Neo-Liberal Policy and Foreign Direct Investment in Africa

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Abstract

This paper analyzes the effects of Neo-liberal policy on FDI in Africa. It uses Freedom Index scores provided by the Heritage Foundation and the Wall Street Journal as a proxy for implementation of Neo-liberal policy. Using a panel-data regression from 1998to 2009, we find that the only Freedom Index measurement that has a statistically significant and positive effect on FDI in Africa was the absence of corruption, suggesting that Neo-liberal policy has had little significance in the FDI-decision making process in the region.
Key words: neo-liberal; foreign direct investment, freedom index, Africa

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I. Introduction

This paper studies the effects of neo-liberalism on Foreign Direct Investment in Africa. Since the early 1980s and the ascendance of the "Washington consensus",many economists have shifted to the belief that a more liberalized economy will promote more economic growth and development. Consequently, many international institutions have encouraged free trade, opening the economy to foreign direct investment along with a host of other policies that endorse free market operations. In fact, the implementation of such policies became a precondition for receiving any assistance from such institutions. In recent years, these policies have come under intense scrutiny, as the implementation of them has had undesirable effects in many countries.(Caffentzis, 2002;MacEwan, 2000)
This paper will investigate the effects that four pillars of economic freedom as provided by the Freedom Index scores produced by the Heritage Foundation and Wall Street Journal (Open Markets, Rule of Law, Regulatory Efficiency, and Limited Government) have on FDI in Africa. We will utilize a panel-data regression for 51 countries on the African continent, ranging from the years 1998 to 2009.The remainder of this paper follows the following format: explanation of neo-liberalism, literature review, an explanation of the model and variables utilized estimations and results, and the conclusion.

II. Neo-Liberalism

In recent decades, a Neo-Liberal philosophy has been overtaking economic policy. The neo-liberal ideology follows that all human activities can be essentially considered as "commodity and the best way (leading to the greatest satisfaction possible)is to organize these activities through a market" (Caffentzis, 2002, P.89) Throughout the 1980's, the major international institutions such as the International Monetary Fund(IMF) and the World Bank began pushing for major market reform overhauls across the globe,mainly in developing countries. The primary aim of such overhauls was the liberalization of the world economy. Success of such policies is subject to debate even in developed countries that have the necessary resources and infrastructureat their disposal to implement them. However, the rapid implementation of liberal economic policy in developing countries that lack such resources and infrastructure are even more problematic.(MacEwan, 2000) Neo-liberal philosophy, in particular, frowns upon government intervention in the economy andconsiders such an intervention as rent-seeking behavior, therefore creating a burden on the economy.

By decreasing such aburden,it is argued that market participants would be able to operate more efficiently(Caffentzis, 2002; Olowu,2001).Consequently, the IMF and the World Bank designed policies with the intention of opening markets of developing countries and reducing the role of government in the hopes of making these countries larger participants in the global economy.With the launching of the Structural Adjustment Programs (SAP's)in the 1980's, a fierce neo-liberal policy was imposed upon developing countries as a condition for receiving any international assistance from the IMF and the World Bank. Many debt-burdeneddeveloping countries had no choice but to embrace the SAPs that encouraged open markets free of government intervention and favored an unregulated global economy. However, the SAP's fell short of meeting their goal and they proved to have adverse effects on many regions of the world. (MacEwan, 2000; Schoenholtz, 1987)

Some researchers have shown that the implementation of neo-liberal philosophy through the SAP's in Africa has been even less successful; and argue that such implementation has brought about more detriment than was initiallyconsidered. For instance, Stein and Nissanke ,(1999), argued that not only have SAP's failed to produce the desired results, but in fact led to the slowing of economic growth, and producing more impediments to growth. Theseprograms have failed to develop the infrastructure necessary to "transform the nature of production and trade" (Stein and Nissanke, P.10). Hopkins (2009), maintained that after attempting to restructure their economies, many of these countries havesince been unable to adequately repay their loans, while also witnessing little (if any) economic growth. Some argued that one important reason that Africa in particular was hurt by the implementation of SAP's as much of its social structure is not conducive to the traditionally accepted markets (Riddell, 1995). Others contended that the SAP's fell short of meeting their goal as a result of market imperfections coupled with corrupt governments unwilling to institute the changes necessary to effectively carry out the long run goals of such programs (Aseidu, 2005). Collier and Gunning (1999) claimed that the SAP's have failed to provide the desired results from a lack of proper sequencing in financial reforms. They stated that such policy implementation may be beneficial for these countries, however the timing in which they are carried out does more harm than good. In recent years, however, as a result of harsh criticism, the IMF and the World Bank began restructuring SAP's in the direction of a more regulated market economy (Olowu, 2001).

III. Foreign Direct Investment in Africa

There has been an extensive body of literature concerning foreign direct investment in Africa. Much of the empirical literature focuses mainly on macro or microvariables paired with institutional effects. Many of the macro variables include market size, openness, and inflation; on the other hand, many of the micro and institutional variables range from human capital to infrastructure. Although, there have been many attempts to investigatethe effects of neo-liberalism in Africa, there has been little effort in the inclusion of the Freedom Index as a proxy formeasuring the effects of such policies on the attraction of FDI to Africa.

Much of the literature devoted to FDI in Africa has focused on the influence of macroeconomic variables. Per capita GDP, GDP or GDP growth, invariably have been included in many of such researches. Aseidu (2005) for instance, contended that the higher levels ofGDP positively affected FDI.Similarly, Mhlanga, Blalock, and Christy (2009) demonstrated that GDP, in the log form, promotes FDI flow to the Southern African Development Community region. On the other hand Anyanwu (2012) showed that GDP per capita did not have a positively significant association with FDI flow in Africa. However, the real GDP growth lagged one period had a positive influence on the flow of FDI to the region. As a measure of macroeconomic instability, inflation rates have been utilized in many researches. Mhlanga, Blalock, and Christy (2009) and Aseidu (2005), for example, found that inflation rates had a negative effect on FDI. Another macroeconomic variable utilized is country openness to trade. Sawkut, Boopen, Taruna, and Vinesh (2007) argued that the openness of an economy to trade has a positive effect on FDI. Dinda (2008) in analyzing factors determining FDI to Nigeria concluded that openness is a significant determinant of FDI to Nigeria. Dinda(2008) utilized the ratio of imports and exports to GDP as an appropriate measure of openness.

There are studies that have considered the microeconomic factors as important variables in influencing FDI. One of these variables is the quality of infrastructure. Dupasquier and Osakwe (2006) argue that FDI in Africa is positively related to the development of infrastructure, as 'the absence of adequate supporting infrastructure….increases transaction costs." (p.251).

The quality of infrastructure has been measured in various ways, including electricity usageand telephone lines per 1,000 people.Mhlanga, Blalock, and Christy (2010), and Blancheton and Opara-Opimba (2010) demonstrated that there is a positive relationship between the number of telephone lines and FDI. With respect to electricity usage as a measure for infrastructure, they revealed a negative relationship with FDI.Anyanwu (2012) also using the number of telephone mainlines and mobile phone subscribers as a proxy for infrastructure, confirmed the importance of availability of infrastructure in attracting FDI. The same conclusion is reached by Hailu (2010).

The availability of natural resources is also considered by many researchers as a major determinant of FDI in Africa. Anyanwu (2012), for instance, argued that natural resources, especially oil, attract FDI to Africa. Aseidu (2005) also discussed that the natural resource intensity and minerals and fuels as a percentage of exports have a positive and significant effect on FDI. Similarly, Dinda (2008) concluded the endowment of natural resources in Nigeria is a significant determinant of FDI flowsinto that country.

The quality of human capital has garnered interest among the academic community, namely with respect to HIV rates among citizens. With HIV being rampant in Africa, it serves as a suitable proxy for health measurements. As researched by Blancheton and Opara-Opimba (2010), the natural logarithm of HIV rates divided by (100-HIV rates) serves as a quality indicator for the effects of HIV on FDI in Africa. The research discovered that the existence of HIV holds negative and significant effects on FDI.

Various measures of political and economic instability incorporated in many studiesshow that these variables have a major negative impact on FDI in African countries. Aseidu (2005) showed that the number of political coups, riots, and assassinations have a negative and highly significant effect on FDI. Aseidu (2005) also demonstrated that corruption rates, lagged by one year, have a negative and significant effect on FDI decision making. Mhlanga, Blalock, and Christy (2009) likewise, found a relationship between measurements of political stability and FDI. Utilizing a series of data from the Political Rights and Civil Liberties Index, they found a positive relationship between the two. Similarly, Blancheton and Opara-Opimba (2010) utilized the scores from the Heritage Foundation's index of economic freedom with levels of corruption as well as democracy, finding positive relationships between both democracy and lack of corruption with FDI.

It is the purpose of this paper to include the Freedom Index as a proxy for the measurement of neo-liberal economic policyeffects on FDI in Africa. Since 1995, the Wall Street Journal and the Heritage Foundation, a prominent Washington think tank, have been tracking the various countries' implementation of neoliberal policy through their measurement of the Index of Economic Freedom. The index breaks economic freedom into ten components: business, trade, fiscal, government, monetary, investment, financial, property, labor freedoms and finally freedom from corruption. It is clear to us that theprevious researchers have failed to include all of these factors in their model and present a more comprehensive account of neo-liberal policy.

IV. Model and Variables

We have employedfixed effects panel estimation of fifty one African countries from 1998-2009 to measure the effects of neo-liberalism on FDI in Africa. Following Asiedu (2005) and Hailu (2010), we employed a fixed effects estimation. This approach has advantage of allowing "to focus on changes within different units over time and … the estimates remain unbiased even when data is missing for some time periods for some cross-sectional units. " (Hailu. P.110). We utilize the following panel regression model:

$$FDI = C + \beta_1 \text{ TRADE} + \beta_2 \text{ INFLATION} + \beta_3 \text{ FOSSILFUEL} + \beta_4 \text{GDP} + \beta_5 \text{GDP GROWTH} + \beta_6 \text{ HIV} + \beta_6 \text{ EDUCATION} + \beta_7 \text{FDILAG} + \beta_8 \text{ FREEDOMINDICATOR} + \varepsilon$$

As it is standard in the literature, the dependent variable, (FDI) is measured as net inflows as a percentage of GDP. We have included eight explanatory variables, which are: Trade, Inflation, Fossil Fuel, GDP, GDP growth, HIV,Education and lag of foreign direct investment. We have also included afreedom indicator, which consistsof eleven various "freedom" indices,and are used as a proxy for neo-liberal policy.According to the literature, FDI decisions are made based on historical data and consequently all variables that are considered to affect such a decision making "would materialize their effect" the following period (Anyauwu2012, P. 454). Hence, we have lagged all variables by one year with the exception of the freedom indicator which was lagged by two years.

All data, with the exception of the Freedom indicator, were acquired from the World Bank data sources.[1] The data pertaining to the Freedom indicator were obtained from Heritage Foundation web site.[2]

We utilize the sum of imports and exports (TRADE) as a measure of trade openness in the economy. The imports and exports are measured as a percentage of GDP each year. AsSawkut, Boopen, Taruna, and Vinesh (2007) argued, trade openness is considered an attractive quality for investors; therefore, we expect to see a positive relationship between trade openness and FDI.

INFLATION is measured as the annual percentage change in average consumer prices. Following the research of Dinda (2009) and (Anyauwu2012), we expect this variable to have a negative relationship with FDI.Inflation is used as a measure of macroeconomic stability, the higher the inflation,the less stable the economic conditions and consequently less desirable to foreign investors.

FOSSILFUEL is fossil fuel consumption as a percentage of total energy consumption. This variable is commonly used as a measurement of degree of environmental friendliness of a country. However, researchers argue that in the context of less developed countries this variable may be used as a measurement of economic development of that country, and so we expect to have a positive effect on FDI. (Holtz-Eakin, and Selden, 1995; Hilton[a], and Levinson1998.)

GDP is included as annual inflation adjusted per capita gross domestic product. After utilizing the ADF test for the existence of a unit root, we first differenced the variable to correct for non-stationarity. As a measure of household income, market size, we should thus expect this variable to be positively correlated with FDI.(Anyauwu2012)

GDPGROWTH is the GDP growth rate, and is used as an indicator of an expanding domestic market and profitable investment opportunitiesfor FDI, and as such, we thus expect this variable to be positively correlated with FDI.(Anyauwu2012) and Hailu(2010)

HIV is measured as the percentage of the population currently living with HIV. The raw data is expressed as a rate out of 100, however consistent with the research of Blancheton and Opara-Opimba (2010), the variable is transformed into a non-linear expression. We took the natural logarithm of HIV rates divided by (100-HIV rates). At any point where HIV rates are below 50%, the computed value will be negative. At 50%, the computed value will be zero, and above 50%, the computed value will be positive. Given the non-linear shape of the natural logarithm function, any increases in HIV rates will cause a decrease in FDI growth.

EDUCATION is measured as the percentage of school age children enrolled in secondary level education. As a measure of the quality of human capital, similar to Blancheton and Opara-Opimba (2010)we expect this variable to be positively correlated with FDI.

FDILAG is a lag of foreign direct investment. The inclusion of such a variable is due to understanding that investors are more likely to invest in a territory that has displayed a successful record in the past, we expect a positive sign on this variable. (Quazi 2007).

FREEDOM includes the composite index of freedom as one measurement as well as components of thefour pillars of freedom: Rule of Law, Limited Government, Regulatory efficiency and Open Market. Each pillar containing several components, each of these components is used in a separate equation. They include: PROPERTY, CORRUPTION, FISCAL, GOVT SPEND, BUSINESS, LABOR, MONETARY, INVESTMENT, TRADEand FINANCIAL. If the neo-liberal policies have been successful in attracting FDI, the coefficient of this variable in the model should produce a positive result.PROPERTY denotes property rights enforcementand assesses “the ability of individuals to accumulate private property.” CORRUPTION measures the level of corruption in government.This variable ranges from 0-100, where 0 means the most corrupt and 100 means the least corrupt. Thus given a higher score of this variable, we should expect a higher amount of FDI, thus yielding a positive relationship.

[1] www.WorldBank.org

[2] http://www.heritage.org/index/

FISCAL signifies fiscal freedom and is "a measure of the tax burden imposed by government." GOVT SPEND considers the level of government expenditures as a percentage of GDP, "the scale for scoring government spending is non-linear, which means that government spending that is close to zero is lightly penalized, while levels of government spending that exceed 30 percent of GDP receive much worse scores in a quadratic fashion." BUSINESS represents Business freedom and is "a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation as well as the efficiency of government in the regulatory process." LABOR shows labor freedom and is a "quantitative measure that looks into various aspects of the legal and regulatory framework of a country's labor market." It frowns upon a high minimum wage; the hindrance to hiring additional workers; rigidity of hours; difficulty of firing redundant employees; legally mandated notice period, and mandatory severance pay. MONETARY denotes monetary freedom "combines a measure of price stability with an assessment of price controls. Both inflation and price controls distort market activity." INVESTMENT characterizes the investment freedom and measures the restrictions imposed on individuals and firms "to move their resources into and out of specific activities both internally and across the country's borders." TRADE is a measurement of trade freedom and is "a composite measure of the absence of tariff and non-tariff barriers." FINANCIAL stands for financial freedom and is a measure of banking transparencyand independence from government control.[3]

V. Estimations and Results

The results of the panel data analysis are presented in Tables(1) and (2).We have estimated elevenseparate equations; each containing all explanatory variables butincluding only one component of the Freedom Index. Table (1) includes the Heritage foundation's the composite freedom index and two pillars of economics freedom: Rule of law (property rights, freedom from corruption); and Limited government (fiscal freedom, government spending). Table (2)includes the two other pillars of freedom: Regulatory efficiency (business freedom, labor freedom, monetary freedom); and Open markets(trade freedom, investment freedom, financial freedom).

All explanatory variables, with the exception of real GDP per capita exhibit signs that meet our expectations. As we expected the GDP Growth is positive and significant in all equations but three indicating he importance of growing local market on attracting FDI. Real GDP per capita, on the other hand shows a negative and significant correlation with FDI in majority of equations, consistent with the finding of Anyauwu(2012). FOSSILFUEL, as anticipated, is positive in all equations; however it demonstrates a positive and significant influence on attracting FDI in seven of our estimated equations. Our proxy for health status (HIV) is negative in, as expected and significant at five of estimated equations. As expected, EDUC, the percentage of school-aged children enrolled in secondary level schools displays a positive relationship with FDI and shows a positive signs in all equations but it is only significant in two. As we predicted, inflation rates display a negative effect on FDI, and are statistically significant in eight estimated equations. The measurement of market openness, TRADE, shows a significant relationship with FDI, and as expected,and is statistically significant infour equations. Finally, the lag of foreign direct investment also shows a positive influence in attracting FDI, and is significant in three of eleven estimated equations.

Regarding the effects of neo-liberal policy on FDI, five out of eleven freedom index variables exhibit a negative sign, among them only one variable, FINANCIAL, being statistically significant at 1% level.The latter revealsthat governments' lack of a tight control on the banking system will discourage FDI. The other six freedom index variables display a positive sign, however, among them only CORRUPTION is statistically significant at 5% level. This finding confirms the argument of most studies that corruption will discourage FDI. As nine out of eleven Freedom Index variables are not statistically significant, and among them only two that are significant with one negatively influencing FDI, we conclude that our results suggest that the adoption of neo-liberal policy has not had any significant effect on attracting FDI to Africa.[4]

[3] http://www.heritage.org/index/

[4] The variables were tested using the Augmented Dickey-Fuller statistic for the existence of a unit-root. All but one of the ADF statistics fell below the critical values at the 1% level of significance, allowing for their usage in the level. The variable that fell above the critical values for the existence of a unit-root was GDP, which was first differenced, and tested again, and falling below the critical value at the 1% significance level.

VI. Conclusion

This research suggests that the Freedom Index scores, as a proxy for neo-liberalism, do not have a statistically significant impact on FDI decision-making in Africa. Having utilized a panel-data regression, we found that the only indicator that had any significant positive on FDI in that region was a measurement of the absence of corruption in a country.

Table 1

	1	2	3	4	5
CONSTANT	-19.19	-19.7	-23.1	-15.01	-21.37
	(-1.96)**	(-1.97)**	(-2.77)***	(-1.83)*	(-2.6)***
GDP GROWTH	0.19	0.19	0.2	0.12	0.2
	(2.31)*	(2.24)**	(2.2)**	(1.3)	(2.27)**
GDP	-0.0016	-0.006	-0.006	-0.005	-0.006
	(2.31)**	(-1.75)*	(-1.74)*	(-1.34)	(1.77)*
FOSSILFUEL	0.21	0.2	0.21	0.1	0.2
	(1.73)*	(1.66)*	(1.75)*	(.74)	(1.67)*
EDUC	0.03	0.03	0.05	0.02	0.02
	(1.72)*	(1.06)	(1.61)*	(1.2)	(.74)
HIV	-2.71	-2.75	-3.04	-2.22	-2.81
	(-2.03)**	(-2.03)**	(-2.54)***	(-2.3)**	(2.29)***
INFLATION	-0.002	-0.002	-0.003	-0.001	-0.003
	(-2.44)**	(-2.44)***	(-2.55)***	(.28)	(-2.54)***
TRADE	0.03	0.03	0.03	0.05	0.029
	(1.57)	(1.52)	(1.63)*	(1.98)**	(1.52)
FDI LAG	0.16	0.16	0.15	0.41	0.15
	(.91)	(.9)	(.85)	(2.12)**	(.89)
FREEDOM	-0.006				
	(-.14)				
PROPERTY		0.0002			
		(.01)			
CORRUPT			0.03		
			(1.98)**		
GOVT SPEND				-0.006	
				(.45)	
FISCAL					0.032
					(1.3)
R-Square	0.65	0.64	0.65	0.55	0.64
Adj R-Square	0.6	0.59	0.6	0.49	0.6
F-Stat	12.88	12.88	13.04	9.37	12.92
N	289	289	289	315	289
d	2.2	2.2	2.19	2.12	2.2

*** Indicates significance at the 1% level
** Indicates significance at the 5% level *Indicates significance at the 10% level

Table 2						
	6	7	8	9	10	11
CONSTANT	-12.6	-21.9	-18	-17	-20.4	-16.25
	(-1.17)	(-2.89)***	(-2.05)**	(-2.01)**	(-2.54)***	(-1.87)*
GDP GROWTH	0.063	0.11	0.2	0.2	0.23	0.23
	(.7)	(1.24)	(2.33)**	(2.42)**	(2.27)**	(2.55)***
GDP	-0.07	-0.005	-0.006	-0.006	-0.006	-0.007
	(-.29)	(-1.41	(-1.78)*	(-1.81)*	(-1.86)**	(-2.03)**
FOSSILFUEL	0.1	0.11	0.22	0.21	0.19	0.22
	(.61)	(.755)	(2.01)**	(1.74)*	(1.51)	(1.89)*
EDUC	0.008	0.01	0.04	0.02	0.016	0.01
	(.34)	(.76)	(1.21)	(.97)	(.69)	(.52)
HIV	-1.22	-1.48	-2.34	-2.52	-2.77	-2.4
	(-.81)	(-1.44)	(-1.66)*	(-1.97)**	(-2.5)***	(-1.81)*
INFLATION	-0.008	-0.011	-0.002	-0.002	-0.002	-0.003
	(-.38)	(-1.04)	(-2.45)***	(-2.47)***	(-2.46)**	(-2.5)***
TRADE	0.07	0.06	0.03	0.03	0.03	0.002
	(1.77)*	(2.02)**	(1.52)	(1.58)	(1.56)	(1.39)
FDI LAG	0.3	0.32	0.15	0.155	0.15	0.14
	(2.57)***	(2.23)***	(.89)	(.87)	(.89)	(.82)
BUSINESS	0.03					
	(.88)					
LABOR		0.13				
		(.98)				
MONETARY			-0.022			
			(-1.13)			
INVESTMENT				-0.019		
				(-1.42)		
TRADE					0.04	
					(1.46)	
FINANCIAL						-0.04
						(-3.82)***
R-Square	0.56	0.56	0.64	0.64	0.65	0.65
Adj R-Square	0.51	0.5	0.59	0.59	0.6	0.6
F-Stat	9.25	9.79	12.93	12.94	13.2	13.1
N	275	327	289	289	289	289

*** Indicates significance at the 1% level
** Indicates significance at the 5% level *Indicates significance at the 10% level

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