The role of institutions in the fdi-growth relationship in a developing economy: a new evidence from Nigeria

Jonathan E. Ogbuabor[1] – Anthony Orji[2] – God'stime O. Eigbiremolen[3] – Charles O. Manasseh[4] – Fidelia N. Onuigbo[5]

Abstract

Following the need for studies on the role of institutions in the foreign direct investment-economic growth relationship in Nigeria and the attendant challenges post by the global pandemic caused by Covid-19, this study investigated whether institutional quality enhances this relationship over the period 1981 – 2018. The study used institutional data from Freedom House, and the autoregressive distributed lag (ARDL) modeling framework. The results show that the role of institutions in enhancing the FDI-growth relationship in Nigeria is significant, both in the long-run and in the short-run. The results also show that trade is an important driver of growth in Nigeria. Among others, the study recommends the evolution of strong institutional framework that can create the enabling environment for inflow of investments into the Nigerian economy. Such institutional framework should entrench respect for the rule of law, property rights, civil liberties, transparency and accountability in governance. Furthermore, there is need to evolve policies that will continue to mitigate the adverse effect of the Covid-19 pandemic since FDI inflows and growth figures have been globally affected by the pandemic.

Key words:

Institutional Quality; Foreign Direct Investment; Economic Growth; ARDL Model

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Introduction

One incontrovertible fact in economic literature is that economic growth is one of the fundamental objectives of every economy. In other words, every economy seeks to grow. But economies do not just grow; they require effective policies and appropriate institutional frameworks to grow. According to Kazeem (2014), attempts at explaining the drivers of growth in various economies have generated an avalanche of reasons

[1] Jonathan E. Ogbuabor, Department of Economics, University of Nigeria, Nsukka (jonathan.ogbuabor@unn.edu.ng; +2348035077722)

[2] Anthony Orji, Department of Economics, University of Nigeria, Nsukka, Nigeria (anthony.orji@unn.edu.ng; +2348038559299)

[3] God'stime O. Eigbiremolen, Department of Economics, University of Nigeria, Nsukka (eigbiremolen.godstime@unn.edu.ng; +2348030426701)

[4] Charles O. Manasseh, Department of Banking and Finance, University of Nigeria, Enugu Campus (charssille@gmail.com; +2348036767885)

[5] Fidelia N. Onuigbo, Department of Economics, Enugu State University of Science and Technology (ESUT), Enugu (ifeifeonuigbo@yahoo.com; +2348037750527)

such as economic, social, cultural, political and institutional factors. However, this study is particularly interested in the contribution of foreign direct investment (FDI) in Nigeria's growth process. This is consistent with some aspects of the extant literature, such as Peres, Ameer and Xu (2018), which have highlighted FDI not only as a key factor of globalization but also as an important stimulator of productivity enhancement, technological advancement, and job creation. Here, FDI is conceptualized as a direct investment in production or business in a country by an individual or company of another country, either by buying a company in the target country or by expanding operations of an existing business in that country (Adeleke, Olowe & Fasesin, 2014). Given the existence of some empirical studies on the FDI-growth relationship in developing countries, one may then wonder if this study is still necessary. Our response to such concern is that this study is very relevant at this time for several reasons. First, the underdeveloped nature of the Nigerian economy means that every effort aimed at increasing the pace and volume of FDI into the economy should be explored. This empirical evidence is one of such efforts which will provide evidence-based policy recommendations to drive the inflow of FDI into the Nigerian economy. Ugwuegbe, Okore and Onoh (2013) share this view. Second, the volume of FDI inflow into the Nigerian economy in recent years leaves so much to be desired when compared to other African economies. For instance, the inflow of FDI into Nigeria declined sharply to an 8-year low of $981.7 million in 2017, while African countries like Egypt and Ghana recorded FDI inflow of $7.4 billion and $3 billion in 2017, respectively. In the same 2017, South Africa, which is the second largest economy in Africa after Nigeria, recorded $150 billion FDI inflow. This shows that a lot of work needs to be done to enhance FDI inflow into Nigeria. According to Tokunbo (2018), Nigeria needs at least $14 billion FDI inflow, but it has only obtained 7% of that requirement. This study contributes to the efforts towards driving FDI inflow to Nigeria.

Third, the decline in FDI inflow in Nigeria raises the important question about the role of institutions in the FDI-growth relationship in the country. Ozekhome (2017) pointed out that countries that have experienced rapid and sustained economic growth are those with sound institutional frameworks that sufficiently attract investment, technological innovation, and invariably make the business environment friendly for foreign investors. The quality of institutions in a country will go a long way in determining the willingness of foreigners to invest in the country. Countries with good institutional qualities are expected to attract more investors than others with poor institutions. Arshad (2016) noted that institutions and different institutional quality variables like corruption, rule of law, political rights, and civil liberties are consistently found to be significantly affecting economic growth. This view is supported by Rodrik (2007), which explained that good institutions are those institutions supporting economic growth in the best possible way. These institutions should be able to protect property rights, uphold the rule of law and rein in corruption, provide appropriate regulation and control market failure, support macroeconomic stability, and promote cohesion of social life of the society. Thus, the concept of institutional quality is of paramount importance in the FDI-growth nexus in Nigeria. Unfortunately, the extant literature has hardly paid any attention to the role of institutions in this relationship. This study fills this gap. Interestingly too, the recent challenges posed by the Covid-19 global pandemic has made it very pertinent to re-examine these issues and offer some economic policy prescriptions to guide policy makers in this post Covid-19 era in Nigeria and other similar economies.