INTERROGATING FACTORS THAT INFLUENCE FOREIGN DIRECT INVESTMENT (FDI) IN DEVELOPING COUNTRIES

(FUWJSS)

Volume4 Number 1
March, 2025

Oluwagbenga Emmanuel Adebayo
Department of Economics, Modibbo Adama University, Yola, Nigeria

Abstract

Foreign Direct Investment (FDI), which is a major contributor to the economic growth and development in many developing countries, including African countries, has been decreasing in some of these countries. This paper synthesized empirical literature on the effect of political stability, geopolitical risk, institutional quality and corruption on FDI across several developing countries. The paper relied on diverse econometric methods, including FMOLS, ARDL and GMM. The results revealed that while some studies reveal that higher level of political stability encourages FDI, some indicated that its effect is insignificant. Moreover, some studies revealed that seemingly undesirable political conditions might attract FDI. The narrative review also captures the influence of institutional quality, political stability and geopolitical risk on FDI inflows. Existing literature yields empirical evidence based on data from various African nations. Hence, this study recommends that governments, regulatory agencies, and policymakers should strengthen institutional quality and implement sustainable policies that create stable political environments that attract FDI with the aim of promoting sustainable development.

Keywords: FDI, political stability, institutional quality, geopolitics, sustainable development

Introduction

Foreign direct investment (FDI) is a driver of economic growth and sustainable development in Africa, bringing about capital, innovation, technology transfer, and job creation. A proper understanding of the determinants of FDI is essential for policymakers that aim to create conducive environments for investment.

Foreign Direct Investment (FDI) is very important as it benefits both the host countries and the investors. At the host countries, it provides more financial resources via investment taxes. It creates employment and leads to transfer of skills, technology, managerial expertise, and better corporate governance (Asongu, Akpan & Isihak, 2018). FDI also brings about digitization. According to Jaiblai & Shenai (2019), FDI can provide much need capital to developing countries, promote local production and exports, create jobs, advance local skills, foster improvements in infrastructure and be an overall contributor to sustainable economic growth.

Various African countries aim to increase the inflow of capital to their economies through FDI. Achieving this will enable the salvage of the continent from its economic woes, and place African countries in good condition to attain the sustainable development goals - SDGs (Adegboye, et al. (2020).

Many developing nations, including those in Africa, are blessed with human and natural resources. However, to harness these resources, technology, finance, and investment are necessary. The investment landscape of these nations have evolved over the years. There have been a rollercoaster of economic, institutional and political variables in recent years. There have been coups, changes in governments from one political party to another, rapid changes in economic policies, inflation, subsidy removal, injustice, harassment, etc. which continually alter the investment environment. These have consequences on the movement of capital from Africa and into Africa.

Developing economies like the sub Saharan Africa (SSA) are faced with lack of the relevant determining factors that should attract FDI. These include factors like effective policies and institutional quality, which will enhance low cost of production, flexible institutions, and favorable tax incentives. It would also aid the distortions of the free market, which destroys motivation, misappropriate resources, and lead to uncertainty in the market (Adegboye, et al. 2020). For example, in Nigeria, there have been continuous changes in economic policies, and political institutions in recent times. The recent subsidy removal was a topic for debate, as it greatly altered the investment landscape, standard of living, prices of commodities, and movement of capital from and into the country.

Despite the benefits of FDI for economic and sustainable development, many African countries find it difficult to attract adequate foreign investment due. This can be seen in the case of Nigeria, where foreign investors moved their businesses, including pharmaceutical and manufacturing companies out of the country. This study seeks to study the extent to which political stability and other institutional variables affect FDI, and to address the gap in understanding how providing insights and to detect crucial trends, reveal consensus or disagreement between various literature (and the aspects) , and suggest areas for further research.

Theoretical Review

This study is pinned on the Eclectic theory. The eclectic framework was developed by Dunning (1980, 1998) to evaluate the significance of the ownership, location, and internationalization (OLI) advantages and how firms leverage resources that make them competitive in host countries. According to the eclectic framework, the location advantages of the host country compensate for the deficiencies in the home country through large and stable markets, skilled human capital availability, and institutional quality (Kwaw &Tian, 2023). The eclectic theory posits that for a firm to engage in FDI, it must fulfil three conditions. First, there must be comparative advantage of the firm over other firms as a result of the ownership of some intangible assets. The second condition is that it must be more of greater benefit for the firm to utilize these advantages, rather than leasing or selling them. Third, the utilization of these advantages in combination with at least some factor inputs located abroad must be more profitable (Moosa, 2015).

The Eclectic Theory is relevant to this study because it is a useful framework in examining the effects of political stability, geopolitical risk and corruption on foreign direct investment, as these variables shape the location advantages of a host country, thereby influencing the decision of a firm to invest in that country. The location advantages of the country may be thwarted by factors such as political instability, geopolitical risk, and corruption, and these factors will deter foreign investors form utilizing their ownership advantages in these markets and economies.

Empirical Review

The empirical literature on the various factors that influence FDI. These include political stability, geopolitical risk,, institutional quality, corruption, etc. It provides insight on how these factors affect investment decisions across various countries. Osuma, et al. (2024) employed Autoregressive Distributed Lag (ARDL) and Fully Modified Ordinarly Least Square (FMOLS) Models to examine the factors that determine FDI decisions from 1996-2023. The results indicated that increased levels of corruption and political instability affect FDI in a negative way, discouraging potential investors and hindering economic growth. This result is in consonance with that of Raphael (2023) which examined the effect of corruption on FDI infows in Tanzania from 1996 to 2021, data from the World Bank Governance Indicators and the Bank of Tanzania (BOT). The findings revealed that corruption exerted a damaging impact on FDI infows in both the short and long run, stressing that corruption hampers economic growth.

Adegboye, et al. (2020) employed the fixed and random effect regression model utilized to estimate the effect of foreign capital on economic development with considerations for the quality of institutions for developing SSA sub-region of Africa. Pooled data for 30 SSA countries was collected for the period within the years 2000 and 2018. The results indicated that economic development is driven by foreign capital inflow in the SSA sub-region of Africa. Moreover, institutional quality is among the factors that determine the level of inflow of FDI to the host SSA sub-region.

Ross (2019) employed random effects model to argue that poor political conditions in developing countries can capture the attention of foreign investors to invest. This is contrary to , Al-Samman and Mouselli (2018) asserted that Gulf Cooperation Council (GCC) countries can increase FDI inflow to their countries by reducing corruption, enhancing political stability, and reducing the quality of regulation. Ali et al. (2010), Aziz (2018), and Fukumi and Nishijima (2010) also generated a composite institutional quality index with the use of International Country Risk Guide (ICRG) index and revealed that institutions are robust determinants of FDI inflow in Arab economies and Latin American region.

Luu et al. (2019) used advanced econometric methods, including two-stage least squares and the generalised method of moments (GMM) to analyse the effect of corruption on FDI flows in 131 countries. The findings showed that although corruption had negative overall effect on FDI, the effects mixed when disaggregated by type of investment. The study revealed that corruption had positive effect on greenfield investments, and negative effect on cross-border mergers and acquisitions (M&As), implying that the nature of investment moderates the effect of corruption.

Youssouf, Joseph and Thiery (2023) used panel data estimation to assess the impact of constitutional changes on foreign direct investment (FDI) in 49 African countries from 1980-2020. The results showed that an increase in the frequency of constitutional changes negatively affects FDI. The results indicate that frequent constitutional changes tend to triggers uncertainty and instability in the region, thereby hindering foreign investment.

Saha et al. (2020) employed two-step GMM to analyse the effect of institutional quality on Foreign Direct Investment (FDI) inflow in 28 lower-middle income countries, in six regions from 2002-2018. He study further used threshold analysis to record the manner in which reaction of institutional quality varied in terms of GDP per capita. The results indicated that control of corruption and regulatory quality improves FDI inflow, while high rule of law and voice and accountability mitigates it in lower-middle income countries. However, government effectiveness, and political stability do not have significant effect on FDI. Moreover, regulatory quality exerts the greatest influence on foreign investment inflows.

Bussy and Zheng (2023) employed the baseline model to analyze the determinants of FDI. The results indicated that increasing geopolitical risk and geopolitical uncertainty (GPR) hinders FDI. The study also studied the role of governance, information, and technology in determining the responses of FDI to GPR. The results showed that effective governance in the destination market protects FDI against GPR. Multinational corporations with sufficient information acquired from closer geographic, cultural and commercial relationships decide to delay FDI as a result of increasing GPR. Moreover, FDI in R&D intensive industries can thrive despite GPR because intangible technology can be easily moved across borders.

Cetin and Yaman (2023) used dynamic panel data estimators to analyse the long run impacts of geopolitical risk and institutional quality indictors on FDI in BRICS countries from 1992-2019. The findings revealed that geopolitical risk has significant negative effect on FDI inflows, while improved rule of law and equitable distribution of resources exert significant positive impacts on FDI inflows.

Atiner and Bozkurt (2023) employed ARDL method to analyse the impact of geopolitical risks on FDI from 1985-2020. Geopolitical (GPR) index was used to measure geopolitical risk. The result indicated that geopolitical risk has negative effect on FDI inflows.

Nhuyen et al. (2022) analysed the effect of geopolitical risk on total factor productivity and FDI inflows in 18 developing economies during the 1985-2019 period the SUR model and the Granger causality test were employed. They results showed that GPR has a negative impact on total factor productivity and FDI.

Özşahin et al. (2022) employed ADRL technique examined the relationship between geopolitical risk and corruption. The study used data from 2013-2020. The results indicated that corruption control has positive effect on FDI inflows, while geopolitical risk has negative influence on FDI inflows. Thakkar and Ayub (2022) analysed the effect of geopolitical risk on FDI. The study used data from 189 spanning from 1948-2019. The method of analysis used was Pseudo-Poisson Maximum Likelihood (PPML) method. The results revealed that geopolitical risk has negative effect on FDI.

Feng et al. (2023) used GMM Method to examine the effect of geopolitical risks on FDI, using data from 45 countries , from 2005-2019. The results revealed that geopolitical risk has significant negative influence on FDI.

Yu and Wang (2023) employed fixed effects model to analyse the impacts of geopolitical risks on FDI flows in 41 countries from 2003 to 2020, taking the following into cognizance: market, strategic, and natural resource. The findings indicated that geopolitical risk has negative significant effect on FDI flows.

Le, et al. (2023) examined the effects of trade openness and political stability on FDI in 25 Asia-Pacific countries from1990 to 2020. Dynamic system Generalized Method of Moments was used to alleviate the heteroskedasticity and autocorrelation issues. Johnson–Neyman test to analyse the moderating role trade openness in the relationship between political stability and FDI. The results revealed that trade openness has a positive effect on FDI. However, political stability affects FDI negatively.

The studies reviewed were mostly based on secondary data and macroeconomic variables, and not micro-level variables. Furthermore the effect of social media on FDI has not been extensively analysed. Hence, this study points out this gap in literature.

Research Methodology

This study employs a narrative review methodology to analyze the effect of political stability, and other institutional variables on foreign direct investment in African countries. A narrative review was used because of the mixed results of current literature on these variables, and the goal of synthesizing varied perspectives and findings into a unified study. This will also be synthesized with theories. Academic databases such as Science direct, Springer, Sage, Nature, were searched during the review. This was systematic and thorough, as studies were selected on the basis of methodological rigour, contribution to current literature, and significance.

These studies were synthesized in an in-depth manner to develop a comprehensive picture of the influence of political stability, geopolitical risk, institutional quality, and corruption on FDI inflows.

Results and Discussion

Adverse Effects of Political Instability and Corruption on FDI:

Various studies have revealed that negative effects of political instability and corruption with FDI. Osuma et al. (2024) indicated that increased levels of corruption and political instability exert negative influence on FDI, thereby deterring economic growth. In agreement to that, Raphael (2023) showed the negative effect of corruption on FDI in the short run and in long run. These results are in consonance with the idea that investors are disinclined to risk and uncertainty, thereby being unlikely to invest in countries that are politically unstable or corrupt. Al-Samman and Mouselli (2018) is also in agreement with this result, signifying that decrease in corruption and increase in political stability can lead to rise in FDI inflows to Gulf Cooperation Council countries.

Positive Effects of Negative Political Conditions on FDI

Some studies provided contrary results. These studies asserted that some negative political conditions can attract foreign investment. Ross (2019) revealed that poor political conditions in developing countries can attract foreign investors. This unexpected finding may be as a result of the willingness of investors to take higher levels of political risk in order to get higher returns. It could also be as a result of the ambitious nature of some investors who want to take advantage of weak institutional frameworks, in fostering their quest for greater profits.

The Effect of Institutional Quality

Institutional quality, which include regulatory frameworks, the rule of law, has emerged as a crucial determinant of FDI inflows. Ali et al. (2010), Aziz (2018), and Fukumi and Nishijima (2010) indicated that institutions are strong determinants of FDI inflow in Arab economies and the Latin American region. Saha et al. (2022) revealed that regulatory quality drives FDI inflow in lower-middle-income countries. Nonetheless, the study also showed that government effectiveness and political stability have insignificant effect on FDI.

Investment Type as moderator

The effect of corruption can be moderated by type of investment. Luu et al. (2019) reveal that while corruption has a negative overall influence on FDI, the results are mixed when type of investment is taken into consideration. There is positive effect of corruption on greenfield investment and negative effect on cross-border mergers and acquisition. These imply that the effect of corruption is moderated by the type of investment.

Typically, in cross-border Merger and acquisition, there is transfer of ownsership of existing firms or assets, which results to capital outflow from the host country. In Greenfield investments, new businesses are formed, and they depend on the investing firm’s capital and strength. Corruption exerts negative influence cross border merger and acquisition by turning the country into a hostile environment that discourages foreign direct investment and decreases local capital formation. On the other hand, corruption can have positive effect on Greenfield investment by offering some advantages to investors. These include: enabling foreign firms to manipulate weak institutions, eliminating competition from local firms, and exploiting lower operational costs.

The Effects of Geopolitical Risk and Uncertainty On FDI inflow

Bussy and Zheng (2023) revealed that increasing geopolitical risk and geopolitical uncertainty (GPR) deters FDI. The study also analysed the role of governance, information, and technology in shaping the responses of FDI to GPR. The results indicated that effective governance in the destination market protects FDI against GPR. Other studies that revealed the negative influence of geopolitical risk on FDI include: Cetin and Yaman (2023); Altiner and Bozkurt (2023); Nhuyen, et al. (2022); Özşahin et al. (2022); Thakkar and Ayub (2022); Feng et al. (2023); and Yu and Wang (2023). According to Youssouf, Joseph, and Thiery (2023) rise in the frequency of constitutional changes leads to decline in FDI inflow to African countries.

Conclusion and Recommendation

This paper underscores the importance of political stability, geopolitical risk, institutional quality, and corruption in shaping the investment landscape in African countries. Generally, political stability is essential for attracting FDI, even though lack of political stability exploited by some foreign investors for personal gains. In line with this finding, it is recommended that governments and policymakers should foster stable political environments to attract foreign direct investment and promote sustainable development. Institutional quality is also promotes FDI inflows. On the other hand, corruption has negative influence on FDI inflows. Hence, the government and regulatory agencies should strengthen the institutional quality in order to gain the trust of investors and promote FDI inflows, and actively implement policies to discourage corruption. Geopolitical risks hinder FDI inflows. In line with this finding, governments should be deliberate about reducing geopolitical risks in various countries, through diplomacy, reinforced security and the rule of law.

Future research should explore the long-term impacts of these factors on FDI and consider the role of additional variables such as social media, in the African context. Moreover, primary data should be used in analyzing particular factors that shape the investment environment.

References

Adebgoye, F.S., Osabohien, R., Olokoyo, F.O., Matthew, O. & Adediran, O. (2020). Institutional quality, foreign direct investment, and economic development in sub-Saharan Africa. *Humanities & Social Sciences Communications*, *7*(38), 1-9.

Ali, F.A., Fiess, N., MacDonald, R. (2010). Do institutions matter for foreign direct investment? Open Econ. *Rev. 21* (2), 201–219.

Al-Samman, H., Mouselli, S., 2018. Does country risk affect FDI to GCC countries? Pertanika J. Soc. Sci. Human. 26 (4), 2627–2642.

Altiner, A. & Bozkurt, E. (2023). Reflections of Geopolitical Risk on Foreign Direct Investments: The Case of Türkiye. *Journal of human and social science researches, 12*(3), 1292-1309.

Aziz, O.G. (2018). Institutional quality and FDI inflows in Arab economies. *Finance Res. Lett. 25*, 111–123.

Bussy, A. & Zheng, H. (2023). Responses of FDI to geopolitical risks: The role of governance, information, and technology. *International Business Review, 32*(2023), 102136.

Cetin, M.A., & Yaman, I. (2023). The importance of geopolitical risk and institutional quality indicators on foreign direct investment to BRICS countries. *Romanian Journal of Economic Forecasting 14*(4), 107-127.

Dunning, J. H. (1980). Toward an eclectic theory of international production: Some empirical tests. Journal of International Business Studies, 11(1), 9–31.

Dunning, J. H. (1998). Trade, location of economic activity and the multinational enterprise: A search for an eclectic approach. Dunning John., Explaining International Production, Unwin Hyman.

Fukumi, A., & Nishijima, S. (2010). Institutional quality and foreign direct investment in Latin America and the Caribbean. Appl. Econ. 42 (14), 1857–1864.

Feng, C., Han, L., Vigne, S., & Xu, Y. (2023). Geopolitical risk and the dynamics of international capital flows. Journal of International Financial Markets, Institutions and Money, 82, 101693.

Kwaw-Nimeson, E., & Tian, z. (2023). Institutional Quality, Foreign Direct Investment, and Regional Integration: Empirical Evidence. From CEN-SAD. *SAGE,2023, Open*, 1-20

Le, A.N.N., Pham, H., Pham, D.T.N., & Duoung, K.D. (2023). Political stability and foreign direct investment inflows in 25 Asia-Pacific countries: the moderating role of trade openness.*Humanities and Social Sciences Communications, 10* (606), 1-9.

Luu, H.N, Nguyen, N.M, Ho H.H, & Nam V.H. (2019). The effect of corruption on FDI and its modes of entry. *J Financ Econ Policy, 11*(2), 232–50.

Moosa, I.A. (2015). Theories of Foreign Direct Investment: Diversity and Implications for Empirical Testing. *Transnational Corporations Review, 7*(3), 297-315.

Nguyen, T. T. T., Pham, B. T., & Sala, H. (2022). Being an emerging economy: To what extent do geopolitical risks hamper technology and FDI inflows?. Economic Analysis and Policy, 74, 728-746.

Osuma, G., Ayinde, A., Ntokozo, N., & Ehikioya, B. (2024). Evaluating the impact of systemic corruption and political risk on foreign direct investment inflows in Nigeria: an analysis of key determinants. *Discover Sustainablity, 5*(432).

Özşahin, Ş., Üçler, G., & Uysal, D. (2022). Jeopolitik risk ve yolsuzluğun doğrudan yabancı yatırımlar için önemi: Türkiye için ampirik bulgular [The importance of geopolitical risk and corruption for foreign direct investments: Empirical findings for Turkey]. Bingöl Üniversitesi İktisadi ve İdari Bilimler Fakültesi Dergisi, 6(2), 257-286.

Raphael, G. (2023). Does corruption attract foreign direct investment infows? Evidence from Tanzania. *Int J Res Bus Soc Sci*, *12*(5), 204–16.

Ross, A.G., 2019. Governance infrastructure and FDI flows in developing countries. Trans. Corp. Rev. 11 (2), 109–119.

Saha, S., Sadekin, M, N., & Sha, S.K. (2022). Effects of institutional quality on foreign direct investment inflow in lower-middle income countries, *Heliyon 8* (2022), e10828.

Thakkar, N., & Ayub, K. A. (2022). Geopolitical Risk and Globalization. The Journal of Applied Business and Economics, 24(3), 140-150.

Youssouf, N., Joseph, K., & Thiery, Y.U. (2023). Constitutional instability and foreign direct investment in Africa. *Economics of Transition and Instituional Change, 32*(1), 3-23.

Yu, M., & Wang, N. (2023). The influence of geopolitical risk on international direct investment and its countermeasures. Sustainability, 15, 2522. http://dx.doi.org/10.3390/su15032522