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INVESTMENT CLIMATE, DOMESTIC PRIVATE INVESTMENT, AND ECONOMIC GROWTH IN SUB-SAHARAN AFRICA

Rosemary Soetan[1] and Dorcas Oke[2*]

[1]Department of Economics, Faculty of Social Sciences, Obafemi Awolowo University, Ile-Ife, Nigeria
[2]Department of Entrepreneurship, School of Management Technology, Federal University of Technology, P.M.B 704, Akure, Nigeria, *Post Code* 340001

ABSTRACT: *The environment in which an enterprise operates influences its performance. This paper investigates the relationship among investment climate, private domestic investment and economic growth in 44 sub-Saharan Africa countries over the period 2004-2015. It uses eight indicators of Doing Business and a set of control variables. Although the results show a robust link among investment climate indices, domestic private investment and economic growth, however, getting electricity, tax and registering business indices had negative effects on economic growth. This finding suggests that government and policymakers should ensure a functioning and enabling investment climate, complimented by strong competitive policies and measures in order to promote private domestic investment for positive economic growth in sub-Saharan Africa countries.*

KEYWORDS: Doing Business, Domestic Investment, Economic Growth, Investment Climate, Transaction Cost

INTRODUCTION

The importance of investment climate for the development and growth of economies cannot be overemphasised. Improving the investment climate gives opportunities and encourages firms to invest productively, create jobs, and lay the foundation for long term business success (World Bank, 2005). These advantages are crucial to enhancing sustainable progress in tackling poverty and improving living standards. Both across and within countries, investment climate influences different decisions of all types of firms. Economic growth is the ultimate objective of macroeconomic policy. The importance of entrepreneurship and domestic private investment for achieving economic growth in present day economies is widely recognized, both by policy makers and economists. Investment is a crucial determinant to establish the basis for the trajectory of growth of the economy. Thus, economies with higher rates of investment double growth. Whereas, economies with low investment rate are observed to grow at a slow pace (Ali, 2013).

Domestic private investment is one of the most important drivers of job creation and economic growth. Despite its importance, domestic private investment is not generally actively encouraged in most developing countries through dedicated policy initiatives. Therefore, a proactive role of governments in supporting and generating better investment climate for entrepreneurship and private investment is an imperative for improved growth (United Nation Conference on Trade and Development, 2012). Bah and Fang, (2010) observed that Africa is by far the poorest region of the world, because only a few African countries have experienced good economic development outcomes. This is as a result of failure to develop sound policies in many African countries particularly, in sub-Saharan Africa countries which were poorly

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ranked by most dimensions of investment climate crucial for long term business success. Doing business is challenging in a large number of countries across the African continent. Investors face difficulties in starting a business, getting requisite licenses, registering property, obtaining credit, protecting investments and enforcing contracts.

The unfavourable investment climate in many African states results from poor governance; institutional failures; macroeconomic policy imperfections; inadequate infrastructure; rampant corruption; bureaucratic red tape; weak legal systems and lack of transparency in government departments. These and other factors have made it difficult for the continent to attract foreign capital and mobilise adequate and sustained levels of domestic private investment needed to attain the levels of growth necessary for poverty reduction. World Bank (2012) noted that around 200 million people are currently unemployed, and 600 million jobs need to be created by 2020 mainly in developing countries. A number of those jobs are expected to be generated in the micro, small, and medium enterprise (MSME) sector given its high labour intensity.

The absence of enabling investment climate is one of the factors behind a repressed private sector in sub- Saharan Africa (SSA). Table 1 shows that most of the SSA economies were ranked low compared to other economies. Raising competitiveness through improving the investment climate is thus a top policy priority in Africa (Yang, 2014). Investment climate otherwise known as business climate is the set of locating specific factors shaping the opportunities and incentives for firms to invest productively, create jobs, and expand (World Bank, 2005). It consists of the institutions and policies that affect firm entry, survival, growth and exit. World Bank (2005) described investment climate as access to basic physical infrastructure such as electricity, telephone, water and roads; access to information and advisory services; higher labour productivity; efficient tax administration and tax rates; access to finance; availability and affordability of urban land; business regulations and trade facilitation services, among other elements. The environment in which an enterprise operates influences its performance. Engagement in entrepreneurship and successful innovation do not only rely on the characteristics of the firm but also on an investment climate that encourages businesses to flourish. A poor investment climate obstructs firms from bringing ideas to the market and hurts innovation and growth, (Pagés, 2010).

Table 1. Ease of doing Business World Economies Ranking

Sub-Sahara Africa		**Europe &Central Asia**		**South Asia& Pacific**		**Latin America& Caribbean**	
Mauritius	25	Geogia	9	Singapore	2	Mexico	49
Zimbabwe	159	Romania	45	Malaysia	24	St Lucia	91
Liberia	172	Cyprus	54	Vietnam	68	Paraguay	108
South Sudan	187	Turkey	60	Indonesia	72	Brazil	125
Somalia	190	Ukraine	76	Cambodia	135	Bolivia	152

Source: World Bank Ease of Doing Business Ranking 2017

In the current global economic climate, growth remains a key government priority of any country. The literature on economic growth has turned to the effects of country's political, legal, economic and social institutions on wealth and long-term growth (Dollar & Kraay (2003), Rodrik, Arvind & Trebbi (2002), Acemoglu, Simon & Robinson, (2001), Easterly & Levine (1997), Knack & Keefer (1995), Mauro (1995)). It is obvious that countries with better institutions grow faster (Messaouda, & Tehenib, 2014). Development organisations are increasingly seeing private sector development as the solution to many of Africa's problems

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(Commission on Growth and Development, 2008; World Bank, 2005). That is, promoting a vibrant private sector is at the heart of the development agenda. Many developing countries have come to the conclusion that jobs and prosperity are best created by unleashing the potentials of the private sector which depend on a vibrant investment climate.

Various researchers (Bah & Fang, 2010; Straub, Vellutini & Warlters , 2008; Aterido, Hallward-Driemeier & Pagés, 2007; Collier, 2000) have investigated the impact of investment climate on output, productivity, economic growth and firms' performance using different measures, at country level and firm level. They showed different results. For example, Bah & Fang (2010) applied the aggregation of a set of obstacles to investment climate as a tax on production and used a general equilibrium model to measure its impact on output and productivity of sub-Saharan African firms. Their results showed that poor business environment accounted for about 80% of the difference in income per capita between the US and the thirty African countries in the sample. Similarly, Straub, Vellutini & Warlters (2008) found some evidence of a positive effect of infrastructure on growth, especially in poorer countries. In a related vein, Aterido, *et al*. (2007) used employment growth as the dependent variable, regressed it on a large number of control and objective investment climate variables; the analysis was based on a sample of 80 Enterprise Surveys. They found a significantly negative effect of power outages (infrastructure) on employment growth for medium sized firms. Collier (2000) emphasised that a poor business environment leads to high transaction costs affecting mostly manufacturing firms in Africa.

It can be concluded that there is no consensus on the relationship between components of investment climate and economic growth; and there is no agreement on which of the investment climate components has a greater significant effect on economic performance. The lack of consensus on the relationship between investment climate and economic growth from extant literature may imply that investment climate does not a have direct effect on economic growth but is transmitted through an intervening variable like domestic private investment. Hence, this paper aims at filling this gap in knowledge primarily by examining the relationship among investment climate, domestic private investment and economic growth in forty-four sub-Saharan Africa countries using eight investment climate variables and some other control variables. This paper will also highlight possible policy interventions for smooth operations of business enterprises in sub-Sahara Africa. The econometric estimation method employed in this study is panel analysis since the study is based on cross country analysis and the theoretical framework adopted in this paper is rooted in the new institutional economics of transaction cost theory which is also known as transaction cost economics developed by Ronald Coase (1960) and Oliver Williamson (1975).

LITERATURE REVIEW

Theoretical Framework

The theoretical framework adopted in this study is grounded in the new institutional economics of transaction cost theory or transaction cost economics developed by Ronald Coase (1960) and Oliver Williamson (1975). The theoretical literature identifies differences in institutions as one of the key sources of differences in cross country income and growth rates. Parente & Prescott (1994) argued that institutional barriers increase the cost of technology adoption and hence reduce long-term income per capita. According to transaction cost theory, firms seek to

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expand in a cost effective manner to ensure profitability (Williamson, 1975). A key challenge to transaction efficiencies is uncertainty about the future of the firm's environment. Uncertainty increases the firm's transaction costs, especially with regard to search, information processing, and adaptation. A particular source of uncertainty in the markets is that associated with political uncertainty (Sashi & Karuppur, 2002). Changes in industrial policy or business regulations pose risks that may increase the costs of doing business, and thereby restrict investment. Economic growth is viewed as a positive feature that makes both the foreign and domestic market attractive for firms in general (Hoffman, Munemo & Waston 2014). Economic uncertainty is the result of adverse economic events such as higher interest rates, inflation, and changes in aggregate demand (Sashi & Karuppur, 2002). The impact of transaction costs on investments has been a subject of inquiry, Whited (1992), Schaller (1993), Faroque & Ton-That (1995) and Rodrik (2008). In general, these authors associate the presence of transaction costs with a negative effect on investment level in certain specific industries in different countries. They also argue that market imperfection have a negative effect on investments. Countries that have high levels of transaction costs therefore tend to have restrictions in their credit markets, and consequently have low investment rates and in turn low economic growth.

Empirical Review

The common underlying assumption from the literature is that countries and firms facing 'better' investment climate can be expected to perform better. Djankov, Caralee & Ramalho (2006) showed that a better investment climate fosters economic growth. Most studies used one or two sets of component of investment climate for their study. For example, Dinh, Dimitris, & Nguyen (2012) observed that access to finance is the most significant constraint on firm growth and that it appears to be most important for small enterprises that are most excluded from financial markets. In contrast, Harrison & Colin (2011) did not find any correlation between access to formal credit or trade credit and their measures of sales and employment growth for either small or large firms. They did, however, find that access to finance is associated with other measures of firm performance. Some results appear to be more common than others although there is probably no variable that is consistently significant or insignificant in all studies. Infrastructure in general is often positively associated with measures of economic growth and firm performance, but some authors find it to be negatively related to economic and firm performance (Straub, Vellutini & Warlters (2008) and Aterido *et al.* (2007). There is less evidence that corruption is significantly associated with firm performance although Fisman and Svensson, (2007) found a negative correlation between corruption and firm growth; other studies did not find similar results. Although fewer studies examined at the effect of regulations, some studies have found that burdensome regulations and labour regulation in particular is associated with slower firm growth. Botero, Djankov, Porter, Lopes-De-Silanes and Shleifer (2004); Heckman and Pagés (2004) employed labour regulations in Latin America and the Caribbean, while regulation of entry was used by Djankov, Porta, Lopez-de-Silanes, & Shleifer (2002).

Marek (2012), in his paper titled 'the doing business indicators, economic growth and regulatory reform on 175 countries between 2003- 2009', found that indicators related to cost have the largest potential for fostering growth. Youssoupha (2013) also reported that poor business environment has a sizeable negative impact on output and investment in his study. Using correlation analysis to investigate the effect of business environment in 8 regions in South Asia (2000-2010), Wendy & Mark (2012) observed that higher productivity and better-performing firms in the region, and in particular firms that recently expanded their employment

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and created jobs, reported significantly higher constraints in terms of the supply of public inputs. Gérard (2014)'s study on private capital and investment climate for economic growth showed that in the short-run there is a significant relationship between private capital, economic freedom and economic growth in Cameroon, in Côte d'Ivoire, in South Africa and in Zambia. Furthermore, a long run relationship exists between the variables. Messaouda and Tehenib, (2014) used two stage least regression on 162 countries (2007 -2011) and found that there was a link between regulation indices and economic growth except trading across borders and dealing with construction permits indices.

Although most studies find that some investment climate constraints affect economic growth and firm performance, there is considerably no consensus on which investment climate component or area is the most important to economic growth and firm performance. This is true even though most of the studies use the same sources of data for instance, from the same Enterprise Surveys or Doing Business data and even when studies are focusing on the same measures of economic performance and firm performance, their findings tend to be dissimilar. That is, different studies find different variables to be the most important, and the reasons for these differences are not always clear.

METHODOLOGY

Sources of Data

Data were obtained from Doing Business Indicator Data (DBI) for 2004 -2015 and World Development Indicator data (WDI) (2015). The Doing Business data started from 2004 for all the countries used for this study. Based on the availability of data, the sample selected consists of 44 sub-Saharan Africa countries (table 1). Annual percentage growth rate of gross domestic product and gross capital formation which are used as proxy for private investment, inflation rate and trade, were sourced from the WDI (2015). The World Bank Doing Business survey compiles ten sets of indicators covering various aspects of the business climate including starting a business, paying taxes, dealing with construction permits, getting credit, protecting investors, international trade, registration of business, closing a business and enforcement of contracts.

Table 2. Countries in the sample

Angola	Djibouti	Liberia	Senegal
Benin	Equatorial Guinea	Madagascar	Seychelles
Botswana	Eritrea	Malawi	Sierra Leone
Burkina Faso	Ethiopia	Mali	South Africa
Burundi	Gabon	Mauritania	Sudan
Cameroon	The Gambia	Mozambique	Swaziland
Cape Verde	Ghana	Namibia	Tanzania
Chad	Guinea	Niger	Togo
Comoros	Guinea Bissau	Nigeria	Uganda
Congo (Democratic Republic)	Kenya	Rwanda	Zambia
Cote d'Ivoire	Lesotho	Sao Tome and Principe	Zimbabwe

Source: Authors' compilation

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Estimation Techniques

The System Generalised Method of Moments (System-GMM) estimators of panel data developed by Arellano & Bover (1995) and Blundell & Bond (1998) was used for the analysis technique in this paper for two reasons. First, it enables us to control for unobserved country specific effects. Second, some of the variables included in the equation are likely to be endogenous and jointly determined with the dependent variable. The most likely sources of bias in cross-sectional econometrics is the heterogeneity bias arising from unobserved heterogeneity related to both *y* and *x*. Two specification tests will be conducted to address the consistency of System-GMM estimator, which mainly depends on the validity of the instruments. The first is a serial correlation test, which tests the null hypothesis of no first-order serial correlation and no second-order serial correlation in the residuals in the first-differenced equation. The second is Sargan test of over identifying restrictions that examines the overall validity of the instruments.

The model of panel data is given by:

$$Y_{it} = X'_{it}\beta + \varepsilon_{it} \qquad (1)$$

i = 1,2……..44

t = 1, 2……..12

Where Y is the regressor and X' is a vector of K regressors and β is the vector of coefficients to be estimated; i is the number of cross sectional series in the model and t is a particular time period; ε is the stochastic disturbance.

Model Specification

The model for the study was based on the dynamic behaviour of the economy described by the neoclassical production function. The Solow (1956) and Swan (1956) theories of economic growth, which commonly represent the neoclassical model are based on an aggregate production function and capital accumulation. The neoclassical production function can be expressed as:

$$Y = f(K) \qquad (2)$$

We incorporate investment climate variable which represent transaction costs and private domestic investment into neoclassical production function to get:

$$GDPG = f(PDINVT, IC, TRAD, INF) \qquad (3)$$

Where: GDPG= Gross domestic product growth per annum; PDINVT= Domestic private investment; IC = Investment climate variables which are: STAR= Starting a business, ELEC = infrastructure (Getting electricity), CRED= Access to credit, REGB= Registering a business, OBTCP= Dealing with construction permits, ENFCON= Enforcing contract, TAX= Tax rate, and INSLV= Closing of business; TRD= Trade; INF= inflation

From equation (3.3), using GMM, the models can be estimated as follows:

The multivariate specification is as follows:

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$$GDPG_{it} = \beta_i + \beta_1 Lnpdinvt + \beta_2 Lnic + \beta_3 Lntrad_{it} + \beta_{14} inf_{it} + \varepsilon_{it} \quad (4)$$

RESULTS AND DISCUSSION

Results from estimating equation (4) are reported in table 3. The table report the results including each of the investment climate indices separately. The specifications in table 3 how that there is no second order serial autocorrelation in the differenced residuals thus the disturbance terms are not serially correlated as indicated by the p-values 0.147 for AR (2); this confirms the consistency of the coefficients. The test of over-identifying restrictions, Sargan test result indicates that the null hypothesis that the error term is uncorrelated with the instruments is not rejected since the p-value is greater than the 5% level of significance. The validity of the instrumental variables of the regression is therefore confirmed and the model is correctly specified. Also, the F- statistics is highly significant. Thus, the results are reliable and consistent.

Table 3. Effects of investment climate and domestic investment on economic growth

Independent Variables	Coefficient	t- Statistics	Probability
Logpdinvt	3.741	3.49	0.001
Logstar	1.500	4.03	0.000
Logelec	-0.941	-2.15	0.033
Logcred	0.912	1.31	0.192
Logregb	-0.733	-1.67	0.097
Logobtcp	0.208	0.91	0.366
Logenfcon	0.926	1.91	0.058
Loginsolv	2.617	3.90	0.000
Logtax	-2.158	-4.13	0.000
Logtrad	2.597	2.47	0.015
Infl	-0.018	-0.72	0.473
Constant = -18.79894 f- Statistics = 4.85(0.000)*** Huasman test = 12.22(0.3472) Panel (hetero) test = 183.46(0.000)*** Number of instruments: Arellano-Bond AR(1) test p-value = -2.60 (0.009)*** Arellano-Bond AR(2) test p-value = -1.45 (0.147)* Sargan test = 60.85(0.002)***			

Source: Authors' computation

The p- value is significant at * ,**, and *** represent 10%, 5% and 1% level significant respectively

The coefficient of domestic private investment (PDINVT) is positive and statistically significant with the p-value less than 5% level of significance. It is an indication that private domestic investment will positively affect economic growth in SSA. This result is consistent with the previous findings that established positive relationship between private domestic investment and economic growth (Kalu, and Mgbemena, 2015, Adam, 2009).

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Most investment climate indices which connote business regulations, have the expected signs and are related to growth rate except getting electricity which was used as a proxy for infrastructure, registering a business and tax indices that have a negative and not statically significant impact on growth, (Table 2). We may explain the negative effect of getting electricity and registering a business indices on growth as an indication that most sub- Saharan Africa countries have low rank in easy of doing business indicator (see table 3). There is evidence in the literature that infrastructure contributes significantly to economic growth. The literature established a robust relationship between infrastructure investment and economic growth (World Bank (2004); OECD (2006); Calderón (2009)). But this paper shows a negative effect of infrastructural (getting electricity) on economic growth though the variation is minute. This result is in line with the finding of Escribano, Guasch and Pena (2010), Straub *et al*. (2008) and Aterido *et al.*(2007) who found that infrastructure has a low and negative impact on Total Factor Productivity (TFP), economic growth and firm performance. This is contrary to the general belief that infrastructure is often positively associated with measures of economic growth and firm performance. This reveals the poor state of electricity provision in most sub-Sahara African countries will negatively affect firm performance and economic growth.

There is strong cross country evidence in the literature that weak institutions adversely affect growth. Dollar and Kraay (2003) stated that improvements in the quality of institutions have a positive effect on long term growth. Taxation is necessary to finance public goods and re-distribute income; the process through which a government collects taxes can cause substantial costs in terms of growth. Lee and Gordon (2005) analysed the effect of statutory corporate tax on the growth rate of GDP and found that a reduction in the corporate tax rate of 10 % increases growth rate by 1-2 %. Similarly, Romer and Romer (2007) found that tax increases are highly contractionary, particularly due to the negative effect of tax increases on investment. High tax rate will discourage investment as it will increase transaction costs and reduce firm's profit. On the other hand, inflation rate which is used as a proxy for macroeconomic instability has a negative effect on growth and it is not statistically significant with the p-value greater than 5% level of significance. This finding corroborated other empirical results which established that inflation has a negative impact on economic growth (Kasidi and Mwakanemela, 2013). In addition, the coefficient of trade is positive and statistically significant with the p-value less than 5% level of significance and this implies that an increase in trade will increase economic growth.

Implication to Research and Practice

The importance of investment climate for the development and growth of economies cannot be overemphasised. Improving the investment climate gives opportunities and encourages firms to invest productively, create jobs, and lay the foundation for long term business success (World Bank, 2005). All of these are crucial to enhancing sustainable progress in tackling poverty and improving living standards. Both across and within countries, investment climate influences different decisions of all types of firms. Thus, the main contribution of this research is the establishment of empirical evidence that complements the body of existing literature on the effect of investment climate and domestic private investment on economic growth in SSA.

Our findings draw some implications for economic policy. It suggests that reforms which improve investment climate can help SSA to grow faster. That is, reform programmes should stimulate firms to change their behaviour, to enhance investment and to encourage innovation. In addition, there is need to ensure a functioning and enduring investment climate, captured by

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a strong competitive policy, in order to encourage private investment for positive economic growth in SSA countries.

CONCLUSIONS

Economic growth is the ultimate objective of macroeconomic policy. Investment is an essential determinant of growth of the economy. Economies with higher rates of investment grow faster unlike those with low investment rate. The effect of investment climate on economic growth has become topical. The lack of consensus in regard to the relationship between investment climate and economic growth instigated this paper. The findings of the study showed that unfavourable investment climate will negatively affect private investment and then economic growth. The results shows that registering a business, infrastructural and tax were the major constraint to investment and then economic growth as they increased transaction costs. According to transaction cost theory, a firm seeks to expand in a cost effective manner to ensure profitability. Strict business regulations increase firms' transaction costs and the cost of doing business, thus restricting investment and economic growth. The effectiveness of good institutional policy can be linked to increases in investment. Private domestic investment is one of the most important drivers of job creation and economic growth. Despite its importance, domestic private investment is not actively encouraged in most SSA countries through dedicated policy. A proactive role of government in encouraging and generating better investment climate for private investment is therefore required. Improving the quality of SSA's infrastructure is a crucial step toward meeting the goals of continuous growth and poverty reduction. Infrastructure quality has a persistence influence on all areas of an economy. Low quality infrastructure services increases business costs. Likewise, higher rates of tax can reduce business entry and the growth of existing firms. To minimise this, governments can simplify their tax codes thereby make it easier to pay taxes and can also introducing tax incentives.

Future Research

This study considered a selected sample of SSA countries. Incorporating foreign direct investment into the model will be an improvement on the current study as the model used in this study only considered private domestic investment. Investment climate variables will affect both foreign direct investment and private domestic investment which make up the total investment of any given economy. The study did not discuss the reforms necessary for favourable investment climate which might have been employed by some of these SSA countries. Further research is needed to investigate and discuss some of the reforms necessary for favourable investment climate that has been employed or need to be employed by some of these SSA countries.

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