The Significance of Foreign Direct Investment to the Economic Development of Sub Saharan Economies

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Abstract

This study attempts to evaluate the impact of Foreign Direct Investment on the economic development of forty three (43) Sub Saharan African countries. The Auto Regressive Vector (VAR) model was employed to effectuate econometric estimations, using annual data obtained from the database of the World Bank: World Development Indicators-WDI, 2018 for the period spanning from 1997 to 2017. The findings of the study show that FDI has a negligible impact on the economic development of the countries studied, whereas economic development that has a positive and strong impact on FDI. It is therefore recommended that: first African economies should develop value chains and attract FDI geared towards the transformation of their natural resources; and second they should improve pro-industry elements like adequate electricity supply, good transportation network, skilled labor, and technological development.

Keywords: Foreign direct investment; Economic development; Sub Saharan economies

Introduction

The transformation of a country from the state of under development to a developed nation with high living standards, long life expectancy and appreciable literacy levels is an immense task, requiring among other things, huge resources, numerous investments, innovations and technological development, and high and sustainable economic growth.

Unfortunately, the resources needed to carryout growth stimulating and development enhancing investments are very often beyond those available, creating a resource gap. This is very peculiar in developing countries, especially in Africa.

Therefore, African economies must first of all fill the resource gap in order to sufficiently invest in their economies so as to produce high value added products, create more jobs, alleviate poverty and improve living standards of their citizens. Secondly, external or foreign capital is highly needed to fill the resource gap because of the relatively weak financial strength of the continent [1].

Today, one of the means to obtain complementary resources to cover the resource gap, increase investments and achieve high economic growth and development is through the attraction of foreign direct investment (FDI). This is because of their potential in transferring technology, creating highly remunerated jobs, raising tax revenues for host country, improving human capital, etc. It is for this reason that, in recent years, the vast majority of the fast growing economies relied heavily on FDI to stimulate and also sustain their rapid economic transformation.

Indeed, FDI, more than ever is regarded as an engine of economic development given that it brings in additional capital, technology and innovation to the host country that would eventually enable it to improve its production and competitiveness [2]. For example, foreign firms, in view of optimizing their production could train the employees of their suppliers on efficient supply means, thereby reducing cost and time in the delivery of inputs. This enables home domestic suppliers to learn new and/or efficient ways to supply their customers and become more competitive.

Moreover, FDI is expected to provide access to foreign markets to the host country firms, thereby facilitating or accelerating the integration of the host country into the global economy. When local firms have access to the world market, they will be more versed with international trade norms. As such, they will easily improve the quality of their produce to those of highly competitive firms on the international market. By so doing, they can become more competitive, gain more market shares, increase their production, enjoy economies of scales, export more and bring home more foreign earnings.

Regarding the essential role played by FDI in transforming economies, many developing countries in general and Africa in particular are increasingly seeking such investments. To this effect, they put in plays incentives to attract more foreign investments that are today very mobile in search for optimum production sites.

FDI flows across the globe, in recent years exceed USD 800 billion dollars; which is quite substantial compared to last decades [3]. Most of the FDI went to developed and emerging economies with relatively advanced manufacturing sectors that could yield more profits. In this regard, FDI flows to Asia were expected to reach USD 515 billion in 2017 and those to Africa were projected to reach USD 65 billion.

Despite the small amount of FDI inflow to Africa compared to the rest of the world, it is mostly directed at a few rich resource countries. For instance, during the period 1991-1994, only 21 per cent of FDI inflows to Sub-Saharan Africa went to countries that were not major exporters of oil or minerals.

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But between 1970 and 2008 South Africa and Nigeria who are richly endowed with natural resources attracted about 46 percent of FDI flows to Africa [1]. The concentration of FDI in the extractive sector in Africa is partly accounted for by poor infrastructure, political upheavals, corruption, power shortages, and insufficient skilled labor [4].

In spite of the small amount of FDI flowing to Africa and its concentration in the primary sector, it is very volatile. This is because investing in the primary sector is very much conditioned by commodity prices. For example, the weak commodity prices in recent years and slowing economic growth caused a fall of FDI inflow to Africa by 14 per cent between 2010 and 2016 [3].

Furthermore, FDI inflows to Cameroon, for the same reasons, declined from USD 726 million in 2014 to USD 627 million in 2015; and to USD 128 in 2016. This makes the African continent vulnerable to external crises that arise from the frequent fluctuations of commodity prices on the world market. Such crises usually have long lasting devastating effects on the continent’s economies because of their weak and fragile nature.

Worse, the extraction of the natural resources causes environmental degradation particularly through deforestation and destruction of biodiversity, among others. Such patterns of environmental destruction have been driven by increased economic activities, of which FDI has become an increasingly significant contributor [5].

Also, foreign companies in Africa send home the profits they make on the continent. This significantly contributes to sweeping out the highly needed financial resources for Africa’s development. To this effect, what is the impact of foreign direct investment to the economic development of Sub African countries?

The rest of the work is organized as follows: section 1 looks at the related literature review, section 2 presents the methodology, section 3 presents and discusses the findings, and section 4 concludes the study.

**Literature Review**

It is often argued that the inflow of additional capital, transfer of technology, the accumulation of human capital, etc. positively affect economic growth and development in a host country. The positive, strong and sustainable economic growth would on it part influence the economic development of an economy [6]. This suggests that economies registering relatively high FDI inflow could have higher growth rates and in turn attract more foreign investments.

Therefore, FDI inflow accelerates growth which eventually attracts more FDI, thereby creating a circle that drives up the production and distribution of wealth in the host economy. More production would in no doubt increase employment, reduce poverty, and raise income levels of the citizens. This would enable them to satisfy their basic needs related to nutrition, education and health, hence improving living standards, and setting the pace for economic development and prosperity.

Foreign investments could also be very essential improving factor for production efficiency as they are embedded with advanced technologies and knowledge that contribute in shifting upwards the host country’s production frontier [7]. This dual role played by FDI in improving production makes it a powerful driver of economic growth with a potential to helping developing and emerging economies to grow substantially, and eventually catch up with world’s most advanced countries. High growth rates resulting from industrial production enable countries to increase and even double their GDP per capita.

To this effect, the living standards will improve. For instance, the acceleration of the industrial revolution in the 19th century enabled Britain to double its per capita income in about 60 years (World Bank, 2017), which eventually increased the purchasing power of the British as well as their consumption. But today, with high levels of technological developments and innovations with strong potentials to accelerate to harness and enhance manufacturing, more people could be brought out of poverty in a shorter period.

Foreign investments directed to the agricultural sector - the backbone of most developing countries, can increase the production of food and raw materials for the local economies through large scale cultivation. This would overcome the problem of food shortages faced by developing countries as well as the insufficient supply of essential inputs to local firms involved in the transformation raw materials like cocoa, rubber, maize, fruits, etc. to finished products with high value added. Agro-FDI can lead to the development of domestic value chains which would facilitate the uptake of business models approach to the international market after the coverage of the local markets [8].

However, agri-FDI oriented towards the exploitation of resources for the supply of their mother firms abroad could be less beneficial to the host country as local industries might be deprived of a good quantity of essential raw materials. This could result to an increase in the import the raw materials by local firms to cover up the supply gap. Consequently, transaction cost would rise and firms would increase the prices of their products. As such, their products will be less competitive on the market if they are not subsidized.

Also, FDI may adversely affect growth prospect of the recipient economy if it leads to substantial outflows of financial capital in the form of remittances of profits or any other concessions that can deprive the host country of due financial resources it could obtain from foreign investments [5].

Exporting huge financial resources from FDI host countries, especially in Sub Saharan African economies is a hard blow to them, given that the resources could be saved in banks, and thereafter borrowed and reinvested in the host country. Africa suffers this effect of FDI seriously to the point of being regarded as capital exporter, whereas it needs a lot of resources for its development. For instance, over the period 1970-2008, capital flight (including illicit capital) was much larger than foreign aid and FDI combined [1]. This is a paradox that is accentuated by foreign investments. Africa needs enormous financial resources to fund its development projects, bring out its population from poverty, and also service and pay back its debts; but it is exporting cash.

Bearing in mind the capital deficiency nature of developing economies as earlier mentioned and the benefits accruable from the activities of multinational corporations, especially in creating employment, raising incomes and reducing poverty, FDI is regarded as an essential tool for improving growth and living standards [5]. FDI generates direct and indirect employment in the host country. Those employed by foreign firms earn relatively high wages and spend part of their income on consumer goods and services. As such, the demand for other goods produced in the economy would rise, leading to a strong and widespread multiplier effect on the economy.

When employment and earnings are high, savings rise. As such, banks would have more liquidity to lend. As such, other economic agents, notably entrepreneurs can easily be granted loans by financial
Institutions to invest and boost their production. Considering Africa's low income and domestic savings level, its resource requirements and limited ability to domestically raise funds, the bulk of its finance for the future would have to come from abroad, mostly in the form of FDI [2].

In this regard, FDI would serve as a stimulus for economic activities. When there is an improvement in economic performance of an economy, income would rise, poverty would reduce and standards of living would rise. Multinational corporations play a non-negligible role in employing local labor, and transferring technology to the host country [1].

In this regard FDI is considered to be essential for every economy and the poor in particular [9]. Therefore, alleviating poverty and enhancing prosperity requires increased private investment, including FDI in low-income countries. Deploying FDI in developing countries, especially in African countries, would provide the critically needed support for economic development by bringing in capital, creating employment, transferring technology and innovations [10].

Moreover, FDI increases and broadens the tax base for host countries governments. The collected tax revenue could subsequently be used to provide social services like healthcare, education, social housing, and supply electricity and portable water. This would improve the population health, increasing access to education and training, and ameliorate the well-being of the citizens. To this effect, the people would be more productive as individuals in good health learn better and perform better at their job sites. Thus, FDI plays an essential role in alleviating poverty, particularly in countries where it increases investments to improve social welfare [4].

In the face of insufficient resources needed to finance long-term development in Africa and the need to achieve the Sustainable Development Goals, attracting FDI has assumed a greater pride of place, more than ever in the strategies for economic renewal being embarked upon by policy makers at all levels. Among different types of private cross-border financial flows, FDI is least volatile, most available to poor countries and least likely to saddle taxpayers in poor countries with unbearable debt service obligations [2]. To this effect, FDI is very essential to promote development [4].

Additionally, FDI increases capital accumulation in the recipient economy, improve efficiency of locally owned host country firms via contract and demonstration effects, and their exposure to fierce competition, technological change, and increase human capital accumulation and boost exports [5]. Indeed, recent evidence shows that human capital accounts for a large share of income variations between countries globally [10].

Towards the end of the 20th century, many countries, including Botswana, Chile, China, Ireland, Japan and Thailand managed to double per capita income in just about 10 years. Such rapid growth is now possible for those developing economies that are able to import and imitate technical and organizational innovations from the world’s leading countries, notably by attracting foreign firms with high levels of technology and innovations levels that would generate stronger spill over effects in the economy. Rapid growth of this nature makes it possible to propel people from poverty to a reasonably comfortable life within a single life span [10].

Nonetheless, the link between growth and employment creation in developing countries is less direct than in the developed world because of the high dependence of the former on the production and export of primary commodities which have little value added compared to industrial production. Also, the growth performance of the developing economies is highly subjective to the fluctuations of the internationally determined prices of primary commodities they export [3].

In many developing countries, the informal sector is quite large, and small-scale self-employment is rather common. Formal employment in the manufacturing sector accounts for a relatively small share of total remunerative occupations than in most developed countries making the contribution of FDI generated jobs and revenue increases to have a very little impact on their economies, especially when the foreign investments are in the sourcing sector [10].

In general, FDI has many effects which vary significantly from one country to another and from one sector to the other. At the level of the firm, several studies provided evidence of technological spill over and improved plant productivity. At the macro level, FDI inflows in developing countries tend to crowd in other investment and are associated with an overall increase in total investment [11].

Basically, the amount of FDI contribution in enhancing growth and harnessing economic development is conditioned by the absorptive capacity of its recipient country. Countries with embryonic technological bases, quasi inexistent industrial sector, considerably large informal sector, and weak financial sector would in no doubt reap insignificant benefits from foreign investments.

Therefore, FDI can be an important vehicle for the transfer of technology and innovation, an enhancer of interactions between local and foreign firm, a production booster, a growth accelerator and catalyst of economic growth in the host country. However, this can only be possible when the host country has a minimum threshold of human capital and absorptive capacity [12]. Without the minimum absorptive capacity, substantial inflow of capital (financial resources) would yield undesired effects such as inflation and the deterioration of commercial balance, among others [13].

Methodology

Data and variables

This study used annual data obtained from the database of the World Bank: World Development Indicators-WDI, 2018 for the period spanning from 1997 to 2017. This period is chosen because of the availability and continuity of data for the following forty three (43) Sub Saharan African countries under study: Angola, Benin, Burkina Faso, Burundi, Cape Verde, Cameroon, Central African Republic, Chad, Congo, Democratic Republic of Congo, Ivory Coast, Djibouti, Equatorial Guinea, Ethiopia, Gabon, Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesotho, Liberia, Madagascar, Mali, Mauritania, Mauritius Island, Mozambique, Namibia, Niger, Nigeria, Rwanda, Senegal, Sierra Leone, Somalia, South Africa, Soudan, South Soudan, Swaziland, Tanzania, Togo, Uganda, Zambia and Zimbabwe.

The explained variable is economic development, composed in this study by GDP per capita (constant LCU); life expectancy at birth, total (years); literacy rate, adult total (% of people ages 15 and above) and CO2 emissions (metric tons per capita). The explanatory variable is foreign direct investment, net inflows (% of GDP). Control variables are gross capital formation (constant LCU), gross domestic savings (constant LCU), and wage and salaried workers, total (% of total employment) (modeled ILO estimate).

Model

In order to evaluate the impact of FDI on the economic
development of Sub Saharan countries, the Auto Regressive Vector (VAR) model was employed. The model is more appropriate for this study because it allows the interaction of all variables in a regression without distorting the structure of estimations. As such, it allows the interaction and analyses of diverse variables with different effects, as is the case in this study. Also, VAR models are dynamic and can better eliminate serial correlation in the errors of a temporal series than the Least Ordinary Squares.

**Specification of model**

The VAR model can be stated as follows:

\[ PVAR: Y_t = \beta_0 + \theta(t) Y_t + \mu + \varepsilon_t \]  

(1)

Where

\[ i=1,2,3,4, \ldots T \]  

\[ Y_t \text{ is a } (8 \times 1) \text{ matrix of endogenous variables} \]

\[ \theta(t) \text{ denotes the polynomial matrix of } 7 \text{ VAR lags variables, that} \]

\[ \theta(t) = \beta_1 + \beta_2 t + \beta_3 t^2 + \ldots + \beta_7 t^7 \]  

(2)

\[ \beta_i \text{ is the } (8 \times 1) \text{ matrix of variables coefficients;} \]

\[ \mu \text{ denotes the fix specific effect of individual countries;} \]

\[ \varepsilon_t \text{ stands for the vector of independently identically distributed (iid) normalcy.} \]

Therefore, the non-restricted VAR model tales following form:

\[ Y_{t-1} = \gamma Lgd_{ct} + \beta_1 Lfdi_{ct} + \beta_2 Lco2_{ct} + \beta_3 Lgcf_{ct} + \beta_4 Lgds_{ct} + \beta_5 Lleb_{ct} + \beta_6 Llra_{ct} + \beta_7 Lwsw_{ct} + \theta_0 + \varepsilon_{t-1} \]

(3)

Where:

\[ Lgd_{ct} \text{ is the log of GDP per capita (constant LCU);} \]

\[ Lfdi_{ct} \text{ stands for the log of Foreign direct investment net inflows (}\% \text{ of GDP);} \]

\[ Lco2_{ct} \text{ denotes the log CO2 emissions (metric tons per capita);} \]

\[ Lgcf_{ct} \text{ represents the log of Gross capital formation (}\% \text{ of GDP);} \]

\[ Lgds_{ct} \text{ is the log of Gross domestic savings (}\% \text{ of GDP);} \]

\[ Llra_{ct} \text{ stands for the log of Literacy rate, adult total (}\% \text{ of people ages 15 and above);} \]

\[ Lleb_{ct} \text{ is the log of life expectancy at birth, total (years);} \]

\[ Lwsw_{ct} \text{ denotes the log of wage and salaried workers, total (}\% \text{ of total employment) (modeled ILO estimate).} \]

From what precedes, the general form of the VAR model could be stated as follows:

\[ Y_{t-1} = \begin{bmatrix} Lgd_{ct} \\ Lfdi_{ct} \\ Lco2_{ct} \\ Lgcf_{ct} \\ Lgds_{ct} \\ Lleb_{ct} \\ Llra_{ct} \\ Lwsw_{ct} \end{bmatrix} + \begin{bmatrix} \beta_1 \\ \beta_2 \\ \beta_3 \\ \beta_4 \\ \beta_5 \\ \beta_6 \\ \beta_7 \end{bmatrix} \begin{bmatrix} Lgd_{ct-1} \\ Lfdi_{ct-1} \\ Lco2_{ct-1} \\ Lgcf_{ct-1} \\ Lgds_{ct-1} \\ Lleb_{ct-1} \\ Llra_{ct-1} \\ Lwsw_{ct-1} \end{bmatrix} + \theta_0 + \varepsilon_{t-1} \]

(4)

To estimate the model, the number of lags has to be determined. As such, the unit root test has to be effectuated before determining the number of lags to be used in estimating the model.

**Estimation techniques**

**Unit root test:** This test is done to verify that the model comports neither seasonality nor tendency, and also to ensure that no factor changes in time.

Thus, the Augmented Dickey Full test of Fisher will be used at this level because it allows for Meta analyses and avoids errors of data in the estimations [8]. The hypotheses of estimation are:

\[ H_0: \text{All panels contain unit roots,} \]
\[ H_1: \text{At least one panel is stationary.} \]

Number of panels=43,

The decision role to accept or reject hypothesis Ho or Ha is:

If p-value <5%, accept Ho. If not, accept Ha.

The choice of the hypotheses is effectuated based on Table 1 below.

Table 1 above shows that at least one panel is stationary given that the p-value <5%. It also shows that the variables do not have the same order. Thus, the Granger co-integration is not necessary. To this effect, we proceed to the determination of the number of lags to be used in the estimation of the VAR model.

**Choice of the number of lags:** In order to carry out the estimations, the number of lags has to be known. This is to minimize the logarithm of the variance of residues by taking into account an additive penalty based on the model size. To do so, the Akaike Information Criterion (AIC), Schwarz Criterion (SBIC) and Hannan-Quinn Criterion (HQIC) are used. The table below summarizes the estimations of the various information criteria.

From Table 2 above, it can be seen that the model has to be differentiated twice for it to be significant and stationary. Also, the variables CO2 emissions, Foreign Direct Investment, gross domestic
product, and gross capital formation would constitute the restricted model. The other variables were eliminated because of non-co-linearity. The final model is presented as follows:

\[
\begin{align*}
Lgdp_{t} &= \theta_0 + \beta_1 Y_{it} + \alpha_i \gamma_i + Lgdp_{t-1} + \varepsilon_{Lgdp_t} \\
Lfdi_{t} &= \theta_0 + \beta_1 Y_{it} + \alpha_i \gamma_i + Lfdi_{t-1} + \varepsilon_{Lfdi_t} \\
Lco2_{t} &= \theta_0 + \beta_1 Y_{it} + \alpha_i \gamma_i + Lco2_{t-1} + \varepsilon_{Lco2_t} \\
Lgcf_{t} &= \theta_0 + \beta_1 Y_{it} + \alpha_i \gamma_i + Lgcf_{t-1} + \varepsilon_{Lgcf_t} \\
\end{align*}
\]

With P the number of lags=2.

Eqn. (5) above therefore stands for the final VAR model to be estimated. Its estimation would enable to capture the interaction between its variables, and evaluate the impact of FDI on economic development and also the possible impact of economic development on FDI. The impact of FDI on economic development would be verified based on the hypotheses Ho and Ha below.

Ho: \( p\/z < 0.05 \), then FDI has a non-significant impact on economic development.

Ha: \( p\/z > 0.05 \), FDI has a significant impact on economic development.

The acceptance or refusal of hypotheses Ho and Ha is based on the following:

\( \rho > 2.76089 \), then the hypothesis Ho is rejected.

\( \rho < 2.76089 \), then the hypothesis Ha is accepted.

Results and Discussions

For reasons of analyses, the results will be presented in two steps. The first will present the static results and the second will present the dynamic ones.

**Static results**

The static test highlights the impact of each variable on the economic development of all the countries under study. The least ordinary squares of a simple regression model on the panel were effectuated to verify this. Its results are presented in Table 3 below.

The results in Table 4 above show that the variables foreign direct investment, gross domestic savings, and literacy rate have a positive impact on economic development; meanwhile the variable waged of salaried workers has a negative impact of economic development. The variables gross capital formation, CO2 emission and life expectancy at birth are not significant, and therefore have no impact on economic development of the Sub Saharan African countries.

**Dynamic results**

These results show the global impact of FDI on economic development of the Sub Saharan African countries under study. The results are presented in the following table.

The results in Table 4 above reveal that FDI has a negligible impact on the economic development of Sub Saharan African economies as shown by the P-value which is almost null. However, it is realized that it is economic development that has a positive and strong impact on FDI. Therefore, it can be concluded that countries with relatively more developed and industrialized economies tend to attract more FDI and reap their benefits significantly.

**Conclusion**

Today, one of the ways to obtain additional capital to fund economic activities is through the attraction of foreign direct investment, gross domestic savings, and literacy rate have a positive impact on economic development; meanwhile the variable waged of salaried workers has a negative impact of economic development. The variables gross capital formation, CO2 emission and life expectancy at birth are not significant, and therefore have no impact on economic development of the Sub Saharan African countries.

![Table 2: Summary of AIC, SBIC and HQIC.](image)

![Table 3: Least ordinary squares simple regression table of all variables.](image)

![Table 4: Dynamic results showing the impact of FDI on economic development.](image)
investment. Therefore, evaluating the contribution of FDI to the economic development in Sub Saharan Africa is very important in crafting and implementing policies that would enable the countries to attract and benefit foreign from investments. It is in this light that this work focused on evaluating the impact of FDI on the economic development of forty three (43) countries in Sub Saharan Africa.

The Auto Regressive Vector (VAR) model was employed to evaluate the impact of FDI on economic development of the forty three (43) countries under study, for the period spanning from 1997 to 2017.

The findings of the study show that the impact of FDI on the economic development of the countries studied is negligible as shown by the P-value of the VAR model which tends towards zero.

Moreover, the results reveal that it is economic development which has a positive and strong impact on FDI. From the findings, it can be affirmed that countries with relatively more developed absorptive capacities likely benefit more from FDI; meanwhile those with fragile economies that are heavily dependent on the export of raw material tend to benefit less from FDI due to their weak economies, making it difficult to absorb the spillovers resulting from foreign investments.

The dependence of most African economies, with few and quasi non-existent infant industries that transform natural resources like cocoa, rubber, timber etc. to finished products with high value added limits substantially their capacity to absorb the spill over effects that result from foreign investments, and eventually accelerate economic development. As such, foreign investments are mostly directed to sourcing activities with the goal of supplying manufacturing corporations offshore, thereby leaving the continent with negligible benefits of their own resources.

In this regard, African economies should develop value chains and attract FDI geared towards the transformation of their natural resources so as create and distribute more wealth that would boost growth and stimulate economic development. Also, other pro-industry elements like adequate electricity supply, good transportation network, skilled labor, technological development, etc. should be improved.

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