

Does Democracy Matter in Foreign Investment Flows to Africa? A Threshold Effect Approach.

Context and problem statement.

While the global economy is struggling with an unprecedented crisis, Africa is one of the few parts of the world to experience a relatively high economic growth. It is thus found that 7 of the 10 economies with the fastest growth in the world are African. According to figures from the African Development Bank (ADB) the average growth will be 4.5% in 2012 while it was 3.4% in 2011. It is estimated at 4.8% in 2013. Sub-Saharan Africa is not at the margin of this African global trend. It had, according to the OECD, grown of 5.3% in 2012 and 5.4% in 2013, and thus is the locomotive of this remarkable performance. In relative terms, the share of Africa in global wealth is influenced by the current performance. Thus, this share is estimated at 4% in 2012, and will reach the level of 12% in 2050. This will allow Africa to become richer than Europe¹. Africa, in fact, is doing well, and for some business intelligence firms, it will be during the next 10 years the most attractive

destination to international investors. In this context, many African countries are engaged in reforms (economic and political) to improve their business climate. Political reforms tend to strengthen civil and political rights. In this sense, the political system that is democracy has become very popular in the continent in recent decades², with some arguing that it is necessary and desirable for the continent's economic and social development in general and attracting international investors in particular. However, this issue remains controversial. Indeed, for others what counts are the economic reforms in the direction of promoting property rights and contract enforcement, through an impartial, fair and transparent law, which provides legal security to economic transactions. For example, some countries still struggling to attract many investors despite a significant level of democracy and increasingly

¹ Guy Gweth (2012). « African Diaspora, this is the time to invest in the country ». In les Afriques, N°217, October, 18, 2012, pp48-52.

² Since the France-Africa summit in La Baule (France), the democratization of political regimes in Africa has become a conditionality of Official Development Assistance (ODA).

imaginative tax and administrative incentives. According to Barro (1997), "economic freedoms either they take the form of markets or governments of smaller size that emphasis on maintaining property rights, are meant to encourage economic growth. This view is supported by empirical results". However, Barro states after that "the relationship between economic freedom and political freedom is more controversial", while Friedman (1962)³ considers that the two freedoms mutually reinforcing. From this Friedman's assertion, we make the hypothesis that the effect of democracy (political and civil liberties) on foreign investment flows to developing countries (DCs) in general and African countries in particular is subject to economic freedom (property rights, rule of law) and more specifically to a level or threshold of economic freedom. This line of research, in our point of view, may nuance on the one hand, and reconcile on the other hand, some controversial empirical results. For example, Aparna and Singh (2013) argue that foreign investors are more concerned with economic freedoms than political liberties in making the decisions of location of their capital. They add that the most democratic countries may receive less flow of Foreign

Direct Investment (FDI) if economic freedoms are not guaranteed. This might be explained by the fact that democratization in developing countries often does not allow to boost the kind of economic reforms that investors expect because of the presence of divergent and competing political interests. This explains why countries like China and Singapore which are not well ranked in democracy index, but have a relatively better rank in terms of property right index, are better in attracting FDI. It appears clearly, in the analysis of Aparna and Singh (2013) that economic freedoms guaranteed determine the attractiveness of democratic countries in the eyes of foreign investors. Our working hypothesis also takes into account the position of Jakobsen and De Soysa (2006) that the pessimist results about the influence of democracy on FDI, including that of Li and Resnick (2003)⁴, are just object to methodological problems. We think that approaching this relationship in terms of a threshold effect is likely to reconcile these different results and problems related to specification and testing procedure. The existence of a

³ Quoted by Barro (1997).

⁴ Who posits that if the transfer of property rights is controlled and limited democracy reduces FDI to developing countries. Quoted by Jakobsen and DeSoya (2006).

threshold effect in the relationship between democratic regimes and foreign investment inflows (direct and portfolio) has been suggested by research works' perspectives. For Kolstad and Villanger (2008), institutional quality and democracy appear more important for FDI in services than investment's general risks or political stability. Still, for the latter, democracy influences FDI inflows only to developing countries, suggesting that the absence of democracy is detrimental to investment if it is below a certain threshold. The existence of this threshold effect is also highlighted by Adam and Filippaios (2008). According to them, it would have a threshold effect on civil liberties below which their repression is associated with more FDI. In the case of sub-Saharan Africa, Brafu-Insaidoo (2012) believes that the probability of existence of a threshold effect of political institutions explain the negative correlation between indicators of democratic institutions and FDI inflow. Once the idea of the existence of a threshold effect is accepted, then the question of how it manifest arises? The threshold effect is it related only to the level of democracy in the country, or is it conditioned by other factors such as the rule of law [FDI and portfolio investment (PI)], the level of economic growth (FDI and PI), the efficiency and depth of

financial system (FDI and PI equity), the level of per capita income (FDI and PI), the level of transparency (FDI and PI) and the budget deficit (PI bond) ?

Objective of the research

The objective of this paper is to verify the existence of a threshold effect about the influence of democracy on foreign investment flows. This effect can occur through the level of democracy itself or by a conditional level of the rule of law index, of economic growth, of the efficiency and depth of financial system, of per capita income, of transparency and of budget deficit.

In the following, we will analyze in a first section the relationship between democracy and foreign investment. The second section will be devoted to the presentation of stylized facts. The methodology will be explained in the third section. Finally, the fourth section will present the empirical results and their discussion.

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