

Policy Reform and Foreign Direct Investment in Africa: Absolute Progress but Relative Decline

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Despite improvements in the policy environment, sub-Saharan Africa's share of foreign direct investment (FDI) in developing countries continues to decline. This article provides an explanation for the deterioration in SSA's FDI global position. It argues that, although SSA has reformed its institutions, improved its infrastructure and liberalised its FDI regulatory framework, the degree of reform has been mediocre compared with the reform implemented in other developing countries. As a consequence, relative to other regions, SSA has become less attractive for FDI. An important implication of these results is that in a competitive global economy, it is not enough just to improve one's policy environment: improvements need to be made both in absolute and relative terms.

1 Introduction

Despite the efforts of African governments to attract foreign direct investment by improving their policy frameworks, and despite signs of renewed economic activity in Africa, Africa has been largely bypassed by the recent foreign direct investment boom. (UNCTAD, 1999: 1)

Foreign direct investment (FDI) in sub-Saharan Africa (SSA) increased substantially in the 1990s. However, the rate of increase was meagre compared with other regions. For example, between 1980-89 and 1990-99, FDI in SSA grew by 218%. This compares with an increase of 990% for East Asia, 560% for Latin America, 789% for South Asia and 760% for all developing countries. As a consequence, Africa's share of FDI to developing countries has declined over time, from about 19% in the 1970s, to 9% in the 1980s and to about 3% in the 1990s. This is in spite of the policy reforms implemented by countries in the region (see above quotation). Thus, with regard to FDI, Africa's experience as compared with that of other developing countries can be characterised as *absolute progress but relative decline*.

The ineffectiveness of policy reform and the deterioration in Africa's FDI global position are frustrating to policy-makers in the region. Indeed, African leaders and the international community have grappled, and continue to grapple, with ways to increase FDI flows to the region. For example, one of the main objectives of the New Partnership for Africa's Development (NEPAD), which was launched in July 2001, is to

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increase Africa's share of FDI.¹ Also, in March 2002, the United Nations Conference on Trade and Development (UNCTAD) for the first time organised a meeting that brought together policy-makers and international business leaders to draw up strategies on how to increase FDI flows to Africa.

This article contributes to this important discussion by examining the underlying factors behind the deterioration of Africa's FDI global position. Drawing on the empirical literature on FDI, the article addresses three questions: (i) Why does Africa's share of FDI continue to decline despite improvements in the policy environment? (ii) How can policy-makers reverse this trend? (iii) How can Africa attract more FDI in a globally competitive economy?

Finding answers to these questions is important to both policy-makers and academics. There are at least two reasons for this. First, FDI is crucial to SSA. FDI serves as a source of capital, stimulates domestic investment, creates employment, promotes the transfer of technology and enhances economic growth.² The role of FDI as a source of capital has become increasingly important to SSA. The reason is that, in order for the continent to achieve its millennium goal of reducing its poverty rate by half,³ the region needs to fill an annual resource gap of \$64 billion, about 12% of GDP.⁴ Since income levels and domestic savings in the region are low, the bulk of the finance will have to come from abroad – official finance (such as aid from the World Bank) or from private foreign investment.⁵ However, official assistance to the region has been declining. For example, net official development assistance to SSA declined from \$17.8 billion in 1995 to \$12.2 billion in 2000, a decrease of about 31% (World Bank, 2003b). In addition, foreign indirect investment (including bond finance and portfolio investment) is unavailable to most African countries. The reason is that most of the countries in the region have thin financial markets. In addition, most of them are unable to raise capital from international capital markets. For example, in 1998, almost all the portfolio investment in the region (\$8.6 billion) went to South Africa. As a consequence, the bulk of the external resources needed for poverty alleviation has to come from FDI. From 1995 to 2001, annual FDI flows to SSA averaged about \$7 billion. Average annual flows fall to \$2.9 billion when Angola, Nigeria and South Africa are excluded.⁶ Thus, filling the annual resource gap of \$64 billion needed for poverty alleviation would require a substantial increase in FDI.

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1. NEPAD is a development plan put together by African leaders to eradicate poverty and promote growth in the region. See Funke and Nsouli (2003) and Owusu (2003) for a discussion of the origin and objectives of NEPAD.
 2. See Mody and Murshid (2002) for a discussion on the relationship between FDI and domestic investment, De Mello (1997) for a survey on FDI and economic growth and Blomstrom and Kokko (1998) for a survey on FDI and technology spillovers to host countries.
 3. The millennium declaration was adopted by the United Nations in September 2000. One of the main objectives is to reduce the number of people living in poverty by 50% by 2015.
 4. It is estimated that reducing the number of Africans living on less than US\$1 a day by 50% would require a 7% annual growth rate. To achieve this growth rate, Africa needs to fill an annual resource gap of \$64 billion. For more on this issue, see the NEPAD declaration document, available at www.avmedia.at/nepad/indexgb.html.
 5. Foreign investment takes three forms: official finance (which includes capital from multilateral agencies such as the World Bank), foreign direct investment, and indirect investment (which includes portfolio investment, bond finance and bank lending).
 6. Note that both Angola and Nigeria are oil-exporting countries.

The millennium goal of halving poverty rates is particularly important to SSA because the poverty rate for the region is very high. About 48% of the populations live on less than US\$1 a day, as compared with 4% for Eastern and Central Europe, 15% for East Asia, 12% for Latin America, 2% for the Middle East and North Africa, 40% for South Asia, and 24% for all developing countries.⁷ Furthermore, in several countries in the region, more than half the population live in abject poverty. For example, the poverty rate for Burkina Faso is 62%, 66% for the Central African Republic, 73% for Mali, 70% for Nigeria and 64% for Zambia. For such countries, the role of FDI as a source of capital is critical. Indeed, the importance of private foreign investment as a source of capital is reflected in the declaration of the NEPAD agreement, which notes that 'NEPAD seeks to increase private capital flows to Africa, as an essential component of a sustainable long-term approach to filling the resource gap'.

This article provides a plausible explanation for the deterioration in Africa's global FDI position and proposes policies that will enhance FDI flows to the region. The analysis focuses on three key policy-related variables that affect FDI flows: (i) infrastructure development; (ii) openness to trade and investments; and (iii) institutional quality. Measures of these variables indicate that SSA's policy environment has improved over time, i.e., has made *absolute progress*. However, compared with other developing countries, policy reform in SSA has been mediocre, i.e., has shown *relative decline*. As a consequence, SSA has become increasingly less attractive as other developing countries have become more attractive for FDI. Thus, the ineffectiveness of policy reform and the deterioration in Africa's FDI global position may be explained by the fact that sweeping reform in other developing countries and mediocre reform in Africa have made Africa less attractive for FDI.

The following section describes how SSA's infrastructure, institutions and FDI policy have changed over time as compared with other regions.

2 Description of the variables and data

According to the 'eclectic' theory of FDI, countries that have a 'locational advantage' will attract more FDI (Dunning, 1988). Location-specific advantage covers any characteristic (economic, institutional and political) that makes a country attractive for FDI. This includes large domestic markets, the availability of natural resources, an educated labour force, good infrastructure, low labour costs and reliable institutions, to mention but a few. The empirical literature on the determinants of FDI to developing countries has generally focused on identifying the location-specific factors and the relevant government policies.⁸ As pointed out earlier, the objective of this article is to prescribe policies that will improve SSA's global (relative) FDI position. It therefore focuses on policy-related variables (i.e., variables that can be altered by policy-makers) that have been found to have an impact on FDI. It considers three policy variables: openness to foreign investment, infrastructure development and the institutional set-up. The next sub-section describes the trends in FDI flows and policy variables for SSA and other developing countries.

7. More information can be obtained from www.developmentgoals.org/

8. For an extensive survey on the determinants of FDI, see Gastanaga et al. (1998) and Chakrabarti (2001).

2.1 FDI flows to developing countries

Table 1 indicates that FDI to SSA has increased over time, i.e., *absolute progress*. However, the growth rate is substantially lower than that for developing countries as a whole, causing SSA's share to decline over time, i.e., *relative decline*.

Table 1: Annual averages of net FDI inflows to developing countries and selected regions, 1970-99 (\$m.)

Region	FDI net inflows			Growth rate (%)	
	1970s	1980s	1990s	1970s-80s	1980s-90s
East Asia and Pacific	749	3,967	43,347	430	993
Latin America and Caribbean	2,498	5,714	3,7480	129	556
Middle East and North Africa	-129	806	3,836	-725	376
South Asia	61	256	2,278	323	789
Sub-Saharan Africa (SSA)	773	1,102	3,509	43	218
All developing countries	4,013	12,059	10,3078	201	755
SSA's share (%)	19	9	3		

Source: World Bank (2003b).

2.2 Openness to foreign investment

Several studies have found that countries that are open will attract more FDI (Asiedu, 2002; Noorbakhsh et al., 2001; Morrisset, 2000). In the FDI empirical literature, the most widely used measure of openness is the share of trade in GDP. Thus, the positive relationship between trade volumes and FDI implies that countries that wish to attract more FDI should increase their trade. However, as pointed out by Rodriguez and Rodrik (2000), this type of policy recommendation is not constructive, the reason being that policy-makers do not directly control the volume of trade. Since the objective of this article is to prescribe policies that will enhance FDI flows to Africa, it considers three measures of openness that can be altered by policy-makers. The variables and their sources are described below and the data are presented in Table 2.

- (i) *Capital controls*: This measures the restrictions on capital market transactions. The rating is computed based on the index of capital controls from among 13 IMF categories. It ranges from 0 to 10, a higher rating implying fewer restrictions.
- (ii) *Restrictions on trade and investment*: This is a composite measure of variables that limit trade and investments. It includes taxes on international trade, regulatory trade barriers (tariffs, quotas, licence fees) and exchange controls. It ranges from 0 to 10, a higher rating implying fewer restrictions. The data for (i) and (ii) are published by the Fraser Institute and are available at www.freetheworld.com/.
- (iii) *Host country's investment climate*: This measures the host country's attitude toward inward investment. The rating ranges from 0 to 12 (a higher score implies a better investment climate) and is determined by four components: risk to operations, taxation, repatriation of profits, and labour costs. The data are published by Political Risk Services (PRS) and are available at www.prsgroup.com/.

The data for all three measures of openness show that SSA has become more open in the 1990s – *absolute progress*. However, the pace of liberalisation was slow compared with other developing countries – *relative decline*. For example, with regard to restrictions on trade and investments, the average rating for SSA improved by about 18%. This compares with an increase of 30% for all developing countries.

Table 2: Measures of openness for selected regions, 1980-99 (%)

Region	Capital controls			Restrictions on trade and investment			Host country's investment climate		
	1980s	1990s	% change	1980s	1990s	% change	1980s	1990s	% change
East Asia and Pacific	3.36	4.89	45.74	6.17	6.61	7.13	6.64	6.32	-4.73
Latin America and Caribbean	2.36	4.12	74.58	3.92	5.65	44.25	4.74	6.36	34.22
Middle East and North Africa	1.7	2.3	35.29	5.0	5.52	10.34	5.83	6.05	3.68
South Asia	0.4	0.6	50.0	3.05	3.59	17.70	5.66	5.49	-3.14
Sub-Saharan Africa (SSA)	0.61	1.07	76.06	4.90	5.81	18.53	5.05	5.40	6.87
All developing countries	1.21	2.25	86.75	3.98	5.19	30.07	5.11	5.79	13.27

2.3 Infrastructure development

Good infrastructure facilitates production, reduces operating costs and thereby promotes FDI (Wheeler and Mody, 1992; Asiedu and Lien, forthcoming). In the literature the number of telephone main lines per 1000 population is often used as a proxy for infrastructure development. This form of measurement has two caveats. First, the data do not include mobile phones. Hence, with the rise in the number of mobile phones, this traditional variable may not be a good proxy for infrastructure. Second, the variable measures only infrastructure *availability* and does not take into account the *reliability* of the infrastructure. To take account of these shortcomings, three other measures of infrastructure development are used here. The data are from World Bank (2003a).

- (i) *Telephones per 1000 population*: This is the sum of telephone main lines and of mobile phones per 1000 population. This variable captures the availability of infrastructure.
- (ii) *Electric power transmission and distribution losses (% of output)*: This includes losses in transmission between sources of supply and points of distribution. This variable measures the reliability of infrastructure.
- (iii) *Gross fixed capital formation (% of GDP)*: This includes land improvements, construction of roads, railways, schools, and industrial and commercial buildings. This variable measures infrastructure development in host countries.

Table 3 shows that infrastructure availability, defined as the number of telephones per 1000 population, improved in the 1990s – *absolute progress*. However, the rate of

increase was less than the rate for all developing countries – *relative decline*. From 1980-89 to 1990-99, the number of telephones per population increased by 71% for SSA. This compares with an increase of 490% for East Asia and 158% for all developing countries. With regard to infrastructure reliability, the data suggest that, as in most developing countries, the quality of infrastructure in SSA declined in the 1990s. However, the rate of deterioration was higher for SSA. For example, electric transmission losses as a percentage of total output increased by 21% for SSA, as compared with an increase of about 9% for all developing countries. Table 3 also shows that countries in SSA on average spent less on infrastructure in the 1990s than in the 1980s. Gross fixed capital formation as a share of total output declined by 13% from 1980-89 to 1990-99. This compares with an increase of 3% for all developing countries.

Table 3: Infrastructure development for selected regions, 1980-99

Region	Gross fixed capital formation (% of GDP)			Electric transmission losses (% of output)			Telephones per 1000 population		
	1980s	1990s	% change	1980s	1990s	% change	1980s	1990s	% change
East Asia and Pacific	25.15	32.59	15.78	8.11	7.56	-6.77	8.71	51.39	489.87
Latin America and Caribbean	20.18	19.28	-4.49	13.05	15.63	19.77	49.75	108.85	118.81
Middle East and North Africa	24.16	21.81	-9.73	10.42	10.92	4.79	26.94	60.51	124.63
South Asia	19.6	21.43	9.34	19.39	19.41	0.10	3.89	12.76	227.97
Sub-Saharan Africa (SSA)	19.91	17.31	-13.06	8.10	9.64	10.64	7.89	13.49	71.15
All developing countries	23.40	24.04	2.74	10.75	11.74	9.19	21.37	55.04	157.53

Source: World Bank (2003a).

2.4 Quality of institutions

Inefficient institutions as measured by corruption, weak enforcement of contracts and a large bureaucracy, deter foreign investment (Asiedu and Villamil, 2000; Wei, 2000; Gastanaga et al., 1998; Campos et al., 1999). For the present analysis, three measures of institutional quality are used: corruption, the rule of law and bureaucratic quality.

- (i) *Corruption*: This variable measures the degree of corruption within the political system. It covers actual or potential corruption in the form of nepotism, excessive patronage and bribery. The ratings range from 0 to 6, a high rating indicating less corruption.
- (ii) *Rule of law*: The variable measures the impartiality of the legal system and the extent to which the rule of law is enforced. The ratings range from 0 to 6, a high rating implying an impartial court system.
- (iii) *Bureaucratic quality*: The ratings range from 0 to 6, a high score implies the 'bureaucracy has the strength and expertise to govern without drastic changes in policy and interruptions in government services'.

Data for the measures of institutional quality were obtained from the International Country Risk Guide (ICRG) published by Political Risk Services (PRS), and are available at www.prsgroup.com/. They indicate that, with regard to corruption and bureaucratic quality, SSA's institutions deteriorated in the 1990s. In contrast, corruption declined in developing countries as a whole and the quality of bureaucracy improved. The rule of law strengthened in SSA in the 1990s – *absolute progress*. However, compared with other developing countries, improvements were meagre – *relative decline*. For example, the extent to which the rule of law is enforced improved by about 11% for SSA, as compared with 58% for the Middle East, 77% for South Asia, and 29% for all developing countries. Thus, despite improvements in institutional quality in the 1990s, SSA seemed less attractive (relative to other developing countries) for FDI in the 1990s than in the 1980s.

Table 4: Measures of institutional quality for selected regions, 1980-99

Region	Corruption			Rule of law			Bureaucratic quality		
	1980s	1990s	% change	1980s	1990s	% change	1980s	1990s	% change
East Asia and Pacific	3.58	3.55	-0.84	3.47	4.32	24.58	2.42	2.59	6.67
Latin America and Caribbean	2.48	2.90	16.99	2.42	3.07	27.09	1.28	1.67	30.09
Middle East and North Africa	2.98	3.05	2.27	2.41	3.81	57.61	1.87	2.09	11.84
South Asia	1.94	2.49	27.82	1.49	2.61	75.51	1.69	1.99	17.17
Sub-Saharan Africa (SSA)	2.74	2.68	-2.35	2.51	2.78	10.76	1.49	1.47	-1.55
All developing countries	2.70	2.89	7.26	2.54	3.29	29.08	1.47	1.71	16.13

3 Conclusion

This article has provided a plausible explanation for the continuing decline in Africa's FDI global position, despite improvements in policy environment. It argues that although SSA improved its infrastructure, liberalised its investment framework and reformed its institutions, the degree of reform was mediocre compared with the reform implemented in other developing countries. As a consequence, relative to other regions, SSA has become less attractive for FDI over time. With regard to policy, the results indicate that SSA needs to keep pace with the rest of the world, the reason being that the world has become more competitive and more integrated. It is therefore not enough just to improve one's policy environment: improvements need to be made both in *absolute* and *relative terms*.

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