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THE ROLE OF INSTITUTIONAL FACTORS ON CAPITAL FLOWS TO MIDDLE-INCOME SUB-SAHARAN AFRICA

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Abstract:
This paper studies the institutional factors that tend to matter for capital inflows, for middle-income Sub-Saharan African (SSA) countries. Previous studies have focused more on macroeconomic push and pull factors and less on institutional factors. The paper aims to contribute to a better understanding of the dynamics between institutional quality and capital flows to middle-income SSA countries; with capital flows disaggregated into foreign direct investment (FDI), portfolio equity, and portfolio debt. The study found that countries that attract high capital inflows tend to have better institutional quality, although better institutional quality has not always translated to higher capital inflows. During the 1990s, the pick-up in capital inflows occurred with improvements in conflict, democratic accountability, government stability, investment profile, and law and order. However, corruption and bureaucratic quality deteriorated, indicating that these factors weighed less in the increase in capital inflows. Differences in dynamics by type of capital flow show portfolio debt better tracking law and order compared to the other capital flows. To our knowledge, this may be the first study of its kind to explore the institutional factors for capital flows at a disaggregated level.

Key words: foreign direct investment, portfolio equity, portfolio debt, middle-income Sub-Saharan Africa, institutional determinants.

JEL classification: E02, F21, F32, F43

1. INTRODUCTION

This paper distills trends and dynamics of foreign direct investment, portfolio equity, and portfolio debt against institutional pull factors of capital flows for middle-income SSA economies. Attracting foreign investment is key for economic development and achieving the Sustainable Development Goals (SDG) in developing economies, including in SSA. Creating an environment that attracts funds towards areas with investor interest while matching domestic economic investment needs is crucial for economic growth and poverty reduction in SSA. Middle-income SSA countries attract higher levels of capital flows compared to low-income SSA countries. They have more diversified types of capital inflows, with several countries experiencing an increase in portfolio inflows in recent decades with those for South Africa, for example, exceeding FDI. In contract, low-income SSA countries attract predominantly FDI and for many, portfolio inflows are non-existent. The institutional environment in middle-income SSA countries tends to be less challenging compared to that in low-income SSA countries with many low-income SSA countries considered fragile and conflict affected states (International Monetary Fund (IMF), 2022), which contributes to their limited ability to attract capital inflows.

This paper analyses the institutional factors for capital inflows to middle-income SSA countries. The empirical literature identifies push and pull factors. Push factors are global factors that drive capital flows from other economies to recipient countries whereas pull factors are those that attract capital flows to recipient countries. Pull factors can be macroeconomic and institutional in nature. This paper focuses on the institutional pull factors. The analysis covers largely the post-

1990 period when most of the data for institutional factors has become available. The capital inflows analyzed are FDI, portfolio equity, and portfolio debt. The countries covered in this analysis are Angola, Botswana, Cameroon, Cote d'Ivoire, Gabon, Ghana, Kenya, Namibia, Nigeria, Senegal, South Africa, Tanzania, and Zimbabwe given data availability. The selection of these countries is based on the World Bank's classification to middle-income country status—both upper-middle income and lower-middle income.

2. THE RESEARCH QUESTION, HYPOTHESIS, METHODOLOGY, AND DATA

The research question for this paper is: which institutional factors matter for capital flows; specifically foreign direct investment, portfolio debt, and portfolio equity; to middle-income SSA? The hypothesis is that bureaucracy quality, internal and external conflict, corruption, democratic accountability, government stability, investment profile, and law and order are institutional factors that matter for capital flows to middle-income SSA. As a methodology, the paper uses an exploratory approach to examining the trends and dynamics of capital flows to middle-income SSA countries against institutional factors that are hypothesized to drive them. It does this by utilizing country-based data and descriptive analysis with data at a disaggregated level of capital flows, which are foreign direct investment, portfolio equity, and portfolio debt; to help gain insights that are typically not found in empirical research. To our knowledge, an analysis of this nature has not been explored for middle-income SSA countries.

The paper utilizes data from the following sources and is processed in the following manner. Capital flows data are derived from the International Monetary Fund's Balance of Payments Statistics. Gross domestic product data are derived from the World Bank's World Development Indicators. Institutional factor data are derived from the International Country Risk Guide (ICRG), which contains a comprehensive set of variables that cover various forms of institutional quality and because the World Development Indicators by the World Bank, which were also comprehensive, have been discontinued. Data are collected and presented graphically for thirteen SSA countries: Angola, Botswana, Cameroon, Coté d'Ivoire, Gabon, Ghana, Kenya, Namibia, Nigeria, Senegal, South Africa, Tanzania, and Zimbabwe. The paper graphically presents capital flows data against data for the various institutional variables over time to help explore trends and dynamics. The development of measurable institutional factors over the last few decades have made research on the importance of these factors to capital flows possible. The importance of institutional factors for capital flows was sparked by the Lucas (1990) critique as further elaborated below.

3. THE INSTITUTIONAL FACTORS

The empirical analysis of institutional factors as drivers of capital inflows in SSA is lacking and especially on capital flows at a disaggregated level. The empirical literature has focused more on macroeconomic push and pull factors and less on institutional factors. Part of the reason is that suitable variables that capture the quality of institutions have lacked until over the past few decades when various measures of institutional quality have been developed and became available. In recent years, international studies have started to analyze institutional determinants of capital inflows, including Busse and Hefeker, 2007; Dutta and Roy, 2011; Akhtaruzzaman, 2019; Asiedu,Jin, and Nandwa, 2009; and Hashimoto and Wacker, 2012. The study of the relationship between capital flows and institutional factors grew following theoretical developments that suggested that macroeconomic factors alone were not sufficiently explaining their relationship, especially for developing countries. Specifically, the neoclassical theory (associated with Ramsey, 1928; Solow, 1956; Swan, 1956; Cass, 1965; and Koopmans, 1965) suggested that capital should flow from rich (North) to poor (South) countries. Lucas, 1990, provided a major criticism of the neoclassical view on capital flows and showed, using data from the United States and India, that capital flows from rich to poor countries are much lower than predicted in the neoclassical theory of capital flows. This critique helped spark interest in finding the important determinants of capital flows to developing economies and research has progressed to suggest an important role for institutional quality as a determinant.

Studies on capital flows in the SSA region have focused on macroeconomic determinants (Opperman and Adjasi, 2017) and even at that focus, they are very limited. There is also a gap in the analysis at a disaggregated level of capital flows for SSA economies. ICRG,.

Capital flows to middle-income SSA have been volatile, especially during periods of global crisis and have been prone to sudden stops, like the experience in other emerging economies in the World (Figure 1). In recent decades, capital inflows to middle-income SSA countries fell sharply during the global financial crisis (GFC) in 2008, in 2015-2016 when there were sudden stops and a significant reduction of capital flows associated with the "taper tantrum" when the United States (U.S.) Federal Reserve announced that it will taper its quantitative easing; and in 2020 because of the Covid-19 pandemic. Portfolio inflows have grown in the last decade relative to FDI. During the GFC, portfolio flows were more affected than FDI with a significant decline especially for portfolio equity while FDI inflows declined modestly in 2009 before a sharp increase thereafter. Both portfolio equity and FDI significantly declined during the "taper tantrum" and both portfolio equity and portfolio debt declined during the Covid-19 pandemic in 2020.

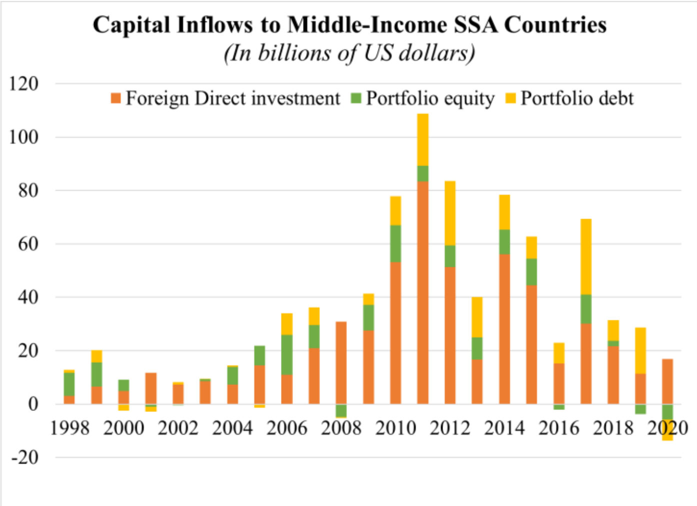


Figure 1. Capital Inflows to Middle-Income SSA Countries
Source: IMF Balance of Payments Statistics, International Financial Statistics, and author's estimates.

One of the aggregate measures of institutional quality that tends to be analyzed in the literature for various measures of capital flows, especially FDI, is the political risk index (such as Caporale, Spagnolo and Nicola, 2022;, Akhtaruzzaman, 2019; Okada, 2013; Hashimoto and Wacker, 2012; and Asiedu, 2002 and 2006). The political risk index is a composite index with 12 components that measure various institutional quality factors, which are government stability, socioeconomic conditions, investment profile, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucratic quality. Figure 2 presents scores that are averaged across countries in each region. The higher the index, the lower the risk. On aggregate, middle-income SSA countries perform better than other sub-Saharan African economies based on the political risk index of the ICRG, but there's great room for improvement when compared to other regions (Figure 2). SSA countries that score well on the political risk index are Botswana (73.5), Nambia, (72), Gambia (64.5), Ghana (64.5), South Africa (64.5), Zambia (63), and Tanzania (60). Good institutional quality signals a favorable environment for foreign investment. The sections below investigate the dynamics between capital flows (FDI, portfolio equity, and portfolio debt) and institutional factors, which are bureaucracy quality, internal and external conflict, corruption, democratic accountability, government stability, investment profile, and law and order. While there are many institutional quality variables in the economic literature, those chosen here are those most likely to be important for capital flows.

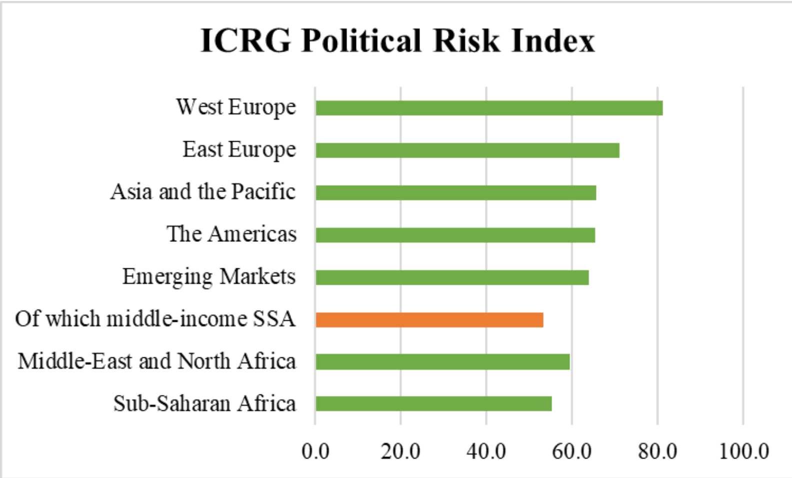


Figure 2. ICRG Political Risk Index: Regional Comparison[1/]

Source: ICRG and author's estimates.

1/ As of February 2022. Middle income SSA is included in Sub-Saharan Africa.

3.1 BUREAUCRACY QUALITY

Bureaucracy quality quantifies institutional strength of bureaucracy to the extent it minimizes revisions of policy when governments change. Bureaucracy interfaces with public administration to determine the nature of service delivery to the country's citizens. Bureaucracy is defined as the most visible branch of the execution of the executive arm of government, which is responsible for putting into effect government policies and programs and provision of goods and services (Akhakpe, 2014). Public administration is a tool for implementing the laws and policies of the government in power and thus facilitate service delivery. Post colonialization, many Sub-Saharan African countries adopted a form of bureaucracy that retained the main feature of the colonial era, which was focused on effectiveness rather than efficiency in the use of public funds (Akhkpe, 2014; Igbokwe-Ibeto, 2019) and thus weak public administration. Middle-income SSA countries have been trying to implement reforms to improve public administration to a structure that does not have a bias towards a government regime and serves any government and continue efficient service delivery independent of the regime, but this remains challenging for some countries.

In the ICRG's bureaucracy quality, a country with low risk (high index value of bureaucracy quality) has bureaucracy that is somewhat autonomous from political pressure. Bureaucracy quality measures up to 4 points, with 4 being best. The ICRG measure shows that bureaucracy quality deteriorated for some middle-income SSA countries in the mid to late 1990, notably for South Africa in 1994 and 1997, for Namibia in 1996, for Kenya in 1995, Cameroon in 1995, and Angola in 1997 (Figure 3). There were improvements for some countries in the late 2000s. Ghana and Kenya perform the best amongst middle-income SSA countries. Countries that tend to do well in bureaucracy quality are advanced economies. Better bureaucracy quality in Ghana likely reflects civil service reforms that have been undertaken over the last two decades. Kenya has implemented public sector reforms aimed at cost-saving, enhancing efficiency, and improving productivity to ensure people-centered public service delivery (Ong'era and Musili, 2019).

The relationship between bureaucracy quality and capital inflows appears, however, to not be strong. The dynamics of FDI are the least influenced by bureaucracy quality while those of portfolio debt appear to be the most likely influenced.

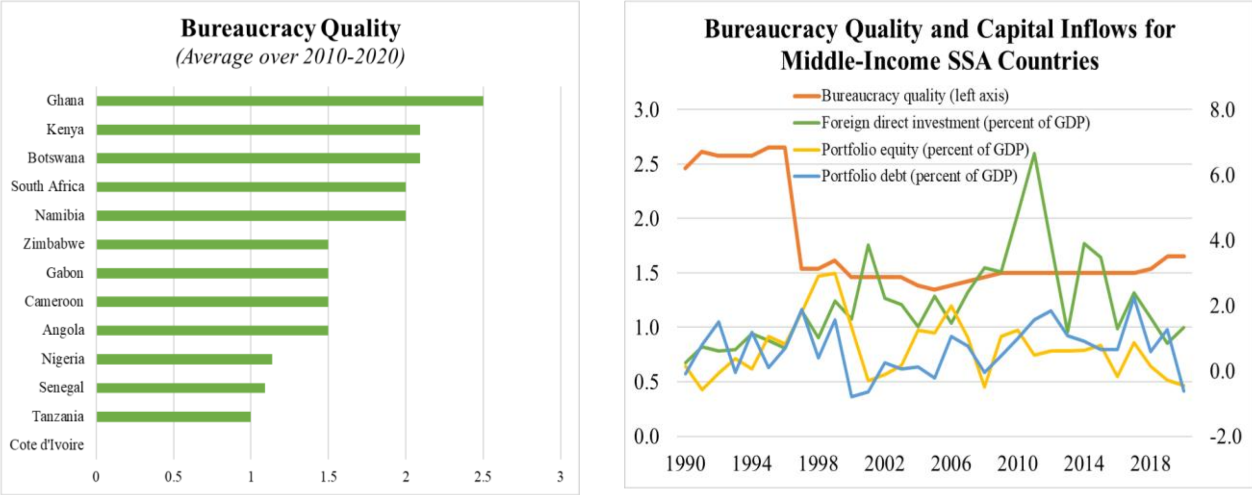


Figure 3. Internal Conflict and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Internal scores up to 12 and the higher the score, the better the quality of institutions.

3.2 CONFLICT

Sub-Saharan Africa has been prone to conflict for an extended period, which hinders foreign investment. In recent decades, the region has had the most countries in conflict only second to the MENA region, while other regions—Asia and Pacific, North and South America, and Europe—have had a lower share of countries in conflict (Fang, Kothari, McLoughlin, and Yenice, 2020). Being in conflict discourages foreign investment. The ICRG assesses countries on two forms of conflict: internal conflict and external conflict. These are discussed below.

3.2.1 INTERNAL CONFLICT

Conflict can inflict large costs on economic development and societal wellbeing. It destroys human life, the infrastructure, human and physical capital and greatly hinders economic growth. Conflict has been a major stumbling block to many economies around the World and especially in sub-Saharan Africa. The ICRG indicator of internal conflict is an assessment of political violence in the country and its actual and potential impact on governance. It has three subcomponents: civil war/coup threat, terrorism/political violence, and civil disorder. Amongst middle-income SSA countries, performance varies on the indicator of internal conflict. Botswana and Namibia are leading; however, these countries do not necessarily attract the largest amounts of capital inflows in the region due to other factors with those of Botswana discussed below under the investment profile. South Africa and Ghana, who are third and fourth in the list (Figure 4) and thus also do well on the internal conflict indicator, attract higher amounts of capital inflows. Since an improvement for the region overall since the 1990s, further progress has stalled. The relationship between bureaucracy quality and capital inflows appears, however, to not have been strong, especially for FDI, indicating that other factors are more important for capital flows.

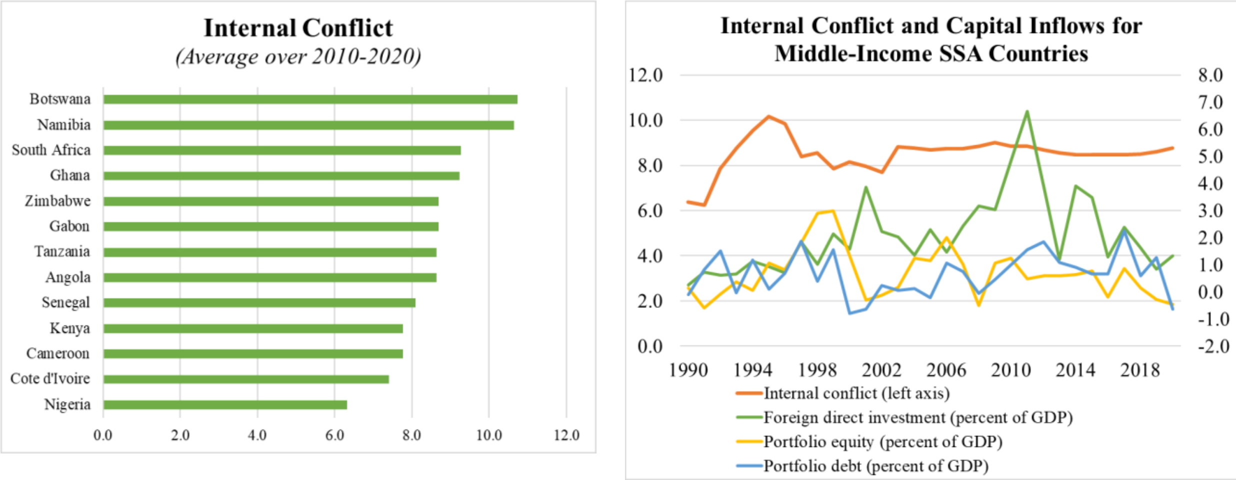


Figure 4. Internal Conflict and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Internal scores up to 12 and the higher the score, the better the quality of institutions.

3.2.2 EXTERNAL CONFLICT

External conflict can take various forms and can severely repel foreign investment and stunt economic development. The ICRG measure assesses the risk to the incumbent government from foreign action, ranging from non-violent external pressure (such a diplomatic pressures, withholding of aid, trade restrictions, territorial disputes, sanctions, etc.) to violent external pressure (cross-order conflicts to all-out war. The measure has a score of zero (very high risk) to 12 (very low risk). As with other institutional variables, some middle-income countries fair better and some need significant improvement. Several countries do well on this indicator. The range of performance of middle-income countries on this measure has narrowed in recent years and most of the countries are at the upper level of the measure, implying closer to very low risk, which is positive for investor sentiment and capital flows. The relationship between bureaucracy quality and FDI appears to not have been strong, while that of portfolio flows appears more plausible (Figure 5).

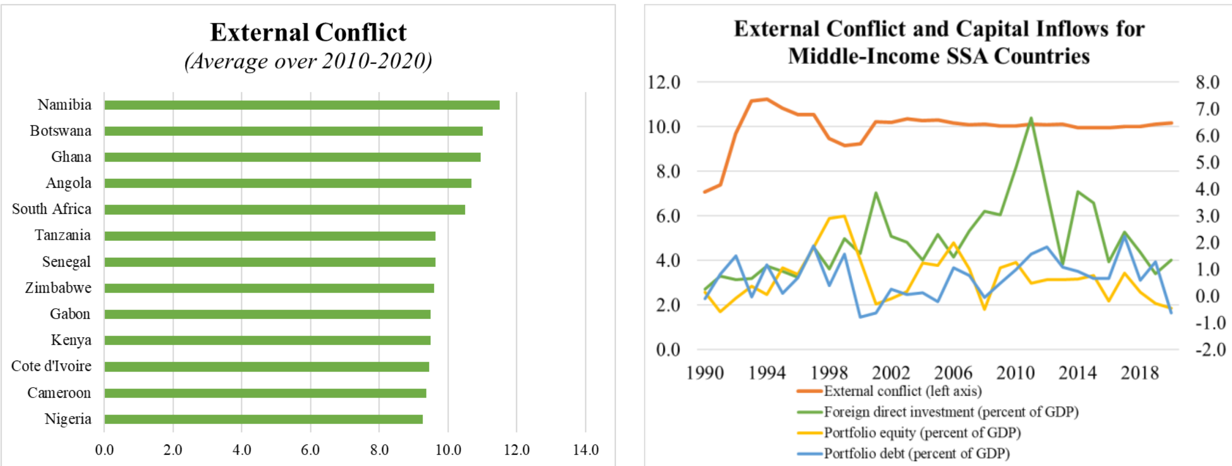


Figure 5. External Conflict and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. External scores up to 12 and the higher the score, the better the quality of institutions.

3.3 CORRUPTION

Corruption has been a major stumbling block to economic development and efforts at poverty reduction in African countries for decades as it presents a high cost to foreign investment.

The economic literature points to negative effects of corruption on economic growth across countries (Uberti, 2021). In 2002, the African Union estimated that around $150 billion is lost each year in the African continent due to corruption.

Amongst middle-income SSA countries, Botswana, Namibia, and Ghana fair best in the region; while others struggle with corruption (Figure 6). In comparison, only one country received the top score in the World as of February 2022, which is Denmark, while New Zealand was second and followed by other developed economies and notably these countries attract the largest amount by far of capital inflows in the World. Other indices on corruption provide corroborative evidence. The World Bank's World Governance Indicators also ranks countries using a similar measure called control of corruption. Botswana fairs best amongst middle-income SSA countries on this measure. Transparency International's corruption perception index is another indicator used by investors to assess the extent of corruption in countries. As of 2021, Botswana is the highest ranking middle-income SSA country, followed by Cabo Verde, Mauritius, and Namibia, who are all above 50, which is the middle of the range between being highly corrupt (zero) and very clean (100).

In recent decades, African countries have begun to take steps to improve the continent's standing on corruption, although much remains to be done to achieve results. There is a recognition that corruption in the continent hinders its ability to attract foreign investment, hampers economic development and efforts at poverty reduction. In August 2001, SADC countries—including many middle-income SSA countries—signed a Protocol Against Corruption (PAC), eradicate corruption amongst members including through the coordination of policies. In 2003, the African Union adopted the African Union Convention on Preventing and Combating Corruption (AUCPCC), whose objectives aim to eradicate corruption amongst members including through the coordination of policies. The AUCPCC drew a roadmap for countries to implement anti-corruption and governance policies at national and regional levels. As of September 6, 2021, 45 of the 55 African Union members have ratified the AUCPCC, including many middle-income SSA countries. However, corruption remains a challenge as scores in this institutional quality indicators have deteriorated since the 1990s and the relationship with FDI does not appear strong, while that with portfolio flows appears more likely.

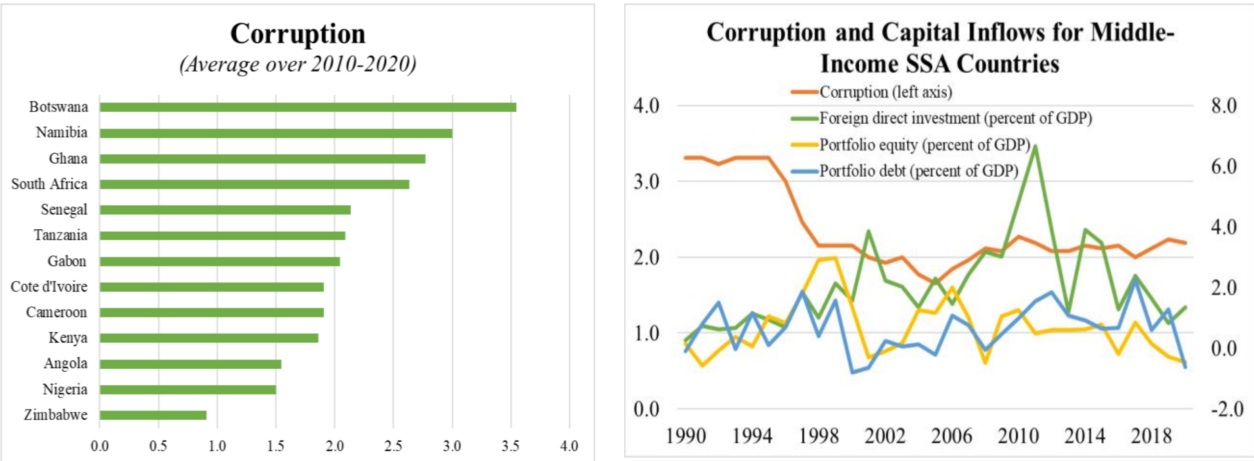


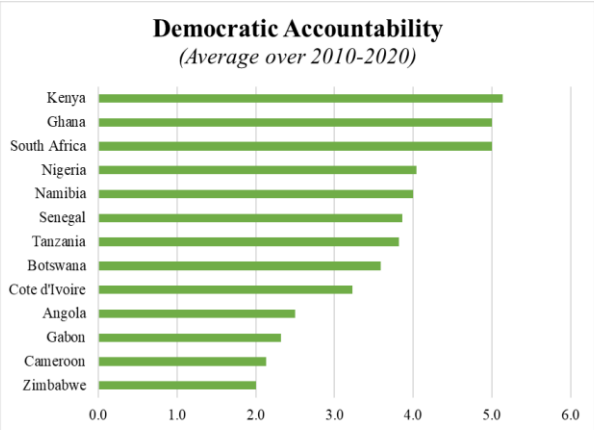
Figure 6. Corruption and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Corruption scores up to 4 and the higher the score, the better the quality of institutions.

3.4 DEMOCRATIC ACCOUNTABILITY

Democratic accountability measures how responsive government is to its people where the less responsive it is, the more likely it is that the government will fall—peacefully in a democratic society but possibly violently in a non-democratic one. The empirical literature has shown that good democratic accountability can neutralize the resource curse in countries with oil resources

(Kassaouri et al, 2020). The ICRG indicator of democratic accountability incorporates several features including the term of the government; free/fair elections; active presence of more than one political party; evidence of checks and balances among the executive; legislative, and judicial; evidence of an independent judiciary, and evidence of protection of personal liberties through constitutional or other legal guarantees. Performance on democratic accountability varies amongst middle-income SSA countries. Kenya and Ghana have had highest scores in recent years (Figure 7) and though Ghana's has declined somewhat in the latest data, Kenya has maintained its top performance in the region, which is comparable to those for some advanced countries and emerging markets (Japan, Brazil) and one of the highest amongst developing economies. The relationship between democratic accountability and capital flows does not appear strong, indicating that other factors are more important in driving capital flows.



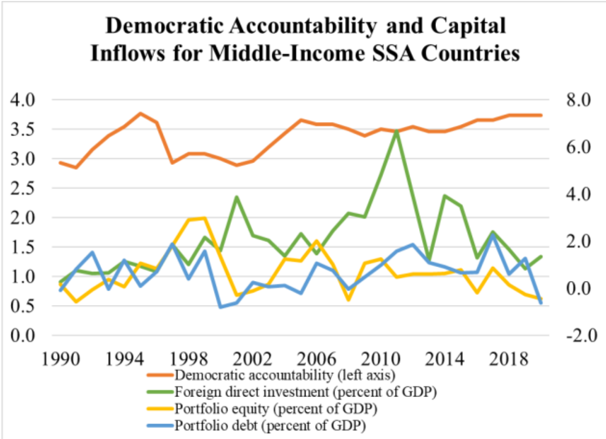


Figure 7. Democratic Accountability and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Democratic accountability scores up to 6 and the higher the score, the better the quality of institutions.

3.5 GOVERNMENT STABILITY

The measure of government stability by the ICRG captures the government's ability to carry out its declared program/s and its ability to stay in office. The measure has three subcomponents: government unity, legislative strength, and popular support. Government stability is generally associated with political stability in the empirical literature and research has shown that political instability can have a negative impact on economic growth. Middle-income SSA countries appear to converge on government stability in the ICRG measure with Namibia and Tanzania leading (Figure 8). In international comparison, two countries are leading in this indicator—the Bahamas and the United Arab Emirates. It appears that capital inflows rose as government stability improved in the 1990s.

The World Bank's World Governance Indicators also ranks countries on a similar measure of political stability and absence of violence and terrorism. It measures perceptions of the likelihood of political instability and/or politically motivated violence, including terrorism. Amongst middle-income SSA countries, Botswana leads and was the 24th in the World as of 2020 with Mauritius next in 47th place, putting them in a favorable position to attract foreign investment. The improvement in government stability in the 1990s, appears to have been associated with an improvement in capital inflows, especially FDI. FDI has been on a downward trend in recent years, and so has FDI after peaking in 2011.

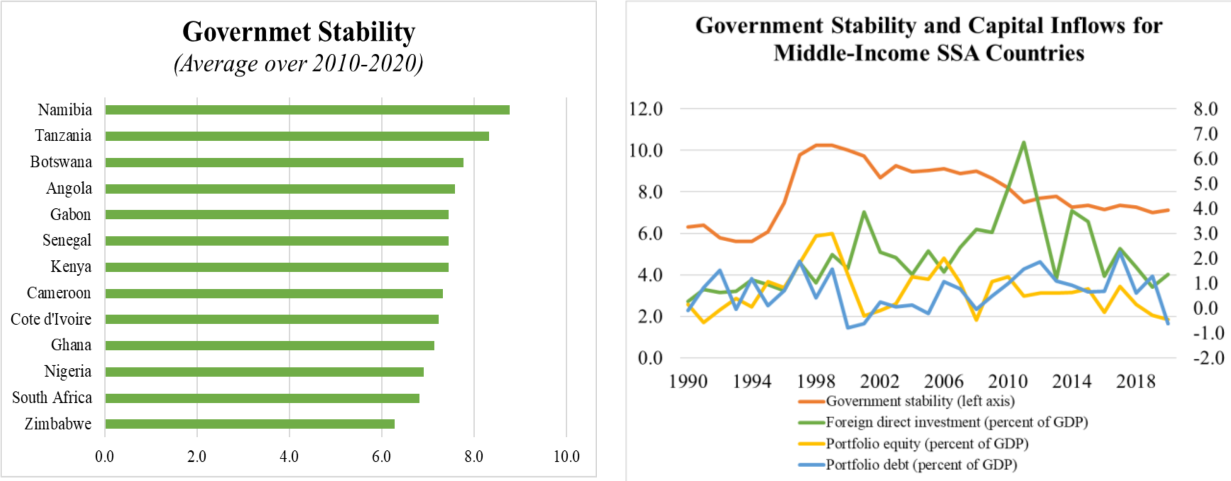


Figure 8. Government Stability and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Government Stability scores up to 8 and the higher the score, the better the quality of institutions.

3.6 INVESTMENT PROFILE

The ease of doing investment helps significantly in attracting foreign investment. The ICRG's investment profile indicator is an assessment of factors affecting the risk to investment that are not covered by other political, economic, and financial risk components. This measure has three subcomponents: contract viability/expropriation, profits repatriation, and payment delays. Performance of middle-income SA countries on the investment profile varies. Botswana has performed the best historically amongst middle-income SSA countries, though, it's score has declined in recent years. The decline may be partly due to Botswana entering the Financial Action Task Force (FATF) grey list in 2018 as one of jurisdictions with strategic deficiencies. Ghana also entered the FATF grey list in 2018. Other middle-income SSA countries have been in the FATF lists in the past, including Nigeria (grey listed in 2009-2013), Angola (blacklisted in 2010-2016), Namibia (grey listed in 2011-2015), Senegal (grey listed in 2021—still in the list as of March 2022). Research has found that grey listing by the FATF results in a large and statistically significant reduction in capital flows (Kida and Paetzold, 2021).

While Botswana performs best on the investment profile, putting them in a favorable position to attract foreign investment, the country has however not attracted high foreign investment. The reasons for this appear multifold including that comparator countries opened to FDI more over the past decades. When apartheid ended in South Africa in 1994, South African companies with investments in Botswana returned to their home country (UNCTAD, 2003). It's been argued that the country had not pursued privatization unlike its competitor for FDI (UNCTAD, 2003). Botswana has implemented policies in recent years to help boost foreign investment and results in the form of a significant increase in capital inflows are yet to be experienced. While the relationship between the investment profile and capital flows does not appear strong overall, the increase in capital inflows in the late 1990s coincided with an improvement in the investment profile (Figure 9).

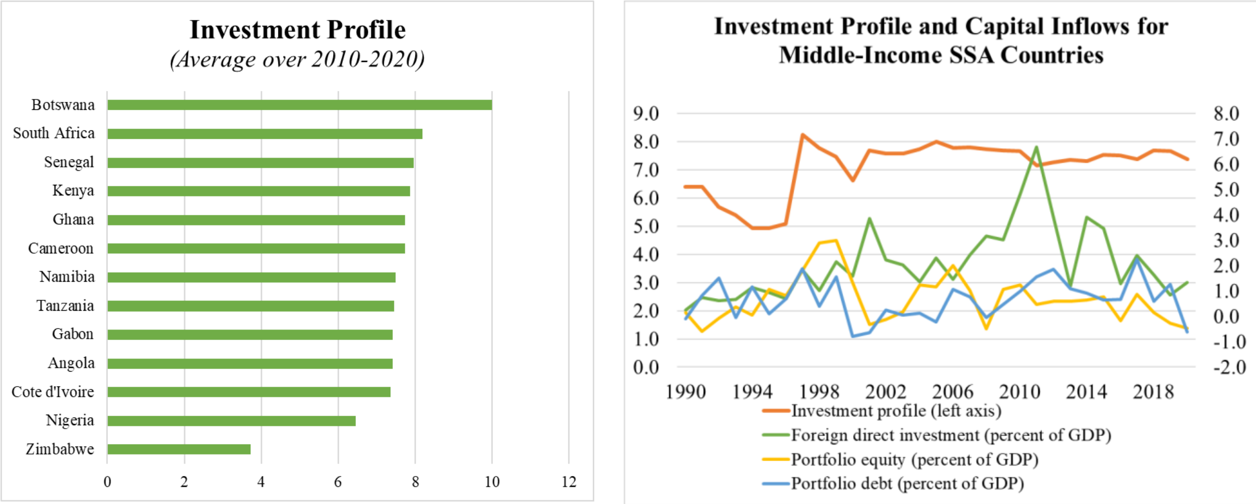


Figure 9. Investment Profile and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Investment profile scores up to 12 and the higher the score, the better the quality of institutions.

3.7 LAW AND ORDER

Rule of law is key for investor confidence as it affects how property rights and contractual rights are protected, which is crucial for foreign investors to have confidence on the security of their investments. The ICRG and the WGI have a similar measure called law and order for the former and rule of law for the latter. In the ICRG measure, middle-income SSA countries that score the highest are Namibia and Tanzania. In the WGI, Mauritius scores the highest and stands at number 43 in worldwide placing, putting it at a favorable position for attracting foreign investment s the country attracts the largest amount of capital inflows. Namibia follows in the 79th position. The empirical literature has found that there is a threshold of law and order where an inflow of foreign capital can exacerbate the ex-ante institutional deficit and push countries to specialize even more in industries that are less reliant on a good contracting environment (Igan, Lauwers, and Puy, 2022). Law and order improved in the 1990s, which was a time of a peak up in capital flows to middle-income SSA economies. The relationship, however, is not clear thereafter (Figure 10).

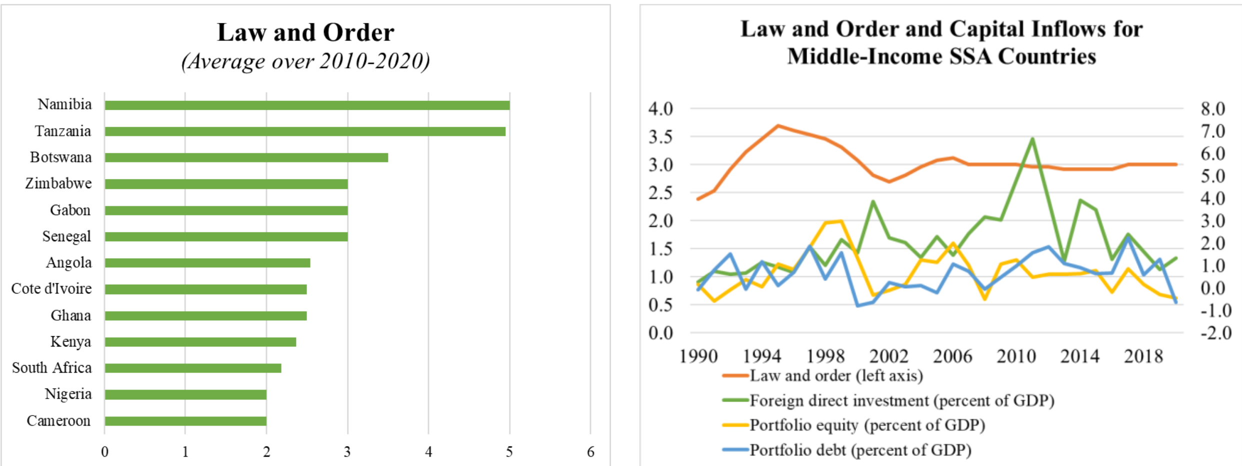


Figure 10. Law and Order and Capital Flows in Middle-Income SSA Countries

Source: ICRG and author's calculations. Law and order scores up to 6 and the higher the score, the better the quality of institutions.

4. CONCLUSION

This paper explored the institutional factors that influence capital inflows to middle-income Sub-Saharan African (SSA) countries. Capital flows were analyzed at a disaggregated level, comprising FDI, portfolio equity and portfolio flows given that the economic literature has suggested that capital flows can have different determinants depending on type of capital flow. Institutional factors analyzed are government stability, socioeconomic conditions, investment profile, external conflict, corruption, military in politics, religious tensions, law and order, ethnic tensions, democratic accountability, and bureaucratic quality. The paper found that capital inflows to middle-income SSA countries have grown significantly over the last two decades but have been volatile. There is much variation on the performance of middle-income SSA countries on measures of institutional quality. Countries that attract high capital inflows tend to have better institutional quality, although better institutional quality has not always translated to higher capital inflows. During the 1990s, the pick-up in capital inflows occurred with improvements in various institutional quality factors—conflict, democratic accountability, government stability, investment profile, and law and order. Thus, it seems that these factors have a role in influencing capital flows. During that time in the 1990s, corruption, and bureaucratic quality, however, deteriorated while capital flows increased, indicating that these factors weighed less behind the improvement in capital inflows. The dynamics on the different types of capital flow show that portfolio debt better tracks law and order compared to the other capital flows, indicating that this factor matters for portfolio debt. Countries that attract the most capital inflows in the region generally have higher institutional quality. An area of further study would be to analyze the institutional drivers of capital inflows to middle-income SSA countries empirically and in a disaggregated manner to distill differences in drivers for different types of flows.

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