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Governance, business environment, and foreign direct investments

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Abstract

In this paper we investigate the relationship between the quality of governance, the business environment and foreign direct investments. Looking at 49 countries in Africa, we present evidence supporting the claim that the quality of governance does affect the stability of policies and the quality of the business environment. However, our data analysis also reveals that neither the quality of governance nor the quality of the business environment have any impact, at least in Sub-Saharan Africa on the level of FDI.

1 Introduction

Several studies published in the course of the past twenty years have shown that governance matters, that corruption has major socio-economic costs and that good governance yields some important developmental dividends (Pelizzo and Stapenhurst, 2013).

Given the importance of governance, several efforts have been made to conceptualize and operationalize governance. The *World Governance Indicators* (WGI) represents one of the most methodologically sophisticated efforts to track the quality of governance in the world and the data generated by WGI have been used extensively to understand the causes, the consequences and the correlates of good governance. The literature that was produced using these data documented the relationship between governance and various developmental indicators. Governance was highly correlated with and possibly responsible for

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income per capita, infant mortality, and adult literacy according to (Kaufmann, Kraay, and Zoido-Lobaton, 1999), income Kaufmann, Kraay, and Mastruzzi (2005), inequality Pelizzo (2012) and for the modernization of the labour force Pelizzo and Stapenhurst (2013).

Governance matters because where governance is poor there are, as (Gray and Kaufman, 1998) point out, higher transaction costs, misallocation of resources, lower ability to raise taxes, higher taxes, lower investments in education and a suboptimal provision of public goods. Worst of all, the absence of good governance ”impedes long-term foreign and domestic investment” (Gray and Kaufman, 1998, 1). In other words, by reducing the level of investments and misallocating resources, low quality governance slows down growth, prevents growth from being sustainable, and prevents countries from becoming properly developed.

The literature on Foreign Direct Investments (FDI) on the African continent has, however, often spoken of a sort of “African exceptionalism,” —that is, the patterns, levels, and flows of FDI into the African continent do not seem to respond to the same factors that affect FDI worldwide. Building on this literature, in this note we wish to test whether and to what extent the level of FDI in Sub-Saharan Africa are affected by the quality of governance and by the quality of the business environment, like in the rest of the world, or whether even in this regard we can get detect some degree of African exceptionalism.

2 Governance

In a much celebrated paper that appeared in *Political Studies*, Rhodes (1996) argues that while very popular the term ‘governance’ was not terribly precise, it is used to denote or a synonymous of “the minimal state, corporate governance, the new public management, ‘good governance’, socio-cybernetic systems, and self-organizing networks”. Rhodes (1996) goes on to argue that governance as good governance referred to the use of power to run a country’s affairs, that good governance could manifest itself on various level (systemic, political, administrative), and that it was regarded by the World Bank and other international institutions as one of the most important, if not the most important, determinant of socio-economic development. [3]

[3] Governance and good governance have also been equated with democracy and/or the absence of corruption. The idea that governance could be equated or reduced to the absence of corruption was criticized by Kaufmann (2005).

While scholars and practitioners have generally supported the claim that governance matters, that good governance is a major determinant of growth, and while it has been extensively documented that international organizations regard the promotion of good governance principles as an essential component of any successful developmental strategy, there has been little agreement as to how exactly governance and good governance should be conceptualized.

The notion of good governance has been used in association with three different, though possibly related, meanings. First of all, in some writings, even in those that acknowledged the multidimensional character of good governance, good governance was often reduced to the absence of corruption–which is why, in this line of scholarship, the dividends of good governance or the costs of corruption (Gray and Kaufman, 1998; Pelizzo and Stapenhurst, 2013) have at times been treated as two sides of the same coin. Second, some writings have treated good governance as the ensemble of practices and procedures that make government representative, accountable, responsive and decisive (Kaufmann, 2005). And since democratic rule or democracy is precisely that political system in which rulers by representing the will of the electorate, to which they respond, have a mandate to make decisions on behalf of the electorate to address the electorate's needs and concerns, it is clear that democracy is fairly similar, if not identical, to good governance. The third conceptualization of governance envisions or treats good governance as a form of governing where the government governs and takes decisions in the interest of the population, regardless of whether and to what extent it is representative.

In one sense good governance is a corruption-free mode of governing, in another sense good governance is simply democratic governance, while in the third sense good governance refers to the fact that it is possible to govern well in settings that are imperfectly representative and democratic. These three conceptualizations of good governance ascribe the good quality of governance to either its non-corrupt, or democratic or technically proficient nature, yet, because of their reductionism they provide a rather inadequate depiction of governance and its qualities.

Documents generated by international organizations have almost always acknowledged the fact that governance and good governance are multi–dimensional as they pertain to and reflect a plurality of qualities and characteristics. For the IMF, good governance is a corruption free, efficient, accountable type of government that respects the rule of law. [4]

[4] http://www.imf.org/external/np/gov/guide/eng/index.htm

For the UN, good governance is a type of governance that is respectful of the rule of law, but also participatory, transparent, accountable, responsive, efficient and effective, equitable and inclusive, and consensus-oriented.[5] While for the World Bank, good governance could be identified in countries with a strong civil society, accountable government, professional bureaucracy, the rule of law, and where decisions are taken in an open and predictable fashion.[6]

In spite of their differences, these three definitions or conceptualizations of governance agree on two basic points: first, good governance is a multidimensional or multifaceted phenomenon, and, second, governance cannot be good in the absence of some level of representativeness, responsiveness and responsibility.

These three characteristics can be used to map the universe of governance as shown in Table 1.

	Representative	Responsive	Responsible
Good governance	+	+	+
Irresponsive democracies	+	–	+
Populist authoritarian	–	+	–
Soft authoritarian, performance-oriented	–	+	+
Technocratic authoritarian	–	–	+
Dysfunctional democracies	+	–	–
Populist democracies	+	+	–
Poor governance	–	–	–

Table 1: Mapping Governence

In countries where the exercise of authority is representative, responsive and responsible governance is good, while in countries where the exercise of authority lacks each of these characteristics governance is bad. Between these two extremes, our taxonomy identifies a wide range of possible options. Our taxonomy identifies countries in which the exercise of authority is representative, but not terribly responsive nor responsible—a category that could be regarded as including all the dysfunctional democracies where elections are held, democratic leaders are selected, but where the government is unable to address citizens' demands or to promote society's collective well-being. There are

5 http://www.unescap.org/sites/default/files/good-governance.pdf

6 http://www-wds.worldbank.org/servlet/WDSContentServer/WDSP/IB/1994/05/01/000009265_3970716142854/Rendered/PDF/multi0page.pdf

countries where the exercise of authority is both representative and responsive, but irresponsible, as in the case of democracies with populist rulers. There are countries where authority is exercised very responsibly, without being either representative or responsive-which is what we find in technocratic authoritarian regimes. There are countries where authority is responsive and responsible, but inadequately representative, and this is the case of soft-authoritarian, performance-oriented rulers. And there are authoritarian regimes, that in their efforts to satisfy citizen demands, take decisions that are detrimental for the society's well-being.

The recognition that governance is multifaceted or multidimensional and that governance dimensions or sub-dimensions could be orthogonal to one another has led analysts to devise multidimensional frameworks for assessing the quality of governance worldwide.[7] For instance, in what possibly represents the most comprehensive–if not the best– effort to date to track the quality of governance worldwide, Kaufmann and his collaborators (Kaufmann, Kraay, and Zoido-Lobaton, 1999) proposed to measure the level of governance on the basis of six indicators: political stability, the absence of politically motivated violence; government effectiveness, which referred to a government's ability to design and implement policies; voice and accountability, which were used to measure the representativeness and the accountability of government; the ability to control corruption; and respect for the rule of law.

These dimensions and indicators have been extensively employed in a wide range of analyses and previous studies have consistently shown that, regardless of which governance measure is used and regardless of how socio-economic development is operationalized, the quality of governance and the level of socio-economic development are strongly related to one another. Better governance is associated with greater wealth, longer life expectancy, higher adult literacy, lower infant mortality, and a more modern economy (Pelizzo and Stapenhurst, 2013). The association between these two sets of variables may not prove causation and, above all, may not prove conclusively the direction of causality—that is, whether more developed countries have better governance because they are developed or whether because better governance promotes development as Kaufmann and his collaborators have suggested for the past two decades.

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[7] Unidimensional/reductionist conceptions of governance and efforts to operationalize it in single metrics (Huther and Shah, 2005) neglect the fact that governance is a multi-dimensional phenomenon, that there is no theoretical reason why countries that perform well on one governance dimension do so also on a different dimension, that an aggregate measure of governance would conceal more about the state of governance in a given country than it actually reveals, and that efforts to assess the qualities of governance should adopt a multi-dimensional approach. A similar approach has led scholars working on democratization to conceptualize democratic qualities in the plural (Morlino, Dressel, and Pelizzo, 2011)..

3 Data, sources and analyses

In order to test whether and to what extent there good governance has business implications, we will explore the relationship between the six indicators of good governance devised by Kaufmann and his collaborators (Kaufmann, Kraay, and Zoido-Lobaton, 1999) and, respectively, the stability of policies, the quality of the business environment and the level of Foreign Direct Investments (FDI).

The six governance indicators are political stability, control of corruption, regulatory quality, rule of law, voice and accountability, and government effectiveness. The data for each of these indicators are taken from the World Governance Indicators. The values for each of the governance indicators vary from a minimum of −2.50 to a maximum of 2.5. FDI is measured on the basis of the net inflows (new investments â€“ disinvestments) as percentage of a country's GDP. The data are taken from the World Bank's Word Development Indicators Dataset.

The short-term policy continuity (STPC) is measured on the basis of a 100-point scale constructed by the Business Monitor International (BMI) which assigns a score of 100 to a country with the highest possible level of policy stability and which assigns a score of 0 to a country where policies have the highest possible level of instability and volatility.

The quality of the business environment is also measured by BMI on the basis of a 100 point scale, where 100 indicates the best and 0 indicates the worst business environment.

In the course of this analysis we will use the data collected in Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Cape Verde, Central African Republic, Chad, Comoros, Congo Brazzaville, Congo Kinshasa, Cote d'Ivoire, Djibuti, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mauritius, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome, Senegal, Seychelles, Sierra Leone, Somalia, Somaliland, South Africa, South Sudan, Swaziland, Tanzania, Togo, Uganda, Zambia, Zimbabwe.

The data collected in these 49 countries shows that in Sub-Saharan Africa, there is a good level of policy continuity, but there is also a great deal of variation in policy continuity across various countries. In fact, policy continuity varies from a minimum of 10 registered in Mali in 2012 to a maximum of 95 registered in Senegal.

The data on the quality of the business environment displays a rather different picture. In our sample, the quality of the business environment is generally disappointing. It varies greatly from a minimum of 19.6

registered in Chad to a maximum of 61.8 recorded in Mauritius—with an average of just 34.92 per cent.

The data on FDI reveal that there is an incredibly high level of variation in Sub Saharan Africa. In fact, FDI varied from a minimum of −6% (which means that disinvestments greatly exceeded new investments) in Angola to a maximum of 78.1% recorded in Liberia. The variation is so great that the standard deviation greatly exceeds the value of the continental mean.

The descriptive statistics (Table 2) paint a bleak picture of the level of governance in Sub-Saharan Africa. The mean score for each of the six indicators is solidly negative which means that regardless of how one measures governance or regardless of what aspect of governance one looks at, the result is consistently that governance in Sub-Saharan Africa is poor. Countries in Sub-Saharan Africa are politically unstable, unable to curb corruption, poorly representative as evidenced by a fairly low score in terms of voice and accountability, have rather ineffective governments, have poor regulatory quality and they are generally disrespectful of the rule of law.

The data also reveal that for each of the governance scores there is considerable variation, which means that while some countries have moderately high levels of governance, other countries have some of the lowest levels of governance in the world. For further details see Table 2.

	Min	Max	Mean	s.d.
STPC	10	95	58.7	21.06
Business environment	19.6	61.8	34.92	8.46
FDI	-6.0	78.1	7.14	12.42
Political stability	-2.27	1.11	-.46	.88
Control of corruption	-1.56	.94	-.63	.61
Voice and accountability	-1.87	.95	-.60	.70
Government effectiveness	-1.66	.93	-.75	.60
Regulatory quality	-1.83	.98	-.61	.58
Rule of law	-1.65	.94	-.69	.59

Table 2: Descriptive Statistics

Governance indicators have generally been recognized as major determinants of socio-economic development. In this paper, we want to test instead how they relate to the business environment and how governance conditions and business environment affect FDI in Sub-Saharan Africa.

	STPC	Bus. Env.	FDI

Political stability	.65 (.000)	.55 (.000)	.01 (.944)
Control of corruption	.42 (.004)	.55 (.000)	.01 (.944)
Voice and accountability	.48 (.001)	.65 (.000)	.00 (.999)
Government effectiveness	.54 (.000)	.87 (.000)	−.16 (.293)
Regulatory quality	.54 (.000)	.79 (.000)	−.17 (.253)
Rule of law	.57 (.000)	.81 (.000)	−.10 (.515)
STPC	1	.43 (.003)	.24 (.126)
Business Environment		1	−.20 (.198)
FDI			1

Table 3: Correlation analysis (.sig)

The results of the correlation analysis reveal that all the governance coefficients are strongly correlated with the STPC and to the quality of the business environment, that STPC is more sensitive to changes in the level of political stability than to changes in any other facet of governance, while the quality of the business environment is more sensitive to changes in the level of government effectiveness. And insofar as it is possible to postulate the existence of a causal link between governance indicators and policy continuity or quality of the business environment, political stability is the single most important determinant of policy continuity while government effectiveness is the most important predictor of the quality of the business environment.

Since the literature has generally posited that political instability and political risk are intimately tied with the quality of governance, that poor governance has a destabilizing effect on political systems, and that political instability affects the level of foreign direct investments (Busse and Hefeker, 2007), the outcomes of foreign direct investments (Clark, 1997), investment strategies Cosset and Suret (1995) and ultimately economic growth (Alesina and Perotti, 1994), it is reasonable to hypothesize that variation in the governance indicators, in the policy continuity and in the quality of the business environment are strongly related to or have a major impact on the level of FDI in a given country.

The results of the correlation analysis tells a rather different story. There is no significant relationship between the net inflow of FDI and the quality of governance, policy continuity or the quality of the business environment. If the correlation coefficients were not insignificant, the results of the correlation analyses would suggest that the net inflow of FDI as percentage of a country's GDP are inversely related to the government effectiveness, the regulatory quality, the level of rule of law, the continuity of policies and the quality of the business environment. In other words, if the correlation coefficients were significant, they would indicate that countries with more unstable, more unregulated, more ineffective political systems are more attractive for investors than countries with more stable, more effective, and more properly functioning political systems.

The fact that correlation coefficients are, instead, insignificant only allows us to say that the volume of FDI is not meaningfully affected, one way or another, by either the quality of governance however measured, the continuity of policies and the quality of the business environment.

To analyze the issue further, we employed regression analysis, for which the results are summarized in Table 4.

	Dependent variable					
	(1)	(2)	(3)	(4)	(5)	(6)
Regressors	STPC	Bus. Env.	FDI	FDI	FDI	FDI
Political stability	12.97^{*} (.004)	$-.05$ (.961)	$.78$ (.598)	—	—	—
Control of corruption	-15.13^{*} (.079)	-5.38^{*} (.002)	7.84 (.211)			
Voice and accountability	-2.81 (.663)	$-.13$ (.928)	5.82 (.301)			
Government effectiveness	4.61 (0.725)	14.12^{*} (.000)	-10.51 (.262)			
Regulatory quality	$.54$ (0.422)	2.80 (.309)	-7.45 (.279)			
Rule of law	$.57$ (0.439)	$.97$ (.763)	$.91$ (.888)			
STPC	—	—	—	$-.05$ (.284)	$-.07$ (.126)	—
Business Environment	—	—	—	$-.09$ (.486)	—	$-.15$ (.198)
R^2	.495	.805	.142	.068	.056	.040
$Adj.R^2$	.414	.774	.006	.021	.033	.017
Number of observations	44	44	45	43	43	43

* indcates statistical significance at 10 % level. Heteroskeasdicity-robust p -values are in paranthesis.

Table 4: Regression analysis

Columns (1) and (2) support our conclusion above that the governance coefficients are strongly correlated with the STPC and to the quality of the business environment. In Regression 1, this correlation is captured by the coefficient of political stability and control of corruption. The negative coefficient of control of corruption is rather surprising, but that is entirely due to the high correlation between the regressors. Indeed, when we check the variance inflation factors, we detect high degree of collinearity. If we regress STPC individually on the governance variables (see the scatter plots in the Appendix), we conclude a positive relationship between STPC and governance variables.

In Regression 3 (Column 3 in Table 4) we confirm our earlier conclusion that none of the political variables has a significant relationship with FDI. We further check this result by regressing FDI on STPC and quality of business environment together (Regression 4) and separately (Regression 5 and 6). We again see that none of the regressors are statistically significant. Furthermore, in all regressions with FDI as independent variable, R^2 values are significantly low, and the adjusted R^2 values drop sharply.

Why there is no significant relationship between good governance, quality of the business environment and policy stability on the one hand and FDI on the other hand?

4 Discussion

There are at least three different, and possibly related, reasons why FDI in Africa does not seem to be affected by the quality of governance however measured, by policy stability and by the quality of the business environment.

The first explanation is that Africa is different. In a pioneering study of FDI in the African continent, Asiedu (2002) reports that Africa was exceptional in several respects. First of all, in spite of a boom in FDI, Africa, which was then the poorest region in the world, was not as successful as other regions in attracting FDI. Second, factors that were responsible for the flow of FDI to non-Sub-Saharan Africa countries were not responsible for the flow of FDI to Sub-Saharan Africa. For example, Asiedu (2002) reports that while higher returns on capital promoted FDI to non Sub-Saharan Africa countries, they did not do so in Sub-Saharan Africa. Similarly infrastructure development was a determinant of FDI to non-Sub-Saharan Africa countries but not to

Sub-Saharan Africa countries. Africa is different. The logic that governs FDI in Africa may not be the same logic that governs FDI in other regions of the world and this could explain why instability and corruption deter foreign investors out of Sub-Saharan Africa but not in Sub-Saharan Africa.

The second explanation is that Africa is a rapidly changing continent and that factors that affect FDI at one point in time, may not be significant at a different point in time. The comparison of two papers by Asiedu (2002, 2006) allow us to illustrate this point. In the 2002 paper Asiedu claims that infrastructure and political instability did not have a significant impact on FDI in Sub-Saharan Africa. In her 2006 paper, she noted instead that the inflow of FDI was affected not only by market size, natural resource endowments, and the presence of efficient legal systems, but also by infrastructure, instability and corruption, which, in her previous study, did not appear to play any role. If the first explanation is that Africa is different, the second is that Africa is rapidly changing. The implication is that the impact that certain social, political, legal factors may have on FDI is not constant, but variable–and it varies not simply in degree (more or less) but also in kind (significant/insignificant).

The third explanation is behavioral. Instability, corruption, and the poor quality of the business environment do not deter foreign investors. There are various reasons why these factors may not deter foreign investors. One reason, simply put, is that foreign investors may have no alternatives to investing in Sub-Saharan Africa and therefore invest in the continent in spite of the fact that it is a riskier business environment than other regions. A second reason why foreign investors may not be deterred from investing in Sub-Saharan Africa is that by anticipating the risks to which they are exposed they can take preventive measures to protect their activities and profits from potential risks and threats. For instance they can buy insurance to protect their investments or they can demand fiscal incentives from host governments (Emel and Huber, 2008) to counterbalance the possible effects of the anticipated risks. Either by insuring their investments or by receiving generous fiscal incentives, foreign investors can take steps to protect the profitability of their investments and may decide to invest in politically unstable, corrupt, environments without jeopardizing their companies' interests.

5 Conclusion

The purpose of the present note was to test whether and to what extent the quality of governance affects the business environment and foreign direct investments. The evidence presented here sustains the claim that the quality of governance does affect the stability of policies and the quality of the business environment. Higher levels of political instability and corruption, lower levels of accountability, lower regulatory quality, lower government effectiveness and a more inadequate enforcement of the rule of law have a negative impact on the policy continuity and on the quality of the business environment.

Our data analysis also reveals that neither the quality of governance nor the quality of the business environment have any impact, at least in Sub-Saharan Africa, on the level of FDI. While the data at our disposal do not allow us to argue conclusively why this may be the case, we used some evidence presented and discussed in the literature to formulate three educated guesses as to why FDI in Sub-Saharan Africa are not affected by either the quality of governance or by the quality of the business environment. In doing so, we have noted that Sub-Saharan Africa is a rapidly changing political and business environment which may respond differently, at different points in time, to similar conditions; that Sub-Saharan Africa is exceptional in several respects and what accounts for FDI to other regions may not apply in this context; and, finally, that foreign investors may not be deterred by the poor quality of governance and of the business environment either because they have no alternatives or because they take steps to prevent/neutralize the problems that they may encounter while running their activities on the continent.

If our last point is correct, the value of governance indicators and other estimates of political risks does not consist so much in helping the analyst to predict patterns and volumes of FDI, but rather consists in providing the business community with the information it requires to anticipate the risks it may be exposed to and to protect the profitability of its investments.

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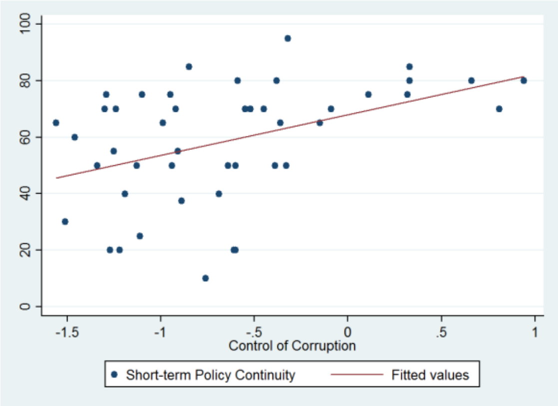
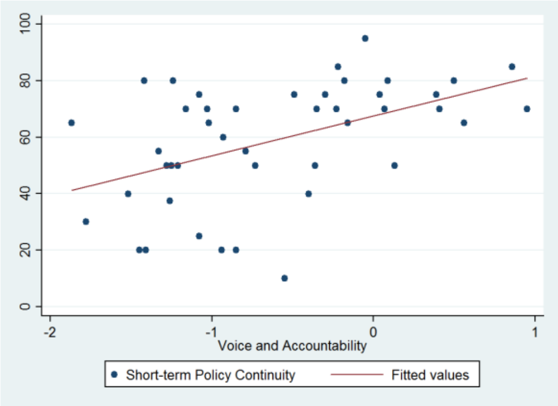
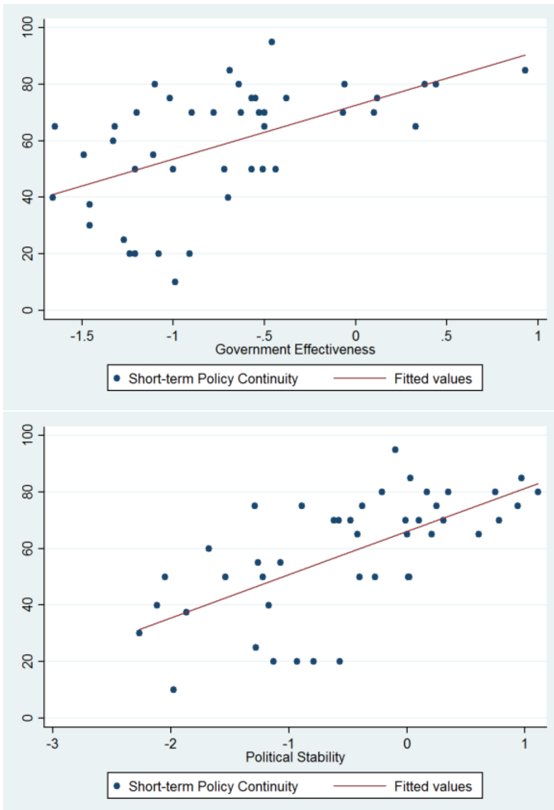
6 Appendix

6.1 Short-term Policy Continuity







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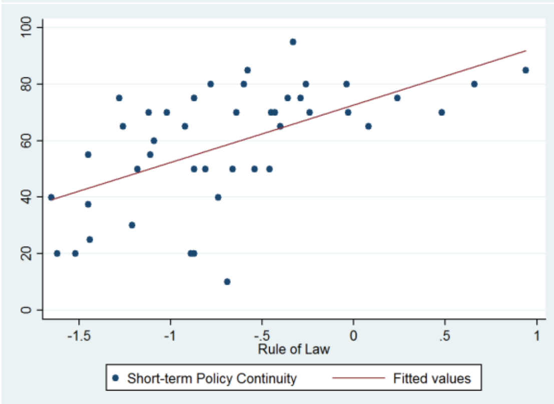
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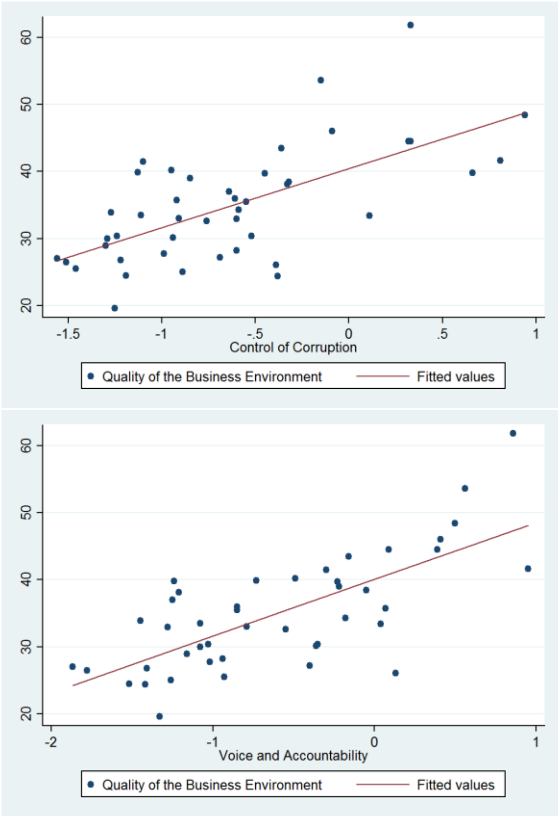
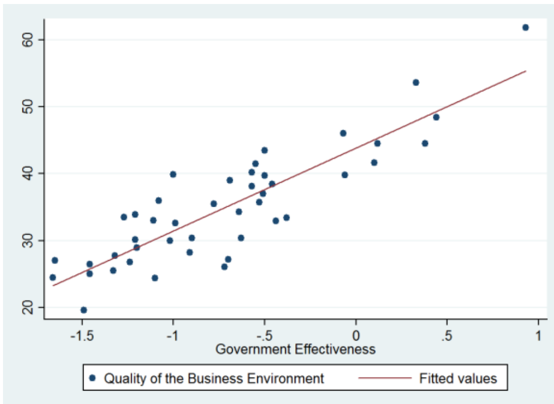
6.2 Quality of Business Environment





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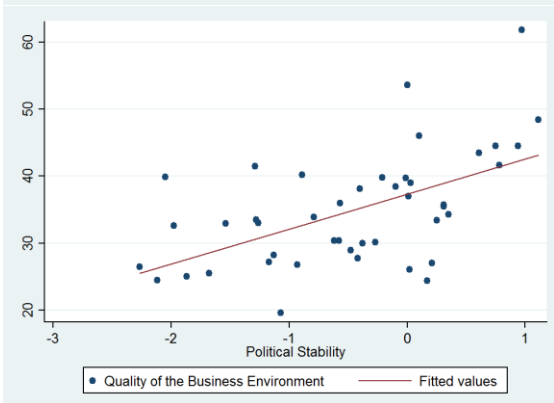

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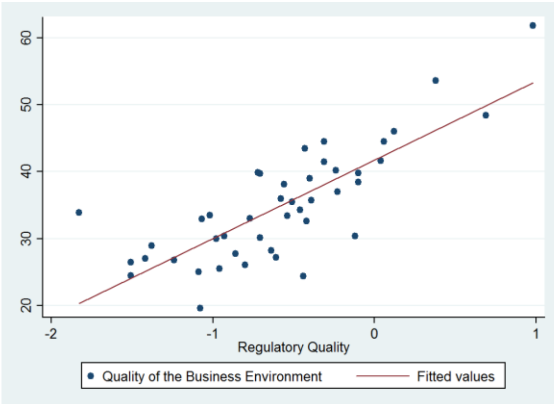
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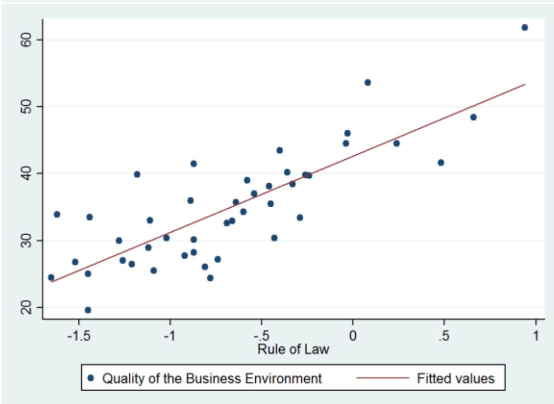
Quality of the Business Environment
Fitted values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60
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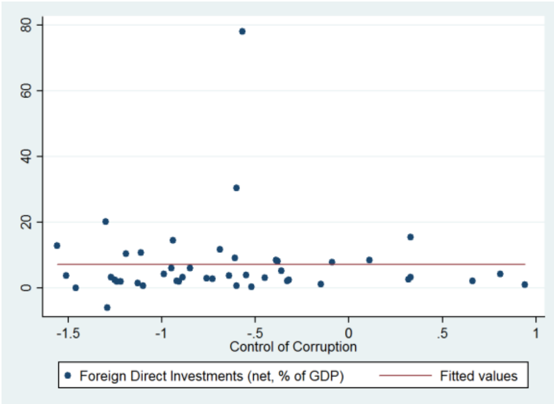
-1
-.5
0
.5
1
Rule of Law
Quality of the Business Environment
Fitted values

6.3 FDI



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.5
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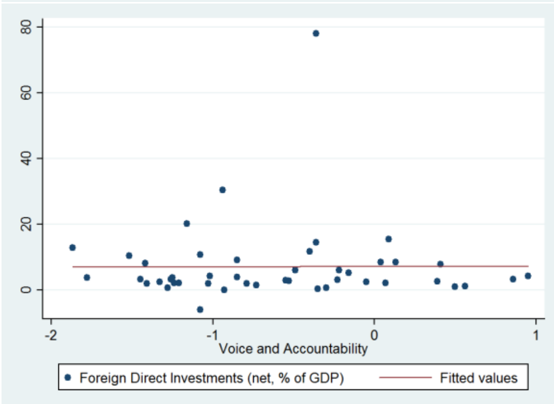
Control of Corruption
Foreign Direct Investments (net, % of GDP)
Fitted values



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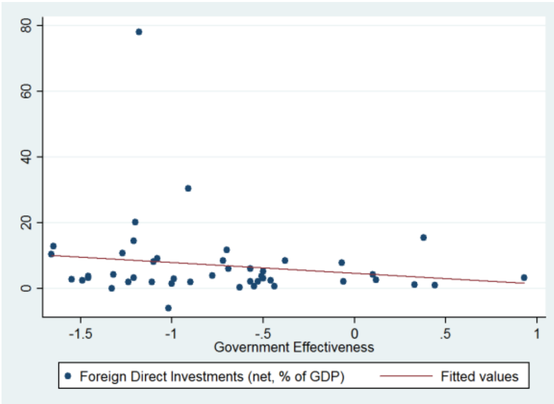
Voice and Accountability
Foreign Direct Investments (net, % of GDP)
Fitted values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-.5
0
.5
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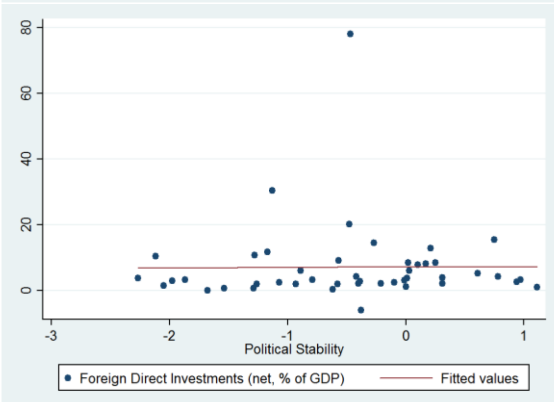
Government Effectiveness
Foreign Direct Investments (net, % of GDP)
Fitted values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-3
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-1
0
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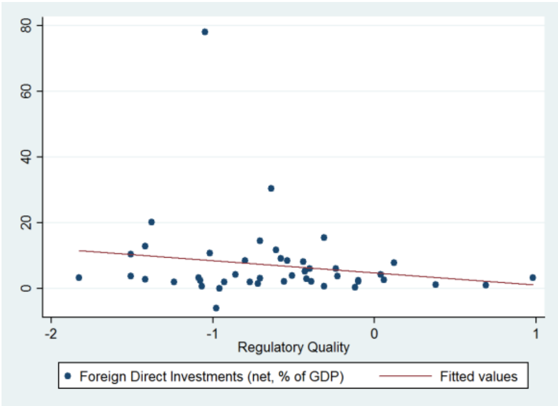
Political Stability
Foreign Direct Investments (net, % of GDP)
Fitted values



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60
40
20
0
-2
-1
0
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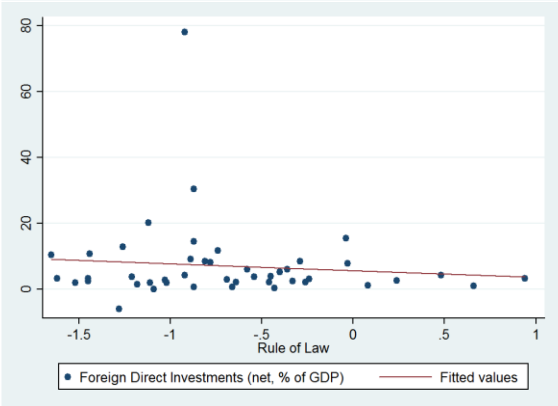
Regulatory Quality
Foreign Direct Investments (net, % of GDP)
Fitted values



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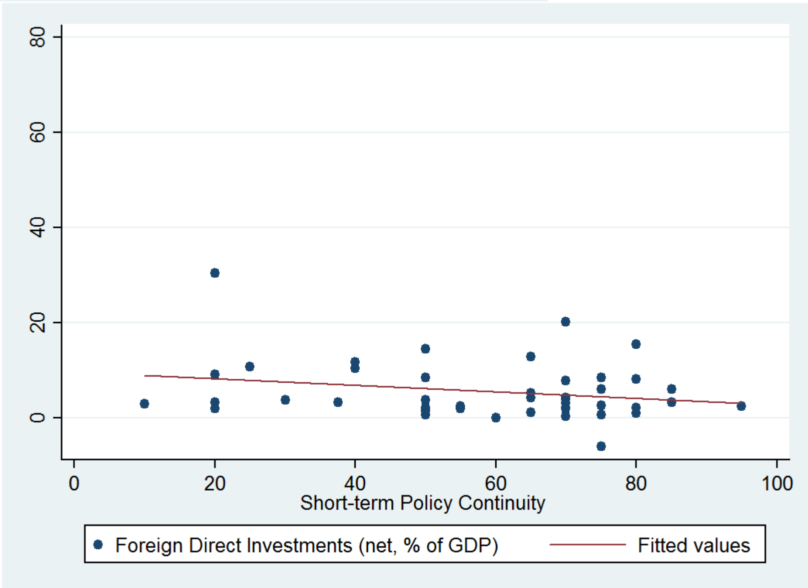
20
0
-1.5
-1
-.5
0
.5
1
Rule of Law
Foreign Direct Investments (net, % of GDP)
Fitted values



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40
20
0
0
20
40
60
80
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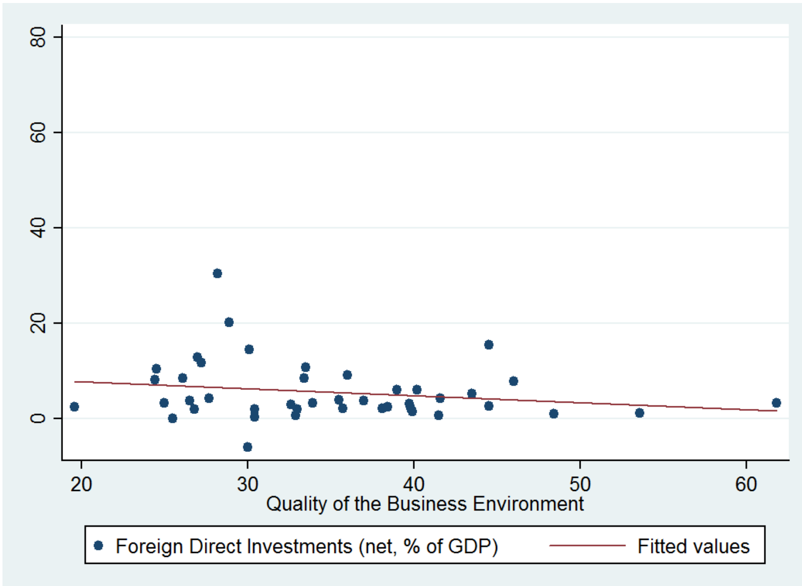
Short-term Policy Continuity
Foreign Direct Investments (net, % of GDP)
Fitted values



80
60
40
20
0
20
30
40
50
60
Quality of the Business Environment
Foreign Direct Investments (net, % of GDP)
Fitted values