



## THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT

### What is the evidence for Africa<sup>1</sup>?

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**Abstract:** The main purpose of the present paper is to provide an overall analysis of recent studies that both focus on Africa and examine the various factors that attract or deter Foreign Direct Investment (FDI) in Africa, in order to find answers to the following question: What are the determinants / impediments of FDI to Africa? To that end I have based my research on the articles published in all the economic journals found in the Econlit database from January 1969 up to May 2007. The keywords “foreign direct investment” and “Africa” yielded ten papers on FDI Determinants to Africa, which are the object of the present paper.

**Key-words:** Foreign Direct Investment (FDI); Africa.

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## **1. Introduction**

The main purpose of the present paper is to provide an overall analysis of recent studies that both focus on Africa and examine the various factors that attract or deter Foreign Direct Investment (FDI) in Africa, in order to find answers to the following question: What are the determinants / impediments of FDI to Africa? To that end I have based my research on the articles published in all the economic journals found in the Econlit database from January 1969 up to May 2007. The keywords “foreign direct investment” and “Africa” yielded ten papers on FDI Determinants to Africa, which are the object of the present paper.<sup>3</sup>

Although there is a dearth of recent research on FDI determinants to Africa (as suggested by several authors – e.g. Krugell, 2005; Asiedu, 2006), the empirical investigation on the issue is not confined to those ten papers. Therefore, we will provide further evidence on the factors that affect FDI to Africa, based on other references on Africa that I have found either from my own search on the issue or from the literature reviews of the studies published in academic journals indexed in Econlit and surveyed here.

The remainder of the paper is organised as follows. Section 2 provides a synopsis of the ten papers on FDI Determinants to Africa and is followed by Section 3 that presents the specific determinants of FDI for Africa, based on the studies surveyed here and other references on Africa. Section 4 contains some concluding comments and remarks. Appendix I provides a detailed description of the studies from Econlit.

## **2. Overview of articles published in Econlit on the determinants of FDI to Africa**

Morisset (2000) makes the point that African countries can also be successful in attracting FDI that is not based on natural resources or aimed at the local market, but rather at regional and global markets, by improving their business climate. Using FDI that does not arise from market size and the natural resources available in the host country as an indicator of the business climate for FDI, the author aims to first identify which sub-Saharan Africa

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<sup>3</sup> The papers are: Morisset (2000), Schoeman *et al.* (2000), Asiedu (2002a), Bende-Nabende (2002), Lemi and Asefa (2003), Asiedu (2004), Yasin (2005), Asiedu (2006), Dupasquier and Osakwe (2006) and Fedderke and Romm (2006). Akinlo (2003) came out in our *Econlit* search using ‘foreign direct investment’ and ‘Africa’ as keywords, but this paper focuses on the FDI contribution to growth and was thus disregarded from the current analysis.

(SSA) countries have been able to attract FDI by improving their business environment and then investigate which policy factors have played a significant role in the improvement of their investment climate.

Evidence from the countries show that, in 1997, Mozambique, Namibia, Senegal and Mali were among countries with the most attractive investment environments, receiving more FDI inflows than countries that have a bigger local market (e.g. Kenya, Congo) and/or natural resources (e.g. Congo, Zimbabwe). Thus pro-active policies and re-oriented governments can generate FDI interest.

To improve the climate for FDI, an econometric analysis for 29 SSA countries over the period 1990-97 indicates that GDP growth rate and trade openness can be used to fuel the interest of foreign investors. A detailed review of the policy reforms implemented in Mali and Mozambique further indicates the following strategic actions for their recent success, beyond macroeconomic and political stability: opening the economy through a trade liberalization reform; launching an attractive privatization programme; modernizing mining and investment codes; adopting international agreements related to FDI; developing a few priority projects that have a multiplier effects on other investment projects; and mounting an image building effort with the participation of high political figures, including the President.

Schoeman *et al.* (2000) analyse how government policy (mainly deficit and taxes) affects FDI through the estimation of a long-run co-integration equation for FDI in South Africa during the past 30 years. Of special importance are the deficit/GDP ratio, representing fiscal discipline, and the relative tax burden on prospective investors in South Africa.

The main finding is that both fiscal policy variables have a negative effect on FDI flows to South Africa. According to the authors, there is room for the South African government to transform its economy into an investor-friendly environment, by adjusting fiscal policy. Serious attention should be paid to the tax burden which is still relatively high.

Asiedu (2002a) uses a comprehensive dataset of 71 developing countries, about half of which are in the poorest region of Africa – SSA – over the 1988-97 period to analyse whether the determinants of FDI to developing countries are equally relevant for SSA. The author focuses on three main variables – return on investment, infrastructure development and openness to trade – and the results imply that Africa is different.

Higher marginal product of capital and better infrastructure do not drive FDI to SSA and, although openness to trade has a positive impact on FDI to SSA, the impact is lower than non-SSA countries. Moreover, being an African country has a negative effect on FDI, mainly due to the perception that Africa is overly risky. The three policy implications are as follows: African countries need to liberalize their trade regimes and the reform must be perceived as credible by foreign investors; successful policies in other regions cannot be blindly replicated in Africa; African governments have to disseminate information about their countries to dispel the myth about the continent.

Bende-Nabende (2002) aims to provide an empirical assessment on the macro locational determinants of FDI in SSA through the assessment of co-integration or rather long-run relationships between FDI and its determinants. The study comprises 19 SSA countries over the 1970-2000 period and employs both individual country data and panel data analyses techniques.

The empirical evidence suggests that the most dominant long-run determinants of FDI in SSA are market growth, a less restrictive export-orientation strategy and the FDI policy liberalization. These are followed by real effective exchange rates and market size. Bottom on the list is the openness of the economy. Thus, as far as SSA is concerned, their long-run FDI positions can be improved by improving their macroeconomic management, liberalizing their FDI regimes and broadening their export bases.

Lemi and Asefa (2003) address the relationship between economic and political uncertainty and FDI flows in African countries. The authors stress the following contributions of their paper: the first study in formally dealing with the role of political and economic uncertainty in affecting FDI in Africa using Generalized autoregressive heteroscedastic (GARCH) model to generate economic uncertainty indicators; the study analyze FDI from all source countries – overall US FDI, US manufacturing FDI and US non-manufacturing FDI – and their responses to uncertainty, whereas previous studies disregarded how the role of uncertainty differs by industrial groups and source countries; the period of analysis and sample countries are large enough for the result to be robust, which other studies did not consider.

The results of the panel study for 29 African countries over the period 1987-99 are as follows: for FDI from all source countries, the impact of uncertainty is insignificant; for aggregate US FDI, economic and political uncertainties are not major concerns; for US

manufacturing FDI, only political instability and government policy commitment are important factors; for US non-manufacturing FDI, economic uncertainties are the major impediments only when coupled with political instability and debt burden of host countries; other economic factors such as labour, trade connection, size of export sector, external debt, and market size are also significant in affecting FDI flows to African economies.<sup>4</sup>

Drawing on the empirical literature on the determinants of FDI, Asiedu (2004) provides an explanation for the deterioration in SSA's global (relative) FDI position. The author argues that SSA's share of FDI to developing countries has declined over time, because of the less attractiveness of SSA for FDI over time, relative to other developing regions. The analysis focuses on three FDI determinants – openness to FDI, good infrastructure and institutional quality – using policy-related measures (since one of the objectives of this paper is to prescribe policies that will enhance SSA's global FDI position) over the 1980-99 period.

The main finding is that, with regard to FDI determinants, SSA's experience can be characterised as absolute progress but relative decline. Indeed, from 1980-89 to 1990-99, SSA has reformed its institutions, improved its infrastructure and liberalised its FDI regulatory framework. However, compared with other developing regions, the degree of changes in SSA has been meagre. The policy implication that follows is the need to enhance SSA's policy environment in both absolute and relative terms.

Yasin (2005) explores the link between the two major sources of external capital needed to fill Africa's significant resource gap (say, FDI and ODA), by using a panel data from 11 SSA countries for the period 1990-2003. The basic assumption is that Official Development Assistance (ODA, i.e. grants and loans from bilateral and multilateral organizations such as the World Bank) may remove some of the obstacles to FDI flows and thus improve the economic conditions that attract FDI.

In line with previous studies, there is a positive relationship between bilateral ODA and FDI, which suggests that ODA granting countries have a significant influence on the locational decisions of the multinational corporations (MNCs) located in these countries. Thus, African countries need to formulate policies to enhance the economic and political relationships with donor countries. As regards to multilateral ODA, the empirical findings on

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<sup>4</sup> The US manufacturing sector includes food, chemical, metals, machinery and equipment, electronics and transportation industries, while the US non-manufacturing sector includes whole sale trade, banking, finance, insurance and other service industries.

its influence on FDI flows are controversial to date. Yasin's estimation suggests that these ODA flows are not a critical requirement for FDI activities by the MNCs in the developing countries.

Asiedu (2006) utilises panel data for 22 SSA over the period 1984-2000 to investigate the influence of natural resources and market size *vis-à-vis* government policy, host country's institutions and political instability in directing FDI flows to the region. The results suggest that countries in SSA that are endowed with natural resources or have large markets will attract more FDI. However, small countries and/or countries that lack natural resources in the region can also obtain FDI by improving their institutions and policy environment, because good infrastructure, an educated labour force, macroeconomic stability, openness to FDI, an efficient legal system, less corruption and political stability also promote FDI.

In light of these findings, Asiedu stresses the importance of regional blocs such as the Southern African Development Community (SADC) in enhancing FDI flows to the region. In addition to expanding the size of the market, regionalism can promote political stability by restricting membership to countries with democratic political systems, as well as provide incentives for member countries to implement good policies through the threat of sanctions or the lost of access to the bloc for errant countries.

Dupasquier and Osakwe (2006) summarize the reasons for Africa's poor FDI record, based on an overview of the empirical determinants of FDI to Africa. Their main aim is to identify concrete actions or strategies that need to be adopted at the national, regional and international level to enhance FDI flows to Africa.

Briefly, these are the following: a) image building through an increase in political and macroeconomic stability, as well as in the protection of property rights and the rule of law; b) supporting existing investors through infrastructure development, provision of services and changes in the regulatory framework (e.g. relaxing laws on profit repatriation); c) marketing investment opportunities through the use of existing investors and information communication technologies instead of over-reliance on Investment Promotion Agencies (IPAs); d) diversification of the economy; e) trade liberalization; f) privatization; g) enhancing regional integration; h) providing an external agency of restraint on domestic policies through the formation of regional groups; i) promoting good governance through regional surveillance mechanisms; j) initiating and encouraging infrastructure development projects at the regional level; k) improving market access at the international level through the

elimination of trade barriers and subsidies on agricultural goods exported by African countries; l) investment promotion assistance by governments of developed countries through the provision of accurate information to investors in their countries; m) technical assistance by governments of developed countries in areas such as capacity building, health and education.

Finally, Fedderke and Romm (2006) focus on the growth impact as well as the determinants of FDI in South Africa. As concerns to FDI determinants, they propose a model of locational choice of the investment activity between domestic and foreign alternatives and employ time-series data for South Africa from 1962 to 1996 to test for the predictions of their model.

In the context of the Johansen VECM specification, the factors that were found to either impede or induce FDI flows into South Africa are the following: labour capital ratio; market size; corporate taxation; wage costs; openness of the economy and the political institutional structure. The negative sign for labour capital ratio found from their estimations suggests that FDI in South Africa has tended to be capital intensive and thence the preponderance of horizontal over vertical FDI in South Africa. In addition, reducing political risk, ensuring property rights, bolstering growth in the market size, as well as wage moderation (ideally lowering real wages), lowering corporate tax rates, and ensuring full integration of the South African economy into the world economy follow as policy prescriptions from the empirical findings of this paper.

### ***3. Further analysis of the evidence on the factors that affect FDI to Africa***

According to Morisset (2000) and Asiedu (2006), the common perception among many observers is that FDI in African countries is largely driven by their natural resources and the size of their local markets. In an econometric study on 29 SSA countries for the period 1990-97, Morisset (2000) found that both market size and natural resources availability have a positive influence on FDI inflows, with an elasticity of 0,91 and 0,92 using panel data and 1,4 and 1,2 using cross-section data, respectively. Panel regressions presented in Asiedu (2006) for 22 SSA countries over the period 1984-2000 show that a standard deviation of one increase in the natural resource variable results in a 0,65 per cent

increase in the ratio of FDI to GDP and a standard deviation of one increase in the market size variable results in a 2,61 per cent increase in FDI/GDP.

Even though the African countries that have been able to attract most FDI have been those with natural and mineral resources as well as large domestic markets, these are not the sole determinants of FDI to the region. Morisset (2000), Asiedu (2006) and many other studies that focus on Africa suggest that the list of factors influencing FDI is fairly long, although not all determinants are equally important to every investor in every location at all times (Ajayi, 2006). For Africa, then, the specific determinants of FDI include market size and growth, availability of natural resources, human capital costs and skills and availability of good infrastructure. Others are openness of the economy, political and economic stability, institutional quality, investment regulation and international treaties and guarantees. Investment promotion, return on investment and other factors such as cost-related factors, concentration of other investors, investment incentives, privatization and inflows of bilateral ODA are also FDI drivers taken into account (Table 2).

**Table 1 - Empirical Determinants of FDI to Africa: A synopsis of the literature**

<b>FDI Determinants</b>	<b>Econlit references on Africa</b>	<b>Other references on Africa</b>
Market Size and Growth	Morisset (2000); Asiedu (2002a, 2006); Bende-Nabende (2002); Lemi and Asefa (2003); Yasin (2005); Dupasquier and Osakwe (2006); Fedderke and Romm (2006).	Agodo (1978); Bhattacharya <i>et al.</i> (1996); Elbadawi and Mwega (1997); Bhinda <i>et al.</i> (1999); Basu and Srinivasan (2002); Asiedu (2003); Onyeiwu and Shrestha (2004).
Availability of Natural Resources	Morisset (2000); Asiedu (2006); Dupasquier and Osakwe (2006).	Basu and Srinivasan (2002); Kolstad and Tondel (2002); Asiedu (2003); Onyeiwu and Shrestha (2004).
Costs and Skills of Human Capital	Morisset (2000); Bende-Nabende (2002); Lemi and Asefa (2003); Yasin (2005); Asiedu (2006); Fedderke and Romm (2006).	Bhinda <i>et al.</i> (1999); Odenthal (2001).
Quality and Quantity of Infrastructure	Morisset (2000); Asiedu (2002a, 2004, 2006); Lemi and Asefa (2003); Dupasquier and Osakwe (2006).	Bhinda <i>et al.</i> (1999); Pigato (2001); Asiedu (2002b, 2003); Onyeiwu and Shrestha (2004).
Openness of the Economy	Morisset (2000); Asiedu (2002a); Bende-Nabende (2002); Lemi and Asefa (2003); Yasin (2005); Dupasquier and Osakwe (2006);	Bhattacharya <i>et al.</i> (1997); Asiedu (2002b); Onyeiwu and Shrestha (2004).



	Fedderke and Romm (2006).	
Economic and Political Uncertainty	Morisset (2000); Schoeman <i>et al.</i> (2000); Asiedu (2002a, 2006); Lemi and Asefa (2003); Yasin (2005); Dupasquier and Osakwe (2006); Fedderke and Romm (2006).	Collier and Pattillo (1997, 2000); Sachs and Sievers (1998); Haque <i>et al.</i> (2000); Jaspersen <i>et al.</i> (2000); Kolstad and Tondel (2002); Asiedu (2003); Martin and Rose-Innes (2003); Rogoff and Reinhart (2003); Onyeiwu and Shrestha (2004).
Institutional Quality	Asiedu (2004, 2006); Dupasquier and Osakwe (2006); Fedderke and Romm (2006).	Emery <i>et al.</i> (2000); Te Velde (2001); Asiedu (2003).
Investment Regulation	Bende-Nabende (2002); Asiedu (2004, 2006); Dupasquier and Osakwe (2006).	Basu and Srinivasan (2002); Asiedu (2003).
International Treaties and Guarantees	Morisset (2000); Lemi and Asefa (2003).	--
Investment Promotion	Dupasquier and Osakwe (2006).	Morisset (2003).
Return on Investment	Schoeman <i>et al.</i> (2000); Asiedu (2002a).	Jaspersen <i>et al.</i> (2000).
Others (e.g. Other cost-related factors; Concentration of other investors; Investment Incentives; Privatization; ODA;...)	Morisset (2000); Schoeman <i>et al.</i> (2000); Bende-Nabende (2002); Lemi and Asefa (2003); Yasin (2005); Fedderke and Romm (2006).	Te Velde (2001); Martin and Rose-Innes (2003)

Market size and growth have proved to be one of the most important determinants of FDI (Krugell, 2005). The most common argument for the relevance of market size and growth in attracting FDI goes like this: a large domestic market size generates scale economies, while a growing market improves the prospects of the market potential (e.g. Tsai, 1994). Thus, an economy with a large market size should attract more FDI and countries that have high and sustained growth rates should receive more FDI flows than volatile economies.

Bende-Nabende (2002) found that market growth and market size are among the most dominant long-run determinants of FDI in SSA. Bhattacharya *et al.* (1996), Elbadawi and Mwege (1997), Morisset (2000) and Onyeiwu and Shrestha (2004) find evidence for the importance of economic growth in attracting FDI flows to Africa. After controlling for relevant country conditions, Elbadawi and Mwege (1997) also show that countries in the SADC region receive more FDI than other countries in Africa. Some investors, notably those from East Asian countries, have invested in Botswana in order to produce for the South

African market (Bhinda *et al.*, 1999). Multinational firms that wished to serve the large market in South Africa located their subsidiaries in Lesotho and Swaziland (Basu and Srinivasan, 2002). Asiedu (2003) and Lemi and Asefa (2003) also conclude that large markets (along with other factors) promote FDI to the region. The same goes for the South African country (Fedderke and Romm, 2006).

In contrast, for US manufacturing FDI to Africa, Agodo (1978) found GDP and GDP per capita to be a positive influence, whilst GDP growth was insignificant. The hypothesis that higher growth rates foster FDI is also not significant in Asiedu (2002a) and Yasin (2005). The authors add that the attractiveness of the host country's market is particularly important for market-seeking FDI, which is not likely to be the case as the countries included in their analysis are mostly poor and small countries.

Historically, the availability of natural resources has been the critical factor in attracting FDI, because of the need of industrializing nations of Europe and North America to secure an economic and reliable source of minerals and primary products (Dunning, 1993). Though declining in relative importance, the availability of natural resources is still of particular importance for inward investment in resource-abundant countries, even though comparative advantage in natural resources by itself is no longer sufficient for FDI to take place (UNCTAD, 1998).

The availability of natural resources has been found to be positively related to FDI flows to Africa (Asiedu, 2003; Onyeiwu and Shrestha, 2004). Kolstad and Tondel (2002) argue that countries rich in oil and other natural resources, such as Angola, are able to attract heavy FDI inflows. Indeed, it is in the mining of high-value minerals and petroleum where Africa is particularly prominent as a host to FDI and where great potential for future FDI exists (Basu and Srinivasan, 2002).

Cheap labour and the quality of the labour force are other important determinants of FDI (Krugell, 2005). Lower labour cost reduces the cost of production; all other factors remaining unchanged (e.g. Schneider and Frey, 1985). However, rather than just low wages, it is important that wages reflect productivity (Krugell, 2005). It is generally believed that highly educated personnel are able to learn and adopt new technologies faster, and the cost of retraining is also less (Pigato, 2001). Thus, countries with a large supply of cheap but skilled human capital attract more FDI.

Lemi and Asefa (2003) and Yasin (2005) find that the availability of an abundant and cheap labour force has the expected positive effects on FDI to Africa. While it may not be singled out as a sole factor, the success of Mauritius in attracting FDI is partly explained by the relatively cheap, adaptable and well trained workforce (Odenthal, 2001). In the same vein, Fedderke and Romm (2006) show that wage costs impact negatively on FDI to South Africa. In addition, Lemi and Asefa (2003) and Asiedu (2006) also find evidence for the important role played by an educated labour force in attracting FDI flows to African countries. However, the lack of middle or senior level entrepreneurial experience has increased the existing skills gap in Africa, and many foreign companies have resorted to employment of expatriate managers (Bhinda *et al.*, 1999).

On the other hand, Bende-Nabende (2002) states that no definite conclusions can be drawn about mean years of education and real wages rates, because some countries in the SSA sample did not have sufficient time-series data for both variables. Morisset (2000) also found that the availability of relatively skilled labour do not appear to have been a major factor in the location decision of MNCs, advancing data shortcomings in most African countries as a possible cause.

The availability of quality infrastructure is an important determinant of FDI (Krugell, 2005). A good quantity and quality of infrastructure, particularly roads, ports, water and power supply and telecommunications, by reducing transaction costs, facilitates business operations (Wheeler and Mody, 1992). Thus, infrastructure facilities are expected to have a positive impact on FDI inflows.

Asiedu (2002b, 2003, 2006) provide evidence that good infrastructure promotes FDI to Africa. However, Pigato (2001) find that Africa lags behind in the number of telephone mainlines and the percentage of roads that are paved. The results from using fixed effects panel estimation in Asiedu (2002b) also indicate that the marginal benefit from increased infrastructure was less in the 1990s than in the 1980s and thus African countries need to provide better infrastructure in order to receive investments at levels comparable to the 1980s. Furthermore, Asiedu (2004) shows that, from 1980-89 to 1990-99, the rate of increase in the availability, reliability and development of infrastructure in the SSA region was less than the rate for all developing countries.

In contrast, many studies find no evidence that infrastructure as measured by the number of telephones per 1,000 population has any impact on FDI inflows to Africa (Morisset, 2000;

Asiedu, 2002a; Lemi and Asefa, 2003; Onyeiwu and Shrestha, 2004). Asiedu (2002a) suggests the following explanation: FDI to Africa tends to be natural resource-based and the availability of telephones is not relevant for natural resource-based FDI. Indeed, as stressed by Onyeiwu and Shrestha (2004), Angola and Nigeria are reputed to be the highest recipients of FDI in Africa in recent times and yet both countries have very poor infrastructure.

In addition to physical infrastructure, availability and efficiency of financial infrastructure is crucial for attracting FDI. If countries have a weak financial market, instead of a well-developed one, it is more difficult for investors to raise funds locally, although under certain circumstances, funds may be channelled from parents companies to their affiliates (Alfaro *et al.*, 2003).

A survey of several African countries by Bhinda *et al.* (1999) found that problems related to mobilizing local banking, leasing or equity finance were on the top of the list of factors discouraging investors in Tanzania, Uganda and Zambia. In contrast, Asiedu (2002a) tested the robustness of her basic model using financial deepening (traditionally measured by the ratio of M2 to GDP) as a control variable, but the estimated coefficient rendered non-significant.

There are two opposing views linking openness of the economy to FDI flows. The “tariff-hopping”/“tariff-jumping” hypothesis posits that high protective barriers stimulates direct investment in the host country as opposed to continuing to service it through exports, because of potential marketing cost savings and transport cost reductions (Krugell, 2005). On the other hand, the more open the economy, the more it would attract the FDI from MNCs seen as different affiliates specializing according to the locational advantages of the host country (Blomstrom and Kokko, 1997). The importance of the latter is well documented in the empirical literature on the determinants of FDI to Africa (Bhattacharya *et al.*, 1997; Morisset, 2000; Asiedu, 2002a, 2002b; Bende-Nabende, 2002; Lemi and Asefa, 2003; Onyeiwu and Shrestha, 2004; Yasin, 2005; Dupasquier and Osakwe, 2006; Fedderke and Romm, 2006).

Several studies have found that FDI in developing countries is affected negatively by economic and political instability (e.g. Lemi and Asefa, 2003). Political instability subsumes many kinds of events like antigovernment demonstrations, assassinations, cabinet changes, constitutional changes, coups, government crises, purges, revolutions, and riots (Moreira, 2006). It is expected to decrease FDI because it increases uncertainty about the cost and

profitability of investment (Krugell, 2005). In turn, instability in macroeconomic variables as evidenced by the high incidence of currency crashes, double digit inflation, and excessive budget deficits is associated with macroeconomic policies that are not sustainable and thus makes investment unattractive (Krugell, 2005).

In a survey of foreign owned firms in Africa, Sachs and Sievers (1998) find that the greatest concern of firm owners is stability, both political and macroeconomic. In an empirical analysis of the social and political development of foreign investment in Africa, Kolstad and Tondel (2002) find that countries that are less risky attract more FDI per capita. Asiedu (2003, 2006) also shows that both macroeconomic and political instability deter investment flows in Africa. In addition, Rogoff and Reinhart (2003) obtain a statistically significant negative correlation between FDI and the following indicators of political and economic instability in Africa: conflicts; inflation; probability that the parallel market premia is above 50 percent. Furthermore, a closer look at the improvements in the business climate of Mali and Mozambique during the 1990s also reveals that macroeconomic and political stability was among the reasons for their recent success (Morisset, 2000).

As stated in the previous section, the study by Lemi and Asefa (2003) examines how uncertainty affects FDI flows to African countries. In general, the results differ by industrial group and source country. For FDI flows from all source countries and for US FDI flows, Lemi and Asefa (2003) show that both political and economic uncertainties are not significant determinants. The same result was reached in Asiedu (2002a).

In relation to political uncertainty per se, Morisset (2000), Onyeiwu and Shrestha (2004) and Yasin (2005) find that political instability is not a significant determinant of FDI flows in Africa. On the other hand, Fedderke and Romm (2006) find that political stability has a positive impact on FDI to South Africa. The results for US manufacturing FDI to Africa also indicate that political instability is a concern to foreign investors (Lemi and Asefa, 2003).

As concerns to economic uncertainty per se, Lemi and Asefa (2003) find that it is binding for US non-manufacturing FDI to Africa only when economic uncertainty is coupled with political instability and debt burden of host countries. Schoeman *et al.* (2000) focus on fiscal stability as it is generally considered to be one of the indicators of macroeconomic stability. The results suggest that the higher the budget deficit relative to South African GDP the greater the negative impact on FDI relative to South African GDP. Finally, based on panel data for 29

African countries over the period 1975 to 1999, Onyeiwu and Shrestha (2004) provide evidence that countries with high inflation tend to attract less FDI.

Unfortunately, the image of the African continent as a location of FDI is unfavourable, because investors perceive the continent as a home for wars, civil unrest, poverty, disease and a generally unfriendly investment destination and this result in the diversion of these investments to other regions (UNCTAD, 1999) In other words, African countries receive less FDI than countries in other regions, by virtue of the (perceived) riskiness of the continent.

Asiedu (2002a) and Jaspersen *et al.* (2000) argue that being an African country is indeed a significantly negative determinant of FDI, because of investors' perceptions of Africa as inherently risky. According to the findings of Haque *et al.* (2000) and Collier and Pattillo (1997, 2000), commercial risk rating agencies rate African countries as riskier than justified by their fundamental investment conditions. On the other hand, a study on private capital flows to low-income countries by Martin and Rose-Innes (2003) reveals that investors no longer fully share the continuing negative perception of much of Africa as a "basket case" region with high risk and low return, which determines the attitudes of many MNC headquarters, the international media and some agencies. In a study of regional susceptibility to war, Rogoff and Reinhart (2003) found that wars are more likely to occur in Africa than in other regions and there is a negative correlation between FDI and conflict in Africa.

There is empirical evidence today that inefficient institutions as measured by corruption and weak enforcement of contracts deter FDI (e.g. Gastagana *et al.*, 1998). According to the institutional quality variable of Knack and Keefer (1995), for instance, the quality of institutions is captured based on the simple average of the ratings provided by the International Country Risk Guide (ICRG) for the following five institutional indicators: rule of law; expropriation risk; repudiation of contracts by government; corruption in government; and quality of the bureaucracy. A country where it takes excessive time and costs to accomplish all procedures necessary to establish and operate will see its potential investors lose money and decide to locate elsewhere or cancel their investment projects (Morisset and Neso, 2002). In addition to the level of bureaucracy involved in establishing a business in a country, the level of corruption or lack of good governance is also a deterrent to FDI, because, for a firm, paying bribes is like paying a tax and, wherever it exists, it creates

uncertainty (Wei, 2000). Corruption can be both the cause and consequence of high administrative barriers in many developing countries (Morisset and Neso, 2002).

Asiedu (2003, 2006) found that an efficient legal framework promotes FDI to Africa, while corruption deters investment flows to the region. Dupasquier and Osakwe (2006) argue that the lack of good legal and judiciary systems is a possible deterrent to FDI in Africa. The institution of the judiciary is critical to protecting property rights and improving property rights, in turn, was found to raise the attractiveness of South Africa as a location of FDI (Fedderke and Romm, 2006). In many non-francophone African countries, Te Velde (2001) found that freehold ownership is prohibited or requires explicit approval, which may involve long delays varying considerably across countries: up to two years in Mozambique, no freehold ownership in Namibia, up to three years in Tanzania, up to eight years in Kenya and up to six months in Uganda. Emery *et al.* (2000) concentrate on Africa, showing that administrative procedures and rules on ownership can form a significant barrier to FDI. Te Velde (2001) found that it takes one to two years to establish a business and become operational in Uganda and Ghana, 18 months to three years in Tanzania and Mozambique, six months to one year in Namibia, but only six months in Malaysia. In general, from the 1980s to 1990s the rate of improvements on institutional quality was lower for SSA countries as compared with other developing countries (Asiedu, 2004).

FDI regulations that have liberalized restrictions have significantly contributed to the improvement of the investment climate (UNCTAD, 1998). They provide for non-discrimination between foreign and domestic private investors, allow profit repatriation, protect against expropriation, grant incentives, strengthen the standards of treatment of foreign investors, and shift away from targeting specific sectors or foreign investors (UNCTAD, 1998).

Bende-Nabende (2002) found that FDI liberalization is among the most dominant long-run determinants of FDI in SSA. The results from Asiedu (2003) also indicate that a good investment framework promotes FDI to Africa, i.e. investment restrictions deter investment flows to Africa (Asiedu, 2003). According to Basu and Srinivasan (2002), excessive market regulations, i.e. domestic investment policies on profit repatriation and on entry into some sectors of the economy were not conducive to the attraction of FDI in Africa. Ghana, for example, has expanded the scope for foreign investment by reducing the sectors previously closed to foreign investment (Basu and Srinivasan, 2002). In general, from the 1980s to the

1990s, the pace of liberalization for SSA countries as measured by three types of indexes (capital controls; restrictions on trade and investment; FDI policy), was slow compared with other developing countries (Asiedu, 2004).

In spite of the liberalization of FDI policies, many argue that national FDI policies may not be enforceable and do not address what foreign investors seek in guaranteeing security and benefits (Lemy and Asefa, 2003). Thus, countries are signatories to bilateral and multilateral investment and trade treaties to show their commitment and to ensure the protection of investment and avoid double-taxation, which will lastly make them more attractive for foreign investors (UNCTAD, 1998).

Lemi and Asefa (2003) found that government policy commitment as measured by the number of Bilateral Investment Treaties (BIT) signed by a host country and membership in Multilateral Investment Guarantee Agency (MIGA) play an important role in attracting US manufacturing firms to Africa. According to Morisset (2000), the adoption of international agreements related to FDI explains the recent improvements in the business climate of Mali and Mozambique. During the 1990s both countries have become members of MIGA. Mali have also acceded to the Convention on the Recognition and Enforcement of Foreign Arbitral Awards, while Mozambique have signed the International Convention on Settlement of Investment Disputes between States and National of Other States (ICSID) and become member of the Industrial Free Zone in 1994 and the World Intellectual Property Organization in 1996.

Examples of other important instruments available for African government's commitment are the agreements in the WTO relating to FDI, such as the Trade Related Intellectual Property Rights (TRIPs) or Trade Related Investment Measures (TRIMs) Agreements, the Paris Convention for the Protection of Industrial Property and the Bilateral Treaties for the avoidance of Double Taxation (DTTs).

Governments can promote FDI by establishing Investment Promotion Agencies (IPAs) that specifically concentrate on marketing activities and joining the World Association of Investment Promotion Agencies (WIPA) that offers training and capacity building opportunities to IPAs (Morisset, 2003). FDI promotion addresses a market failure related to imperfect information on investors' as well as on the host government's side and thus emphasizes countries attractiveness for foreign investors (Wells and Wint, 1990).



Morisset (2003) shows that greater investment promotion is associated with higher cross-country FDI inflows. However, the author argues that investment promotion is more effective in a country with a good investment climate and a relatively high level of development. On the same vein, Dupasquier e Osakwe (2006) state that African governments set up agencies to promote foreign investment without taking steps to lift the constraints on FDI in the region and therefore IPAs have not been successful in reversing the declining trend in FDI flows to the region.

The profitability of investment, the productivity of capital is another major determinant of FDI flows. FDI will go to countries that pay a higher return on capital, i.e. the international movement of FDI occurs when rates of return on FDI exceed the rates of return on home investment (Root, 1984).

Jaspersen *et al.* (2000) and Asiedu (2002a) use the inverse of real GDP per capita as a proxy for the rate of return on investment (as capital-scarce countries generally have a higher rate of return, implying low per capita income) and found a negative relationship between the two variables for the Africa region and for non-SSA countries, respectively. Moreover, Schoeman *et al.* (2000) use the yield-interest differential in order to capture the return on investment in South Africa (for investment to be profitable, the yield on investment should exceed its opportunity cost, the real interest rate) and found that an increase in the difference between the yield (return) on investment and the interest rate increases FDI flows in South Africa.

Alongside the host country's real wage rates, foreign exchange rates, land and property rents/rates, fuel costs, local input costs (where applicable), level of taxation, transportation costs, and cost of capital are other key cost-related locational factors that may considerably influence the choice of an investment location (Bende-Nabende, 2002). Schoeman *et al.* (2000) and Fedderke and Room (2006) find that corporate tax rates impact negatively on FDI to South Africa. Bende-Nabende (2002) and Yasin (2005) show that low currency values are expected to encourage FDI flows in Africa. Lemi and Asefa (2003) use the cost of capital (i.e. lending interest rate) as a control variable for examining the relationship between uncertainty and FDI flows in African economies, but the estimated coefficient rendered non-significant.

Foreign investors can be lured to countries with an existing concentration of other foreign investors, since it is a good signal of favourable conditions and there are evident

economies of scale in the development of backward and forward linkages (UNCTAD, 1998; Kinoshota, 2003). However, the agglomeration of economies or the clustering of investors as partially captured by the share of urban population does not appear to have been a major determinant in the business climate for FDI in Africa (Morisset, 2000).

Host governments offer incentives in the form of fiscal and financial attractions to positively influence FDI inflows, by reducing costs and making investment more profitable (Krugell, 2005). However, the empirical evidence shows that incentives influence investment decisions only at the margin, i.e. in places where other aspects of the business climate are already favourable (e.g. Bergsman, 1999). In short, incentives play a role once fundamentals are sufficient (Te Velde, 2001).

FDI policies are usually accompanied by other policies aimed at influencing locational decisions, such as privatization policies; if privatization programmes welcome foreign investors, then it broadens the scope of FDI (UNCTAD, 1998). Indeed, launching an attractive privatization programme is among the strategic actions recommended by Morisset (2000) for the improvement of the investment climate for FDI, based on a detailed review of the policy reforms implemented by two of the most attractive countries during the 1990s: Mali and Mozambique. However, a survey of investors by Martin and Rose-Innes (2003) did not bring out privatization as one of the factors for the large capital inflows to Africa, except for a few investors who had bought privatized companies.

As stated in the previous section, the study by Yasin (2005) examines how ODA influences FDI in Africa, based on the assumption that ODA programs may remove some of the obstacles to FDI flows and thus improve the economic conditions that attract FDI. The results for Africa indicate that a positive relationship exists between bilateral ODA and FDI, while multilateral ODA is not a critical requirement for FDI activities by the multinationals located in these countries.

#### **4. Conclusion**

Many possible concluding comments and remarks can be drawn from this survey. At least, two important remarks should be made. First, the common perception among many observers is that FDI in African countries is largely driven by their natural resources or aimed

at the local market. As stated in the previous section, these are not the only determinants of FDI to the region. Even though the African countries that have been able to attract most FDI have been those with natural and mineral resources as well as (relative) large domestic markets, many other factors influence investment decisions in Africa. Second, several of the factors discussed above are indeed impediments or obstacles of FDI to Africa and thus reasons why Africa, in general, has not been successful in attracting FDI. However, awareness of these constraints enables government agencies and the like to devise concrete strategies to reverse Africa's poor FDI record.

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