GDP growth still positively affect FDI inflows to the tune of about 44% per percentage increase in GDP growth, $p < 0.001$. Therefore, economies with potential are attractive to investors as also found by Ali, Fiess and MacDoNald (2010). The finding that GDP growth attracts FDI is in line with the findings by Mhlanga, Blalock and Christy (2009).

The argument that stable economies attract FDI inflows (Ali, Fiess & MacDoNald, 2010) seems to have been supported by the results from the 15 African countries studied. Both Tables 4 and 5 show that macroeconomic stability, as proxied by GDPD, significantly attracts FDI inflows. For the disaggregated model, market stability attracts FDI inflows by about 26%, $p < 0.001$, while for the aggregated model it attracts FDI inflows by about 24%, $p < 0.001$. Thus, stable economies are likely to attract more FDI.

For the openness variable, terms of trade, Tables 4 and 5 show that TOT has a significant positive effect on FDI inflows. This finding corroborates empirical evidence by Ali, Fiess and MacDoNald (2010) and

Siddica and Ankur (2017). It was also found that openness improves FDI inflows among Southern African Development Community countries (Mhlanga, Blalock and Christy, 2009). In this study, a percentage increase in Terms of Trade leads to a 10% increase in FDI inflows (Table 4) and a 6% increase in FDI inflows (Table 5), $p < 0.001$. The results seem to corroborate the market seeking behaviour of foreign investors. Economies with improving TOTs have better chances of attracting FDI.

Conclusions

Study findings seem to indicate that institutional quality is a very important variable in attracting FDI inflows to the selected African countries. This is because both aggregated and disaggregated models have shown that the institutional quality variable is a significant variable. Despite having four out of the six components of institutional variable components used in this study having a negative sign, the aggregated model has a positive sign. This may show that the two components having a positive effect, control of corruption (CC) and rule of law (RL) have a greater impact in attracting FDI to the selected African countries. Improving on the control of corruption and rule of law will attract more FDI in the selected former British colonies.

Future studies may focus attention on the source of FDI inflows to the former British colonies. It is very important to understand whether the institutions instilled by the British are still attracting the Britons to still invest in their former colonies. It is equally important to look at the sectorial FDI in this relationship between FDI and institutional quality in former colonies. This study, however, remains relevant because it has shed some light in this regard.

Declarations

Competing Interest:

No competing interests to declare

Employment

Not Applicable

Financial interest

None.

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