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Quality of Institutions as a Determinant of Foreign Direct Investment Inflow and Economic Growth: Recent Empirical Evidence from Nigeria.

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Abstract

The inflow of foreign direct investment has been recognized in economic literature and proven by empirical studies as one of the key drivers of economic growth, especially on the heel of its roles in filling the resource gap and enabling knowledge and technology transfer in developing countries. This paper investigates the impacts of the quality of institutions and effective policy on the inflow of foreign direct investment and economic growth in Nigeria from 2012 – 2021. The study utilizes a quantitative research technique to assess how the quality of institutions in Nigeria has either enabled or hindered the inflow of FDI and economic growth. Evidence shows that the poor quality of institutions in Nigeria has bred inefficient bureaucracy, corruption, and weak governance which in turn encroach on indices of economic freedom such as legal structure and security of property rights and regulation of credit, labour, and business. Low economic freedom triggers low FDI inflow which has inhibited favourable economic growth outcomes in Nigeria. We, therefore, recommend the following policy applications, amongst others: building and strengthening effective institutions to transmit efficient information and protect property rights, improving the macroeconomic policy framework to address macroeconomic instability which distorts the policy environment, and implementing effective corruption control measures to strengthen governance and its institutions which is fundamental to the inflow of foreign direct investment and economic growth in Nigeria.

Keywords: *Institutions, Foreign Direct Investment, Gross Domestic Product, Economic Freedom Indices.*

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1.0 INTRODUCTION

There is no gainsaying the fact that the roles of Foreign Direct Investment (FDI) in filling the resource gap in developing countries have received substantial consideration in the economic literature. Falki (2009), for example, noted that the effects of FDI on the host economy are normally believed to be: an increase in employment, augmenting productivity, boost in exports, and amplified pace of transfer of technology. The potential advantages of the FDI to the host economy are: it facilitates the utilization and exploitation of local raw materials, introduces modern techniques of management and marketing, eases access to new technologies, foreign inflows can be used for financing current account deficits, finance inflows form FDI do not generate repayment of principal or interests (as opposed to external debt) and increases the stock of human capital via on-the-job training. The realization of the importance of FDI informed the radical and pragmatic economic reforms introduced in the mid-1980s by the Nigerian government. The reforms were designed to increase the attractiveness of Nigeria's investment opportunities and foster growing confidence in the economy so as to encourage foreign investors to invest in the economy (Ojo, 1998).

However, despite the overwhelming evidence on the tailwind impact of foreign capital inflows on capital formation and economic growth in most countries, extant literature has emphasized the role of effective and quality institutions and enabling policy environments in the link between foreign direct investment and growth. Proponents of the quality of institutions as a vehicle for attracting FDI and triggering growth argue that in a market economy, institutions help transmit information, enforce property rights and contracts, and manage competition in the marketplace. In a broad sense, institutions are expected to facilitate the generation of new ideas, define property rights and contracts, stimulate innovations, lower transaction costs, and correct market failures. Reducing uncertainty and fostering efficiency enhance strong economic performance (Ibi-Ajayi, 2002). According to North (1990), developing countries are poor because the institutional constraints define a set of payoffs to political/economic activities that do not encourage productive activities. This institutional framework affects growth because it is integral to the amount spent on both the costs of transactions and the costs of transformation.

Given Nigeria's abysmally poor macroeconomic performance in spite of the various reforms and adjustments that have been implemented over the years, there must be some other explanation for the growth process since the known economic factors in the literature do not account for Nigeria's growth experience vis-a-vis the inflow of foreign direct investment. According to Ibi-Ajayi (2002), that missing link is often linked to the roles of institutions and policies. In other words, macroeconomic performance outcomes are influenced by indicators of institutional quality, policy measures, and other exogenous variables.

In essence, this term paper discusses the interaction between the quality of institutions and effective policy and the inflow of foreign direct investment (FDI) and economic growth in Nigeria by highlighting how institutions and policies affect growth performance through the instrumentality of FDI. It is now possible in economic analysis to measure the extent to which the quality of institutions and policies affect growth performance. The theory and fact are then applied to the Nigerian situation in order to address the reasons for Nigeria's low inflow of foreign capital and the consequent low growth rate – a rate that has been described as both disappointing and dismal.

The rest of the paper is laid out as follows: Section 2 lays out the statement of the problem by highlighting the inherent problems with the interactions of all the variables of interest in this study. Section 3 centres on the examination and in-depth analysis of the trends of FDI growth

and GDP per capita growth in Nigeria from 2012 -2021. We dwell on the conceptual and theoretical framework in Section 4 by highlighting the definitions and the roles of institutions and policies in the FDI-growth nexus and examining the theories behind the interactions. Section 5 reviews the empirical literature to identify the previous research contributions to the FDI-growth nexus and situate the research gap to be filled by the present study while Section 6 discusses the data and methodology adopted for the study. Section 7assesses the application of institutional quality to FDI inflow and economic growth outcomes, citing recent evidence from Nigeria. Section 8 draws the paper to a close with a conclusion and policy prescriptions.

2.0 STATEMENT OF RESEARCH PROBLEM

Available evidence suggests that Nigeria's economic performance with regard to foreign capital inflow has not been impressive as the available evidence from the World Bank Development Indicators (2023) indicates that the net inflow of FDI into the economy has been incongruent with the pattern of economic growth in recent times. Indeed, between 2017 and 2018, the FDI net inflows for Nigeria nosedived from US$ 2,412,974,916 to US$ 775,247,400 and for the same period, the GDP growth (annual %) rose from 0.8% to 1.9%. The decline in FDI inflow in Nigeria raises an important question about the role of institutions and policies 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, and 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.

In a related sense, Ibi-Ajayi (2002) submits that bureaucratic inefficiency and institutional quality influence growth through many channels. Inefficient and corrupt bureaucracies require lengthy and expensive procedures (because of bribes) for opening up businesses. This may lead to a reduction in foreign investment and the channeling of domestic investment towards the underground economy. An inefficient bureaucracy also provides a low level of productive public goods for a given level of taxation. Also, poor enforcement of the law, especially enforcement of contracts, makes investment activities costly, uncertain, and risky for domestic, and in particular, foreign investors.

Similarly, as noted by Goldsmith (1998), the state can wreak enormous damage to investment drive and growth outcomes if it put in place rules and policies that can discourage the creation of wealth. The state may also inflict uncertainty if it changes its rules ever so often, and does not state clearly the rules of procedure. In Nigeria, there are instances of institutional failure that occur when the structures and apparatuses of the state itself cause rather than reduce uncertainty. The diseconomies with regards to the high cost of implementing costly strategies to hedge against uncertainty nurtured by a poor policy framework and macroeconomic instability hamper the inflow of foreign capital in the form of FDI and divert domestic investment to the underground economy which promotes rent-seeking rather than productive activities. The atmosphere of uncertainty that is created by a poor policy environment increases both economic and governance risk indices and discourages local and foreign investors in Nigeria to leave and move to countries with more effective institutional frameworks and a more stable macroeconomic policy environment. The number of foreign investors, with the accompanying massive and sustained capital flight,

leaving Nigeria for safer destinations is enormous – a bad signal for FDI inflows and economic growth outcomes.

Thus, the concept of enabling policy measures and institutional quality are predominant factors in the FDI-growth nexus in Nigeria as anywhere else. Unfortunately, the extant literature has hardly paid any attention to the simultaneous roles of institutions and policy measures as the key drivers of the inward flow of foreign capital, and by implication, the *sine qua non* for sustainable economic growth in Nigeria. Previous literature focuses on the role of institutions only, believing that policy itself is dependent on effective institutions. Do policy measures matter for FDI inflow and growth in the same manner effective and strong institutions do? This study fills this gap. Interestingly too, the recent changes in policy directions on the heels of the Company and Allied Matters Act (2020) and the passing of the Petroleum Industry Bill into the Petroleum Industry Act (2021) have made it very pertinent to re-examine these issues and offer appropriate policy prescriptions.

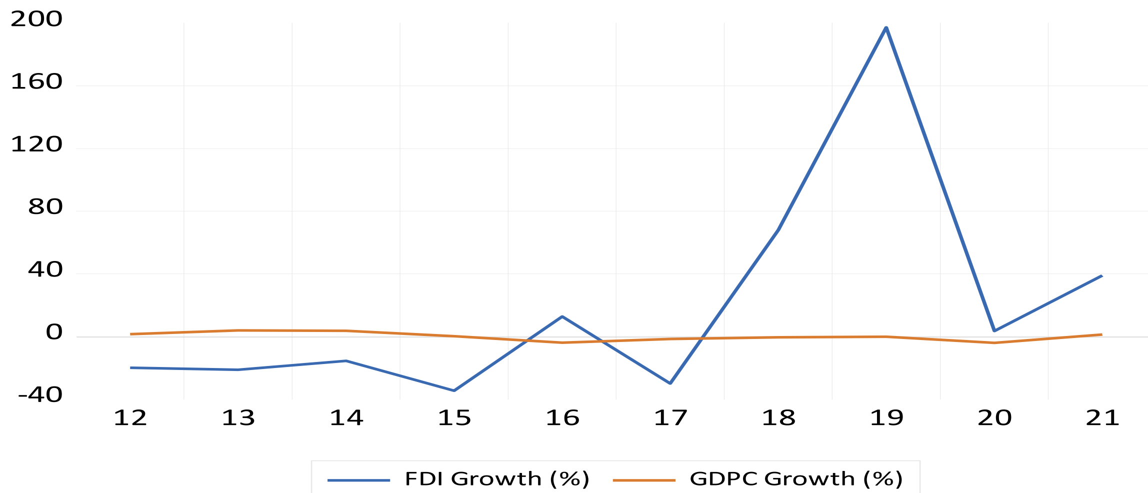
3.0 TRENDS OF FOREIGN DIRECT INVESTMENT AND GROSS DOMESTIC PRODUCT PER CAPITA PERFORMANCE IN NIGERIA (2012 – 2021)

Prior to 2015, Nigeria was one of the few countries that have consistently benefited from the FDI inflow. Nigeria's share of FDI inflow to Africa averaged around 10 percent, from 24.19 percent in 1990 to a low level of 5.88 percent in 2001 up to 11.65 percent in 2002. Nigeria was the continent's second top FDI recipient after Angola in 2001 and 2002. FDI inflow into Nigeria for the period 1970 to 2002 rose from N128.6 million in 1970 to N434.1 million in 1985 and N115.952 billion in 2000. This was an increase in real terms from the decline of the 1980s.

Statistics from the World Development Indicators (WDI) by the World Bank indicate that Nigeria recorded an average 12.7% increase in FDI net inflow in 2010, and from 2011 -2012, it declined to -20.03%, while in the same period, the performance of GDP per capita slumped to 1.4% from a previous level of 2.4% in 2010 even though remarkable improvements were recorded in 2012 and 2013 with a growth rate of 3.83% and 3.55% respectively. The improved performance of the GDP per capita despite the slump in FDI inflows was due to the other determinants of economic growth, especially improvements in economic freedom arising from the consolidation of democratic governance in Nigeria. It refers to the freedom to choose and supply resources, competition in business, free trade with others and secure property rights as representing important ingredients needed for achieving economic development.

Furthermore, between 2015 – 2020, Figure 1 shows the poor performance of GDP per capita and negative performance of FDI net inflows into the Nigerian economy on the heels of inadequate infrastructural facilities, poor business environment, poorly formulated macroeconomic policies, and poor institutional quality, unattractive risk-adjusted returns on investment, among other, may have contributed significantly to the fall in FDI inflow into the country, and this, in turn, may have fueled the poor output growth performance of the Nigerian economy in recent years. The negative and fast-declining net inflows of FDI into Nigeria in the period under review may be due to the escalation of a number of risk factors. These factors include insecurity, foreign exchange risks, and policy uncertainties, among others. For instance, foreign investors pulled out N1.77 trillion from the nation's stock market in the last two years, citing insecurity and economic uncertainties arising mostly from inconsistent policy measures.

Figure 1: FDI Inflow and GDP Per Capita Performance in Nigeria (2012 – 2021)



Source: Author, with data from World Development Indicators (2023)

Figure 1 above also shows the poor performance of GDP per capita arising from dismal and disappointing economic growth outcomes which may be linked to persistent negative growth of net inflows of foreign direct investment in Nigeria over the last decade. The poor performance of FDI in Nigeria relative to the actual potential may have significantly fuelled unimpressive economic growth as Nyoni and Bonga (2018), for example, have estimated that FDI has a positive and statistically significant impact on economic growth in Nigeria. Even though the dismal and disappointing performance of GDP per capita for Nigeria for the period under review may also be due to other precipitant factors such as persistent inflation, unfavourable interest rates regimes, low earnings from exports due to the spillover of the global financial crisis as well as a sustained slump in private and public investment arising from poorly-formulated and shabbily-executed policies and macroeconomic-wide institutional constraints.

Against this background, this paper, therefore, investigates the role of policy measures and institutions in the FDI-growth relationship in Nigeria in order to provide evidence-based policy options that can drive FDI inflow and economic growth in the country. Specifically, the paper examines how FDI impacts on economic growth in Nigeria. It also examines how effective policy measures and institutional quality impact economic growth in Nigeria.

4.0 CONCEPTUAL AND THEORETICAL FRAMEWORK

4.1 Conceptual Framework

4.1.1 Institutions: Definition and Major Roles

Even though there is no universally accepted definition of institution, it will suffice to state a few generally accepted definitions of institution as presented in the existing economics literature:

(i) Institution may be defined as the formal and informal constraints on political, economic, and social interactions (North, 1990);

(ii) Institutions have been defined as rules, enforcement mechanisms, and organizations. Institutions encompass "the public bodies through which the state

discharges its most fundamental responsibilities, maintaining law and order, investing in essential infrastructure, and raising taxes to finance such activities" (World Bank 1991);

(iii) Institution derives from a particular, established code of conduct, which shapes the behaviour of a particular group of men who implicitly or otherwise have a loyalty to that code and are subject to certain controls (anxiety, guilt, shame, expulsion, etc.) if they violate the norms (Bells, 1988).

Institutions are made up of formal rules, informal constraints, and their enforcement characteristics. Formal rules, of course, are very straightforward. They are rules put into place; they are laws, constitutions, regulations, whatever, that have the character of being specific and being defined precisely. Informal norms of behaviour provide us with more problems because informal constraints do not show up in formal terms. They are ways of doing things and are terribly important. The kinds of formal rules that we have in fact occupy a very small proportion of the guides to everyday behaviour and actions. In many ways, norms are more important than the formal rules.

According to North (2003), Institutions would not exist in a frictionless world where there is no uncertainty. Institutions exist to reduce uncertainty in the world. In a world without institutions, we would not know how to deal with each other. Institutions are the incentive systems that structure human interaction. They can make predictable our dealings with each other every day in all kinds of forms and shapes. They thereby not only reduce uncertainty in the world but allow us to get on with everyday business and solve problems effectively. When we say institution structures human interactions what we mean is that they provide incentives and disincentives for people to behave in certain ways; and if they are effective, they structure and provide incentives and also structure economic, political, and social activity. The table below depicts the expected relationship between institutional measures and economic growth.The table below depicts the relationship between institutional measures and economic growth as presented by Ibi-Ajayi (2002).

Table 1: Institutional Variables and Their Impact on Economic Growth.

S/N	Institutional Measure Type	Component of Institution	Effect on Growth
1	Socio=political Instability	*Coup d'etat*	-
		Revolution	-
2	Quality of Governance	Corruption	-
		Protection of Property Rights	+
		Law Enforcement	+
		Effective Regulation	+
3	Nature of governance	Democracy	+-?
		Autocracy	-
4	Socio-economic Characteristics	Income Inequality	-
		Ethnic Conflict	-

Source: Ibi-Ajayi (2002), pp. 25

In a market economy, Ibi-Ajayi (2002) submits that institutions help to transmit information, enforce property and contract rights, and manage competition in the marketplace. In a broad sense, institutions are expected to facilitate the generation of new ideas, define property rights and contracts, stimulate innovations, lower transaction costs, and correct government and

market failures. Reducing uncertainty and fostering efficiency enhance strong economic performance. The capacity of the state to provide and effectively operate these institutions largely determines how well individuals, firms, and organizations behave in a market economy and how well the market functions to guarantee suitable economic well-being and the quality of life of the citizenry.

4.1.2 The Transmission Mechanism between Foreign Direct Investment (FDI) and Economic Growth

Within the neoclassical growth framework of Solow (1956), the impact of FDI on the growth rate of output was highly constricted owing to diminishing returns to physical capital. As such, a level effect rather than a rate effect could only be exerted on the output per capita. In effect, the flow of FDI has no appreciable impact on the growth rate of output in the long run. Thus, with neoclassical models, FDI as a veritable engine of growth was seriously undermined. However, with the exposition of new growth theory, FDI is capable of affecting both the level as well as the rate of growth of output per capita. Literature has clearly delineated on how FDI may potentially enhance the growth rate of per capita income in the host country.

Apart from factors like the existence of human capital resources, the absorptive capacity of the host country, good trade policies, the size of the market, institutional quality, effective policy, and a host of other factors that had earlier been explained. The importance of the quality of institutions and the effectiveness of policies have been well-stressed in the emerging FDI literature. Institutional quality is seen as a measure that indicates the quality of governance and institutions in a country. Olanrewaju *et al* (2019) submit that while the effects of institutional quality could vary widely in an economy, institutional quality appears to be the dominant driving force behind inclusive growth. According to Heritage Foundation has been defined as the absence of government coercion or constraint on the production, distribution, or consumption of goods and services beyond the extent necessary for citizens to protect and maintain liberty itself".

Economists have long accorded greater importance to freedom to choose and supply resources, competition in business, free trade with others, and secure property rights as representing important ingredients needed for achieving economic development. According to Frazer economic freedom index, there are five major components of the index and these include are the size of government, expenditures, taxes, and enterprises; legal structure and security of property rights; access to sound money; freedom to trade internationally and regulation of credit, labour, and business.

4.2 Theoretical Framework

Several theories of FDI abound in the literature, such as the internalization theory and the eclectic theory, among others. Two of these theories will be explored in this section to put the paper in a proper perspective and establish the theoretical foundations of FDI and economic growth.

a. Internationalization Theory

According to Dunning (2008), the internalization theory explains FDI as an organizational hierarchy, which internalizes the market for cross-border intermediate products. The theory is essentially directed to explaining why cross-border transactions of intermediate products are organized by hierarchies rather than determined by market forces, and why there is a strong presence of high-technology industries among multinational corporations. The notion of

internalization implies that firms aspire to enhance their internal markets as soon as the cost of business activities within the firm becomes minimal. Thus, foreign firms are prompted to engage in FDI whenever they perceive that the net benefits of their common ownership of domestic and foreign activities, and the transactions arising from them, are likely to exceed those offered by external trading relationships. Thus when these foreign firms perceive the chances of higher profitability from affiliate firms, they become eager to make their investment decisions. Asogwa (2014) amplified this theory by pointing out that FDI takes place only if the benefits of exploiting firm-specific advantages outweigh the relative costs of the operations abroad.

b. Theories of Institutional Quality

Theories of institutional quality can be classified into the old institutional theory, the methodological individualism, and the new institutional theory. According to Hodgson (1993), the 'old' institutionalism established the importance of institutions and proclaimed the need for genuinely evolutionary economics. However, it proceeded in a more and more descriptive direction, leaving many of the core theoretical questions unanswered. Proponents of this theory believe that the neoclassical idea of the rational utility-maximizing agent is inadequate and erroneous. Thus, this institutional theory does not take the individual as a constant variable; instead, individuals are shaped by institutional and cultural arrangements.

Molinari (2013) propounds the second-best theory of institutional quality and confronts two types of institutional shortcomings in this benchmark setting. The first is corruption. Its role, as it is standard in the literature, is to change the objective function of the Government: instead of maximizing social welfare, a dishonest public official maximizes the kickbacks he can get. The second is the lack of a satisfactory system of public governance, an element which is more difficult to capture because there is no univocal notion of what bad governance is; for example, for some authors, corruption is one of the many forms that bad governance takes. In this paper, however, while corruption is related to the decision-maker's selfishness, governance has to do with the way the decision process works and with the capacity of the governing body to formulate good policies and implement them. One major ingredient to complete this task, in today's complex organizations, is the ability to gather the information that is usually dispersed among many actors of the front-line staff and move it upwards to the final decision maker. Good governance with the decision maker's access to reliable information.

5.0 REVIEW OF EMPIRICAL LITERATURE

There are studies in the literature investigating the relationship between institutional development and foreign direct investments. Considering the work of North (1991), economic institutions establish the incentives faced by both domestic and foreign economic agents. In that respect, institutional variables such as government policy (Gomes-Casseres, 1991), intellectual property rights protection or political risk have been considered as crucial in developing foreign business investment strategies.

Tun, Azman-Saini and Law (2014) studied the importance of institutions for the growth-enhancing effect of FDI in a panel of 78 countries. The study used interaction terms between FDI and institutional quality to capture this mediation effect. The findings revealed that the coefficient on FDI is statistically insignificant which implies that the impact of FDI on growth is transmitted through institutional quality and it has no direct impact on growth. Furthermore, the coefficient on the institution was found to be positive and statistically significant at the 1% level. Thus, the study highlighted the complementary relationship

between FDI and institutional quality, whereby the impact of FDI on growth actually depends on the quality of institutions in the host countries.

In a related empirical study, Nguyen, Su, and Nguyen (2018) studied the impact of institutional quality on economic growth for 29 emerging economies using the System GMM estimators. The study found that the coefficient of the interaction between institutions and FDI was negative, while trade openness and FDI have the expected positive impacts on economic growth. Furthermore, the interactions between institutional quality and trade openness also have significant negative coefficients. Brahim and Rachdi (2014) studied the role which institutions play as regards the relationship that exists between FDI and economic growth in the MENA region. The major contribution of the study centered on the analysis of how institutional quality affects the FDI-economic growth nexus. The results show that the effect of FDI on economic growth was largely dependent on the development of institutions in MENA countries such that only countries with good institutions can exploit the advantages of FDI on growth.

Chauvet, Collier, and Hoeffler (2007), cited in Elijah and Ayodele, 2013) estimate the cost of state institutional failure and weak capacity for economic growth, both for the failing state itself and for its neighbours covering a global sample of developing countries over the period 1974-2001. Employing the Ordinary Least Squares (OLS) and the Generalized Method of Moment (GMM) as techniques for estimations, the empirical results revealed that a failing state at peace significantly reduces the growth rate by 2.6 percent relative to being at peace with adequate policies and governance, while violence and crimes induce a further loss of 1.6 percent of growth per year.

Knutsen (2010) investigates the impact of democracy and dictatorship on economic growth in Sub-Saharan Africa, and whether the effect of democracy on growth depends on the level of state capacity and institutional structures. Importantly, the study focused on the adverse economic effects of dictatorial regimes in countries with weak state institutions. In such context, leaders pursue policies that are macroeconomically inefficient, but which enhance their survival in office and increase their personal wealth. The empirical analysis shows that democracy most likely contributes to higher growth rates in Sub-Saharan Africa and that democracy has a larger positive effect on growth in Africa than globally. Moreover, the empirical findings using African and global evidence show that democracy has a particularly positive effect in countries with weak state institutions. The interaction between weak state capacity and dictatorship is found to be a vital factor underlying Africa‘s many economic development disasters. Against the background of these empirical findings, the author suggests the building of strong institutions, particularly state capacity to enhance growth in Africa.

Similarly, Najabat and Hamid (2017) found that FDI has a positive impact on the economic growth of Pakistan. Arshad (2016) explored the role of institutional quality on economic growth and more specifically the role it plays through foreign direct investment in a group of 106 countries. The results show that besides a strong direct positive effect on economic growth, the aggregate institutional quality variable as well as all individual variables except for the rule of law have a small but significant indirect impact on the economy that takes place through boosting FDI.

While investigating the impact of institutions on FDI inflow and economic growth in Nigeria, Ozekhome (2017) found that democratic institutions and foreign direct investment have a significant impact on the economic growth in Nigeria. The results also show that weak institutions have a destabilizing effect on economic growth, while the impact of FDI on the

other hand was found to be positive and significant. Using the Autoregressive Distributed Lag (ARDL) modelling framework to investigate whether or not institutional quality enhances the relationship between FDI and economic growth in Nigeria between 1981-2018, Ogbuabor*et al* (2020) this study investigated whether institutional quality enhances this relationship over the period 1981 – 2018 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 openness is an important driver of growth in Nigeria.

Emmanuel (2016) also found that FDI impacts positively and significantly on economic growth in Nigeria. In a study of institutional quality and FDI in Nigeria, Esew and Yaroson (2014) established that political stability and corruption are major determinants of FDI inflows to Nigeria, while human capital and trade openness are also significant determinants of FDI inflow to Nigeria. Okonkwo, Egbunike and Udeh (2018) found that FDI increased Nigeria's exports in the period 1990 to 2012; while Akanegbu and Chizea (2017) established a positive relationship between FDI and output growth in the Nigerian economy. Izilien and Mohammed (2017) found that democratic institutions and FDI are significant variables for driving rapid economic growth in Nigeria. Both Aguda and Oladuja (2017) and Adeleke, Olowe and Fasesin (2014) found that FDI largely promotes economic growth, while Onakayo (2012) found that even though FDI has a significant impact on the output of the Nigerian economy, the growth effects of FDI differ across sectors.

Overall, we find that the role of both institutions and policy variables in the FDI-growth nexus in Nigeria has largely remained unexplored in a single study. This study, therefore, contributes to the extant literature by investigating the simultaneous roles of effective policy and quality institutions in enhancing or impeding the foreign direct investment (FDI)-growth relationship in Nigeria using empirical data from 1991 – 2021.

6.0 DATA AND METHODOLOGY

This study utilizes a quantitative research approach based on numbers. Ratios and percentages were used to determine commonalities or patterns in the data. The results are reported in graphs and tables to confirm or refute our assumptions and establish generalizable facts on the roles of the quality of institutions in influencing FDI and economic growth in Nigeria.

Secondary data is used in this study. Data for the real GDP (RGDP) annual growth, real GDP per capita (GDPC) growth, and foreign direct investment (FDI) inflow annual percentage change for Nigeria wereobtained at the constant 2015 US$ and sourced from the World Bank's World Development Indicators database at https://data.worldbank.org/indicator.Data for the corruption perception index (CPI) for various years were derived from the Transparency International database at https://www.transparency.org/en/cpi/2021, while the indices of economic freedom of the world (EFW) are sourced from the Frazer Institute of Economic Freedom database at https://www.fraserinstitute.org/studies/economic-freedom. The data used captures the period from 2012 to 2021.

7.0 ASSESSING THE APPLICATION OFINSTITUTIONAL QUALITY TO FDI INFLOW AND GROWTH PROCESS: RECENT EVIDENCE FROM NIGERIA

This section discusses the impact of institutional quality and effective policy on the FDI inflow and growth performance of the Nigerian economy from 2012 – 2021 with a view to understanding the precipitant factors responsible for the present situation and thinking of the future.Table 1 depicts the annual percentage growth in Gross Domestic Product (GDP), the FDI Inflow annual percentage growth, and the GDP per capita (annual percentage change) for Nigeria between 2012 and 2021. Even though the GDP grew from 4.23 percent in 2012 to 6.67 in 2013, it steadily declined thereafter. Nigeria's economic potential is constrained by

many structural issues, including inadequate infrastructure, tariff and non-tariff barriers to trade, obstacles to investment, lack of confidence in currency valuation, and limited foreign exchange capacity, not to mention the rising insecurities instigated by the proliferation of insurgency and wide-scale terrorism. The growth recovery in Nigeria for 2023 (2.8 percent) is still fragile as oil production remains subdued and the new administration faces many policy challenges.

Table 2: Annual Percentage Growth in GDP, FDI Percentage Growth, and Annual Change in GDP Per Capita Growth

Year	Annual % Growth in GDP	FDI Inflow (annual % change)	GDP Per Capita Growth (annual % change)
2012	4.23	-20.03	1.4
2013	6.67	-21.32	3.83
2014	6.31	-15.62	3.55
2015	2.65	-34.72	0.07
2016	-1.61	12.7	-4.05
2017	0.81	-30.12	-1.71
2018	1.92	69.87	-0.59
2019	2.21	197.34	-0.26
2020	-1.79	3.48	-4.16
2021	3.65	38.9	1.18

Source: Author, with data from World Development Indicators (2023)

In terms of GDP per capita, Nigeria's performance has virtually been at negative growth rates for the most part of the period under review. The average growth rate for Nigeria during the period is -0.074 which is one of the lowest in Sub-Saharan Africa. The World Bank in its 2022 Report submits that Nigeria's economy in 2021 will be the same size as it was in 2010, which translates to a decade of lost growth. Nigeria has been facing declining incomes since 2016 as its annual population growth rate of 2.6 percent has been higher than its GDP growth rate of -4.05 percent, -1.71 percent, -0.59 percent, -0.26 percent, and -4.16 percent in 2016, 2017, 2018, 2019, and 2020 respectively, data from World Development Indicators show. Nigeria has slummed into two recessions in the past five years owing to the collapse in oil prices and disruptions caused by the Covid-19 pandemic. The contractions have weakened the nation's productive capacity, leading to a decline in output per capita.

In the same review period, the net inflow of FDI into the economy recorded a negative and disappointing performance for the most part of the period, reaching an all-time decline of -34.72 in 2015. Given her natural resource base and large market size, Nigeria qualifies to be a major recipient of FDI in Africa and indeed is one of the top three leading African countries that consistently received FDI in the past decade.

However, a report by the National Bureau of Statistics (NBS) and the Nigeria Investment Promotion Council (NIPC) indicates that the total value of capital importation into Nigeria declined to $875.6 million in the second quarter of 2021 from $1.9 billion in the first quarter of 2021. Notably, the figure represents a decrease of 54.06 percent compared to the first quarter and a 32.38 percent decrease compared to the second quarter of 2020. The NBS said the largest amount of capital importation was received through portfolio investment, which accounted for 62.97 percent ($551.37 million) of total capital importation followed by Other Investments, which accounted for 28.13 percent ($246.27millon) of total capital imported,

and Foreign Direct Investment (FDI), which accounted for 8.90 percent ($77.97m) of total capital imported in Q2 2021.

Interestingly, the above situation gives credence to the fact that while the large presence of foreign investors in the market signifies strong attraction to the country; their sudden reversal also portends great danger, given the bearish mode currently being witnessed in the stock market, manufacturing, and other areas of investment. In Nigeria, the inability of the economy to sustain growth and meet its external obligations may be an indirect consequence of disappointing FDI inflow performance and inadequate inflow of foreign investment resources, given rise to low levels of per capita real income, high average and marginal consumption propensities, low savings, and restricted new productive capital formation. It is being stated that the growing gap between the domestically available supply of savings, foreign exchange, government revenue, and skills, and the planned level of these resources is the bane of Nigeria's abysmally poor growth performance in recent decades.

Now, the question is: Is there an empirically established nexus between Nigeria's poor growth performance, and the low levels of FDI inflows in recent decades, and if so, are effective policy and institutional quality significantly responsible for the link?

We examine this question under the following sub-headings:

a. *Weak and Ineffective Institutions*

Since independence, Nigeria has experienced different governance regimes, ranging from totalitarian regimes to liberal democratic governments. But there is anecdotal evidence that government and regulatory institutions in Nigeria are generally weak giving rise to market failures, where market participants engage in fraudulent and anti-competitive behaviours. Because these institutions are weak in Nigeria, they have failed to ensure the existence of checks and balances to guarantee the right of everyone (most especially the foreign investors) and this ensures that offenders in the marketplace are not penalized due to their political/economic status in the state.

As Ibi-Ajayi (2002) has noted "In an environment of weak institutions, firms cannot engage in complex, long-term and multiple contract exchanges with effective enforcement as they do in industrial economies. A basic structure of property right that encourages long-term contracting appears essential for the creation of capital markets." According to Glaeser (2010), Nigeria's institutions can be classed as weak because they are not fulfilling their purpose, for example, Nigeria's institutions are not able to protect property rights, laws and regulations are not enforced properly, the government is not being able to offer social support as there's no access to a good level of medical care and mental health support. Nigeria's institutions are weak because their institutions have failed to build infrastructures stable for development.

Essentially, there is ample evidence that the market-regulating and market-stabilizing institutions in Nigeria institutions in Nigeria are weak and ineffective and are unable to provide access to finance which is vital in any economy, an efficient financial system that allocates financial resources quickly and cheaply presents an incentive for people to invest and innovate. These are major constraints to ease of doing business in Nigeria. If Nigeria's market-creating institutions were to improve in this area there would be a huge attraction for the inflow of FDI into the economy. Table 2 shows the ease of doing business and the number of days it takes to open up a new business in Nigeria is lower and longer respectively than in two of the MINT countries (Mexico and Turkey), highlighting that Nigeria's market-

regulating institutions lack the power to effectively create the enabling environment for local and foreign investment to thrive.

Table 3: Comparison of Ease of Doing Business and Number of Days Required to Open Up a New Business in MINT Countries (Nigeria, Mexico and Turkey)

Year	**Current Ease of Doing Business Ranking (2021)**			**Time Required to Start a New Business (in Days)**		
	Nigeria	Mexico	Turkey	Nigeria	Mexico	Turkey
2012	-	-	-	-	-	10.5
2013	-	-	-	30.3	-	10.5
2014	-	-	-	30.3	8.4	11
2015	-	-	-	30.3	8.4	11
2016	-	-	-	24.9	8.4	10
2017	-	-	-	18.9	8.4	10
2018	-	-	-	10.9	8.4	7
2019	-	-	-	7.2	8.4	7
2020	-	-	-	7.5	8.4	6.8
2021	131st	60th	34th	8.0	8.4	6.8

Source: Author's computation, based on data from World Development Indicators.

For the discerning minds, the above indicators are revealing. They show that Nigeria's poor quality of institutions of market regulation and market-stabilizing has been reflected in the poor ranking in the ease of doing business (131 out of 270 countries) relative to the other MINT countries (Mexico and Turkey) and the longer number of days it takes for a new business to start up compared to the other MINT countries considered. With the exception of 2019 and 2020, it takes a relatively longer period for new businesses to open in Nigeria than in the other MINT Countries. It is, therefore, no coincidence that the FDI inflow into Nigeria recorded the lowest slump (-34.72) in 2015, the same year the number of days required to open up a new business in Nigeria was the longest at 30.3 days. Effective institutions play a crucial role in shortening the number of days required to open up new businesses in an economy, and the latter variable in turn influences the FDI inflow into the economy, which is vital for the growth process.

b. Corruption and Poor Governance

The International Monetary Fund (1997) defines corruption as "the abuse of public power for private gains." Transparency International defines corruption is "the abuse of entrusted power for private gain" and can be classified as grand, petty, and political [another term it as 'looting'], depending on the amount of money lost and the sector where it occurs (Transparency International 2009:14). Khan (1996) defines corruption as an act which deviates from the formal rules of conduct governing the actions of someone in a position of public authority because of private - regarding - motives such as wealth, power or status (Lawal 2007). It is dishonest material gain as well as immaterial gain [power, position, and other pleasures] (Kinoti and Kimunyu 1997:23).

Corruption is one of the institutional qualities that can determine FDI inflows in a country. Studies have shown that countries with good regulatory frameworks attract more FDI inflows while those with poor legal structures cannot safeguard investment (Peres, Ameer and Xu, 2018). Ibi-Ajayi (2002) identifies three basic forms of corruption, namely: ***Embezzlement***, or the theft of public funds; ***Bribery***, or the demand for political payment in exchange for favourable decisions; and ***Nepotism***, or the placement of family members or other supporters

into key positions. He further noted that "corruption thrives generally in situations where distortions in public policy and regulatory framework provide the scope for it and where the institutions of restraint are weak. Corruption arises whenever officials have wide discretion and little accountability, and where there is artificial scarcity. The strength and quality of institutions provide the necessary brake to corruption and its attendant effect on economic performance.

Similarly, corruption in Nigeria has bred long-term detrimental impacts on the regulatory environment and the efficiency of the state apparatus as it creates incentives for politicians and public officials to create more regulations, restrictions, and administrative procedures in order to have more opportunities to extort small payments from citizens and companies. This, in turn, has exacerbated rent-seeking behaviour and bred inefficiencies as the practice of obstructing matters until facilitating payments have been made spreads across the public service. For instance, Nigeria's ranking on the corruption perception index (CPI) published by Transparency International (TI) has continuously deteriorated since 2010 reaching a position of 150 out of 180 countries with an extremely low index of 2023. The latest ranking suggests that the country is still being plagued by such indices of corruption as bribery, diversion of public funds, public officials using public office for private gain without consequences, the ability of governments to contain corruption and enforce effective integrity mechanisms in the public sector, red tape, and excessive bureaucratic burden which may increase opportunities for corruption, meritocratic versus nepotistic appointments in the civil service.

Table 3 depicts Nigeria's corruption perception indices from 2013 – 2021. It is evident that the level of endemic corruption over the decade has continued to escalate, producing negative impacts on the quality of institutions and stunting the growth process by limiting (or discouraging) the inflow of FDI and diverting domestic investment to the underground economy.

Table 4: Nigeria's Corruption Perception Index (CPI) Result since 2013

	2013	2014	2015	2016	2017	2018	2019	2020	2021
Score out of 100 (lower is worse)	25	27	26	28	27	27	26	25	25
Rank (higher is worse)	144	136	136	136	148	144	146	149	149

Source: Author's computation, based on data from Transparency International

Clearly, the presence of large-scale corruption in the private and public spheres in Nigeria has reduced government capacity in Nigeria leading to a lack of accountability in the conduct of government/official business, absence of transparency in decision-making, the unpredictability of government action and behaviour, opacity in the provision of information (information asymmetry) and inability to enforce the rule of law, subjecting economic agents to the risk of arbitrariness from the various arms of the state apparatuses. Corruption disrupts governance practices, destabilizes governance institutions, reduces the provision of services by the government, reduces respect for the rule of law, and reduces public trust in government and its institutions. Impaired governance, in turn, reduces social capital and public trust in governance institutions; this reduces the public funds available to support

effective economic growth programs and reduces the capability of the government to help its citizens and the poor, in particular.

c. *Low Economic Freedom*/Frazer Index of Economic Freedom

According to the Frazer Institute (2022) Economic Freedom is closely related to the rule of law. Economic freedom implies equal opportunities for all to participate in commercial affairs, initiate financial transactions and create business enterprises. It requires equal protection under the law and is opposed to favouritism. The property rights of the poor are protected as vigorously as those of the wealthy and well-connected – it is compatible with government regulation designed to promote the common good by, for example, addressing poverty, preventing human rights abuses, and protecting the environment. Economic freedom is made of five components which include size of government **(SG);** legal structure and security of property rights **(LS);** access to sound money **(AM);** freedom to trade internationally **(FT); and** regulation of credit, labor, and business **(RG)**.

Observably, in the developed nations, economic freedom is undeniably a public good as can be observed from unfettered enjoyment of it among and/or between the various economic agents, but contrariwise, lacking and even if exists, scarcely enjoy by various economic agents from the developing countries‟ counterpart. By implication, economic freedom as a bundle of goods or services in these countries is essentially luxurious in nature. Arguably, countries within sub-Saharan region in particular are seen operating on the negative and extreme end of economic freedom continuum thus raising pertinent issue about economic woes befalling the region.

Nigeria, like any other Africa countries has witnessed a series of violations in socio-politico-economic freedoms over the years. This is particularly the case during the military era which accounted greatly to the political annals of the country. With the emergence and enthronement of the democratic dispensation, a pocket of violations were still observed in virtually all facets of human lives in the country but with some signs of respite. However, the interactions between economic freedom and FDI to generate the desired economic growth has not improved substantially as unimpressive economic freedom in Nigeria continues to clog the wheel of FDI inflow into Nigeria, leading to disappointing and dismal growth performance.

Table 4 shows Nigeria's performance in economic freedom indices based on the Economic Freedom of the World (EFW) ranking by the Frazer Institute 2020 Annual Report. This performance is compared with another MINT country – Indonesia, for the same period. It is evident from the indices that Indonesia performed better than Nigeria in all the indices of economic freedom, except for size of government (SG) and regulation of credit, labour and business (RG) indicators. Also, in the overall performance for the year under review, Nigeria was ranked at 92nd position with a score of 6.70 below Indonesia which ranked 66th position with an aggregate score of 7.09. The implication is that the lower economic freedom in Nigeria may be responsible for the dwindling share of FDI in the growth contribution and policies geared toward attaining improvements in institutional factors are likely to boost the inflow of FDI into the economy.

Table 5: Economic Freedom Performance Index for Nigeria and Indonesia (2020)

Country Rank/Score/Indicator of Economic Freedom	**Nigeria**	**Indonesia**
Size of Government (SG)	9/8.46	25/7.91
Legal Structure and Security of Property Rights (LS)	139/3.75	102/4.90
Access to Sound Money (AM)	76/9.0	21/9.58
Freedom to Trade Internationally (FT)	157/4.5	85/6.60
Regulation of Credit, Labour and Business (RG)	26/7.78	123/6.46
Overall Ranking/Score	92/6.70	66/7.09

Source: Author's computation, based on data from Frazer's Economic Freedom of the World (EFW)

It is important to note that a large government size in countries with weak institutions is particularly harmful to the attraction of foreign investors, and, hence, to growth outcomes. Weak institutions here refer to the inability to provide the necessary and adequate enforcement of laws and order, and protect property rights and security for citizens (Ibi-Ajayi, 2002). Nigeria's poor performance in the legal structure and security of property rights (LS) index reinforces the fact that through insecurity, political uncertainty, monetary policy instability, and the social climate of Nigeria as of today, the reputable legal protection for foreign investment in Nigeria is highly compromised. Nigeria has problems of Oligarchy where the rich dominate politics- it may generate investment because the rich will have incentives to protect their own property rights thereby creating a non-level playing field and potential hold-up problem because power is monopolized by the rich. The situation highlights the fact that there is a need for institutional reform.

Interestingly, it is now obvious that the machinery of the state can be arbitrarily deployed against foreign investors by unscrupulous market players. FDI is attracted to an independent, fast and efficient, reliable, and just judicial system. Foreigners will certainly not be attracted to investing in countries where they believe that their justice systems may be deployed unfairly and wrongly to discriminate against them in favour of indigenes, as such practices may make it impossible to protect their investments. The bitter truth is that in the absence of a solid legal structure and protection of the property rights of foreigners in Nigeria, it will be an uphill task attracting FDI, especially when investors are able to secure viable alternatives in more welcoming climes.

8.0 CONCLUSION AND POLICY PRESCRIPTIONS

It has been demonstrated that the main economic factors responsible for growth in Nigeria do not fully explain the sustained decline in the FDI inflows and its dismal growth performance over the decade. We have found that the missing link in Nigeria's disappointing growth outcome is the extremely low level of FDI inflows which results from ineffective policies and inefficient institutional frameworks. This study has dwelt elaborately on how corruption, weak institutions and governance, low economic freedom, insecurities and poor conflict-managing institutions, and lack of legal structure and security of property rights have

stemmed the tide of FDI inflows into the Nigerian economy, causing deleterious effects on growth. Because institutions in Nigeria are weak and ineffective, they have accentuated the atmosphere of uncertainty, increase transaction and production costs and lead to inefficiency and slow growth.

Consequently, we can conclude that there is a strong and significant empirical linkage between the declining rate of FDI inflows into Nigeria and its growth performance as measured by the GDP annual growth rate and the growth of GDP per capita, that is, the low and declining level of FDI inflow has been one of the major precipitant factors for the poor growth performance in Nigeria. At the root of this linkage are such institutional factors as ineffective and weak institutions, bureaucratic inefficiencies, increasing transaction costs, large government with weak apparatuses, low economic freedom, high political risk factors arising from insecurities and poor conflict management, etc. FDI inflow is necessary for growth. Only countries that have created the right institutions and enacted the right policies have been able to attract high FDI inflows to address their domestic capital deficiency and, therefore, stimulate their economic performance through increased production capacity and growth. Nigeria cannot grow unless FDI is attracted inwardly, and foreign capital cannot be attracted unless the right institutions are created and strengthened and appropriate policies are enacted and tenaciously implemented to create a stable macroeconomic and policy environment necessary for FDI inflows.

Arising from the conclusion, the following policy measures are prescribed to improve the FDI-growth nexus in the Nigerian economy to produce the desired outcomes:

i. **Building and Strengthening Effective Institutions**

An effective institutional and macroeconomic environment must be created on priority to attract large FDI by building and strengthening institutions to ensure that information is efficiently and reliably transmitted to the market players, to enforce property rights and contracts, to stimulate innovation and lower transaction cost and to correct government and market failure. More emphasis should be on market-creating institutions, that is, such things as property Rights, legally binding contracts, and the rule of law. Property rights protect assets held by an individual or firm from being taken by others which protects citizens from various forms of government expropriation or entry barriers that protect large firms. Market-regulating institutions are equally necessary to enforce rules for the benefit and protection of investors. They help compensate for market failures and deal with any externalities arising from fraud and anti-competitive behaviour. A regulatory environment is essential for innovations to transpire as it ensures that markets are fair, efficient, and transparent.

ii. **Improving the Macroeconomic Policy Framework**

Nigeria's macroeconomic indicators in recent years have been disappointing as important macroeconomic variables continue to deteriorate, scaring away potential foreign investors. There is a dire need for the swift implementation of the appropriate macroeconomic policies to address the perennial problem of inflation, unemployment, exchange rate unavailability, etc, to engender macroeconomic stability. Nigeria’s policies that maximize benefits from FDI must include policies for macroeconomic stability, infrastructure reliability, and labor force training and development. Nigeria lags behind in indices of Business Enabling Environment (ranked 131st (DB score of 56.9) of 190 countries by The International Finance Corporation (IFC)-World Bank Doing Business Report 2020) which is not conducive to doing business. Hence, such issues as the norms and procedures of registering

property, protection of investors, excessive bureaucracy, lack of rationale tax structure, competition rules, and time taken in enforcing contracts, etc. need to be addressed.

iii. **Increasing Human Capital Accumulation**

To maximize the benefits of FDI persistently, Nigeria should place a high premium on the development of the education sector to build human capacity to improve the share of skilled labour in the labour force. Domestic absorptive capacity is a critical factor in determining FDI inflows and an adequate supply of skilled manpower is a *sine qua non* for revving up the capacity of the Nigerian economy to absorb FDI required for improved growth performance. When associated with low-cost, higher-skilled labour makes certain countries particularly attractive to MNCs in specific sectors. The quality of labour is fast becoming one of the most critical drivers of FDI, if not the most.

iv. **Ensuring Political Stability**

A dynamic market economy requires political stability for its best possible outcomes. Political instability generates economic uncertainty because of a turndown in investment. A strong financial sector generates higher saving efficiency and it leads to elevated economic growth however, this strong financial sector can only be flourished under a politically stable environment. Political instability is escalating the political risk factor in the FDI decision-making framework and thereby encroaching on the confidence of investors in Nigeria. In the business sector decisions are mainly based on political stability, not on the type of government in place. In recent years, Nigeria has experienced democratic governance but FDI is rapidly diminishing, indicating that to attract a desirable amount of FDI political condition of the country must be sound and stable.

v. **Effective Corruption Control**

Corruption has made our world a more dangerous place. As governments have collectively failed to make progress against it, they fuel the current rise in violence and conflict – and endanger people everywhere. The only way out is for states to do the hard work, rooting out corruption at all levels to ensure governments work for all people, not just an elite few. A study by Zangina and Hassan (2020) reveals that corruption inhibits FDI inflow, and corruption control has asymmetric effects on FDI inflow to Nigeria. The coefficient of positive shock or changes in respect of corruption control is positive as well as statistically significant during the long run, while the coefficient of negative shock is negative but statistically insignificant. This implies that improvement in corruption control encourages the inflow of FDI to the country, whereas a decrease in corruption control has an insignificant effect.

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