**Foreign Direct Investment and Poverty Reduction**

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**ABSTRACT**

*This paper investigates the extent to which two-way trade and investment between the United States and Africa meet the Sustainable Development Goals. The US government announced the “Prosper Africa” initiative in June 2018 to advance mutually beneficial trade and commercial ties between the United States and countries across the African continent, with the bold goal to double trade and investment. Despite the debate about the extent trade openness benefits poor people in developing countries, the literature has been slow to address the impact of Foreign Direct Investment (FDI) and associated changes in relative factor prices. Using a panel of trade, investment, and poverty data, this paper will identify the extent to which FDI flows from the United States to African nations, as well as the reverse, impact key SDG targets.*

Key words: International Business, Foreign Aid, International Agreements, Poverty Analysis

JEL Classification: F23, F35, F53, I32

**Abstract**

This paper investigates the extent to which two-way trade and investment between the United States and Africa meet the Sustainable Development Goal. The US government announced the “Prosper Africa” initiative in June 2018 to advance mutually beneficial trade and commercial ties between the United States and countries across the African continent, with the bold goal to double trade and investment. Despite the debate about the extent trade openness benefits poor people in developing countries, the literature has been slow to address the impact of Foreign Direct Investment (FDI) and associated changes in relative factor prices. Using a panel of trade, investment, and poverty data, this paper will identify the extent to which FDI flows from the United States to Africa, as well as the reverse, impact key SDG targets.

1. **Introduction on FDI and Poverty**

A number of sources suggests that the relationship between investments in FDI and poverty reduction is not straightforward. This research posits that if FDI is to reduce poverty, efforts are needed to protect and include vulnerable groups while increasing their productivity, competitiveness and capacity to capture the gains of trade. Ravallion (2006) argues that while growth is necessary for poverty reduction, it is insufficient.[[2]](#footnote-1)

The Prosper Africa initiative seeks to increase mutually beneficial economic growth between Africa and the United States by substantially increasing two-way trade and investment. The proposed objectives address investment de-risking, deepening market analysis, and removing policy, regulatory, and logistical trade barriers in Africa.

Africa’s population is expected to grow from 1.2 billion in 2015 to 1.7 billion by 2030, with expended spending increasing from $4 trillion to $6.6 trillion. Over 80 percent of this population growth is expected in cities. Economic growth across the sub-continent averaged 5.8 percent from 2004 to 2004, but has not created quality jobs. Per OECD (2018), vulnerable employment will not increase from 66% by 2022. The U.S. government is making the bet that increasing trade and investment will help break this vulnerability. The U.S. government has initiated this work because its trade relationship with sub-Saharan Africa has been declining, while China’s trade now surpasses the United State in trading with Africa and may soon surpass it in foreign direct investment. with its public and private investment falling behind China.

Van Tulder and Van Zanten (2018) use the 2015 SDGs as a framework for perspectives on multinational enterprises, as they represent a UN agreement to unlock $12 trillion in business opportunities. They found that the nature of frontrunner MNEs’ initial engagement with the SDGs, the targets supporting SDG 16 (peace, justice and institutions) received the highest scores, showing that companies acknowledge that they cannot do business in a failing society. But they mainly envisaged their contribution to this SDG through internal, governance-oriented policies. Indeed, most of the targets that MNEs actively engage with can be implemented throughout their (valuechain) operations, such as reducing pollution. More importantly, companies currently focus primarily on SDG sub-targets that “avoid harm.” For “doing good” targets, such as providing public goods like infrastructure, multi-stakeholder partnerships are critical, yet MNEs’ engagement is low. Amongst the MNEs studied, European MNEs engage with substantially more SDG targets, making them more supportive for the SDGs’ integrative ambitions. MNEs in industries with greater negative social and environmental externalities are more involved with SDG targets that help them avoid doing harm

1. **Literature Review**

TBD. Would be nice to have on hand a junior partner to maybe run the lit review. I’ll ask around DC. It’s also useful for us to write them up, I have notes on the papers we’ve been sharing, if you want to also start typing them in, we’d have a rough draft.

1. **Trends in development aid and FDI in Africa**

*Here, to update some of the work from my 2013 paper. I’ll copy in some of the work from there, as the basis. Shouldn’t be more than a half-days work to make the figures and write them up.*

Throughout the latter half of the twentieth century, Africa lagged the rest of the world with regard to the creation or receipt of private investment, capital formation, and global FDI flows. For its primary source of external capital, Africa relied on development aid, usually in the form of concessionary loans. In an empirical analysis, Nicholson (2012) identifies sub-Saharan Africa as an “AID-oriented region” in which aid flows continue to dominate private investment flows.[[3]](#footnote-2) As Figure 5 shows, the African share of FDI in developing countries was more than 50 percent in the 1970’s, reaching a peak of 59 percent in 1972, but slipped below 10 percent by the 1990s; meanwhile, Africa’s share of development aid has reached around 40 percent.[[4]](#footnote-3)

*Figure 5: Trends in development aid and FDI in Africa*

Asiedu (2002) investigates the “Africa effect” in which the explanatory factors for FDI in developing countries may not have similar force in sub-Saharan Africa. Using data for the years 1988 to 1997, she finds that determinants of FDI such as return on investment and infrastructure have positive impacts in developing countries outside of Africa but have no statistically valid impact in sub-Saharan African countries.[[5]](#footnote-4) In addition, she finds that “openness to trade”, as defined by the ratio of total trade to GDP, promotes FDI in all developing countries but has a significantly smaller marginal impact in sub-Saharan Africa. She concludes that, on this metric, Africa is different and suggests that effective policies elsewhere may not be effective here. Asiedu explains the lack of explanatory power of return on investment as due to a reputation effect across the continent, including risk of investment, lack of information, and the risk of policy reversal. The openness-to-trade indicator may be less effective in Africa due to the debt cycle story, and infrastructure could be related to resource-based FDI in Africa. Collier (2007) suggests that a potential issue for investment in Africa may have been the “time-consistency” problem, in that present governments are unable to bind themselves from confiscating investments in the future which then diminishes investment. This dynamic, however, may have changed based on a structural policy reform of the 2000s.

Anyanwu (2012) finds in an analysis of FDI from 1996 to 1998 that FDI flows to African countries are positively associated with market size, openness, rule of law, clusters, and natural resources. He also found that FDI is negatively correlated with higher financial development in Africa, and that “higher FDI goes where foreign aid goes.” He argues that foreign aid affects FDI through a “positive vanguard effect”, by lowering perceptions of investment risks and cultivating donor-specific norms, while also improving social and physical infrastructure.

In sub-Saharan Africa, incoming FDI increased from US$6.7 billion in 2000 to US$25.7 billion in 2010. With these trends, foreign investment has become a much more significant source of capital for investment in African countries and in 2009 accounted for 18 percent of their gross fixed capital formation.[[6]](#footnote-5) The catalyst for the change in investment flows could be a number of factors, including debt relief or other types of development aid. We reassess these statistics under the hypothesis that the debt relief programs represent a potential structural break in the African investment climate. The programs themselves may be representative of a broader geo-political shift in Africa: a post-war and post-debt climate of development.

A conclusion to be drawn is that there is no statistical difference for HIPC countries in Africa compared to HIPC countries outside of Africa. To the extent that African countries have historically offered different incentives for FDI and other market-based activities, these differences appear to have arisen because countries in Africa have skewed towards being heavily-indebted and poor. One story is that when it comes to debt and FDI, Guinea is more like Guyana than like Botswana. Debt relief is a story about Africa only because most debt relief took place in Africa. An implication is that following the debt relief initiatives, we can anticipate that FDI will flow to Africa by similar mechanisms as in other regions. If the continent is “open for business”, the ability for countries to again engage in public financing to improve market conditions should be anticipated as a positive turn of events.

One future direction will analyze FDI by sector, specifically disaggregating the flows to account for extractive industries. As foreign investment in Africa has traditionally been focused on natural resources, further indications that the market potential of the region has shifted in the past decade will be indicated by the mix of investment opportunities. This line of research would also benefit from a stronger measure of infrastructure that accounts for roads, electricity, and internet access.

Our identification strategy is based on the natural experiment presented by the HIPC debt relief program of the 2000s, by creating control groups of “non-HIPC countries in Africa” and “HIPC countries outside of Africa.” These two comparison sets of longitudinal panel data allow us to identify the specific impacts of HIPC while isolating pan-African geo-economic and –political trends. The identifying assumption is simply that HIPC debt relief initiatives affected only those countries that received debt relief, with all other differences among countries captured by either geography, fixed effects, or other relevant controls. By including both non-HIPC countries in Africa and HIPC countries outside of Africa we obtain sufficient heterogeneity to capture the impact of the policies.

To this point, we engaged in three different tests, outlined in Table 1.

*Table 1: Different Tests*

|  |  |  |
| --- | --- | --- |
| Research Question | Econometric Method | Result |
| Did something happen in Africa? | Clemente, Montañes, and Reyes (1998) | * Solves for global max in t-stat to identify “optimal” structural break over time |
| Did it affect the determinants of FDI? | Elliot and Müller (2006) | * Analysis of parameter stability of coefficients |
| Was it a result of debt relief? | Natural Experiment around an Event Study | * Control vs. HIPC shows whether the effects were due to HIPC or not * Control vs. Africa shows whether the effects were African-centric or not * Control vs. “Event” shows whether the effects were due to debt relief, or to a “proxy plus” |

We collected data on debt, gross capital formation, and FDI from the World Development Indicators on 42 sub-Saharan African countries from 1970 to 2010 to test this proposition.[[7]](#footnote-6) Table 2 describes the data used in the analysis with summary statistics presented in the appendix using determinants suggested by Anwanyu (2012).

*Table 2: Data Description*

|  |  |
| --- | --- |
| Variable | Definition |
| FDIflows | Foreign direct investment, net inflows |
| UrbPop | Urban Population (percent of total) |
| GDPpc | GDP per capita (constant 2000 $) |
| Trade | Trade ( percent of GDP) |
| Credit | Domestic credit to private sector ( percent of GDP) |
| ExRate | Official exchange rate (local currency per US$, period average) |
| Telephone | Telephone lines (per 1,000 people) |
| ODAflows | Net ODA received |
| GDPgrowth | GDP growth (annual percent) |

1. **Simple regression of FDI**

Per La Goff & Singh, and can something simple like:

(2)

This work should be straightforward, collecting the data and running the regressions in a focused day, which gives us ‘innovative results’ that we can present but frankly won’t be interesting. I want to do this exercise to get used to collaborating on analysis, get something to present to seminars for feedback, and also get immersed in the literature.

Repository of great data: <http://www.cepii.fr/CEPII/en/bdd_modele/presentation.asp?id=8>

1. **Poverty Framework**

*(I’ll leave this in as current discussion, from an earlier paper that will likely remain un-completed. There are some decent ideas in here that can be fleshed out for our current purposes.)*

Kenya & East Africa’s trade and resilience work is increasingly a target for foreign and domestic investment, particularly as the Government of Kenya (GOK) seeks to expand the country’s growth to improve rural standards of living. Inadequate business management and technical skills among enterprise personnel, as well as high input costs, further constrain enterprise growth and sector competitiveness. A lack of modern value-adding technologies restricts high-value market opportunities that could drive improved production and quality among producers. This, perhaps, represents an opportunity to facilitate additional linkages with U.S. businesses for equipment purchases.

Kenya & East Africa’s fragmented production base of smallholder farmers creates its own supply chain challenges for agribusinesses seeking to deliver a steady stream of quality product to domestic or export markets. Enterprises struggle to secure reliable deliveries of fresh produce from farmers and must deal with irregular quality and varieties, leading to high transaction costs and reduced competitiveness of finished products. Producers typically sell their produce at harvest, at the farm gate, putting them in the role of “price takers” and perpetuating a lack of trust in value chain relationships. Low prices and lack of advisory services in turn discourage farmer investment in quality inputs and provide little incentive to adopt improved production practices. Accessing the neighboring markets presents additional challenges to deliver high quality fresh product. Delays at the border impede products being delivered to markets across East Africa in a steady and timely way which leads to great losses among entrepreneurs.

Regional trade plays a role in increasing the availability of diverse and nutritious foods for vulnerable households, including staples, horticulture, fruits and animal-based products, but the impact on malnutrition has been difficult to quantify. Strengthening regional linkages between producers and the growing numbers of urban consumers by addressing the market, infrastructure and policy constraints to the access and price volatility of agricultural products stabilizes incomes and generates money for rural producers that they can use to buy additional food and non-food items. Additionally reducing the time and cost for the cross-border trade of agricultural products addresses regional food security by allowing food to easily move from areas of surplus to deficit. The challenge in the East Africa is to find ways of leveraging the positive links between producers, processors, markets and consumers awareness to improve diet diversity, quality and food safety strengthening food security and addressing both acute and chronic malnutrition in the region.

In 2011 and 2017, extreme weather events led to drought conditions in Kenya and East Africa. The 2011 drought led a humanitarian crisis requiring $427.4m emergency funds, but the 2017 drought only required $Y. Some of the averted assistance can be attributed to mitigated risk through intraregional trade, as resilient market systems have the capacity to effectively draw upon and allocate resources in the face of shocks and stresses in ways that maintain or improve the functioning of the market system and the wellbeing of its actors. The extent to which such impacts of trade can be quantified are yet to be determined.

Private sector led trade and investment approaches that contribute to market systems resilience might include those that support: connectivity among actors based on merit, performance, and equity, not just loyalty; business strategies that add rather than extract value to the system; decision making that considers various courses of action based on evidence; competition that promotes innovation and delivers value to customers; cooperation that benefits the overall systems in contrast to collusion that extracts value at the expense of others; or diversification characterized by variation and balance in different types of products, firm sizes and structure, and marketing channels. Building on the past achievements of USAID East Africa on gender and trade, addressing systemic gender biases through trans-border women trader associations, joint border committees that address sexual violence and theft issues, and one-stop border posts that reduce the time women and men take at border points can further strengthen the resilience of market systems.

1. **Conclusion**

TBD

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1. This paper reflects the research and opinions of the author and does not reflect the views of the U.S. Agency for International Development. Please do not cite or circulate without permission from the author. [↑](#footnote-ref-0)
2. Ravallion, M (2006), “Looking Beyond Averages in the Trade and Poverty Debate.” *World Development*, vol.34, No. 4., pp. 1374-1392. [↑](#footnote-ref-1)
3. This designation contrasts with “FDI-oriented regions” in which investment has overtaken development as the primary source of external capital. FDI-oriented regions include East Asia, Latin America, and the former Soviet Union, where development aid has been drawing down heavily in the past decade and private investment has been increasing substantially. [↑](#footnote-ref-2)
4. Regarding total global FDI (not just those to developing countries), in 1970, Africa received 6 percent of total global FDI, but these fell to around 1 percent for most of the 1980s and 1990s. Source: UNCTAD Stat. <http://unctad.org/en/Pages/Statistics.aspx> [↑](#footnote-ref-3)
5. Note that Asiedu (2002)’s measures infrastructure by the number of telephones per 1,000 people, which may no longer be a reliable indicator given changes in telecommunication technology. She points out that infrastructure might not be as relevant for resource-based FDI, which is common to sub-Saharan Africa. [↑](#footnote-ref-4)
6. Data according to WDI. These figures dipped slightly following the global recession. [↑](#footnote-ref-5)
7. Data was not available for Equitorial Guinea, Namibia, Niger, Sao Tome and Principe, and Somalia. Due to the time period under investigation, South Sudan was not included in the analysis. [↑](#footnote-ref-6)