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The relationship between FDI, political and institutional risk in Sub-Saharan Africa

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TABLE OF CONTENTS

Contents

ABSTRACT	iv
ACKNOWLEDGEMENTS	v
LIST OF TABLES	vi
LIST OF FIGURES.....	vii
LIST OF ACRONYMS.....	viii
CHAPTER ONE: INTRODUCTION	1
1.1 Introduction and background of the study	1
1.2 Problem Definition	2
1.2.1 Foreign Direct Investment inflows in Sub-Saharan Africa.....	2
1.3 Research Objectives	5
1.3.1 General objective	5
1.3.2 Specific objectives	5
1.4 Research Questions.....	5
1.5 Justification of the study	5
1.6 Organisation of the study.....	6
CHAPTER TWO: LITERATURE REVIEW	7
2.1 Introduction.....	7
2.2 Theories of Foreign Direct Investment.....	7
2.3 Political Risk and Foreign Direct Investment.....	8
2.4 Institutional Risk and Foreign Direct Investment	10
2.5 Empirical Literature	11
2.6 Concluding Remarks	15
CHAPTER THREE: RESEARCH METHODOLOGY.....	16
3.1 Introduction.....	16
3.2 Research Design	16
3.3 Model Specification.....	17
3.3.1 Dependent Factor.....	18
3.3.2 Factors of Interest	18
3.3.3 Control Factors	19
3.4 Econometric Estimation Technique	21
3.5 Diagnostic Tests.....	22
CHAPTER FOUR: RESEARCH FINDINGS	24

4.1 Introduction.....	24
4.2 Multicollinearity Test Results	24
4.3 Serial Correlation and Over-Identification Test Results	24
4.4 Estimation Results	25
4.5 Concluding Remarks	29
CHAPTER FIVE: CONCLUSIONS.....	30
5.1 Introduction.....	30
5.2 Conclusions.....	30
5.2.1 Do political and institutional risks significantly affect Foreign Direct Investment in Sub-Saharan Africa?.....	30
5.2.2 Does political risk affect Foreign Direct Investment in Sub-Saharan Africa to a greater or lesser extent than institutional risk?	30
5.2.3 Do the interactive effects of political risk out-weight those of institutional risk?.....	30
5.3 Recommendations for Future Research.....	31
REFERENCES.....	32

ABSTRACT

This study uses Generalised Method of Moments to investigate the roles of political risk and institutional quality determinants of Foreign Direct Investment inflows to 20 countries in Sub-Saharan Africa between 2003 and 2019.

The results show that both political risk and weak institutional quality significantly and negatively affect FDI in Sub-Saharan Africa. The GMM interaction terms for institutional quality are larger than those for political risk. These results emphasize the importance of institutional quality above that of the political system, suggesting that institutional quality is more attractive to foreign investors than a sound political system. This is probably because foreign investors are more concerned with long-run regulatory enforcement and investment protection than by short-run political dynamics.

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LIST OF TABLES

Table	Title	Page
1	Top 10 FDI-receiving countries and governance indicators	3
2	Top 10 FDI recipients in the Sub-Saharan region	4
3	Pairwise Correlation Matrix Results	24
4	Diagnostic Test Results	25
5	Generalised Method of Moments Estimation Results	26
6	Interaction Models	27

LIST OF FIGURES

Figure	Title	Page
1	FDI inflows in Africa 2000-2018	2

LIST OF ACRONYMS

ARDL	Autoregressive Distributed Lag
BRICS	Brazil, Russia, India, China, and South Africa
EAC	East African Community
ECOWAS	Economic Community of West African States
EU	European Union
FE	Fixed Effects
FDI	Foreign Direct Investment
GDP	Gross domestic product
GMM	Generalized Method of Moments
ICT	Information and Communications Technology
OLS	Ordinary Least Squares
MENA	Middle East and North Africa
MENAT	Middle East and North Africa and Turkey
MINT	Mexico, Indonesia, Nigeria, and Turkey
PTR	Panel threshold regression
SADC	Southern African Development Community
SSA	Sub-Saharan Africa
UNCTAD	United Nations Congress on Trade and Development
US	United States
VECM	Vector Error Correction Model

CHAPTER ONE: INTRODUCTION

1.1 Introduction and background of the study

Foreign Direct Investment (FDI) is a key source of external financing and economic development, supplementing a country's available capital, viand providing spill overs of technology, skills, innovative capacity, and the creation of export opportunities (Musibah, 2017). However, most FDI is motivated by long term investment decisions and can thus be significantly exposed to political and institutional risks. Sub-Saharan Africa (SSA) has substantially lower savings rates than the world average, making it harder to finance growth and development. As a result, SSA is highly dependent on external capital, either via debt or FDI.

In SSA, FDI inflows tend to be skewed to countries that have significant natural resources, which also suffer from endemic levels of corruption because the payment of bribes acts as a catalyst for weak institutional processes (Gossel, 2018). Mining in most SSA countries is politically charged, meaning that political systems and institutions of economic policy safeguard certain freedoms relating to auctioning of mineral rights. For this reason, attempts to enhance value addition with the help of foreign companies often fail due to institutional and political risk.

Leverly and Grace (2018) note that weak democratization, which also has an impact on a country's institutions, negatively affects FDI. Additionally, Berman (1998) suggests that institutional voids have created political risks because of militarism, patrimonialism and patronage. According to Collier (2010), the potential wealth of resource-rich countries can finance conflicts and rebellions, encouraging political conflict and eroding the accountability of government to its citizens. However, despite all this, it seems resource-based countries remain the major recipients of FDI in SSA.

In non-resource based SSA countries, FDI inflows remain very low mostly because of negative perceptions, weak governance and policy incoherence (Gossel, 2017). Over the past decade, political progress in SSA has been limited by the politicization of public institutions, while the clinging to power and alteration of the constitutions by many political leaders has increased political risk in most SSA countries, thus affecting the inflows of FDI (Gossel, 2017).

When considering their impact on FDI, political and institutional risk may well-interact and should thus not be considered separately.

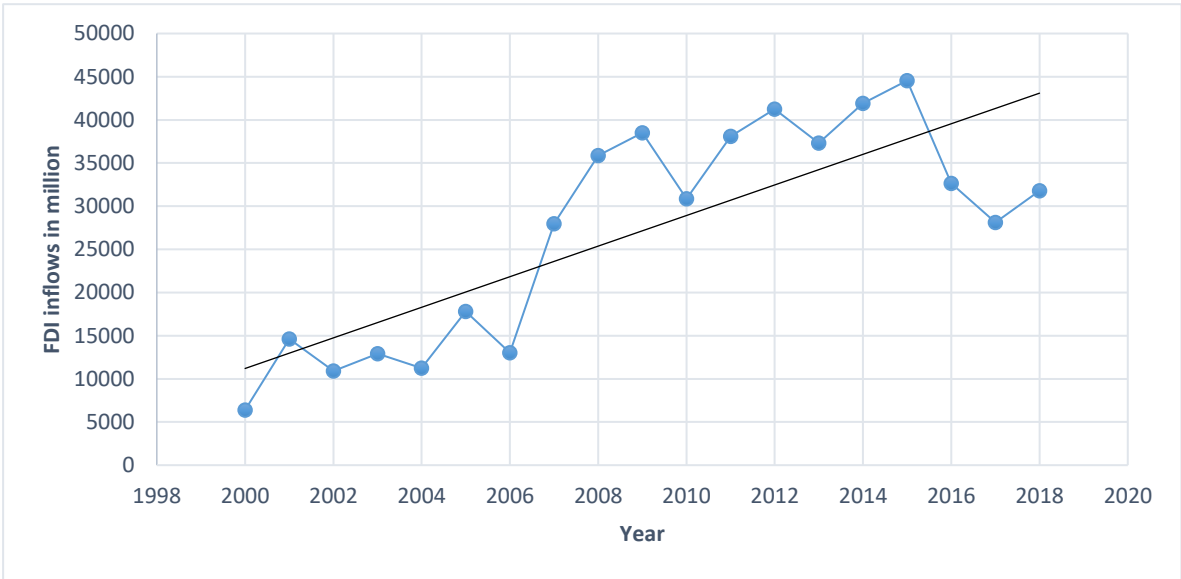
1.2 Problem Definition

1.2.1 Foreign Direct Investment inflows in Sub-Saharan Africa

The FDI inflows to Africa over the period of 2000-2018 are presented in Figure 1 below. As can be seen, from 2000 to 2015 FDI inflows steadily increased from just \$7 billion in 2000 to \$46 billion in 2015 (an annual increase of around 11% (UNCTAD, 2019)). However, in the succeeding years, the inflow of FDI declined mostly because of increased tension among resource-rich countries. By 2018, FDI inflows to Africa had declined to about \$32 billion as a result of lower-than-expected global economic growth.

Many small and resource-poor economies have suffered as a result of the concentration of FDI inflows among resource-rich economies. For example, Angola and South Africa account for about 78 percent of FDI inflows in the SADC region; Ghana and Nigeria account for about 68 percent in West Africa; Tanzania and Ethiopia account for 43 percent in East Africa; and the Congo and the Democratic Republic of Congo account for 58 percent in Central Africa (*ibid*).

Figure 1: FDI inflows in Africa 2000-2018



Source: UNCTAD (2019)

Table 1 below shows the top 10 FDI-receiving countries¹ and their corresponding governance indicators. As can be seen, FDI inflows in SSA is concentrated in a few countries within the region. Angola has been the largest recipient of FDI with an average share of 21% followed by Nigeria and South Africa who had a share of 11% and 9% respectively in the Sub-Saharan region. However, the indicators show that the amount of FDI inflows is not clearly associated with stronger governance or institutions. This could either indicate that FDI investors do not respond to good governance or strong institutions; or that the lack of good governance attracts FDI instead (Sy and Sow, 2016). For instance, foreign investors may decide to invest in the information, communication, and technology (ICT) sector in Africa, irrespective of the governance of recipient countries because they expect high returns.

Table 1: Top 10 FDI-receiving countries and governance indicators

	FDI as a percentage of GDP	Control of corruption quartile (1: Worst; 4: Best)	Government effectiveness quartile (1: Worst; 4: Best)	Voice and accountability quartile (1: Worst; 4: Best)	Political stability quartile (1: Worst; 4: Best)	Regulatory quality quartile (1: Worst; 4: Best)	Rule of law quartile (1: Worst; 4: Best)
Liberia	27.2	2	1	2	1	1	1
Equatorial Guinea	21.1	1	1	1	3	1	1
Seychelles	12.0	4	4	4	4	3	4
Republic of the Congo	11.6	1	1	2	2	1	1
Mozambique	11.0	3	3	3	4	3	3
São Tomé and Príncipe	10.2	3	3	4	4	2	3
Chad	7.8	1	2	1	1	2	1
Madagascar	6.9	4	2	3	3	3	3
Angola	6.7	1	2	1	2	1	1
Cabo Verde	6.5	4	4	4	4	4	4

Source: Sy and Sow (2016)

¹ The table shows the top 10 recipients of FDI in SSA ranked in descending order of their average 29-year annual inflows of FDI.

Table 2 below further shows that countries with a positive and high Polity score (except for Angola) receive more FDI. Thus, more politically stable countries appear likely to receive more FDI. Looking at the economic freedom index captures components of institutional quality namely rule of law property rights, judiciary effectiveness, and government integrity among others. Countries such as Tanzania, South Africa, Nigeria and Ghana are freer in as far as foreign direct investment is concerned. However, despite these facts, some countries in Africa such as DRC and Zimbabwe have poor political and institutional ground but they have investors which means there is another driving force leading to increased FDI inflows.

Table 2: Top 10 FDI recipients in the Sub-Saharan region

Rank	Country	Mean Annual FDI 1990-2018	As a % of FDI to Africa	Mean Economic Freedom Index (1990-2018)	Mean Polity Score (1990-2018)
1	Angola	7103.7	21	52.2	-2
2	Nigeria	3580.9	11	57.2	4
3	South Africa	2962.6	9	58.8	9
4	Mozambique	1215.9	3	50.5	5
5	Ghana	1100.7	3	59.4	8
6	Congo	938.1	3	41.8	-4
7	DR Congo	766.5	2	41.8	-3
8	Tanzania	696.7	2	61.7	-1
9	Zambia	622.5	2	53.5	6
10	Other	6399.8	19		NA

Source: UNCTAD

1.3 Research Objectives

The objectives of the study are subdivided into general and specific objectives.

1.3.1 General objective

The general objective of the study is to investigate the relationship between both political risk, institutional risk and Foreign Direct Investment inflows in Sub-Saharan Africa.

1.3.2 Specific objectives

To complement the general objective, the study focused on the following specific objectives:

1. To examine whether political risk affects FDI in SSA to a greater or lesser extent than institutional risk?
2. To examine whether political risk and institutional risk substitute or complement each other on FDI flows in SSA.

1.4 Research Questions

The primary research question that this study seeks to investigate is:

Do political and institutional risks significantly affect FDI in SSA?

In addition to this primary research question, the study will also investigate two related sub-questions:

1. Does political risk affect FDI in SSA to a greater or lesser extent than institutional risk?
2. Do political risk and institutional risk substitute or complement each other on FDI attraction in SSA?

1.5 Justification of the study

In comparison to other regions of the world, FDI inflows to Sub-Saharan Africa have been low; for example, FDI inflows as a percentage of GDP to SSA is 2.29 percent, compared to 2.55 percent in East Asia, 2.38 percent in the OECD, and 2.37 percent in Europe in the five year period 2016 to 2020 (World Bank, 2021). Foreign Direct Investment (FDI), a key factor of globalisation, is an important stimulator of productivity enhancement, technological advancement, and job creation. However, SSA countries that have attracted FDI tend to be resource-based and suffer from high political risk and weak governance institutions. Against this background, it is important to study the patterns of FDI inflows in SSA to understand the

extent to which institutional and political risk are stimulating or hindering the inflows of FDI into the region.

Numerous factors have been identified as drivers of FDI but in recent years political and institutional issues have assumed more prominence amongst these (Mádr and Kouba, 2015; Peres *et al.* 2018; Ross *et al.* 2019). Poor institutions, according to Buchanan *et al.* (2012) and Ali *et al.* (2010), are effectively a tax on FDI, while government instability, religious and ethnic tensions impede economic progress (Qian and Baek, 2011). However, studies to date are unclear about the extent to which institutional and political risk impact FDI in emerging countries, and especially in SSA. This study seeks to fill this gap in the literature.

1.6 Organisation of the study

The study comprises five chapters. Chapter 1 has introduced the topic of the study, the problem to be addressed by the study's significance. Chapter 2 gives a critical review of the topic, surveying the impact of institutional quality and political risk on foreign direct investment in developed and developing countries. Chapter 3 addresses methodology - the research tools and econometric model used in the study. Chapter 4 details the data utilised in the empirical analysis. Chapter 5 presents and discusses the results of the estimations. Finally, Chapter 6 concludes the study with a summary of the key findings and recommendations for future research.

CHAPTER TWO: LITERATURE REVIEW

2.1 Introduction

This chapter focusses on the theoretical and empirical literature devoted on the relationship between institutional risk, political risk and FDI. The review thus consists of three sub-sections: political risk and FDI, institutional risk and FDI, and third section consist of SSA cross-country and country-specific studies. The literature review then concludes with a summary of the key themes. The study was rooted on various theories of Foreign Direct Investment including Capital Market theory, Location-Based approaches to FDI, Institutional FDI, Fitness theory, and the Eclectic Paradigm.

2.2 Theories of Foreign Direct Investment

Capital Market Theory, was one of the earliest approaches used to explain FDI. The basic hypothesis is that foreign investment usually arises as a result of capital market imperfections, (Aliber, 1971). Nayak and Choudhury (2014) stated that economies with weaker currencies are more attractive for foreign investors than equivalent economies with stronger currencies, the weaker currencies giving an absolute advantage in taking advantage of differences in the market capitalisation rate. A major criticism of Capital Market theory is that it cannot be applied in less developed economies with zero, highly imperfect or non-existent capital markets, or in those with heavily regulated foreign exchange rates (Lall, 1979).

Location-based approaches to FDI theories rest on the proposition that the extent of FDI is based on the national wealth of a country; the national wealth encompassing factors such as the volume of natural resources, local market size, availability and quality of labour and infrastructure, and government policy. An off-shoot of this location-based theory is the gravity approach to FDI wherein it was assumed that FDI flows between two countries is highest, if those two countries are similar geographically, economically and culturally. (Popovici and Călin, 2014). This theory, however, assumes a highly basic approach to the economics of FDI whilst the concept of FDI flows is more complex than just being about cohesions among economies-

The Institutional FDI Fitness theory was propounded by Wilhems and Witter (1998). The term 'FDI Fitness' relates to the country's ability to attract, absorb and retain FDI. It is the country's

ability to adapt, or to fit to the internal and external expectations of its investors, which gives countries the upper-hand in harnessing FDI inflows. The concept itself attempts to explain the uneven distribution of FDI flows between nations. Wilhems' institutional FDI fitness theory rests on four central pillars (governmental, educational, socio-cultural and market fitness) which themselves stand on socio-cultural foundations, these being, according to Wilhelms and Witter (1998), the oldest and most complex of all institutions.

The Eclectic Paradigm integrates all of the theories of FDI explained above. It integrates international trade, internalisation theories and imperfect markets, and complements these with the location-based approach theory, (Dunning, 1980). According to Dunning (2001), for a firm to engage in foreign direct investment, it must simultaneously fulfil three conditions. The firm should possess net ownership advantages over other firms serving particular markets. Interestingly, these ownership advantages are firm-specific and exclusive to that firm, in the form of both tangible and intangible assets such as trademarks, patents, information and technology, which would result in production cost reductions for the firm, enabling it to therefore compete with firms in a foreign country.

2.3 Political Risk and Foreign Direct Investment

According to Asiedu, (2013), high political risk deters investment; there should thus be a negative relationship between FDI and political risk because the latter distorts the economic and financial environment, reducing the efficiency of government and business institutions. Cross-country studies, however, show that this assumption does not always hold in reality. Busse and Hefeker (2007) explored the connection between political risk, institutions and FDI inflows for the period 1984-2003 using data from 83 developing countries. Fixed effects and GMM showed that law and order, government stability, quality of the bureaucracy, investment profile, ethnic tensions, internal and external conflict and democratic accountability were statistically significant determinants of FDI. Further results indicated that foreign investors were highly sensitive to the local political environment with an unstable political situation having a negative impact on FDI.

Guerin and Manzocchi (2009) used a random effect Tobit model to investigate the effects of political regimes on the flows of FDI from advanced to emerging countries over the period 1992-2004. The results suggest that democracy in a country positively influences the inflow of

FDI from developed to emerging countries. Their results accord with the findings of Busse and Hefeker (2007) that foreign investors are concerned about the political stability of a country before committing capital and thus, democratic countries are likely to attract investors.

Krifa-Schneider and Matei (2010) use a fixed-effect and dynamic panel models to examine the effect of the business environment and political risk on FDI in 33 developing nations. They report that the scale of FDI depends on the progress of sound economic policies, good governance, socio-political stability and adequate infrastructure. Building on the study above, Bissoon (2011) uses multiple regression models to investigate the impact of institutional quality on FDI in developing countries over the period 1996 to 2005. He finds that FDI inflows are significantly related to the quality of institutions in the target country and thus concludes that a less volatile inflation rate, efficient and less corrupt institutions, a good regulatory framework and political stability all impact positively on FDI inflows.

Vadlamannati (2012) examines the relationship between the actions of the branch offices of American-led international private companies and political risk in 101 developing countries over the period 1997-2007. Using panel data techniques, the study concludes that low levels of political risk leads to an increase in investment by American led companies. The lower the political risk, the higher level of the proportion of fixed asset investment. Furthermore, low political risk is also related to the increase in the return on investments. Thus in accordance with Bissoon (2011), there is an inverse relationship between political risk and foreign direct investment flows.

Hayakawa *et al.* (2013) use various components of both political and financial risk to determine their impact on inward FDI flows from both short and long-run perspectives, for 90 developing countries. The study uses the Generalized Method of Moments (GMM) estimators for the period 1985-2007 and reports that the political factors of corruption; religious tensions, government stability, and ethnic tensions are negatively related to FDI flows. In relation to Hayakawa *et al.* (2013), Madr and Kouba (2015) study the political effects on FDI inflows in emerging economies using panel data regression analysis. The results show that the influence of the political environment on FDI is not unequivocal in emerging markets.

Erkekoglu and Kilicarslan (2016) differed even more strongly with Hayakawa *et al.* (2013). Investigating the relationship between political risk and FDI in 91 countries using pooled

ordinary least squares for the period 2002 to 2012 they found that increases in political stability and management effectiveness, and the absence of violence, all reduced FDI.

More recently, Balan (2019) investigates the political and financial determinants of FDI inflows to the Middle East and North Africa and Turkey (MENAT). Using panel data estimations for the period 1984 to 2014, the results reveal that investment profile, religious tensions, and current account balance are the potentially significant determinants of FDI inflows. The analysis also indicates that a positive investment profile, profits repatriation and payment delays, lower religious tensions and lower risk points of current account are associated with higher volumes of FDI flows into the MENAT countries. However, their results accorded with Madr and Kouba's (2015) that the role of political stability is not unequivocal and it has a positive impact on determining foreign direct investment.

In summary, while political risk has been found to influence the level of FDI, the empirical relationship between political risk and FDI is ambiguous.

2.4 Institutional Risk and Foreign Direct Investment

According to Asongu (2013), high institutional risk is likely to discourage FDI, particularly in countries where property rights are poorly protected as multinationals then face higher expropriation risk. However, in developing countries, this may not hold because of the inherently weak institutional structures. In a cross-country study, Bissoon (2011) used a sample of 45 developing nations to investigate whether the quality of institutions was positively related to FDI. Causality analysis indicated that FDI inflows were significantly related to the quality of institutions through a unidirectional causality which runs from FDI to institutional quality.

Phung (2017) investigates the impact of institutional and political variables on FDI in 111 developing countries. The study uses generalised methods of moments (GMM) covering the period 2002 to 2012, and the results indicate that institutional factors are insignificant as determinants of FDI (except for employment contract protection), but finds that political factors are significant determinants of FDI. Peres *et al.* (2018) further examine the impact of institutional quality on FDI by categorising the countries as developed or developing. OLS analysis covering the period of 2002 to 2012 finds that institutional quality positively and

significantly impacts FDI in developed countries but that (in accord with Phung) this relationship did not hold in developing countries.

More recently, Sabir *et al.* (2019) study the impact of institutional quality on FDI inflows in 59 low, lower-middle, upper-middle and 89 higher-income countries over the period of 1996-2016. The results of a GMM analysis show that institutional quality positively affects FDI in all of these country groupings, but more significantly in developed countries than in developing ones, which accords with both Phung (2017) and Peres *et al.* (2018). In another GMM analysis, Hayat (2019) examines the impact of institutional quality on economic growth and FDI using GMM across a panel of 104 countries. The results show that both FDI inflows and institutional quality are significantly associated with economic growth, but the hypothesis that FDI leads growth is only applicable to low and middle-income countries while growth is more likely to lead FDI in high-income countries. Like Sabir *et al.* (2019) however, Hayat finds that regardless of the route, institutional quality is a significant driver of FDI.

At a more country-specific level, Asongu *et al.* (2018) investigate the determinants of FDI in the BRICS (Brazil, Russia, India, China, and South Africa) and MINT countries (Mexico, Indonesia, Nigeria, and Turkey) using pooled time-series cross-sectional analysis between 2001 and 2011. The results do not show that institutional quality and natural resource endowment as significant determinants of FDI. In contrast, Chodisetty and Reddy's (2019) similar study, covering the period from 2002 to 2017, indicates that institutional quality has had a significant effect on FDI flows in Brazil, India and China. These results differ from Hayat's (2019) which suggested that FDI stimulates growth only in developed countries.

In summary, although there is no consensus in the literature on the impact of institutional quality on FDI, many studies suggest that institutional quality tends to have a positive association.

2.5 Empirical Literature

Having explored a sample of cross-country and country-specific studies devoted to FDI in non-SSA countries, the literature review next considers studies that focus on SSA.

In a cross-country study, Asiedu (2006) examines the determinants of FDI with special attention to the roles of natural resources, market size, government policy, institutions and political instability as determinants of FDI inflows. Using a sample of 22 African countries for the period 1984 to 2000, he finds that FDI is attracted by large local markets, natural resource endowments, good infrastructure, low inflation, an efficient legal system and a good investment framework but it is inhibited by corruption and political instability.

Asiedu and Lien (2011) later investigate the relationship between democracy, FDI and natural resources. Their study uses a linear dynamic panel model from 112 developing countries, many in Africa, over the period 1982 to 2007. They find a generally (but not universally) positive relationship between political instability and FDI inflow. More specifically, their results show that deepening democracy enhanced FDI in 90 countries but reduced it in 22 countries. However, the positive relationships observed were most significantly associated with countries where the share of natural resources in total exports was low. Okafor *et al.*'s (2011) similarly investigate the relationship between democracy and FDI inflows using evidence from 48 SSA countries in panel data regression models for the period 2000 to 2010. Their findings were less optimistic; they reported an inverse relationship noting that as Sub-Saharan countries progress towards deeper democracy, FDI inflows decrease.

Gangi and Abdulrazak (2012) study the impact of governance on FDI flows to 50 African countries for the period 1996 to 2010. They find that in contrast to Asiedu and Lien (2011), political stability is significant for governance but insignificant for FDI.

Sedik and Seoudy (2012) investigate the relationship between country risk and FDI in 20 MENA countries from 1999 to 2010. Their results indicate that high levels of political risk have a positive and significant effect on FDI whereas low levels of economic and financial risk have a positive but insignificant effect. Al-Khouri and Khalik (2013) conduct a similar study of 16 MENA countries for the years between 1984 and 2011. Fixed effects and random effects models show that there is a positive relationship between deferred values of FDI, market size, and political risk and FDI. Furthermore, among 12 political risk variables, there is a close relationship between corruption, external conflict (tension) and FDI movements, which accords with Asiedu and Lien (2011).

Fiodenji (2014) investigates the linkages between political risk, institutional quality and FDI among 30 SSA countries from 1984 to 2007 to test the hypothesis that countries whose governments are highly ranked in terms of institutional quality tend to do better in attracting FDI. Empirical analysis finds that, as hypothesised, institutional quality is a significant determinant of FDI. In addition, the results accord with Asiedu and Lien's (2011) in showing that natural resource endowments matter; more resource-intensive countries tending to attract more FDI.

Bbale and Nnyanzi (2016) study the relationships between institutional quality and inward FDI across a panel of 44 SSA countries between 1996 and 2013. Fixed-effects estimation confirms the crucial role of institutional quality in attracting FDI inflows but the impact is found to vary regionally. Institutional quality is found to be most significant for the East African Community (EAC) and Economic Community of West African States (ECOWAS) but less so for the SADC countries.

Gossel (2017) investigates the relationship between democratic capital, democratic rights and FDI in 42 SSA countries over the period of 1972–2014. The fixed effects regressions analysis shows FDI being affected to a greater extent by the accumulation of democratic capital than by contemporaneous democratic reforms or the components of democracy (civil liberties and political rights). FDI is also found to respond positively to the accumulation of democratic capital in more democratic SSA countries, to the durable accumulation of democracy in less democratic countries, and to political repression in more democratic countries. Thus in accordance with Bbale and Nnyanze (2016), democracy is crucial in determining FDI. Gossel (2018) studies the relationship between FDI, democracy and corruption across 30 countries in SSA over the period of 1985–2014 to determine whether the 'helping hand' or 'grabbing hand' hypothesis is most applicable. GMM analysis shows that corruption is used by foreign investors to overcome the region's weak democratic regulatory and institutional status, which accords with Gossel's (2017) earlier work. Jumanne and Keong (2018) similarly examine the role of institutions on FDI in 46 Sub-Saharan African countries over the period 2000-2015 using dynamic GMM. The results show that although quality institutions attract FDI inflows, the FDI-resource curse exists in countries with weak institutions. Hence, SSA countries with significant resource dependence tend to have poor institutions, which then only attracts resource-related FDI as noted earlier by Asiedu and Lien (2011).

More recently, after conditioning for institutional quality in a panel of SSA countries from 2003 to 2012, Ngundu and Ngepha (2019) examine the effects of FDI from China, United States, European Union and the rest of Asia on economic growth. Panel threshold regression (PTR) analysis finds that FDI from these countries only has a positive impact on economic growth once a minimum threshold of rule of law is exceeded. However, FDI from China and the rest of Asia is less dependent on institutional quality as the growth effect of FDI from Asia is positive in countries with SSA governance ratings of at least -0.89 while negative in countries falling within a range of -1.35 and -0.89. In contrast, FDI from the EU and US tends to have economic growth effects in SSA countries with governance ratings of at least -0.90 and -0.62, respectively. Hence, these results confirm that China and the rest of Asia tend to invest in both weak and strong governance countries in SSA whereas, US and EU FDI tends to flow to only strong governance SSA countries. Ross *et al.* (2019) investigate the impact of institutional quality on Chinese FDI in Africa over the period of 2003 to 2015. They find that countries that are able to provide a politically stable environment and control levels of corruption tend to attract more Chinese FDI, thus negating the argument that Chinese FDI is attracted to countries with weak governance as posited by Chen *et al.* (2018).

Gossel (2020) examines this relationship between FDI and democratic institutions more deeply by investigating the association between FDI and elections in 37 SSA countries over the period 1972–2012. The results of GMM analysis show that FDI is deterred by both executive and legislative/parliamentary elections, as well as by behavioural unfairness and liberation elections, but is less affected by perceptual unfairness and post-election violence. This study thus follows with Jumanne and Keong (2018) in suggesting that the higher the political risk, the less the inflows of FDI.

On a country-specific basis, Chaib and Siham (2014) examined the impact of institutional quality in attracting FDI in Algeria over the period 1995-2011 using the Heritage Foundation's economic freedom index which reflects economic institutional quality (EIQ). A vector error correction model (VECM) a long-run relationship linking FDI to political institutional quality, voice of accountability, rule of law and control of corruption. The study also found that economic institutional quality has a positive impact on FDI, which accords with Bbale and Nyyanzi (2016).

Akpo and Hassan (2015) examine institutional influences on FDI in Nigeria by applying an autoregressive distributed lag model for the period 1980 to 2012. The results show that institutional quality has a long-run association with FDI whereas trade openness is significant in both the short- and long-run, which accords with Chaib and Siham (2014). Omodero (2019) studies the impact of corruption on FDI flows in Nigeria over the period from 1996 to 2017 using OLS. The results find that corruption has a significant but positive influence on FDI flows in Nigeria, which accords with the findings of Asiedu and Lien (2011) who report that control of corruption has a positive impact on FDI.

Meyer and Habanabakize (2018) study the relationship between FDI, political risk and economic growth in South Africa using an ARDL model covering 1995 to 2016. The study reports that an increase in GDP and political risk leads to a short and long-run growth in the level of FDI. However, the results further show that in the long run, political risk has a higher impact on FDI than GDP, which accords with Gossel (2017).

In summary, the results from cross-country and country-specific studies of the Sub-Saharan Africa show that political instability and poor institutional quality negatively affects FDI. However, studies further show that high natural resource endowments tends to attract FDI even to countries that suffer from endemic political and institutional weakness-

2.6 Concluding Remarks

The literature reviewed above suggests that the relationships between political risk, institutional risk and FDI are inconsistent and vary with region, resources endowment, and country-specific factors. However, in general, studies find that institutional quality and political stability have a positive impact on FDI. More specifically, while political risk has been found to have both negative and positive impacts on FDI, institutional quality tends to have a positive impact on FDI. In addition, studies report the relationship between FDI and institutional quality is not identical in developed and developing countries, being stronger in developed countries, possibly because of the inherently weak institutional quality in developing countries. Lastly, studies find that natural resources also have a significant effect on the relationships, which has implications for a highly natural resource endowed region such as SSA. Studies find that that high natural resource endowment tends to attract FDI even if a country suffers from endemic political and institutional weakness.

CHAPTER THREE: RESEARCH METHODOLOGY

3.1 Introduction

This section explains the research process that is used to investigate the relationship between political risks, institutional risks, and FDI in SSA over the period of 2003 to 2019. This section consists of the following sections: first, the research ideology is explained. Second, the steps used to conduct the analysis are explored. Lastly, the empirical model is specified.

3.2 Research Design

Research design encompasses the ‘procedures for collecting, analysing, interpreting and reporting data in research studies and thus includes the plan for connecting the conceptual research problems with the pertinent (and achievable) empirical research’ (Creswell and Clark, 2007). It establishes the procedure used and the methods to be applied in collecting and analysing this data, and how they answer the research questions (Almalki, 2016). Research design is classified into quantitative, qualitative and mixed research and the method of research resides in the paradigms and the communities of the scholar as well as the nature of the research (Eyisi, (2016).

Quantitative research is used to quantify a problem by generating numerical data which can be used for statistical analysis. It uses measurable data to formulate facts in a study while qualitative research is primarily exploratory research (AFIDEP, 2017). In contrast, mixed-methods involves the collection or analysis of both quantitative and/or qualitative data in a single study in which the data are collected concurrently or sequentially, are given a priority, and involve the integration of the data at one or more stages in the research process (Gutman and Hanson, 2003).

There are two broad methods of reasoning in research namely inductive and deductive approaches. Deductive reasoning works from more general to more specific analysis, which implies that it is a top-down approach (Soiferman, 2010) where the researcher works from hypothesis to data and to or contradict theory (Cresswell and Clark (2007). In contrast, inductive research entails moving from specific observations to broader generalisations and

theories. Exploratory research is conducted when enough is not known about a phenomenon and a problem that has not been clearly defined (Saunders *et al.*, 2012). It does not aim to provide the final and conclusive answers to the research questions but merely explores the research topic with varying levels of depth. Therefore, its theme is to tackle new problems on which little or no previous research has been done (Brown, 2006). Even in the extreme case, exploratory research forms the basis for more conclusive research and determines the initial research design, sampling methodology and data collection method (Singh, 2007).

This study uses a deductive quantitative research approach.

3.3 Model Specification

The empirical strategy utilised in this study is based on the Location FDI theory (Popovici and Călin, 2014), Institutional FDI fitness theory (Wilhems, and Witter, 1998), and an adaptation of Gossel (2018). The basic model estimates the effects of political risk, institutional quality, trade openness, economic development, inflation rate, infrastructure development, and a dummy variable for natural resource endowed countries on FDI. Thereafter, the regressions are re-estimated to capture the potentially differing effects of political risk and institutional quality by including an interaction term. Thus, the models can be summarised as follows:

$$FDI_{it} = \alpha_0 + \alpha_1 FDI_{i,t-j} + \alpha_2 PR_{it} + \alpha_3 INF_{it} + \alpha_4 INFRA_{it} + \alpha_5 GDPPC_{it} + \alpha_6 TO_{it} + \alpha_7 NRE_{it} + \mu_{it} \quad (1)$$

$$FDI_{it} = \alpha_0 + \alpha_1 FDI_{i,t-j} + \alpha_2 IQ_{it} + \alpha_3 INF_{it} + \alpha_4 INFRA_{it} + \alpha_5 GDPPC_{it} + \alpha_6 TO_{it} + \alpha_7 NRE_{it} + \mu_{it} \quad (2)$$

$$FDI_{it} = \alpha_0 + \alpha_1 FDI_{i,t-j} + \alpha_2 PR_{it} + \alpha_3 INF_{it} + \alpha_4 INFRA_{it} + \alpha_5 GDPPC_{it} + \alpha_6 TO_{it} + \alpha_7 NRE_{it} + \alpha_8 PRIQ_{it} + \alpha_9 FDIPR_{it} + \alpha_{10} FDI IQ_{it} + \mu_{it} \quad (3)$$

$$\begin{aligned}
FDI_{it} = & \alpha_0 + \alpha_1 FDI_{i,t-j} + \alpha_2 IQ_{it} + \alpha_3 INF_{it} + \alpha_4 INFRA_{it} + \alpha_5 GDPPC_{it} + \alpha_6 TO_{it} + \\
& \alpha_7 NRE_{it} + \alpha_8 PRIQ_{it} + \alpha_9 FDIPR_{it} + \alpha_{10} FDIIQ_{it} + \mu_{it}
\end{aligned}
\tag{4}$$

where *FDI* is foreign direct Investment, *PR* is political risk, *IQ* is institutional quality (a composite index from Kuncic's database), *INF* is inflation rate, *GDPPC* is gross domestic product per capita, *TO* is trade openness, *INFRA* is infrastructure development and *NRE* is a dummy variable for natural resource endowment and μ_{it} is the error term.²

The models specified in equations (1) – (4) makes use of one dependent variable, two variables of interest, and four control variables.

3.3.1 Dependent Factor

The dependent variable is FDI as a percentage of GDP (*FDI*). FDI is defined as cumulative net inflows of FDI capital as registered in the reporting country's balance of payments statistics (Kruja and Dragusha, 1996), and thus includes the sum of new equity purchased or acquired by parent companies in overseas firms they are considered to control (including establishment of new subsidiaries), reinvestment of earnings by controlled firms, and intra-company loans from parent companies to controlled firms.

3.3.2 Factors of Interest

The two primary independent variables of interest in this study are political risk and institutional risk.

Political Risk

According to the World Bank (2011), political risk is broadly defined as the probability of a company's operations being disrupted by political forces and events. Political risk can take the form of transfer and convertibility restrictions, corruption, government expropriation of assets, breach of contract, failure to honour sovereign financial obligations, the wrongful calling of credit letters, foreign currency inconvertibility, terrorism, political violence and war, civil disturbance, inability to repatriate funds and other adverse regulatory changes (Ginsburg,

² All estimations as well as the various econometric tests are conducted using Stata 14.1 econometric software.

2013). The political environment affects the investment climate, in partnerships with foreign companies. This study uses the political risk index from the International Country Risk Guide (ICRG) provided by the Political Risk Services (PRS) Group.

The political risk rating from PRS comprises 12 weighted variables which portray both social and political characteristics to ensure a robust coverage of political risk. The risk rating is calculated using casual assumptions, expert judgment and weights. The level of political stability remains the reason for measuring political risk of any given country. The risk components and weights that constitute political risk are, socioeconomic conditions, government stability, external and internal conflict, investment profile, law and order, corruption, ethnic tensions, military in politics, democratic accountability, and quality of bureaucracy. The political risk index (*PR*) is rated from 0 (political risk) to 6 (political stability) where a high rating implies a low political risk rating.

Institutional Risk

Institutional risk (*IQ*) comprises the risks associated with weak property rights, rule of law, corruption and political restrictions. This study makes use of Kuncic's (2014) database, which groups over 30 institutional indicators derived from different sources such as the Heritage Foundation, Freedom House, Fraser Institute, ICRG, World Bank World Governance Indicators (WGI), Polity and Transparency International into three institutional spheres: legal, political and economic. Using Kuncic's database provides an index of institutional quality to reflect the institutional environment of a country. The relative institutional quality values derived from Kuncic's database range from -2 to 2, with a mean of zero (0). The index is calculated using factor analysis to identify the latent factor scores each year for every country, within each institutional group. The advantage of this index is that it combines comprehensive sources of legal, political and institutional quality variables for the sampled Sub-Saharan African countries.

3.3.3 Control Factors

In addition to the dependent variables and two independent variables of interest, this study also uses four control factors selected in accordance with the relevant literature. All of the data relating to the control variables was obtained from the World Bank's World Development Indicators.

Inflation

A stable macroeconomic environment should encourage inward FDI because low inflation rates are a sign of internal economic stability (Andinuur, 2013). This study uses the consumer price index (CPI) as a proxy for inflation and expects an inverse relationship between it and FDI.

Gross Domestic Product Per Capita

This study includes GDP per capita (GDPPC) to control for the effects of market size and market seeking FDI. Large and growing markets allow firms to exploit economies of scale; they represent the demand for goods and services, which has been cited as critical for attracting FDI (Asiedu, 2006; Cheung and Qian, 2009; Kolstad and Wiig, 2012). The growth prospects of the recipient economy are also likely to be considered when potential investors evaluate inward investment activities (Bhasin *et al.*, 1994; Morrissey and Rai, 1995) as they represent market size.

Infrastructure Development

Improvements to infrastructure facilitate trade and improve factor productivity in an economy. Hence, increasing infrastructure should significantly and positively impact FDI inflows in developing economies (Asiedu, 2006; Khadaroo, and Seetanah, 2010). Following Nguea (2020) and Asiedu (2006), this study uses the African Infrastructure Development Index (AIDA) as a proxy for infrastructure.

Trade Openness

Trade openness is a key determinant of FDI (Faroh and Shen, 2015; Xaypanya *et al.*, 2015) because it facilitates financial openness. This study uses the sum of exports plus imports as a percentage of GDP as a measure of trade openness. A positive association between trade openness and FDI is expected in accordance with the export-led and import-led growth hypothesis (Aizenman, and Noy, 2004; Aizenman, 2008).

Natural Resource Endowment

Natural resources are a significant component of exports from many African countries but are unfortunately associated with 'Dutch disease' (Wantchekon and Jensen, 2000; Asiedu and Lien 2011; Henri, 2019). Hence, the analysis includes a binary dummy variable to differentiate SSA countries that are significantly resource endowed countries against those that are more diversified. The dummy variable takes the value of one for highly resource endowed economies and zero for less resource endowed countries (Aregbeshola, 2014; El-Wassal, 2012).

3.4 Econometric Estimation Technique

The relationships specified in equations (1) – (4) above are analysed using the Generalised Methods of Moments (GMM) approach originated by Hansen (1982), enhanced by Holtz-Eakin *et al.*, (1988) and advanced by Arrelano and Bover (1995) and Blundell and Bond (1998). The GMM approach circumvents several modelling concerns such as endogeneity of regressors, that are inadequately addressed by Fixed Effects (FE) and Random Effects (RE) models. As a result, the GMM model addresses the endogeneity problem and is also able to fit linear models with a dynamic dependent variable (Roodman, 2009). Dynamic panel data estimators have additional advantages over static panel estimators. These include the ability to express a data generating process (DGP) that hinges on its past values and current and past values of explanatory variables that are not strictly exogenous (Bun, and Sarafidis, 2015), and the technique is explicitly designed for panels with short T and large N . The general expression of a dynamic panel takes the form:

$$Y_{it} = \alpha y_{i,t-1} + \beta X'_{it} + \mu_i + v_{it} \quad i = 1, \dots, N; t = 1, \dots, T \quad (5)$$

Where x'_{it} is a vector of regressors, μ_i is the individual specific effects, v_{it} is the error term with zero mean, constant variance and uncorrelated with time and individuals. In this specification, $y_{i,t-1}$ is correlated with μ_i since the past values already depend on the individual effects (Kruiniger, 2009).

This encroaches on the compatibility of conventional panel data estimators because $y_{i,t-1}$ is correlated with both x'_{it} and v_{it} . As a result the random effects Generalized Least Squares (GLS) and fixed effects Within Group (WG) estimators are biased and inconsistent (Bond 2002; Bun and Sarafidis 2015) causing the model to suffer from endogeneity problem.

Anderson and Hsiao (1982) first made an attempt to address the problem by taking $\Delta y_{i,t-2}$ and $y_{i,t-2}$ as instruments of $y_{i,t-1}$, an approach supported by (Holtz-Eakin *et al.*, 1988). Arrelano and Bond (1991) building on Holtz-Eakin *et al.* (1988) then developed the difference Generalized Methods of Moments (GMM) estimator. They obtained estimators by using the

moment conditions generated by lagged levels of the dependent variable, $(y_{i,t-2}, y_{i,t-3}, \dots)$ with v_{it} .

GMM estimation validates the instruments by including current and first lags of the dependent variable and independent variables as the instruments. The GMM estimated model therefore becomes:

$$Y_{it} = \beta_0 + \beta_1 Y_{i,t-1} + \beta_2 X'_{it} + \mu_i + v_{it} \text{ GMMSTYLE}(X'_{it}, \text{laglimit}(\# \#) \text{ and } \text{IVSTYLE}(X'_{it}))$$

(6)

Lags (# #) instructs the specified lag limits to be used as the endogenous variables. In the presence of autocorrelation in the disturbance term, the instruments become invalid, which distorts the efficiency and reliability of estimators (Arellano and Bond, 1991; Blundell and Bond, 2000; Bowsher, 2002). If v_{it} are serially correlated of order 1, then $y_{i,t-2}$ is endogenous to v_{it} . To verify the consistency of the GMM estimator, the Hansen test of over-identifying restrictions is used. Rejecting the test null hypothesis, implies that the instrumental variables are not correlated with the residual and satisfy the orthogonality conditions required (Hansen, 1982). A serial correlation test is also conducted to ensure that the errors exhibit no second-order serial correlation.

3.5 Diagnostic Tests

In order to make sure that the model does not suffer from econometric problems such as multicollinearity, second-order serial correlation and over-identification; the following diagnostic tests were performed.

Multicollinearity

Multicollinearity is common when dealing with data that involves a time trend because some of the explanatory variables may be related. The main challenge caused by multicollinearity is that it can make the coefficients of the regression indeterminate (Gujarati, 2004). In this study, multicollinearity is assessed using a pairwise correlation matrix to ensure that there is no correlation coefficient in excess of 0.8 (Kunter, *et al.*, 2004).

Autocorrelation Test

The inclusion of a lagged dependent variable is likely to cause the model to suffer from autocorrelation (Baltagi and Kao, 2012). The existence of serial correlation can invalidate some or all of the variables. When estimating an Arrelano and Bond (1991) GMM model, the AR(2) term is thus tested for the presence of autocorrelation where a significant AR(2) coefficient below 5% indicates the presence of serial correlation.

Over-identification Test

To check whether the model is correctly-identified, the Hansen test is conducted. This test is based on the assumption that the model parameters are correctly identified via a priori restrictions on the coefficients (Hansen, 1982). The null hypothesis that identifying restrictions are valid is rejected if the probability value is below the 5% significance level.

CHAPTER FOUR: RESEARCH FINDINGS

4.1 Introduction

The purpose of this chapter is to present, estimate and interpret the empirical results in order to answer the research questions presented in chapter one.

4.2 Multicollinearity Test Results

Table 3 presents the pairwise correlation test results. As can be seen, none of the correlations exceed 0.8 but political risk (*PR*) and institutional risk (*IQ*) share a high pairwise relationship with correlation of 0.614. Hence, the two factors of interest are regressed in separate models as specified in equations (1) – (4).

Table 3: Pairwise Correlation Matrix Results

Variable	FDI	PR	IQ	INFRA	INF	GDPPC	TO
FDI	1.000						
PR	0.195	1.000					
IQ	0.228	0.614	1.000				
INFRA	0.185	0.166	0.291	1.000			
INF	0.112	0.083	0.1148	-0.010	1.000		
GDPPC	0.091	0.069	0.251	0.093	0.127	1.000	
TO	0.345	0.323	0.124	0.163	0.042	0.004	1.000

4.3 Serial Correlation and Over-Identification Test Results

The estimations were tested for serial correlation and over-identification using the Arellano and Bond AR(2) autocorrelation test and Hansen test respectively. The results presented in Table 4 below show that the models do not suffer from serial correlation and that the instruments used are valid and thus the models are correctly identified. Arellano and Bover, (1995) and Hansen, (1982) argued that the higher the values for the AR(2) and Hansen tests, the better and the more reliable the results will be.

Table 4 Diagnostic Test Results

	Difference GMM				System GMM			
	1-1	1-2	1-3	1-4	1-1	1-2	1-3	1-4
AR(2)	0.231	0.318	0.286	0.394	0.321	0.259	0.367	0.152
Hansen	0.415	0.281	0.192	0.286	0.165	0.219	0.189	0.157

Source: Researcher Calculation using Stata 14.1

4.4 Estimation Results

The results of the analysis that explores the extent to which institutional and political risk impact FDI in SSA are presented in Table 5 below. As expected, lagged FDI is significant and positive, which accords with the long-run nature of this form of investment (Phung, 2017). Regarding the control factors, models 1_1 and 1_2 show that trade openness, infrastructure development and GDPPC are highly statistically significant and positive for both models while inflation is significant and negative. These results suggest that, FDI is attracted by per capita wealth creation, infrastructure development, and by heightened trade in SSA economies, which accords with the literature.³ The negative coefficients for inflation indicate that FDI is discouraged by the erosion of returns and policy instability associated with weak monetary policy, independence, and stability, which accords with the literature (Gossel, 2018; Mishkin, and Eakins, 2009; Nijathaworn, and Disyatat, 2009). The natural resource endowment dummy shows that well-endowed economies tend to attract more FDI than equivalent less-endowed economies. Henri (2019) reports that the patronage associated with natural resources in SSA negatively affects the regions rule of law, public administration, regulation, voice and accountability, political stability, as well as negatively impacting corruption, GDP per capita and eroding physical and human capital accumulation. This is possibly because FDI to SSA is predominantly resource extractive rather than ‘greenfield’ or ‘brownfield’. Unfortunately, this form of FDI has been found to prefer to negotiate directly with more autocratic governments that can protect their investment and opportunities rather than with more open democratic

³ For example Asiedu (2006); Cheung and Qian (2009); Pazim (2009); Kolstad and Wiig (2012); Faroh and Shen (2015); Xaypanya *et al.* (2015); Ee (2016); Gossel (2017, 2018, 2020); Nguea (2020).

governments and thus can have significant impacts on democratization in SSA countries (Asiedu and Lien, 2011; Li and Resnick, 2003; Gossel, 2018).

Table 5: Generalised Method of Moments Estimation Results

	<i>Difference GMM</i>		<i>System GMM</i>	
	<i>1-3</i>	<i>1-4</i>	<i>1-3</i>	<i>1-4</i>
L.FDI	0.214** (0.082)	0.302*** (0.096)	0.198*** (0.032)	0.337*** (0.048)
INF	-0.112** (0.041)	-0.916** (0.369)	-1.213*** (0.186)	-0.853** (0.326)
INFRA	0.268*** (0.087)	0.253** (0.105)	0.291*** (0.046)	0.264*** (0.051)
GDPPC	0.137*** (0.039)	0.119*** (0.043)	0.995*** (0.282)	0.153*** (0.019)
TO	0.182** (0.077)	0.215** (0.082)	0.201*** (0.047)	0.211*** (0.056)
NRF	0.316*** (0.039)	0.419** (0.154)	0.429** (0.170)	0.363*** (0.076)
PR	3.147*** (0.597)		2.268** (1.021)	
IQ		2.792*** (0.765)		2.531** (1.016)
PRIQ	3.415** (1.239)	2.986*** (0.375)	3.109*** (0.377)	2.752*** (0.547)
FDIPR	1.583*** (0.380)		1.317** (0.480)	
FDIIQ		1.942*** (0.615)		1.837*** (0.354)
Instruments	16	17	14	11
F-stat	54.405***	85.216***	103.549***	26.814***
Observations	340	340	340	340

Source: Researchers Calculation using Stata 14.1

*, **, *** denote the rejection of the null hypotheses at the 1%, 5%, 10% level of significance

The results in Table 5 show that the political stability (*PR*) coefficient is significant in model 1-1, which suggests that FDI responds positively to declining political risk. Considering that many SSA countries are resource export-dependent, this result suggests that improved political stability in SSA could attract more diversified FDI.

The coefficient of institutional quality is also positive, that is improvements in institutional quality attract FDI inflows. Considered together the positive coefficients of political stability and institutional quality are associated with a reduced cost of investment, and thus higher diversified FDI inflows (Alfaro, *et al.* 2008; Asiedu, 2006; Buchanan, *et al.*, 2012; Cleeve, 2012; Hayakawa, *et al.* 2013). Unfortunately, many of SSA's resource extractive countries suffer from patrimonial and clientelist networks which negatively affect FDI by complicating negotiations and raising suspicions as to whether the agreed benefits will be delivered (Efobi, 2015; Gossel, 2018; Rodriguez *et al.* 2005; Uhlenbruck *et al.* 2006). Consequently, it is possible that diversified FDI will more likely be attracted to SSA countries that are less resource-dependent as they will be able to improve their institutional and political stability at a faster pace than resource export-dependent SSA countries (Makoni, 2018; Jumanne and Keong, 2018). However, as noted by Gossel (2017), FDI is affected by the long-run accumulation of democratic capital rather than short-run democratization, and thus institutional and political reforms will likely only attract diversified FDI if they derive sustained democratization rather than to contemporaneous democratic reforms that can be easily reversed or eroded (Collier, and Vicente, 2012; Wantchekon, and Jensen, 2000).

Lastly, the positive coefficients of political risk and institutional quality suggest that FDI to SSA is not attracted by as hypothesized by Li and Resnick, (2003); Harstad, and Svensson, 2011 and Li, (2009).

Table 6 Interaction Models

	<i>Difference GMM</i>		<i>System GMM</i>	
	<i>1-3</i>	<i>1-4</i>	<i>1-3</i>	<i>1-4</i>
L.FDI	0.214** (0.082)	0.302*** (0.096)	0.198*** (0.032)	0.337*** (0.048)
INF	-0.112** (0.041)	-0.916** (0.369)	-1.213*** (0.186)	-0.853** (0.326)
INFRA	0.268*** (0.087)	0.253** (0.105)	0.291*** (0.046)	0.264*** (0.051)
GDPPC	0.137*** (0.039)	0.119*** (0.043)	0.995*** (0.282)	0.153*** (0.019)
TO	0.182** (0.077)	0.215** (0.082)	0.201*** (0.047)	0.211*** (0.056)
NRF	0.316*** (0.039)	0.419** (0.154)	0.429** (0.170)	0.363*** (0.076)
PR	3.147*** (0.597)		2.268** (1.021)	
IQ		2.792*** (0.765)		2.531** (1.016)
PRIQ	3.415** (1.239)	2.986*** (0.375)	3.109*** (0.377)	2.752*** (0.547)
Instruments	16	17	14	11
F-stat	54.405***	85.216***	103.549***	26.814***
Observations	340	340	340	340

Source: Researchers Calculation using Stata 14.1

*, **, *** denote the rejection of the null hypotheses at the 1%, 5%, 10% level of significance

Having examined the effects of political stability and institutional quality on FDI, the discussion next turns to the interactions between political stability and institutional quality (*PRIQ*) in order to determine whether political stability and institutional quality substitute or complement each other in FDI attraction. The interactions indicate the impact on FDI of a change in the level of political stability for a given level of institutional quality.

The interaction results are presented in Table 6. They show that overall, the macroeconomic control factor coefficients are relatively unchanged from Table 5 the focus is therefore on the governance and interaction terms. The coefficient of the interaction term (*PRIQ*) is positive suggesting that political stability and institutional quality are substitutive. This suggests that good institutions and political stability are more valuable for governments wishing to encourage

FDI. Additionally, the coefficient of the institutional quality interaction is larger than that of the political risk interaction. This suggests that good institutions are more valuable than political stability for governments wishing to encourage FDI as has been argued elsewhere e.g. (Kuncic, 2012; Peres *et al.* 2018; Phung, 2017), foreign investors are more concerned with long-run regulatory enforcement and investment protection and political dynamics.

4.5 Concluding Remarks

The data set used showed no severe collinearity multicollinearity between the independent variables. Tests for autocorrelation and overidentification tests indicated that neither was a problem in the model. The GMM results showed that both political and institutional risk discourage FDI inflows in SSA. The control factors, trade openness, infrastructure development, GDP per capita, and natural resource endowment were found to positively attract FDI inflows whilst inflation impacted FDI inflows negatively. The interaction results, indicated that FDI is attracted more by good institutions than by political stability. Therefore, the forthcoming chapter presents conclusion of the study and recommendations to future studies.

CHAPTER FIVE: CONCLUSIONS

5.1 Introduction

The main purpose of this study was to investigate the relationship between FDI, political and institutional risk in Sub-Saharan Africa for the period 2003 to 2019 using the Generalised Method of Moments approach.

5.2 Conclusions

The results of the analysis provide the following insights on the research questions listed in section 1.3. With regards to the primary research question:

5.2.1 Do political and institutional risks significantly affect Foreign Direct Investment in Sub-Saharan Africa?

The findings show that the worsening of political risk and institutional quality significantly and negatively affects FDI in Sub-Saharan Africa. Li and Resnick (2003), Gehlbach and Keefer (2011), and Resnick (2001) contend that FDI will be attracted to autocratic regimes that can protect their interests, but, in contrast this study finds that politically and institutionally stable economies in SSA tend to attract more FDI inflows, whilst politically unstable and institutionally weak economies attract less FDI. This agrees with Aguiar *et al.* (2016); Hayakawa *et al.* (2013); Hecock *et al.* (2014); Mádr and Kouba (2015); Bbale and Nnyanzi (2016); Chen *et al.* (2018); Phung (2017) and Ross *et al.* (2019).

5.2.2 Does political risk affect Foreign Direct Investment in Sub-Saharan Africa to a greater or lesser extent than institutional risk?

The results suggest that institutional quality is stronger than political risk as a driver of FDI. This may be because foreign investors are more concerned with long-run regulatory enforcement and investment protection than with short-run political dynamics (Kuncic, 2012; Peres *et al.* 2018; Phung, 2017). Alternatively, FDI may be more responsive to the democratic capital accumulated over the long-run, than to short-run democratic reforms that can be easily reversed or eroded (Collier and Vicente, 2012; Wantchekon and Jensen, 2000).

5.2.3 Do political risk and institutional risk substitute or complement each other in FDI attraction?

Interaction terms were estimated for political risk and institutional quality (PRIQ). The coefficient of the political risk-institutional quality was positive suggesting that FDI is attracted

by both good institutions and political stability, possibly because foreign investors are more concerned with long-run regulatory enforcement, investment protection than by short-run political dynamics (Kuncic, 2012; Peres *et al.* 2018; Phung, 2017). More so, a politically stable economy is more likely to be characterized by a sound institutional environment.

5.3 Recommendations for Future Research

This study could be expanded in the following ways:

The study has considered SSA as a regional block but this does not consider the effects of the possible disparities that arise, such as differentiated colonial histories, resource endowment, and democratic levels. It is possible that a future study could be expanded to include these factors. The study also considered FDI regardless of source country, however, it is possible that China and other countries have differing investment motives and react differently to SSA's political and institutional reforms. A future study could therefore consider the relationships between FDI, political risk, and institutional quality on the basis of the source regions of FDI. Future studies should look at the interactions between political risk with institutional risk for FDI to ascertain whether they substitute or complement each other. Lastly, the democratic trajectories of SSA vary from autocracies to more democratic regimes, and a future study could seek to determine whether the disparities in democratic quality in SSA significantly affect the relationship between FDI, political risk, and institutional quality.

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