The impact of Foreign Direct Investment and the institutional quality on Welfare in Latin America and Sub-saharan Africa

Aloui, Zouhaier

Faculty of Economic and Management of Sousse University of Sousse, Tunisia

9 August 2019

The impact of Foreign Direct Investment and the institutional quality on Welfare in Latin America and Sub-saharan Africa

Zouhaier Aloui

Faculty of Economic and Management of Sousse

University of Sousse, Tunisia

Department of Economics

Email: Zouhaier_a@yahoo.com

Abstract

This article examines the impact of foreign direct investment (FDI) and institutional quality on well-being in Latin American and sub-Saharan African countries between 1996-2014. We use as key variables FDI, indicators of institutional quality (control of corruption and the rule of law) and the Human Development Index (HDI) as the main variables. Our analyzes confirm the positive and significant relationship between FDI and well-being in Latin America. Although the rule of law has been established to improve well-being. This result shows that legal variables of institutional quality play an important role in improving well-being. Nevertheless, this relationship between FDI, institutional quality and well-being is significantly different between Latin America and sub-Saharan Africa. So legal indicators create a positive effect on well-being. This study shows that institutional quality indicators attack well-being in the Latin American region. In addition, the quality of institutions and the strengthening of governance tend to amplify the positive effects on well-being in the region. The result of the regression confirms the positive links between FDI, institutional quality and improved well-being. Regarding the impact of FDI and institutional quality on well-being, FDI and the rule of law have more impact on improving well-being in Latin American countries than in sub-Saharan African countries.

Keywords: Foreign Direct Investment, Institutions, Welfare, Latin America, Sub-Saharan Africa.

1. Introduction

The international community made a commitment to the United Nations Millennium Development Goals (MDGs) in New York in 2000 to halve the extreme poverty rate by 2015, and outlined eight areas. Achieving these goals would contribute to human development and poverty reduction. Unfortunately, at present, most African countries are off-track with respect to these goals. The international community has been discussing a new post-MDG policy until 2030. To rectify the situation, an important source of capital investment is needed in most African countries, the private sector is recognized as a major driver of growth. Therefore, FDI is essential to achieve the MDGs. As a result, it is instructive to consider the Millennium Declaration of September 8, 2000: We "the United Nations General Assembly aim to halve, by 2015, the proportion of the world's population whose income is less than a dollar a day. We are also committed to taking special measures to address the challenges of poverty eradication and achieving sustainable development in Africa, including debt cancellation, improved market access increase in official development assistance (ODA) and foreign direct investment flows, as well as technology transfers. (UN Millennium Declaration, 8 September (2000)).

The role of foreign direct investment in developing countries, which is essential for economic development and poverty reduction, is an engine of economic growth and has many benefits by creating jobs, enabling access to foreign markets, technology transfer and, generally, skills in host country firms. Foreign direct investment is considered "a key driver of economic growth and development. FDI stimulates not only capital formation, but improves the quality of national capital" (Gorg and Greenaway, (2003)). According to Asiedu (2006) "it stimulates wages and the employment situation at the national level, promotes the transfer of technology between foreign and domestic firms and improves the productivity of the labor force". In this framework, foreign direct investment (FDI) has shown that it plays an important role in promoting economic growth, and that it ensures a technological level and the creation of new jobs in developing countries (Blomstrm and Kokko, (1996), Borenzstein, De Gregorio and Lee, (1998)). They also showed that foreign direct investment works as a means to integrate developing countries into the global market and increase the capital available for investment, thus leading to an increase in the economic growth needed to reduce poverty and raise the standard of living (Dollar and Kraay, (2000)).

Strictly speaking, good governance can simply mean the efficiency with which a government performs its work and promotes the public good. The public good is broadly defined as law enforcement and order, revenue collection, allocation of resources to meet specific demands, provision of infrastructure and promotion of human rights. Although democracy reinforces good governance, it is not necessarily equivalent to democracy. A single party and authoritarian regimes usually do not have good governance because they are easily ready for corruption and human rights abuses. Democratic regimes, which are much more open to public scrutiny and periodic tests of legitimacy through elections, tend to be more sensitive to good governance.

If governments can not access financial resources properly, their economic activities will be challenged with difficulties in the development process. National savings remain the main source of financing for investment, although in most developing countries that do not meet the level of investment needs do not arrive at capital formation. These countries have turned to foreign investment and participation in economic activities as a means of overcoming the investment gap and breaking the vicious circle of poverty and underdevelopment. Foreign direct investment affects poverty through the process of job creation; it is useful to examine its impact on poverty. Much research has investigated the effect of FDI on economic growth, but its relationship to poverty has been little studied.

The impact of FDI and institutional quality on well-being through a study of the countries of Latin America and sub-Saharan Africa over the period 1996-2014. We also measure the improvement of well-being as the Human Development Index (HDI). The independent interest variable consists of FDI inflows, the institutional quality is measured by two indicators (control of corruption, rule of law) and is measured by the World Bank. We examine the following research questions:

(1) Does FDI and Institutional Quality Improve Wellbeing in Latin America and Sub-Saharan Africa?

(2) Does FDI and institutional quality have more impact on improving well-being in Latin America than in sub-Saharan African countries?

This article is organized as follows: we present a literature review on the link between FDI and well-being, between institutional quality and well-being. Then we will present the methodology and describe the variables, the sample and the specification of the model. We examine the empirical results on the link between FDI, institutional quality and well-being. Finally, we will present our findings and policy implications.

2. Literature review of the relationship between FDI, institutional quality and well-being

2.1. The impact of FDI on well-being

FDI contributes to development in at least three ways: (a) it is a perpetual source of new investment capital enabling countries to increase imports and accumulate capital more rapidly, (b) they encourage transfer of technology and increase the stock of human capital and boost the productivity and growth of domestic firms in the long run, and (c) help to accelerate the process of economic integration and competitiveness by helping to link developing economies to global supply and production chains. FDI as a key factor for generating growth is therefore the most important ingredient for poverty reduction. FDI has the potential to improve the quality of growth by, (a) reducing volatility in capital flows and income, (b) improving assets and distributing income at the time of growth privatization, (c) contribute to the improvement of social and environmental standards, and (d) contribute to the improvement of social security and basic services for the poor.

According to Ozturk (2007) "during the fluctuations of capital flows in the 1990s, foreign direct investment was the main source of flows in developing countries". Asiedu (2002) stated that "while foreign direct investment contributes to growth, few empirical work on foreign direct investment has focused on Africa, which is the poorest region in the world." A large number of studies have analyzed the relationship between FDI and economic growth. The main research concern is whether FDI has an impact on a country's economic development and to what extent. The implicit assumption is that economic growth naturally leads to improved well-being. Most research concludes that foreign direct investment stimulates economic growth.

Foreign direct investment has been recognized as an important source for economic development. Many studies claim that FDI could close the gap between investment and national savings (Todaro and Smith, (2003) and Hayami (2001)); it can also increase tax revenues and improve the management, technology and skills of the labor force in host countries (Todaro and Smith, (2003) and Hayami (2001)). Many researchers believe that the benefits acquired from FDI can include the acquisition of new technologies, job creation, human capital development, contribution to the integration of international trade, improvement of domestic investment and tax revenues increasingly generated by foreign direct investment (Jenkins and Thomas in 2002). All of these benefits should contribute to economic growth and increased employment which is an effective tool for achieving improvement in poverty reduction.

FDI is not only a movement of capital but also job creation and technology transfer. According to Borensztein, Gregorio and Lee (1995) FDI plays a positive role in the economic growth of host countries. Research that examined the relationship between FDI and economic growth using FDI variables and GDP growth showed mixed results. Several studies have analyzed the relationship between FDI and economic growth to determine the effects of FDI on economic development. Economic growth improves well-being while FDI is a factor that stimulates economic growth. In general, foreign direct investment generates an increase in total investment. It represents an investment that is added to the domestic investment. FDI can also have an impact on domestic investment. Borensztein, Gregorio and Lee (1998) studied the impact of FDI on domestic investment. They perform a cross-sectional analysis of 69 countries over a period from 1970 to 1989. The authors conclude that there is a complementarity effect between the two, in some estimates.

Income growth is more than necessary, but it is not enough to reduce poverty. Aitken and Harrison (1999) confirmed that the presence of foreign capital can reduce the productivity of local firms. To test the nature of the effect of FDI on domestic investment, Agosin and Mayer (2000) developed a theoretical model. They also conduct an econometric study using panel data covering the period 1970-1996 and three different regions: Africa, Asia and Latin America. The authors found that FDI has a ripple effect on domestic investment in Asian countries, the effect is neutral for African countries; that is, a one dollar increase in FDI leads to a $ 1 increase in investment. On the other hand, this effect is transformed into an eviction effect for Latin American countries. The Latin American countries that suffer from crowding out are more liberal countries compared to Asian countries that are more productive.

2.2. The impact of institutional quality on well-being

Pacha (2000) examined nine factors of good governance for achieving growth objectives, including equity, fiscal discipline, institutional capacity, credibility and coherence, protection of the public interest, the ability to manage crises, effective service delivery, integrity and sovereignty. He said the growth of Pakistan's economy has been mixed on the basis of these indicators of good economic governance. He recommended that if Pakistan wants to improve its rate of growth, it must improve its economic governance. In a cross-country analysis of all developing countries, Chauvet and Collier (2004) found that these countries suffer from poor governance with an average growth of 2.3 percentage points of GDP per year less than other developing countries. There are also other recent findings that suggest a strong causal effect, better governance with better development outcomes.

Ahmad (2001) has studied the impact of the political economy on poverty in the economies of South Asia, and has developed a framework for measuring governance and linking it to poverty reduction. The study showed that governance is a critical issue in South Asian economies that negatively impact on country poverty trends. Hassan (2002) explored the inverse causality between poverty and governance and proved that the highest levels of poverty are the main reason for poor governance. In addition, he said that good governance alone is not enough to fight the level of poverty, it is not necessary that only pro-poor policies can reduce poverty. In addition, Asian economies have been able to reach low levels of poverty, even in the presence of poor governance.

It is very difficult to include the poor in the decision-making process; with a further deterioration of the situation, they lose even their interest in this process. In addition, when poverty continues to increase, the poor become more concerned about their existence rather than the essentials of good governance, such as equality, equity and justice, and so on mismanagement creates personal security concerns whose poor is the vicious circle of poverty and governance continues to grow. Thus, only a governance policy for the poor by the government can solve the problem.

Hyden (1992) examined the relationship between poverty reduction and good institutions in Africa, those who are absolutely poor in Africa rely on mechanisms outside the system to solve their problems of poverty. According to Kempe (2002) it can be noted that good governance, in all its aspects, shows a positive correlation with the achievement of better growth rates, notably through the creation of market support institutions. Similarly, United Nations Secretary-General Kofi has stated that "good governance is perhaps the single most important factor in eradicating poverty and promoting development" (United Nations (1998)). The president of the African Development Bank (AfDB (1999)) emphasized that "good governance is not only a laudable goal, but also a prerequisite for sustainable development and long-term poverty reduction". While the Executive Secretary of the United Nations Economic Commission for Africa (ECA (2005)) proclaimed that "good governance is essential for Africa's political and economic transformation".

The main objective is the shift from development to institution building, decentralized governance and poverty reduction, which is part of Washington's broader movement to the post-Washington consensus. According to Schneider (1999) traditional poverty reduction strategies have yielded disappointing results in many cases, particularly in situations of high initial inequality that tend to reflect political obstacles to development. Participatory governance is based on ideas of political and institutional economy and experiences promoted by social activists. Their role is threefold: i) to ensure that decision-makers and their administration are more engaged than they tend to be in the parameters of non-participatory governance; (ii) adopt basic policies on better information; and (iii) implement more effective and efficient policies. Strengthening governance is therefore advanced as an essential condition for improving the lives of the poor and reducing poverty. However, despite the importance of the subject, there are surprisingly few theoretical and empirical studies exploring the direct relationship between governance and poverty reduction. (Earle and Scott (2010), Khan (2009)).

3. Methodology

3.1. Variables

The main variables that we use to explain the impact of FDI and institutional quality on well-being are FDI flows, institutional quality indicators (Corruption, Rule of Law) and the HDI. The set of variables are defined as follows:

FDI: Foreign direct investment flows as a percentage of GDP.

Institutional quality: Institutional quality is measured by two indicators (the control of corruption, the rule of law) and is measured by the World Bank.

HDI: A more appropriate indicator of the well-being of the population has been recently defined by the United Nations Development Program (UNDP) as a Human Development Index (HDI). The HDI is by construction one of the best measures of a country's human development. According to the UNDP definition, the HDI is a composite index that measures average achievement of countries in three basic aspects of human development: health, knowledge and standard of living. Health is measured by life expectancy at birth, knowledge is measured by a combination of adult literacy rate and gross enrollment ratio (primary, secondary, tertiary) and standard of living is defined by the GDP per capita.

We also use a number of control variables:

Control variables

Inflation (INF): This is measured by the percentage change in the GDP deflator, which reflects the percentage increase in the Consumer Price Index (CPI).

The ratio of total debt (Debt / GDP): it is measured by total debt to GDP.

Official Development Assistance (ODA): as a percentage of GDP, it represents disbursements of loans and grants on concessional terms (excluding the repayment of capital) and grants by public agencies of the organization for economic development cooperation (OECD) gathered in the Development Assistance Committee (DAC).

International Remittances (TRANSFER): As a percentage of GDP, they include current transfers by migrant workers and wages and salaries earned by non-resident workers.

Government Expenditure (GE): This is measured by the share of total government consumption relative to GDP.

3.2. Sample

Our study covers the period from 1996 to 2014 in Latin America and sub-Saharan Africa. The availability of data on FDI, HDI and institutional quality indicators (Corruption, Rule of Law) was the main factor in selecting countries and data.

3.3. Regression model specifications

To study the impact of foreign direct investment and institutional quality on well-being in the Latin American and sub-Saharan region between 1996-2014. We used the following model:

$$\mathbf{HDI_{it}} = \beta_0 + \beta_1 \mathbf{FDI_{it}} + \beta_2 \mathbf{corruption_{it}} + \beta_3 \mathbf{rule\ of\ law_{it}} + \beta_4 \mathbf{INF_{it}} + \beta_5 \mathbf{debt_{it}} + \beta_6 \mathbf{ODA_{it}} + \beta_7 \mathbf{Transfer_{it}} + \beta_8 \mathbf{GE_{it}} + \varepsilon_{it}$$

4. Analysis of the results

The purpose of this study is to assess the impact of FDI and institutional quality on well-being in Latin America and sub-Saharan Africa. To achieve our goals, we address the following two research questions:

1. Does FDI and Institutional Quality Improve Wellbeing in Latin America and Sub-Saharan Africa?
2. Does FDI and institutional quality have more impact on improving well-being in Latin America than sub-Saharan Africa?

Table 1: Results of the regressions on the impact of FDI and institutional quality on well-being for Latin America.

The variables	Coefficient	P(t)
FDI	**0.434**	**5.15*** **
Corruption	**-0.382**	**-0.26**
Rule of law	**5.193**	**2.67*** **
Inf	-0.035	-0.96
Debt	0.004	0.43
ODA	-0.001	-1.49
Transfer	0.593	5.09***
GE	-0.788	-5.70***
Constant	76.627	33.83***
Nb observation	474	
R^2	0.19	

*** Significant at 10%; ** Significant at 5%; *** Significant at 1%**

Table 2: Results of regressions on the impact of FDI and institutional quality on well-being for sub-Saharan Africa.

The variables	Coefficient	P(t)
FDI	**0.010**	**0.32**
Corruption	**2.330**	**1.29**
Rule of law	**4.280**	**2.07** **
Inf	0.015	1.90**
Debt	-0.012	-2.61***
ODA	-0.005	-1.83*
Transfer	-0.126	-0.90
GE	-0.527	-5.08***
Constant	88.252	41.10***
Nb observation	718	
R^2	0.07	

*** Significant at 10%; ** Significant at 5%; *** Significant at 1%**

The estimates in Table (1) and (2) show how FDI and institutional quality affect well-being in the 1996-2014 period. However, the FDI coefficient is also positive and economically significant at the 1% level in Latin America but not significant in sub-Saharan Africa. When foreign direct investment increases by 1%, welfare should increase by 0.434 point. These results are consistent with the results of the Sharma and Gani (2004) studies which concluded that FDI was beneficial for improving well-being. This result can be explained by the fact that FDI contributes to economic growth in Latin America, which has generated revenues for states and populations in the region through fiscal policies and job creation. FDI has promoted social security improvements and basic services for the poor. FDI creates jobs, develops local skills and stimulates technological progress.

Like the model results with the indicators of institutional quality, More specifically, the effects of corruption on non-significant welfare in Latin America and sub-Saharan Africa and the rule of law has a significant effect and positive in Latin America and sub-Saharan Africa. The rule of law improved their change in the welfare of (5,193) in Latin America and (4,280) in sub-Saharan Africa. These results are consistent with results in previous governance and well-being studies.

The coefficients of inflation, development aid and external debt are not statistically significant in Latin America and significant and negative in sub-Saharan Africa but significant and positive inflation. Thus, the international transfer of funds and government public spending also appear positive and significant in Latin America.

In conclusion, our results support the hypothesis that FDI and institutional quality have a major impact on well-being in Latin America more than sub-Saharan Africa. Better quality governance will encourage foreign direct investment, fostering economic growth and improving well-being. They can also increase the efficiency of social services to the poor.

5. Conclusion and political implications

The study examines the effect of foreign direct investment and institutional quality on well-being in Latin American and sub-Saharan African countries for the period 1996-2014. This paper finally examines how FDI and institutional quality affect well-being. Estimates suggest that FDI inflows have a positive impact on well-being in Latin America. The results further suggest that the rule of law has a statistically significant positive effect on improving well-being in Latin America and sub-Saharan Africa. Regarding the impact of FDI and institutional quality on well-being, FDI and the rule of law have more impact on improving well-being in Latin American countries than in sub-Saharan African countries.

Therefore, foreign direct investment can contribute to improving well-being in Latin America and not in sub-Saharan Africa, and the policies put in place to attract FDI should be adapted on a regional basis. FDI to sectors that benefit the poor is lacking. Regional policies to attract FDI need to be carefully designed to direct investment to the most productive sectors of the economy. It is therefore essential that governments in the region continue to attract foreign investors (FDI) while improving the quality of their institutions and governance.

References

Agosin, M., et Mayer, R., (2000). « Foreign Investment In Developing Countries Does it Crowd in Domestic Investment? », No. 146 February 2000.

Ahmad, S., (2001). «Poverty Reduction and Governance in South Asia», Mahbub ul Haq Human Development Review 1:1, June

Aitken, B., et Harrison, E., (1999). « Do Dmestic Firms Benefit from Direct Foreign Investment? Evidence from Venezuela », The American Economic Review.

Asiedu, E., (2002). « On the Determinants of Foreign Direct Investment to Developing Countries: Is Africa Different? », World Development, 30 (1), pp. 107-19.

Asiedu, E., (2006). «Foreign Direct Investment in Africa: The Role of Natural Resources, MarketSize, Government Policy, Institutions and Political Instability», The World Economy, Vol. 29, No. 1, pp. 63-77, January 2006.

Banque Africaine de Développement (BAfD) (1999). « Politique du groupe de la banque en matière de bonne gouvernance », Département des opérations centrales

Blomstrom, M., and Kokko, A., (1996). «The Impact of Foreign Direct Investment on Host Countries: A Review of The Empirical Evidence», National Bureau of Economic Research.

Borensztein, E, De Gregorio, J et Lee, J.W (1995), « How Does Foreign Direct Investment Affect Economic Growth?», NBER Working Paper No. 5057.

Borensztein, E., J. De. Gregorio, et Lee, J.W (1998) « How does foreign direct investment affect economic growth», Journal of International Economics 45 (1): 115-135.

Chauvet, L., et Collier, P., (2004). « Development Effectiveness in Fragile States: Spillovers and Turnarounds», Centre for the Study of Africa Economies, Department of Economics, Oxford University.

Commission Economique pour l'Afrique (CEA) (2005), Page consultée le 10 octobre 2005, A propos de la CEA, En ligne Adresse URL : http : //www.uneca.org/fr/fr_main.htm

Dollar, D., et Kraay, A., (2000). «Growth Is Good for the Poor», Development Research Group The World Bank.

Earle, L., et Scott, Z., (2010). «Assessing the Evidence of the Impact of Governance on Development Outcomes and Poverty Reduction», Issues Paper. International Development Department University of Birmingham, 2010

Gorg, H., et Greenaway, D., (2003). «Much Ado About Nothing? Do Domestic Firms Really Benefit From Foreign Direct Investment?», IZA, Discussion Paper Series N 944

Hassan, M. K., (2002). « Risk, return and volatility of faith-based investing: The case of the Dow Jones Islamic Index», Paper in Proceedings of 5thHavard University. pp.43-67.

Hayami, Y., (2001). «Development Economics: From the Poverty to the Wealth of Nation», Oxford University Press, 2001.

Hyden, G., (1992). « Governance and the study of politics», Hyden G and Bratton M (eds) Governnace and Politics in AfricaLondon. Lynne Rienner Publishers, pp1.329.

Jenkins, C., et Thomas, L., (2002). «Foreign Direct Investment in Southern Africa: Determinants, Characteristics and Implication for Economic Growth and Poverty Alleviation», CSAE-CREFSA.

Kempe, R. H., (2002). «Toward Good Goverance and Sustainable Development: The African Peer Review Mechanism», in Governance 18(2): 283-311.

Khan, M., (2009). « Governance, Growth and Poverty Reduction», DESA Working Paper No. 75.

Kofi, A., (1998). «Démocratie et gouvernance mondiale : quelles régulations pour le XXIe siècle ? », Lindesmith Center 1998a

Nations Unies (2000), Les OMD- Objectifs du Millénaire pour le développement (OMD)- ONU. Siège de l'Organistion à New York.

Ozturk, I., (2007). «Foreign Direct Investment-Growth Nexus: A Review of The Recent Litterature», International journal of Applied Econometrics and Quantitative Studies Vol. 4-2

Pacha, Hafiz A., (2000). « Elements of Good Economic Governance», Social Policy Development Centre. (Research Report No. 30).

Schneider, H., (1999). «Participatory governance for poverty reduction», Centre de Développement de l'OCDE, Cahier de Politique économique N 17.

Sharma, B., et Gani, A., (2004). « The Effects of Foreign Direct Investment on Human Development», Global Economy Journal, 4 (2), 1-20.

Todaro, M., et smith, S., (2003). «Economic Development», Pearson Education Limited, 2003.