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Impact of Trade Openness on Foreign Direct Investment in Sub- Saharan African Countries

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Abstract

No country in the world that is stay isolated and become developed without influence of other countries in one way or the other. Countries in the world are working hard through various economic policies in order to attract more Foreign Direct Investment (FDI). Therefore any attempt to find out the influence of FDI is paramount important. The paper seek to look into the impact of trade openness on Foreign Direct Investment in Sub-Sahara African Countries for the period of 2000 to 2017. The study employed panel data analysis, including the panel unit root test, panel co integration test and fully modified least square method (FMOLS). The findings reveal that, all the variables were cointegration of order one and having a long run relationship. More so the results show that trade openness was positive and statistically significant in influencing FDI in the region, while corruption was negative and statistically significant in influencing FDI in the region. The findings suggest that, the existing trade policies should be amend by governments through various legislative arms of government to give room for inflow of capital and new technological advancement from developed countries where these FDI comes from to those countries under study. Also Governments in the region should create more polices that is used to reduce the level of corruption in the system through improvement of the existing institutions that fight corruption to a standstill.

Jel Classification; E01, E24.

Key Words: *Emerging Sub-Saharan Africa Countries (ESSAC), Foreign Direct Investment, (FDI), Fully Modified Least Square Method (FMOLS), Trade Openness*

1. Introduction

World Economic Integration has been given much attention since the beginning of the 1990s popularized by globalization that made it possible for people to invest anywhere around the globe, especially where economies of scale is higher. This brought notable changes among host countries, concerning the inflow of FDI in their countries. Developing countries (DC) view FDI as an engine of growth because it provides capital for investment, Employment Opportunities and bridge the foreign exchange gap in their economy. FDI can be defined as capital flows resulting from the behaviour of multinational companies (MNCs). Therefore, the variables influence the behavioural side of MNCs could influence the magnitude and the FDI direction. MNCs extend their operations to a foreign country for a variety of purposes including, but not limited to, the leveraging of economies of scale/scope, the use of different benefits, mostly due to a life-cycle trend of their goods or simply because their rivals participate in similar activities. Governments, on the other side, are also involved in political competitiveness by changing major factors in their economic policies like local labour market conditions, business taxes, tariffs, subsidies, privatization and regulatory policies to improve FDI activity in their countries Agiomirgianakis et al. (2006).

However, restrictions and limitations on international firms' entry and operations have been a major concern in the literature due to the impact of multinational firms in developing countries (including emerging Sub-Saharan African countries). Hence, those limitations are being swapped by strategies that intend to encourage investment inflows in developing countries. Modernization theories postulate that FDI offers host economies with capital, boosting technology transfer, and improve their administrative skills and good governance; these in turn increase the labour productivity and economical growing in such countries Asiedu, E, .(2004).

In 1990 the total amount of FDI was \$207 billion, in 2011 it exceeded \$1,524 trillion (UNCTAD, (2012). Globally the flow of (FDI) has increased greatly to reach \$1.762bn in 2016, representing about 38% increase over the level recorded since the world fiscal disaster

of 2008 (UNCTAD,(2016). Notwithstanding with increase in global FDI, FDI inflow in African region is very negligible compared to the other regions in the world. For example out of the \$1,365,106.9 trillion total FDI inflow in the world in 2010, Africa received only \$46,620.1 billion representing only 3 per cent of the total world FDI inflow and it was less than 3 per cent in 2016 respectively (WDI, 2017).

Researchers from Africa worries about this negligible FDI inflow in to the region which create huge questions on the determinant of FDI in the region. Therefore this paper try to investigate the impact of Trade openness on FDI in some selected Sub-Saharan African Countries for the period 2000 to 2017.

2. Literature Review

2.1. Theoretical Framework

The theories of International Trade offer a strong foundation for understanding FDI. Trade between different groups of people can be traced back many Centuries. However, it was not until the 15th Century that people tried to explain why trade occurs and its resultant benefits (Wild et al., 2008). Mercantilism is an early trade theory that sought to explain why countries should engage in international trade. This theory states that nations accumulate financial wealth by encouraging exports and discouraging imports (Wild et al., 2008). A variety of European countries, such as Britain, France, the Netherlands, Portugal, and Spain, adopted this economic philosophy from the 16th century to the late 18th. One of the issues with Mercantilism is that if both nations were to ban imports and allow exports only, trade would be quite limited and confined to necessary products and services only.

The free market view of foreign investment is drawn from the Classical Economics and International Trade Theories of Smith (1776) and Ricardo (1817). According to Smith, the invisible hand of the market will determine what a country imports and was put forward by Smith. This theory was the first to explain why free trade is beneficial to a country.

2.2. Empirical Literature

Empirical finding of the relationship between Trade openness and FDI has been discussed by so many researchers around the globe, but yet the findings fails to reach consensus. For instance Maxwell, (2017) examined the main determinants of foreign direct investment in Ghana. He employed time series data on FDI, economic openness, GDP per capita, exchange rate, government consumption expenditure, political rights, natural resource endowment, macroeconomic stability and interest rate from Ghana over the study period 1980 to 2014.

Similarly, natural resources, the openness of the nation's economy and market, the size and level of government's expenditure and consumption, its infrastructure and moreover the interest rate regime in the nation were the factors that determine Ghana's FDI. He suggested that government must create the facilitating political environment and socio-economic with attractive features for FDI. Similarly, the government must showcase the investment potentials of the country to the world through the several Ghana Investment Promotion Centre (GIPC), technological mediums and the Free Zones Board (FZB) are creditable creativities by the government towards appealing FDI. Shiba (2016) studied the determinants of FDI inflows in India. The variables include FDI as dependent, GDP, Trade Openness and Exchange rate as independent variables. From the result, among the long run Coefficients, the influence of GDP to inward FDI is the highest which is 2.276.

Also, Owusu-Antwi et al (2016) studied empirically the factors that have an influence on FDI flows in Ghana from 1983 to 2012. They applied co-integration analysis. The findings of their research showed that exchange rate, inflation, and openness of trade were significantly affecting the FDI in the long run. While natural resources have a negative long-run relationship with the FDI inflows. However, they used GDP as a proxy for market size and economic liberalization which found to be insignificant. However, all the variables were found to be insignificant except natural resources in the short run, which contributed negatively to the mining sector. They recommended that "Ghana's policy makers should focus on how to articulate the required policies that can fascinate the right kind of FDI in the mining sector. Lateef and Muhammad (2015) found that FDI flows to Sub Saharan Africa economies unaffected by conflict and political instability exceed those with crisis. For FDI to thrive in these countries, it must introduce sound economic policies and make the country investor friendly. There must be political stability, sound economic management and well developed infrastructure".

Pavlos and Nikolaos (2013) investigated the relationship between exports, foreign direct investments (FDI) and economic growth in five Euro zone countries (Greece, Portugal, Ireland, Spain, and Italy) using panel data for the period 1970 to 2011. The panel data causality results revealed that there is bidirectional causality between exports and economic development, while there is no causality between economic growth and FDI no between FDI and exports. Also, Pravin and Jadhav (2012) found that market size measured by real GDP is a significant determinate of FDI which implies that most of the investment in BRICS is motivated by market-seeking purpose. He also indicates that trade openness, natural resource

availability, rule of law, voice and accountability are statistically significant. Coefficients of market size, trade openness are positive which implies that these variables have positive effect on total inward FDI. Natural resource availability has negative effect on total inward FDI, this particular result indicate that FDI is not motivated by resource-seeking purpose in BRICS economies. Bonnie and Rishi (2012) stated that, a panel data analysis of 164 countries from 1996 to 2006, to examine the impact of institutional quality on FDI levels and volatility. The revealed that, good institutional quality matters to FDI. We provide evidence that institutional quality has a positive and significant effect on FDI.

Dutta and Roy (2011) investigate that, the role of political risk in association with FDI and financial development. Using a panel of 97 countries over 20 years, they establish a non-linear association between financial development and FDI inflows. Financial development leads to greater FDI inflows up to a certain threshold of financial development. Reiter and Steensma (2010) the most important determinant variable in attracting foreign investors is a developed human capita with a cheaper cost of hiring. That is to say, the efficiency of the labour force is expected to have a significant impact in achieving the goals of the organization hence attracting more FDIs. Matthias and Carsten (2007) explored the linkages among political risk, institutions, and foreign direct investment inflows, for a data sample of 83 developing countries covering 1984 to 2003 and the results showed that, government stability, internal and external conflict, corruption and ethnic tensions, law and order, democratic accountability of government, and quality of bureaucracy are highly significant determinants of foreign investment inflows in developing countries.

More so, Azam and Lukman (2010) using a quantitative approach found that trade openness has been a significant determinant for India from 1971 to 2005. Oman (2000); Cohen, (2007) as well as Dunning and Lundan, (2008). The more changes and policies governments institute that lead to openness of their economies, the greater the likelihood of receiving large sums of FDI in terms of both quantity and quality. However, empirical studies examining its effect show different results. Nurudeen et al. (2011) and Seetanah and Rojid (2011), by studying the FDI determinants in Nigeria and Mauritius" respectively, show a strong link between trade openness and the level of inflows. Although the model used for Mauritius was differenced vector autoregressive (DVAR), in the case of Nigeria, both ordinary least squares (OLS) and error correction techniques (OCT) were used.

However, other researches relating to Malaysia using the OLS model, Sharma, Nayagam, & Chung, (2012) and Central and South-eastern Europe (CSE) employing the OLI framework Mateev, (2009) found out that trade openness did not have a statistically significant impact on inward FDI in respective countries, despite its influential role". It has been indicated that in the case of CSE, the variable might have been correlated with other factors that influence investment decisions. The study on Malaysia highlights the issue with the use of the model and specification of proxies included in the analysis, given the fact that many other determinants appeared to be insignificant as well. Moreover Jordaan (2004) claims that the impact of trade openness on FDI depends on the type of investment. When investments are market-seeking, trade restrictions and therefore less openness can have a positive effect on FDI. The reason stems from the tariff jumping hypothesis, which argues that foreign firms that seek to serve local markets may decide to set up subsidiaries in the host country if it is difficult to import their products to the country. In contrast, multinational firms engaged in export-oriented investments may prefer to invest in a more open economy since increased imperfections that accompany trade protection generally imply higher transaction costs associated with exporting. Borensztein et al (1998), examined, that, the study aims to determine the effect of FDI on economic growth in 69 developing countries in the period of 1970-79 and by using regression bound to panel data. Based on the results, it has been seen that, FDI is a means of technology transfer contributing a lot to the economic growth. However, FDI has positive effect on economic growth, when advanced technology is accompanied by capital and human capital at a certain level.

From the aforementioned empirical studies none of the study identify corruption as among the factor that determine FDI in their research. This paper try to look this key variable as among the major factor affecting FDI inflow in African region. Indeed, other researchers report different result and finding in their research, this mixture the final finding and conclusions emanates from different methodology, variables used and the period cover of study. There is disparity of study area that fundamentally affects the behavior of the macroeconomic variables. This is because where the area of study is not the same, or is very different, the methodology and variables that can be used will differ. Secondly the cover period of research is 2000—2017 study period is a great improvement in the above literature. Lastly, the choice of the research variables and use recent econometrics techniques is a significant stride in the literature in finding factors affecting the patterns of foreign direct investment in emerging sub-Saharan African countries. Therefore this research work

employed Fully Modified Ordinary Least Square (FMOLS) which is none of the researchers used before in this field of study.

3. Material and Method

3.1. Sources of Data

The data for the purpose of this study are collected on eight emerging sub Saharan African countries, namely Angola, Ethiopia, Ghana, Kenya, Mozambique, Nigeria, Senegal and South Africa spanning a 16-year period, from 2000 to 2017. Country selection was largely determined by data quality and reliability over the sample period. The data Foreign Direct Investment net inflow stand as FDI, meanwhile Import and Export, is used as proxy for Trade Openness stand as TOP. The Corruption Perception Index (CPI) is used as proxy for Corruption, stand as COR. The data is obtained from world development indicators (WDI) 2017 in World Bank website database.

3.2. Model Specification

Even though none of the researcher applies the Fully Modified Ordinary Square (FMOLS) model in analyzing the Influence of trade openness on foreign direct investment in Sub Saharan African Countries. Therefore, in order to investigate factors affecting the influence of economic growth and financial instability of Foreign Direct Investment in sub- Saharan African countries, the research adopt Pravin and Jadhav (2012) model with some modification. The rationale for using this model is that the FMOLS model generates dependable estimates for the small sample size and offers a robustness check for the results. Initially, the FMOLS method was incorporated and maintained by Philips and Hansen (1990) to estimate a single co-integrating relationship with a mixture of I(1) and then has a benefit over the EG methods in implementing adequate correction to resolve the inferential problem in the EG method and therefore the t-test for long-run estimates is valid (Himansu 2007).

Therefore the method was adopted based on the objectives of the research stated earlier and the nature of data used. The models are specified as follows:

$$FDI = F(TOP, COR) \dots \dots \dots 1$$

Where:

FDI = Foreign Direct Investment, net inflows

TOP= Trade Openness

COR= CPIA transparency, accountability, and corruption in the public sector rating (1=low to 6=high)

F= functional relationship

*= multiplication symbol

Therefore, the above equations are transformed in to econometric models as follows

$$FDI_{it} = \alpha + \beta_1 TOP_{it} + \beta_2 COR_{it} + \varepsilon_{it} \dots \dots \dots 2$$

Where, the prior expectations of the parameters in equation 1 are, $\beta_1 > 0$ and $\beta_2 < 0$ respectively.

4. Results and Discussion

4.1. Descriptive Statistic

The natural starting point of our formal analysis is the examination of the stochastic properties of the data. Therefore, descriptive statistics describe the basic features of the data used in this study. The aim of this statistics is merely to summarize a data set, rather than being used to test the hypotheses. Table 1 presents the descriptive results of the variables used in the study. The variables are FDI, TOP and COR respectively, where FDI is the dependent variable while TOP and COR are independent variables. The table shows that, FDI has the highest mean of 1.97E+10 follow by TOP with mean of 57.06685 respectively. While COR has the lowest mean of 3.003676. In terms of median, FDI still has the highest value of 1.21E+10 among the variables; follow by TOP with 59.93863, then COR with 3.000000. The maximum and minimum value of the variables under study show that FDI has the maximum of 9.89E+09 and minimum of -7.12E+09, TOP with 118.1226 as maximum and 13.97926 as minimum, lastly COR has a maximum of 4.000000 and minimum of 2.500000 respectively, also the descriptive statistics, including the indicators of skewness and kurtosis, as well as the test for normality of the variables are presented. This allows us to make some inferences about the distribution of the variables. The distributions of the dependent variable FDI and other Independent variables appear to be normally distributed, as shown by the jarque Bera LM test. The dependent variable as well as Independent variables appears to have a kurtosis of less than three (3).

Table 1 Descriptive Statistic

	FDI	TOP	COR
Mean	1.98E+09	57.06685	3.003676
Median	6.71E+08	59.93863	3.000000

Maximum	9.89E+09	118.1226	4.000000
Minimum	-7.12E+09	13.97926	2.500000
Std. Dev.	2.86E+09	25.95121	0.401370
Skewness	0.084489	0.076168	0.676692
Kurtosis	2.890900	2.566065	2.263313
Jarque-Bera	7.676475	1.198534	1.772242
Probability	0.721532	0.549214	0.224580
Sum	2.69E+11	7761.091	408.5000
Sum Sq. Dev.	1.11E+21	90917.79	21.74816
Observations	136	136	136

Source: Author's Computation 2019.

4.2. Cross-Sectional Dependence Test (CD Test)

Cross-sectional dependence test was conducted in order to examine the contagious effects of shocks within the cross-sections (Pesaran & Yamagata, 2008). Table 2 presents the comparism of Breusch-Pagan LM, Pesaran Scaled LM and Pesaran CD tests of cross-sectional dependence. Based on the results, all the variables indicates no presence of common factor affecting the cross sectional units which paved way to use the first generation panel unit root test.

Table 2 Cross-Section Dependence Test

Test	Statistic	d.f.	Prob.
Breusch-Pagan LM	29.5862	28	0.1023
Pesaran scaled LM	11.03605		0.0925
Pesaran CD	40.009508		0.2501

Source: Author's Computation 2019

4.3. Panel Unit Root Test

In order to avoid spurious regression result, Im, Pesaran and Shin W-stat panel unit root test proposed by Im, Pesaran and Shin (2003) was conducted for the variables of interest under study. The Test was estimated both at level and at first difference, with trend and intercept as presented in table 3 below.

Table 3 Im et al Unit Root Test

Variables	At Level		At First Difference	
	Statistic	Prob.	Statistic	Prob.
FDI	-1.40491	0.0800	-4.73782	0.0000*
TOP	-0.50514	0.3067	-5.18852	0.0000*
COR	1.64083	0.9496	-1.67953	0.0465**

. Source: Author's Computation 2019

4.4. Pedoroni Co-integration Test

After testing the panel unit root test which paved way to conduct the cointegration test among the variables. Therefore, table 4 presents the results of the Pedroni panel co-integration for the trade openness and FDI in the Emerging Sub Saharan African countries (ESSACs). The table indicates that the null hypothesis of no co-integration cannot be rejected for Panel ρ -statistics, Panel PP-statistics and Group ρ -statistics. However, the null hypothesis of no co-integration is rejected for Panel v -statistics, Panel ADF-statistics, Group PP-statistics and Group ADF-statistics at 1 percent level of significance.

Table 4 Pedoroni Co-integration Test

Test	Statistic	Prob.	Weighted Statistic	Prob.
Panel v -Statistic	-1.135626	0.8719	-0.433208	0.6676
Panel ρ -Statistic	-0.580821	0.2807	-0.902029	0.1835
Panel PP-Statistic	-1.727402	0.0420**	-4.333921	0.0000*
Panel ADF-Statistic	-2.778714	0.0027*	-3.542206	0.0002*
Group ρ -Statistic	0.002611	0.5010		
Group PP-Statistic	-9.907001	0.0000*		
Group ADF-Statistic	-4.800043	0.0000*		

Source: Author's Computation 2019

*Note: *&** indicate significant at 1% and 5% level of significance*

4.5. Fully Modified Ordinary Least Square Regression (FMOLS)

Having found the long run relationship among the variables for the ESSAC countries, the next stage is to estimate the FMOLS regression. Table 5 shows the FMOLS estimation for the model of FDI and Trade Openness in the ESSACs countries. From Table 13, the estimated coefficient of TOP was positive and statistically significant at 1% level of significant in attracting FDI for ESSACs while COR was negative and statistically significant in determining FDI in the sampled study area under review. The finding of this study is in line with the finding of Maxwell, (2016), for Ghana, Owusu-Antwi1 et al (2016), for Ghana and Shiba (2016), for India and among others. The result also reveals that, Corruption was negative and statistically significant at 1% level of significant. This means that a 1% increase of corruption may lead almost 5% decrease in FDI in the sample area. The result indicates that corruption is one of the major factor determining of FDI in the region under study. This findings is in line with finding of Matthias and Carsten (2007) for developing countries.

**Table 5 FMOLS Regression Result
Dependent Variable FDI**

Variable	Coefficient	Std. Error	t-Statistic	Prob.
TOP	41655675	0.555844	74941342	0.0000*
COR	-4.97E+08	0.481617	-1.03E+09	0.0000*
R-squared	0.747536			
Adjusted R-squared	0.633623			

Source: Author's Computation 2019

*Note: * indicates significant at 1% level of significance.*

4.6. Discussion and Policy Implication

The aim of the paper is to investigate the impact of Trade Openness on Foreign Direct Investment in Emerging Sub-Saharan African countries for the period of 2000 to 2017. The Descriptive statistics were first employed in order to provide an inside of the data in terms of the pattern and normality distribution of the data. This include mean, median, Skewness, Kurtosis and Jarque-Bera. Evidence from the descriptive statistic results showed that, the variables under study were normally distributed. In view of that, the properties of the data were checked using panel unit root test in order to avoid spurious regression results. Im, Pesaran panel unit root test was conducted. The result revealed that, the variables under study were not stationary at level but are stationary at first difference. This means that, the variables are integrated of order one (I(1)). In line with the result of panel units root test conducted the long run co integration test was estimated using Pedroni Co integration test. Evidence from the result indicates the existence of long run relationship among the variables under study. This implies that, there is existence of economic potentialities and economic prosperities in the long run in the region, which lead to the improvement of the standard of living, increase in jobs opportunities, consequently reduction of poverty in the region, as pointed out by Borensztein, De Gregorio and Lee, (1998) among other.

In order to investigate the effectiveness of the variables, fully modified ordinarily least Square (FMOLS) was employed. The finding of various results revealed that, there is a positive relationship between FDI and TO in the SSEACs under study this means that, any improvement in the level of TO may lead to increase in FDI inflow to the host Countries. This lead to free movement of capital and goods from the foreign Investors (MNCs) to the host Countries, as pointed out by Pavlos and Nikolaos (2013), Reiter and Steensma (2010)

and among other While in the case of corruption there is negative relationship in determine the FDI inflow in to the region. This implies that, the higher the level of corruption the lower the FDI inflow into the region. The Policy implication of this finding shows that, corruption lead to political instability, insecurity, lack of good governance, transparency and accountability as pointed out by), Maxwell, (2016), Lateef and Muhammad (2015), Bonnie and Rishi (2012), Dutta and Roy (2011) and among other.It is important to know that, Corruption has a serious effect in any economy be it developed or Under developed .It destabilize the economy in terms of hindering the economic activities to move in a right way which result in reduction of the image of Sub Saharan African Countries in the rest of the world.

5. Conclusion and Recommendations

5.1. Conclusion

The aim of this research is to investigate the impact of Trade Openness on foreign direct investment in emerging sub- Saharan African countries for the period of 2000 to 2017. The properties of panel data were checked to avoid spurious results followed by co integration analysis as well as estimation of the variables using FMOLS under study. Based on the finding of the research, the studies conclude that, trade openness and corruption have great impact on FDI in the study area.

5.2. Recommendations

Based on the findings of this paper the following recommendations are suggested:

Governments in ESSACs countries should increase their political will to eradicate corruption in the system through establishing institutions that will fight corruption to a standstill. In the case of Nigeria, Present efforts already yielding good results should be strengthened and expanded in scope. The Economic and Financial Crime Commission (EFCC) and the Independent Corrupt Practices Commission (ICPC), for instance should be given more legal backing, manpower and financial resources to improve their performance now and in the future. In this regard, ESSACs countries should emulate this policy to eradicate corruption in the region. These measures will assist to reduce the level of corruption and increase FDI to the area under study as observed from findings of the study.

Moreover, there is the need to review trade policies among the countries under study as it was observed from finding that trade openness has positive effect on attracting FDI that will strengthen capital inflow to the region in order to promote productivity and economic

development. Therefore, the existing trade policies should be amended by African government through various legislative arms of government to give room for inflow of capital and new technologies advancement from developed countries where these FDI comes from to those countries under study.

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