



Natural Resources, Quality of Institutions and Foreign Direct Investment in sub-Saharan Africa

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Abstract

An analysis of statistics on foreign direct investment (FDI) inflows reveals that some countries in sub-Saharan Africa (SSA), which are heavily endowed with natural resources and have internal conflicts, have managed to attract significant FDI. This study sought to determine whether it is possible that, for the same countries with weak institutions, some foreign investors can be attracted to invest in them while others are systematically repelled. We found that weak

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institutions are favourable to FDI inflows into the extractive sector, while they crowd out FDI into other sectors. Thus, resource-rich countries do not need institutional reforms to attract FDI.

Introduction

One of the major challenges of sub-Saharan Africa (SSA) is to find ways to finance its development. To this end, several countries in the region have opted for the attractiveness of foreign direct investment (FDI); especially in view of the spectacular economic growth of the countries of South-East Asia due to this capital. FDI is indeed considered as likely to induce transfers of capital, technology, and know-how, and, in addition, do not create debt. With the reforms initiated, going as far as creating an investment promotion agency, in 20 years (1996–2016) SSA has witnessed its share of total FDI double. However, despite everything, the SSA share remains seven (7) and 22 times lower than that of developing economies of America and Asia respectively (UNCTAD, 2017).

Why does capital go so little towards an area that is sorely lacking?

Several empirical studies argue that weak institutions are the main reason explaining why Sub-Saharan Africa appears as a typical example of the Lucas paradox. It means that the poor quality of institutions discourages investors as it constitutes an additional barrier to FDI inflows (Aleksynska and Havrylchuk, 2012). In particular, corruption imposes additional costs to investors and increases uncertainty about future costs and returns on investment (Wei, 1997, 2000; Wei and Shleifer, 2000; Hellman et al., 2002; Javorcik and Wei, 2009; Belgibayeva and Plekhanov, 2015). In Cameroon, for example, the unfair competition of cigarettes from Nigeria, which fraudulently crossed borders through corruption, caused the foreign-owned British American Tobacco company close its factories and relocate to neighbouring Nigeria. Similarly, a poor definition of property rights, the impartiality of justice and the risks of expropriation have also been important disincentives (Warrick and Hallward, 2005), as noted in Zimbabwe (Gwenhamo, 2009) and also in the former Zaire, with the brutal nationalization of foreign companies by Mobutu's government. In addition, political instability increases the uncertainty of returns on investment, forcing foreign investors to choose other destinations (Alesina and Perotti 1996; Kaufman et al., 1999; Basu and Srinivasan 2002; Chan and Gemayel, 2004). This indicates that good quality institutions attract FDI and poor quality pushes them back (Dunning, 2002, Brindusa, 2005; Stein and Daude, 2007; Julio et al., 2013; Komlan, 2016).

Surprisingly, Iraq and Afghanistan have recorded increases in peak FDI inflows amid conflicts, and statistical analysis on the World Bank (2017) and UNCTAD (2017) data showed that several SSA countries have also attracted large volumes of FDI during periods of socio-political instability. In South Africa, despite the tensions and hostilities observed during the second half of apartheid (from 1970 to 1991), inflows of FDI accounted for 40%, 48% and 42% respectively of the total FDI for SSA in 1970, 1974 and 1984. In Sudan, throughout the 25 years (from 1980 to 2005) of the second civil war, inflows of FDI steadily increased at the average annual rate of 24.91%. This country also recorded the largest flows in its history (2.5 billion dollars) in 2006, during the Darfur war, often compared to genocide. Throughout its 27-year civil war², Angola saw its inflows of FDI increase, on average, by 47.1% annually. Despite the troubles that accompanied the fall of Mobutu, inward FDI in the Democratic Republic of Congo (DRC) increased by 238% from 1997 to 1998. As if the proliferation of rebel formations and the unrest observed in the following years was insignificant, FDI entering the DRC increased at an average rate of 37% between 1999 and 2004 and then 45.8% between 2006 and 2011. Given that war should cause investors to flee, what explains this inverse phenomenon?

Would poor institutions be attractive?

Aleksynska and Havrylchuk (2012) argue that foreign investors are discouraged by poor quality institutions, but sometimes their fears are shattered by the abundance of natural resources. Indeed, all these countries have abundant natural resources. Several reasons can then justify the attractiveness of these economies.

Almost invariably, the assaults of rebel groups, formed under the guise of a liberation movement, have primarily targeted areas rich in natural resources. This is the case with oil control (in Angola, Congo, Central African Republic (CAR), Uganda, Sudan, Niger Delta in Nigeria and Chad); diamond mining (in Angola, Guinea, Liberia, northern Côte d'Ivoire, DRC and Sierra Leone); and the control of cobalt, gold and tin in Kivu, Uranium to Niger, forest resources or land (Burundi, Côte d'Ivoire, Darfur and Rwanda). In fact, rebel control of areas endowed with natural resources is strategic because it allows them to buy weapons, finance their actions and recruit militia (Bannon and Collier, 2003; Orruj et al., 2007; Lansana and Gberie, 2007). Thus, foreign companies already in place have often paid royalties to the rebels to continue their operations. This is the case with logging in CAR, in the area controlled by the anti-balaka³. More generally, to obtain financing, the rebels enter resource contracts with traders and foreign firms, which can then return to Western markets via mafia networks through some relatively more stable neighbouring countries.

2 From 1975 to 2002.

3 The Anti-balaka is an alliance of militia groups based in the Central African Republic.

This was the case in Angola with diamonds mined and evacuated by Zambia and South Africa, and in the DRC with cobalt routed through Rwanda. However, conflict financing has often forced governments to set a special tax, but often they enter operating contracts with foreign firms for the few natural resources they still control. Consequently, the governments must guarantee to these firms the protection which would allow them to conduct the extraction; The Cosleg joint venture is an example. Given the ORYX Natural Resources diamond consortium, it is worth noting that often foreign firms invest in an unstable environment, establish agreements with local or international military companies and local elites (Bayart et al., 1997; Hugon, 2009). Having become dependent on income from natural resource extraction, political elites have no incentive to initiate effective institutional reforms. On the contrary, they are accomplices to lack of transparency and corruption, which is all in favour of foreign firms. Indeed, taking advantage of this situation, several foreign firms require or pay bribes to avoid paying taxes, to escape the environmental requirements related, for example, to the treatment of extraction sites, some of which (copper) have a real damaging effect on the health of the populations. In some countries, such as Ghana, the management of mining contracts was formerly the responsibility of the mines minister who, against bribes, could decide that the foreign firm should pay the State only 4% or 5% of its exploitation. In 1961, faced with the urgent need to obtain revenue, Niger accepted a deal to exploit its uranium at a price almost 5 times lower (41 euros instead of 186 euros) than the market price. So, weak institutions allow multinationals, among other things, to obtain contracts, avoid additional costs and increase their profit margins.

Chinese companies specifically choose to invest in countries with a very high political risk. The first reason explaining the propensity of Chinese firms to invest in countries with weak institutions relies on the fact that such economies are little coveted by Nordic firms since they are highly demanding in terms of the quality institutions. Second, it appears that the objectives sought by firms differ according to legal status (Buckley et al., 2007). Thus, public enterprises are not necessarily guided by the pursuit of profit. Very often they are engaged in a conquest to obtain the energy resources essential to the functioning of their economies. It is therefore unlikely that public enterprises will be affected by the quality of institutions as would be a private enterprise. The participation of public enterprises in international investment involves a political economy dimension. Thus, Chinese extractive companies have a strong propensity to invest in countries that have strong political ties with their country. In several African countries, such as Tanzania, the Chinese government uses diplomatic tools to negotiate oil and mining contracts for firms from China (Li et al., 2013).

Another reason that drives companies, especially from the South, to invest in countries with worse institutions is linked to the lockdowns put in place by developed countries to thwart the important strategic acquisition attempts initiated by firms

from developing countries or from countries in transition. In this way, these firms have little choice but to invest in countries where weak institutions constitute a less rigid constraint, in countries with similar institutions or simply in oil and mining activities regardless of the type of institutions (Aleksynska and Havrylchyk, 2012). The action taken by the Canadian Government in 2004, influenced by public opinion, to prevent the firm “China Minmetals” from investing nearly USD 6.7 billion in the acquisition of the Canadian mining company “Noranda” is an illustration of this.

Aleksynska and Havrylchyk, (2012) consider that without institutional reforms, developing countries will always be attractive. But is it possible to increase the inflow of FDI to countries with intense natural resources, simply by improving the quality of their institutions? It seems that weak institutions have either no effect on FDI in natural resources or a positive effect. Conversely, can one argue that the impact of the quality of institutions would be identical on foreign firms interested in investments on technology, intellectual property, and services?

This study sought answers to these questions with a dual purpose, namely:

- To identify and analyse the link between the exploitation of natural resources and the quality of institutions.
- To assess the effect of the quality of institutions on FDI inflows by sector.

Asiedu (2005) investigated whether natural resources and market size on the one hand, and government policies and institutions on the other were of equal importance to foreign investors. She concludes that in Africa all these factors matter. Only, it does not distinguish the type of foreign investors. In the Netherlands, Poelhekke and Van der Ploeg (2010) analysed the composition of FDI and hypothesized a resource-FDI curse. They showed that natural resources have a direct and negative effect on non-natural resource FDI inflows. Asiedu and Lien (2011) argued that in developing countries democracy helps mitigate the curse while Asiedu (2013) disclosed that institutions are the vehicle of the curse. Komlan (2013) concurred for SSA, but Komlan (2016) then concluded that the effect of institutions is negative or pitiful depending on whether the country has abundant natural resources or not.

This study corroborates the hypothesis of a curse conveyed by the quality of the institutions. Only, unlike previous research, we look at countries with intensive resources and we assume that the negative effect of institutions is not exercised on all FDI, but rather on that directed to non-natural resource sectors. Another contribution of this study lies in the assessment of the quality of institutions directly linked to natural resources, by adopting two variables measuring transparency as institutional variables. These are dummy variables that capture countries commitment to the

Extractive Industries Transparency Initiative (EITI) and countries' compliance with transparency requirements.

Methodology

The study covers five sub-Saharan Africa (SSA) countries⁴ over the period 1996 to 2015. This sample and the period were selected based on the availability of data on FDI flows to extractive activities. The unavailability of these data in most countries significantly reduced the temporal and spatial dimension of the study. In the end, the selected sample comprised five of the eight SSA countries that the International Monetary Fund (IMF) (FMI 2013) considers as oil exporters. Except for Cameroon, these economies are all dependent on their oil exports.

Conclusion and policy recommendation

The study of the determinants of FDI has been the subject of much work. The existing studies have resulted in giving pride of place to the quality of institutions. From this point of view, it is considered that good institutions attract FDI and bad institutions repel them. Yet it is still possible to observe that some attractive countries do not have institutions of better quality than those of other countries which are less attractive. Aleksynska and Havrylchuk (2012) argue that it all depends on the similarity between the institutions of the investor's country and those of the host country. This study assumes that this could perhaps be explained by the sector of the host economy that interests the investor. This assumption is confirmed at the end of the analysis carried out using the PMG method on a sample of five SSA oil-exporting countries. This means that investments in extractive activities are not sensitive to the quality of institutions in general, and to a certain extent, weak institutions have an attractive effect. However, the same institutions exert a crowding-out effect on inward FDI flows to non-extractive activities. As argued by Aleksynska and Havrylchuk (2012), there will always be firms to invest in the primary sector regardless of the quality of institutions. In this way, it is possible in resource-rich countries to increase FDI inflows, especially in non-natural resource sectors, by improving the quality of institutions. In particular, the risks of political instability must be reduced by promoting true democracy and decentralization, strengthening the control of corruption and accountability through full transparency. In the same vein, countries with abundant resources have every interest in joining the EITI and complying with the requirements of transparency. This is because, it is an effective way to move away from unethical firms, and to limit opportunistic behaviour that often leads to socio-political unrest. Moreover, dependence on natural resources does not determine the quality of institutions. Conversely, the low economic diversification of the countries studied is attributable to the poor quality of their institutions. Unfortunately, the study does not

4 Cameroon, Chad, Congo, Equatorial Guinea and Gabon.

determine the origin of the quality of the institutions nor does it examine the effect of the neighbourhood, which could nevertheless reveal the interdependencies between countries and the need to conduct coordinated institutional policies.

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Mission

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