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Drivers and extent of foreign direct investment in Sub-Saharan Africa

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A close-up photograph of a car's dashboard, focusing on a black compass with white markings. The background is blurred, showing parts of the car's interior.

KCG Policy Paper

Drivers and Extent of Foreign Direct Investment in Sub-Saharan Africa

Holger Görg

Drivers and Extent of Foreign Direct Investment in Sub-Sahara Africa

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Abstract: When it comes to attracting foreign direct investment, Africa as a whole may be described as some-thing like the “forgotten continent”. In a global comparison, the continent is fairly insignificant as a destination for the investment of foreign companies. This paper makes this point using aggregate data on world-wide FDI stocks. It then tries to explain why this is the case. It first reviews the important drivers of FDI that have been identified in the literature, and then compares the performance of African countries in terms of those determinants with that of other potential host countries.

Keywords: Foreign direct investment, Sub-Sahara Africa, Drivers, Performance

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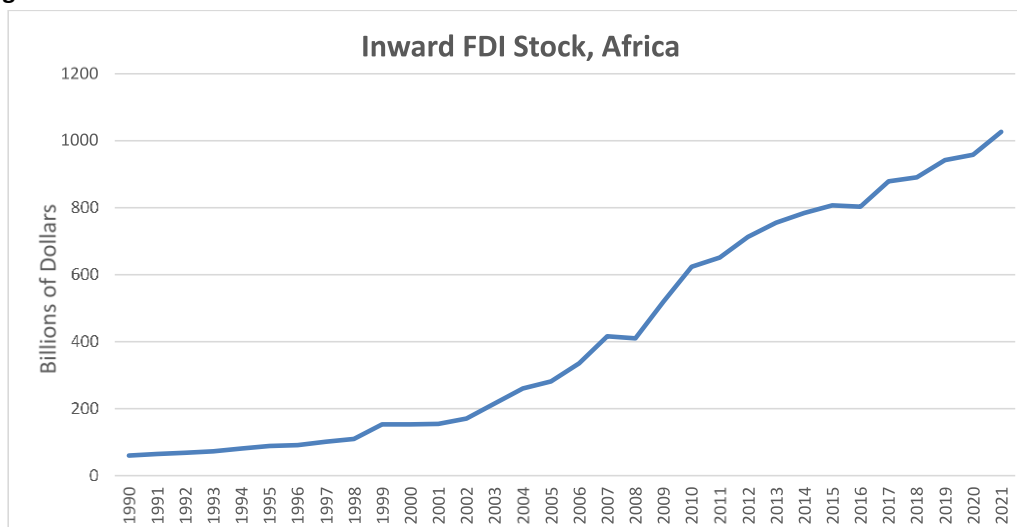
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Starting Point: Development of FDI in Africa

When it comes to attracting foreign direct investment (FDI), Africa as a whole may be described as something like the “forgotten continent”. In a global comparison, the continent is fairly insignificant as a destination for the investment of foreign companies. This is despite the fact that, at a first glance at the development of total FDI stocks in Figure 1, the continent has clearly increased total inward FDI in absolute terms.

Figure 1

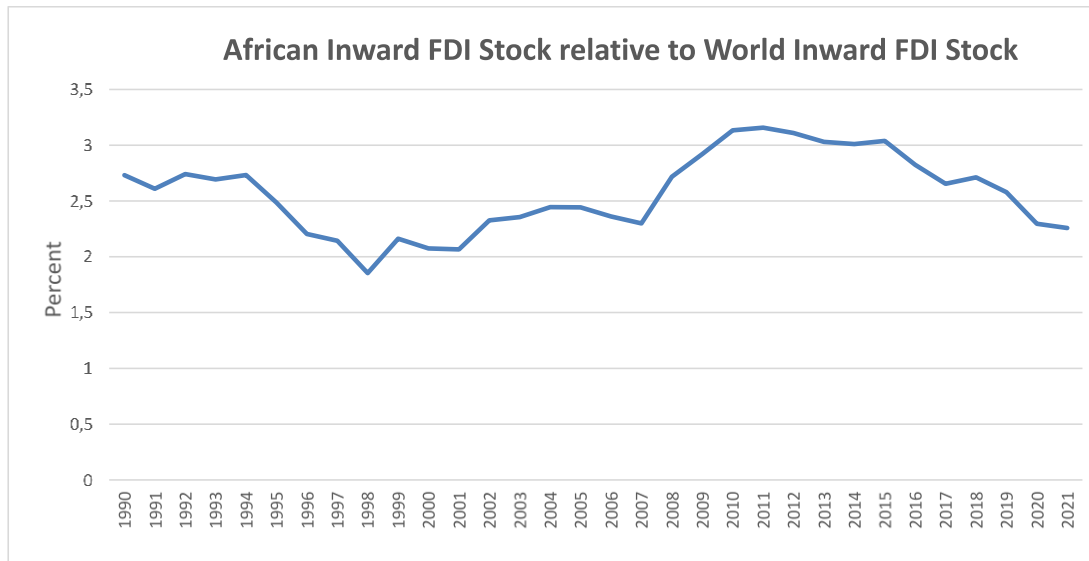


Source: based on data from the UNCTAD World Investment Report, various issues.

According to data from various issues of the UNCTAD World Investment Report, inward FDI stocks in Africa stood at roughly 153 billion USD in 2000 and increased – for the first time ever – to just over 1 trillion USD in 2021. However, this growth happened at a time when total world-wide FDI also increased tremendously, and appears less impressive when put into perspective. For example, the total FDI stock in the whole continent of Africa in 2021 is far less than half of the total inward FDI attracted by the United Kingdom in the same year (at roughly 2.5 trillion USD), and just close to double the total inward FDI in Mexico (at 576 billion USD).

Moreover, in relation to world-wide FDI, the African continent has also not performed particularly well. While it managed to raise its share of the world total from about 2.1 percent in 2000 to some 3.1 percent in 2012, it has fallen consistently since then. In 2021, inward FDI in Africa accounted only for 2.2 percent of the world total, and being on a downward trend (Figure 2).

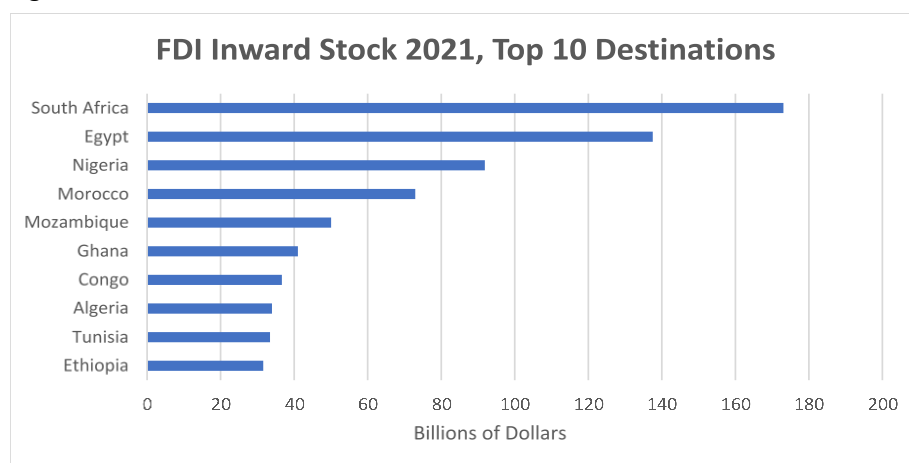
Figure 2



Source: based on data from the UNTAD World Investment Report, various issues.

It is also instructive to look at where the main destinations are for inward FDI in Africa. Figure 3 charts the Top 10 destinations in 2021. It becomes immediately clear that inward FDI is heavily concentrated in terms of host countries. Indeed, the top 5 destinations account for just over half of the total (about 525 billion USD). Among these, the top destination is – no huge surprise – the most developed economy in Africa, the Republic of South Africa. It alone accounts for 17 percent of the total, with 176 billion USD worth of inward investment.

Figure 3

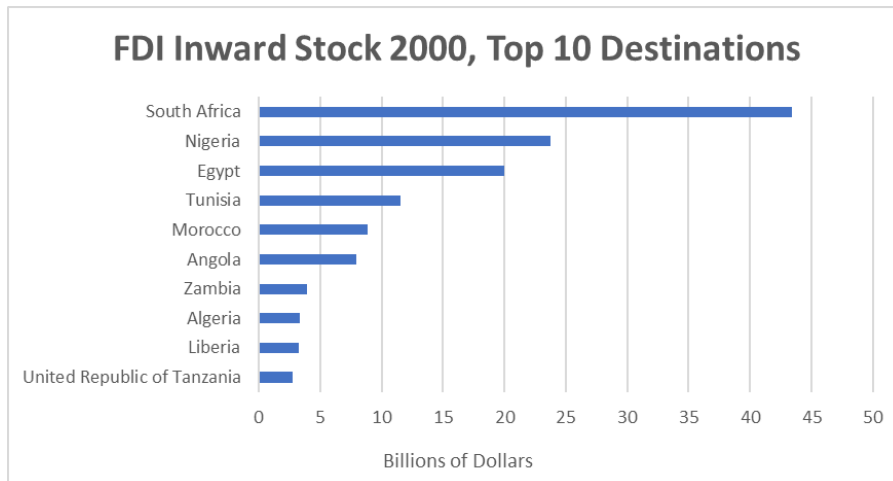


Source: based on data from the UNTAD World Investment Report, various issues.

The top 3 destinations' rank has been undisputed over the last twenty years, as the ranking for the year 2000 in Figure 4 shows. The Republic of South Africa, Egypt and Nigeria clearly dominate as host countries for FDI into the African continent. What is notable, though, is that there has been turnover

in the ranking in particular among Sub-Saharan African countries. While in 2000, Angola, Zambia, Liberia and Tanzania were among the top 10, these have been replaced by other Sub-Saharan countries that entered the ranking: Mozambique, Ghana, Congo and Ethiopia. These new host countries also attract much larger shares (and absolute values) of inward FDI than the other Sub-Saharan African countries did in 2000.

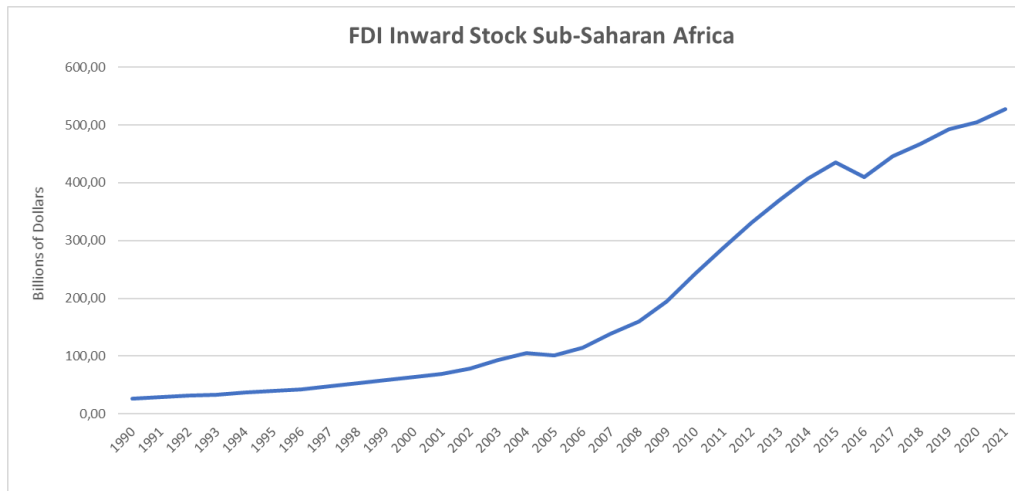
Figure 4



Source: based on data from the UNTAD World Investment Report, various issues.

The rise of FDI into Sub-Saharan African countries also becomes apparent when looking at the total development of the absolute value over time. As Figure 5 shows, this has increased steadily over the last two or three decades, accelerating particularly since about 2008 / 2009, when most of the rest of the world was hit by the financial crisis. In 2021, total FDI stock in Sub-Saharan African countries (without South Africa) amounted to roughly 527 billion USD, representing about 51 percent of total FDI in Africa (compared to only about 39 percent in 2008). This increase in inward FDI is an important development, as it may signal that Sub-Saharan African countries are becoming more attractive to foreign investors. Whether and how this trend may continue, remains to be seen, of course.

Figure 5



Source: based on data from the UNTAD World Investment Report, various issues.

Overall, however, it becomes clear from these figures that FDI into the African continent is low by world wide standards. The question the following sections aim to address is why this may be the case. To answer this question, the literature on the determinants of FDI will be briefly reviewed. Comparing what the important determinants are with the actual performance of African countries may allow one to draw some conclusions and policy lessons on what should be done to improve Africa's position as a destination for world wide foreign direct investment.

Determinants of FDI in the literature

The factors that attract FDI into a country have received ample attention in the literature, aptly summarized by, e.g., Blonigen (2005) and others. Research looks at a wide array of possible determinants, ranging from the "pure" economic variables to political, geographical and other factors. A few studies with most relevance to the African case are summarized in Table 1.

Empirical work on the determinants of FDI has looked at this question using mostly aggregate country level data. These studies generally underline the importance of "economic fundamentals" such as, e.g., market size and growth, income levels, openness to trade and labour endowments (which also proxy for labour costs). The rationale behind these variables reflects the idea, that there are two fundamental objectives for investing abroad: One is to gain access to markets, the second is to locate production in

low cost locations with production then integrated into global value chains.¹ While theoretically different, in practice one is likely to observe a combination of the two driving investment decisions.

Against this background, market size and growth reflect the size of the market and, all other things equal, the larger and more developed the market, the more attractive it becomes for foreign investors intending to service this market. Labour endowments and labour cost proxy the second idea, namely that investors look for countries that are well endowed with production factors, which also implies low costs of these factors. Here it is important to note that income levels are sometimes used in empirical studies as proxy for the cost of labour in the absence of more appropriate data on the actual cost of labour or other factors.

Openness to trade is important if the investments are in production facilities which are then linked into global supply chains, in this case it is crucial that imports of intermediates, as well as exports of the processed goods, can easily cross borders.

As regards labour endowments, many researchers consider specifically the importance of human capital for attracting FDI, since it is indicative of a more productive and more skilled workforce. Moreover, a higher quality workforce is also more likely to attract value-adding FDI with the potential for generating strong positive effects to the domestic economy, as opposed to resource extracting FDI with little potential for such “spillovers” (e.g., Cleeve et al., 2015; Noorbakhsh et al., 2001; Suliman and Mollick, 2009).

The role of other determinants, such as exchange rates and access to credit as well as geographic determinants such as coastline access and endowments of natural resources are also highlighted in some studies, as they also impact on the cost of conducting business abroad. However, results on these variables appear less robust than the overwhelming evidence on the role of economic fundamentals (Blonigen and Piger, 2014; Blonigen, 2005, Onyeiwu and Shrestha, 2004). This suggests that it is important to get these fundamental economic factors right for attracting foreign investment. Countries with larger market size, better growth performance, good endowment of labour and that are open to international trade are better able to attract investors, all other things equal.

Research on the importance of “infrastructure” for attracting FDI also does not come to an unanimous verdict. Conceptually, access to good and reliable infrastructure is again an important factor of cost, e.g., a good road or railroad network may determine the speed and hence the cost of transporting goods to or from the production plant. However, here it is important to point out that infrastructure

¹This is what Markusen (2001) refers to as horizontal respectively vertical FDI.

is a very wide concept, including roads, ports, airports but also telecommunications and digital infrastructure among many other aspects (e.g., Donaubauer et al., 2016). In particular the latter are often found to be important determinants of inward FDI as they determine the quality of communication with customers, suppliers as well as headquarters. Mensah and Traore (2022) is an interesting current study looking specifically at access to high speed internet. They find – for their sample of Sub-Saharan African countries – that such access is an important determinant for attracting inward FDI, in particular in the banking and high technology sectors. They also show, however, that for this positive effect to develop, reliable supply of electricity (another important aspect of “infrastructure”) is necessary.

A number of studies also examine the role of the political and institutional framework in a host country. Suliman and Mollick (2009) in their analysis for a number of Sub-Saharan African countries find that political unrest and war are negatively related with incoming FDI, while countries with more pronounced civil liberties tend to attract FDI more strongly than others. Cleeve (2008) also finds – using data for Sub-Saharan African countries – locations with better fiscal incentives and higher political stability are also more attractive to foreign investors. Similarly, Adelke (2014) also finds that countries with weaker governance structures are less likely to attract inward FDI. An important aspect related to the quality of the institutional framework is corruption. Here the evidence is fairly ambiguous. On the one hand, corruption may deter inward FDI as it implies that institutions are weak and governance ineffective. On the other hand, corruption may “grease the wheels” of government and may therefore be beneficial to the operations of multinational firms (Zander, 2021).

At a more general level, Asiedu and Freeman (2009) look specifically at the importance of the level of democracy. From their analysis of aggregate data for 112 developing countries they conclude that countries with higher levels of democracy (measured using commonly-used indices of the political climate) are associated with higher FDI inflows. Interestingly, this is only the case, however, if the value of exports from oil and minerals is less than some critical value; in other words, if the host country is not too dependent on natural resources. If this dependence is too high, then higher levels of democracy are not associated with higher levels of FDI, they may even deter new investments. This is an important point for African countries. Many observe conclude that FDIs in specifically SSA countries are typically not FDIs in manufacturing, but that they have a more resource extracting nature with few and weak linkages to domestic firms. This has of course implications for their potential effects (or rather lack thereof) on the domestic economy (Morrissey, 2011; Gui-Diby and Renard, 2015).

Overall, this research suggests that, for attracting inward foreign direct investment, it is of high importance that the right political and economic framework conditions are in place. These conditions avoid or at least mitigate unforeseen risks and thus attract new investments. Research also concludes,

however, that in African countries in particular, such political institutions are generally not sufficiently developed, which can deter foreign investors (e.g., Busse and Hefeker, 2007; Asiedu and Freeman, 2009).

While these studies look at a fairly general definition of the policy or political environment, other researchers look more specifically at particular government policies. Fiscal (financial) incentives can play a role and, as already mentioned before, Cleeve (2008) finds evidence to suggest that such incentives can attract FDI. Another incentive is a favorable tax regime, and there is plenty of international evidence to suggest that this also can play a large role in attracting new investments (Görg and Strobl, 2015; Davies et al., 2021). But these are not the only policies that affect FDI. Asiedu and Lien (2004) show that capital controls implemented by local governments can have detrimental effects on FDI, as they put limitations on the activities of foreign investors in the country. Furthermore, as transparent information about business conditions is often scarce in developing countries Harding and Javorcik (2011) convincingly show that investment promotion agencies, particularly in developing countries, can be an important tool to attract new investments into the local economy. Governments also implement Special Economic Zones in order to attract investments, and this has become a widespread tool in the last decades or so. However, what evidence is available is quite mixed and does not suggest strong effects – at least for African countries – of the establishment of SEZ on a country’s ability to attract new inward investment (Farole, 2011; Glitsch et al., 2020).

In the context of evaluating possible determinants, Asiedu (2002) asks whether “Africa is different”. She conducts an empirical analysis of determinants of FDI for a large number of developing countries using aggregate country level data from the World Bank World Development Indicators. She investigates whether the impact of a number of determinants is different for African compared to other developing countries. Her results show firstly that openness to trade, higher return on investment, and better infrastructure attract investments to all countries, while GDP growth, a measure of inflation or a measure of political instability do not play a role in her sample. Concerning differences between African and other countries, she finds that, even when controlling for a number of observable potential determinants, African countries generally attract less FDI than comparable other developing countries. This, she conjectures, may reflect that investors generally see African countries as riskier than otherwise comparable investment locations on other continents.

How does Africa do on these determinants?

What can one learn from these studies about what may possibly explain the lack of strong FDI into the Sub-Saharan African countries? To answer this, it may be useful to look at how African countries are doing as concerns the above outlined determinants.

Firstly, market size and growth. It is clear that some of the Sub-Saharan African countries are among the poorest in the world, making them unattractive for FDI that is aimed at serving local markets. However, there is also some spread across the continent, with countries like Nigeria, Ghana and Kenya being in the group of lower-middle income countries, and Botswana, Gabon and Namibia classified as upper-middle income countries.² Also, as pointed out above, the Republic of South Africa, as the most developed economy in Southern Africa, is by far the largest recipient of FDI, reflecting the importance of market size for FDI. The lesson from this is clear: if countries aim to attract FDI that should serve the local market they need to have a well developed economy providing growth prospects to the multinational firms. While development of the local market is of course the aim of the host country governments in Africa as well as international organizations, history shows that this is hard to achieve.

Secondly, openness to trade. In order to allow the free flow of goods that are imported or exported by multinationals, countries need to be open to trade. As it stands, the whole African continent only accounts for between 2 to 3 percent of world trade – a tiny share. More worryingly, the share of inter-African trade is very low. As Olney (2022) shows, the share of trade conducted within Africa is only 12 percent, compared to the share of intra-North American or intra-European trade at 47 percent respectively 69 percent. This shows that trade costs are very high and trade barriers persist between African countries, which may limit their attractiveness as hosts for internationally engaged multinational firms.

Thirdly, endowment and cost of labour. At a first glance, this should be a plus for African countries. As a whole, the continent of Africa is well endowed with labour and its population growth is higher than in any other region in the world.³ Additionally it has the youngest population, with the share of the population at age of 14 or below, at 42 percent, compared to 18 percent in Europe and North America,

² See <https://blogs.worldbank.org/opendata/new-world-bank-country-classifications-income-level-2022-2023> (accessed 8 September 2022)

³ See <https://www.statista.com/statistics/997040/world-population-by-continent-1950-2020/> (accessed 8 September 2022)

or 20 percent in East Asia.⁴ However, it is not just the quantity but also the quality of the factor labour that matters. Here African countries are not performing that well, unfortunately. While a comparison of quality of labour is of course difficult across countries, one may just illustrate the point using data from the World Economic Forum's Global Competitiveness Report, which also includes an index on quality of skills of human capital. The top ten ranks according to this index, not surprisingly, belong to developed countries in Asia, Europe and North America. The highest ranked African country is South Africa at rank 84, followed by Botswana and Kenya at rank 92 respectively.⁵ This clearly shows that African countries are well behind other potential host countries vying for inward FDI. To increase inward FDI, upgrading the local education systems should therefore be of importance.

Thirdly, infrastructure. Even if the empirical evidence is not fully agreed on the significance of infrastructure for attracting inward FDI it is an important aspect to consider. Of course, "infrastructure" is a very broad concept with different aspects and therefore hard to measure in empirical analyses. Donaubauer et al. (2016) provide internationally comparable measures related to different aspects of infrastructure. The verdict of their analysis is clear, however: Countries in Sub-Sahara Africa perform poorly in terms of transport and ICT infrastructure, where the latter also includes digital infrastructure. In terms of transport infrastructure, Guinea and Cote d'Ivoire rank highest at 49 and 51, while in terms of ICT South Africa is the best performing, with rank 89 in the world. The difference in rankings between transport and ICT infrastructure also shows that Africa has some catching up to do in particular in terms of digital infrastructure.

Fourth, political and institutional framework. Again, the notion of political and institutional stability is difficult to gauge but we may use rankings from the Global Competitiveness Report on "Institutions" as a rough indicator. In terms of this indicator there is substantial heterogeneity across Sub-Saharan African countries, with Rwanda ranked 29th in the world, followed by Namibia (51), Ghana (59) and Botswana (62). However, also some of the worst performing countries are in Sub-Saharan Africa, with Angola, Burundi and the Democratic Republic of Congo listed on ranks 134 to 136 (out of 140). Another issue related to the institutional quality is the level of corruption. According to the Transparency International Corruption Perception Index 2021 corruption in Africa is generally much higher than in Europe or North America, although there is again much heterogeneity across the continent. In Botswana and Namibia, corruption perceptions are much lower than the world average, with the

⁴ See <https://www.statista.com/statistics/932555/global-population-by-age-by-continent/> (accessed 8 September 2022)

⁵ See <https://www3.weforum.org/docs/GCR2018/05FullReport/TheGlobalCompetitivenessReport2018.pdf> (accessed 8 September 2022)

countries being ranked at 45 and 58, respectively, out of 180 territories. However, some of the countries with the highest perceived levels of corruption are also in Sub-Saharan Africa, such as the Democratic Republic of Congo (rank 169) or South Sudan (180).⁶

What to take away?

Summing up, it is quite clear that Africa has the potential, certainly in terms of labour endowments and sheer size, to play a much larger role in the global economy. It is also apparent, however, that in order to boost inward FDI, African countries will need to improve their performance across a range of determinants. For this, efforts from local policy (targeting, e.g., corruption, political stability, or education) are necessary, but also support from the international community to assist in improving infrastructure and fostering overall development.

Of course, FDI itself – once it is in the country - can also be beneficial here. From an economic point of view, FDI by multinational enterprises channels not only new investment to the host country thus boosting national income and generating new jobs. There is an additional important potential benefit, namely the inflow of new foreign knowledge and technology. This latter aspect of FDI may lead to spillovers to the local economy, resulting in higher productivity growth and thus accelerating overall economic development of the host country. These external effects from multinationals to domestic firms are generally referred to as ‘productivity spillovers’ or ‘technology spillovers’ (see e.g., Görg, 2016, Farole and Winkler, 2014, Javorcik, 2015). On the other side of the coin, of course, multinationals may crowd out domestic entrepreneurship with potential negative effects for the economy.

Host country governments seem to assume that, on balance, positive effects generally outweigh the potential negative consequences and that FDI can help fostering economic development. Of course, in order for such benefits to take place, FDI needs to be attracted in the first place. Hence there is a rationale for efforts made by governments to actively attract multinational companies and encourage foreign direct investment into their economies.

⁶ See <https://www.transparency.org/en/cpi/2021> (accessed 8 September 2022)

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Table 1: Literature on determinants of FDI with a focus on Sub-Saharan African countries.

Author(s) year of publication	Country	Data sources Period covered	Topics	Major Findings
Suliman, Mollick 2009	SSA	World Development Indicators (WDI) - World Bank 1980-2003	determinants of FDI flow	Determinants of FDI inflow: (1) literacy/education promote FDIs (2) political rights and civil liberties promote FDIs (3) War and/or political conflict has a negative effect on FDI inflow.
Asiedu 2002	SSA	World Development Indicators (WDI) - World Bank 1988-1997	determinants of FDI in developing countries	(1) Determinants of FDIs are different for SSA countries and other developing countries. (2) higher ROI and good infrastructure positively impact FDIs in non-SSA countries, but not in SSA countries. (3) openness to trade promotes FDI to SSA and non-SSA countries, but the marginal benefit of increased openness is smaller for SSA countries
Cleeve, Debrah, Yiheyis 2015	SSA	UNCATD FDI database Barro and Lee education dataset World Development Indicators (WDI) - World Bank African Development Indicators (ADI) - World Bank Polity IV Project 1980-2012	Human Capital, FDI flows, skill formation model	(1) Human Capital has a positive and significant effect on FDI inflow (2) Other common control variables like market size, growth, natural resource endowments, major economic shocks and coastline access have been verified to influence FDI flows. (3) The effect of human capital on FDI seems to be constant over time.
Onyeiwu, Shrestha 2004	African countries	World Development Indicators (WDI) - World Bank Annual Survey of Freedom in the World - Freedom House 1975-1999	Determinants of FDI flows	Determinants of FDI flows: (1) economic growth, (2) inflation, (3) openness of the economy, (4) international reserves, (5) natural resource availability Moreover: political rights and infrastructure does not contribute to FDI inflow.

Author(s) year of publication	Country	Data sources Period covered	Topics	Major Findings
Cleeve 2008	SSA	UNCTAD and World/African Development Indicators of the World Bank 1990 - 2000	fiscal incentives, FDI flows	Determinants of FDI flows: (1) market size, (2) infrastructural development, (3) skill intensity, (4) relative wealth and labour costs, (5) openness of the economy, (6) fiscal incentives, (7) political stability
Asiedu, Lien 2004	diverse	Annual Report on Exchange Rate and Monetary Arrangements - IMF Cross-National Time Series Data Archive World Development Indicators (WDI) - World bank 1970-2000	FDI, liberalization, capital controls, capital flow	General: Capital control negatively impacts FDI (1) Impact of capital controls on FDI varies by region and over time (insignificant in 1970s, 1980s and significant in 1990s) (2) Capital controls have no significant effect on FDI in SSA and Middle Eastern countries, but have a significant negative effect in East Asia and Latin America note: capital controls investigated were (a) existence of multiple exchange rates; (b) restrictions on capital account (c) restrictions on the repatriation of export proceeds
Noorbakhsh, Paloni, Youssef 2001	diverse	World Development Indicators (WDI) - World Bank Industrial Development Report (1996,1997) - UNIDO note: data on years of education was taken from the World Bank website 1980-1994	FDI, human capital	(1) human capital is a statistically significant determinant of FDI inflows (other significant determinants found in the study: growth of the domestic market, stable macroeconomic environment, liberalization policies, energy availability, supportive business environment) (2) human capital is one of the most important determinants of FDI inflows (3) the importance of human capital for FDI inflows has become increasingly greater over time
Mensah, Traore 2022	SSA	fDiMarkets database africabandwidthmaps.com database submarinecablemap.com	FDI, Internet access, Banking	(1) High-speed internet induces FDI into the banking and technology sectors. (2) The effect persists in countries with reliable electricity supply.

Author(s) year of publication	Country	Data sources Period covered	Topics	Major Findings
Morisset 2000	African countries	World Bank database 1990-1997	FDI, policy change	(1) African countries that offer a large domestic market and/or natural resources attract FDI (2) African countries who have attempted to improve their business climate/investment environment were able to attract more FDI inflows compared to countries with bigger local markets and/or more natural resources. (3) As improvements were named: (a) economic growth (b) aggressive trade liberalization, opening economy (c) privatization programmes (d) modernizing mining and investment codes (e) adopting international agreements related to FDI (f) developing priority projects that have a multiplier effect on other investment projects (g) image building and inclusion of political figures