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Does Foreign Direct Investment Reduce Poverty in Africa and are There Regional Differences?

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Summary. — This paper re-examines the relationship between foreign direct investment (FDI) inflows and welfare (or poverty reduction) in Africa. Using FDI net inflows *per capita* and the United Nations Development Program's Human Development Index as the principal variables, our analyses confirm the positive and strongly significant relationship between FDI net inflows and poverty reduction in Africa but find significant differences among African regions. We also find that FDI has a greater impact on welfare in poorer countries than it does in wealthier countries. For instance, while the relationship between FDI and poverty reduction is positive and significant for economic communities in Central and East Africa, it is non-significant in Northern and Southern Africa. Furthermore, the relationship was found to be ambiguous in West Africa. Our results are robust to many model specifications.
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Key words — Africa, FDI, foreign direct investment, economic growth, poverty reduction, regional integration, welfare

1. INTRODUCTION

The United Nations' Millennium Declaration of 2000 outlines eight Millennium Development Goals (MDGs) for 2015. [1] All eight aim to accelerate human development and reduce poverty in developing nations. Unfortunately, at present, most African countries are off-track with respect to meeting these goals. To redress the situation, significant amounts of capital investments are required. An important source of capital investments is foreign direct investment (FDI). In most African countries, the private sector is recognized as a principal driver of growth. Hence, FDI is critical to achieving the MDGs. As the financial and economic crises have persisted, however, most developed countries have begun to design economic and fiscal policies to keep capital at home, thus putting the MDGs in even greater jeopardy. [2] Because of their development levels, African countries need continuous foreign investments to stimulate their economies and trigger reductions in poverty. Over recent decades, FDI to Africa has increased both in terms of average net inflows of FDI *per capita* and as a proportion of the gross domestic product (GDP) (United Nations Conference on Trade, 2010b). At the same time, real *per capita* GDP as well as the Human Development Index (HDI) [3] has been improving (United Nations Development Programme (UNDP), 2010). More FDI, thus, appears to be linked to better welfare [4] or less poverty.

The literature is rich in studies analyzing the causal relationship between FDI and economic growth (e.g., Alfaro, 2003; Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004; Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2010; Apergis, Lyroudia, & Vamvakidis, 2008; Carkovic & Levine, 2005; Chowdhury and Mavrotas; Hansen & Rand, 2006). These studies analyze the overall impact of FDI on economic growth, assuming a perfect positive correlation between economic growth and welfare. However, this assumption has been questioned (e.g., Anand & Sen, 2000). Indeed, economic growth with inequality may maintain or increase the level of poverty in a country. More specifically, even if economic growth has been found to be necessary in improving well-being, economic growth that is not pro-poor (i.e., not redistributive) may create inequality and may actually negatively impact welfare (Ravallion, 2007).

At the same time, the literature has been limited due to the difficulty in measuring welfare and economic development. Two popular indicators in this area are GDP *per capita*

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and poverty incidence.[5] The former is widely used and is available for all countries on an annual basis though it only measures one dimension of development. The latter is a good measure of overall well-being, but the data are not available for all countries. Even where the data are available, not all countries use the same measurement indicators. Over the last three decades, the United Nations Development Program's (UNDP) HDI has become (almost) the universally accepted measure of human development. At present, HDI is readily available for all countries. Nonetheless, the few researchers who have used HDI to analyze FDI's direct impact on welfare have focused on Asia or on low- and middle-income countries (Sharma & Gani, 2004). To our knowledge, no study using HDI has been carried out for African countries.

Finally, several studies have shown economic integration to be important in attracting FDI. Asiedu (2006), for example, finds that the size of a country's market as measured by GDP is a key determinant of FDI inflows. The majority of African countries have relatively small markets. To overcome this limitation, most multilateral and bilateral development agencies promote regional integration as a means of attracting FDI and, thereby, improving growth and reducing poverty (UNCTAD, 2010a; UNECA, 2010).

This paper studies the relationship between FDI net inflows and poverty reduction in Africa, especially in Africa's regional economic communities (RECs). We explore two research questions: (1) does FDI reduce poverty in Africa? and (2) does FDI reduce poverty more in some African regions than in others?

We consider five RECs: the Arab Maghreb Union (AMU), the Economic Community of Central African States (ECCAS), the Economic Community of West African States (ECOWAS), the Intergovernmental Authority for Development (IGAD), and the Southern African Development Community (SADC). We also consider five customs and monetary unions: the Economic and Monetary Community of Central Africa (CEMAC), the East African Community (EAC), the Southern African Customs Union (SACU), the West African Economic and Monetary Union (WAEMU), and the embryonic West African Monetary Zone (WAMZ).

Insofar as capturing levels of human development is concerned, we use HDI as our key welfare or poverty-reduction indicator. As a check and to ensure robustness, we also use an alternate welfare measure common to the literature, real GDP *per capita.* To measure FDI, we use net *per capita* inflows of FDI. Our alternative measure is the ratio of total FDI net inflows over GDP and the ratio of total FDI net inflows over gross capital formation (GCF).

This paper's contribution to the literature is twofold. First, we believe this study to be the first to analyze the extent to which FDI reduces poverty in Africa. Second, our study analyzes how membership in an REC impacts the ability of FDI to reduce poverty. Using the Granger causality Wald test, our analyses find a positive causal relationship between FDI and welfare in Africa. Moreover, our panel and cross-sectional regression analyses indicate that FDI impacts welfare positively and significantly in Africa and that the relationship is robust to different model specifications. However, FDI's impact on welfare differs between African regions. For instance, in Central and East African RECs (CEMAC, EAC, ECCAS, and IGAD), FDI impacts welfare positively and significantly, whereas in Southern and Northern African RECs (AMU, SACU, and SADC), the impact of FDI on welfare is not significant and in West Africa (ECOWAS), it is ambiguous; that is, its impact is negative and non-significant in the WAEMU region and is positive and non-significant in the WAMZ region.

This paper is organized as follows. Section 2 reviews the literature on the relationship between FDI and economic growth and between FDI and welfare. Section 3 discusses our methodology and describes our variables and our sample of countries and regions. Section 4 presents the empirical results of our analysis of the relationship between FDI and welfare in Africa and Africa's RECs. Section 5 concludes and formulates policy recommendations.

2. REVIEW OF THE LITERATURE ON FDI AND WELFARE

Numerous studies have analyzed the relationship between FDI and economic growth to determine the extent, if any, to which FDI impacts economic development. The assumption common to these studies is that economic growth improves welfare. Overall, conclusions have been mixed, but most research find that FDI stimulates economic growth. The differences in the findings could arise from a number of methodological and conceptual factors, such as the lack of a comprehensive, harmonized dataset, different definitions of FDI, and different econometric specifications.

This section begins by reviewing the theory on the transmission mechanisms between FDI and welfare. It then discusses the causality between FDI and economic growth and reviews recent findings in that regard. Finally, it presents the main findings on the link between the degree of development of a country's financial market and the impact of FDI.

(a) *Theoretical arguments: the link between FDI and welfare*

Since World War II (WWII), two trends have characterized the evolution of FDI in developing countries. First, from the end of WWII to the end of the Cold War in the 1990s, FDI flows and stocks increased around the world, especially in developing countries. During this period, FDI flows were mainly driven by political rather than by economic motives. Second, since the 1990s, FDIs have been concentrated in countries that offer fiscal benefits, subsidies, and other incentives.

The impact of FDI on human development can be analyzed from at least two viewpoints. On the social side, reducing poverty and improving welfare are the priorities of the governments of developing countries. Foreign investment can help achieve these goals because investments create jobs, develop local skills, and stimulate technological progress. On the economic side, recent literature on endogenous growth suggests that human capital may be the principal contributor to self-sustained growth in GDP *per capita*.[6] One of the main contributors to human capital is human development. It is, then, of prime interest to assess how FDI impacts human development.

FDI can impact welfare through both direct and indirect channels.[7] A direct channel consists of spillovers to the private sector (backward and forward linkages). Spillovers can take place if FDI creates positive vertical spillover effects with local suppliers (backward linkages) through local sourcing and firms (forward linkages). FDI may also create positive horizontal spillovers by promoting and enhancing competition and causing new technologies to be implemented. In addition to these positive spillovers to local firms, FDI can impact welfare directly by creating jobs for new workers. For this channel to be efficient, the number of jobs created must be greater than the number of jobs lost as a result of FDI-related activities—layoffs pursuant to mergers and acquisitions, the closing of local firms, *etc.* FDI in a labor-intensive, pro-poor sector such as agriculture is, thus, likely to have the greatest impact on welfare.

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