



NEXUS AMID INSTITUTIONAL QUALITY, FOREIGN DIRECT INVESTMENT AND ECONOMIC GROWTH IN SOUTH AFRICA

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Abstract

This paper examines the nexus amid institutional quality, foreign direct investment and economic growth in South Africa (SA). The study employed ARDL techniques to evaluate the nexus using annual data sourced from World Development Indicator (WDI), 2022. The findings of the study show that inflation, education expenditure (EDE), FDI, and institutional quality are positively impacting SA economic growth over the long and short term. Inflation has both short-term and long-term positive effects on the growth of the South African economy, according to the results, which show that FDI, EDE, and the quality of institutions are all very important factors that determine the country's economic growth. Therefore, special attention must be paid to attracting FDI by improving the quality of institutions and increasing the EDE in the economy. Essentially, extra care should be taken to lower inflation to accelerate South Africa's economic growth and governments must fight corruption, bolster the rule of law, and provide a transparent and predictable regulatory environment to draw in both foreign and domestic investors. These programs have the potential to create jobs, facilitate technology transfer, and boost economic growth.

Keywords: *Economic growth, Institutional quality, Inflation, ARDL.*

Introduction

The receiving economy has significant institutional challenges because of the connection amid foreign direct investment (FDI) and economic growth (Adekunle, 2024; Adegboye et al., 2020; Bekun et al., 2023; Husnain et al., 2024; Ogundipe et al., 2020). Considering the inadequate funding nature of developing nations over time and the cumulative benefits from foreign investors operations, FDI is viewed as an fundamental element of Africa emancipation. As a result, successive governments in the area have shifted their focus and attempts to integrate

their nations globally to boost foreign direct investment (FDI) in their various nations. Following earlier attempts at achieving the Millennium Development Goals (MDGs), it will assist the Africa economy recover and keep African countries in a strong position to meet the Sustainable Development Goals (SDGs).

In the meantime, the recipient economies' degree of institutional quality is seen as a crucial component that can be employed to excite FDI in any state. It calculates how much FDI can stimulate the economy. On the one hand, new data indicates that more businesses in various African industries are expanding through foreign direct investment. The comparatively higher level of FDI's observed in SSA nations during the previous year's makes this clear. On the other hand, multinational corporation's overseas investments in the majority of SSA economies typically depend on the host nations' natural resources, especially in the areas of manufacturing, oil production, and agriculture (Adekunle et al., 2023; Adegbeye et al., 2020).

The acts of transnational firms and their paraphernalia on the domestic nation are greatly influenced by institutions. Laws, organizational structures, rules, culture, and conventions are examples of formal and informal constraints that make up institutions. Institutions also affect the connection amid FDI and GDP. The degree and track of FDI influences on the local system are determined by the institutional environment, which is particularly important for developing countries with different institutional frameworks than developed ones (Mehmood et al., 2023). By safeguarding private property, upholding legal requirements, and creating product and intermediary markets, domestic framework can lessen the indirect consequences of FDI on growth. A more sophisticated institutional framework lessens the indirect effects of FDI on growth by promoting competition for output optimization among domestic and foreign businesses (Wang et al. 2013). Institutions deficiency, however, might make FDI more expensive (Uddin et al., 2023).

One of the core forces behind economic expansion and knowledge transfer from advanced to less developed countries is foreign direct investment (FDI). The host country's productive capacity is increased, management skills are improved, capital formation is increased, employment opportunities are created, competitiveness is increased, productivity of snowballing factors is increased, and macroeconomic prosperity is encouraged, among other ripple effects of foreign direct investment (FDI) (Rehman et al., 2021). Because of the advantageous economic climate, MNCs have spent the last two decades making investments in emerging markets. The expansion of emerging economies is hampered by several issues, including poor infrastructure, restricted assets and cash stock, a paucity of innovation and

advancement, and industrial retardation (Abubakar, 2020). Additionally, many businesses, especially manufacturing, suffer from an imbalance between imports and exports. According to Saidi et al. (2023), FDI inflows into developing nations serve as channels, promoting the growth of experienced workers, cutting-edge technology, and exploration and training. Emerging nations in the SSA, are categorized by the lack of important features which should attract FDI. Factors such as standard INFSR, good policies, and high-quality institutions will improve flexible institutions, cheap production costs, and advantageous tax breaks. Additionally, it would support the distortions of the free market, which deprive people of their purpose, steal resources, and even out the extent of creating an unpredictable marketplace. Additionally to impeding advance in developing countries, the issues of transparency, accountability and institution quality also hinder FDI. The purpose of the study is essentially to use the ARDL approach to quantify the connection amid institutional quality, foreign investment inflows, and economic growth in South Africa.

Literature Review

In recent years, the significance of institutions in attaining and maintaining economic growth has come to light more and more. By providing frameworks for social, political, and economic interactions, institutions have integrated norms or cultural frameworks that reduce economic and political instability. National unity, access to justice, anti-corruption efforts, and democratic accountability are examples of institutional quality components that are necessary for economic efficiency, sustainability, and overall macroeconomic stability (Khan et al., 2022). The three main types of institutions are political, legal, and economic. To reduce uncertainty, laws, rules, and regulations are established by political institutions, defend ownership rights and strive for societal progress. While economic institutions encourage the efficient allocation of resources through advancements in technology, physical capital, and human capital, legal institutions enforce the laws, rules, and regulations established by political institutions. Ineffective policymaking, inadequate law enforcement, and weak institutions can all obstruct efficient resource allocation and economic advancement (Bayraktar et al., 2023).

There is still a wealth of conflicting data regarding the effect of FDI on GDP, even with the comparatively large number of research studies on the connection amid FDI and economic growth in growing countries. This paper links FDI to economic growth, demonstrating that FDI enhances the economic growth of recipient economies. By exposing local enterprises to the best practices, advancement in technology, and human development, FDI improved capital-

intensive technology in the recipient nations and, ultimately, increase exports of commodities. A substantial investment inflow, foreign direct investment (FDI) can enhance knowledge transfer, create more new job possibilities, boost economic growth, and supplement local investment (Akinlo, 2004; Ejemeyovwi et al., 2020; Adegboye et al., 2020c).

However, the social and economic climate of the host economy largely determines how quickly FDI can accelerate economic growth (Buckley et al., 2002; Adegboye et al., 2020a; Matthew et al., 2020; Osabohien et al., 2020). Similarly, various empirical papers have stated that FDI raises the GDP (Dike, 2018; Nuzhat, 2009; Ayanwale, 2007). Dees (1998), FDI serves as cogent driver in explaining GDP of China. De Mello (1999) discovers a direct connection for a certain Latin American country, deduce the same claim. In a similar vein, Blomstrom et al. (1994) shows that FDI inflow directly impacted economic growth. However, they note that FDI directly affects GDP above a certain income threshold. Although the total effect is negligibly favorable, According to Ayanwale (2007), non-extractive investment boosts Nigeria's economic expansion. By encouraging domestic savings, increasing capital formation, and foreign investment inflows can have a direct impact on the growth of an economy by promoting information exchange in the host developing markets (Nuzhat, 2009). More recent times, Osabohien et al. (2020) discovered that FDI has a positive impact on employment and economic growth using fully modified ordinary least squares (FMOLS). Adegboye et al. (2020a) used fixed and random effects regression analysis to validate the findings of Osabohien et al. (2020) that governance and accountability problems negatively affect foreign direct investment inflow and economic growth in Nigeria. In addition to the positive relationship between inflow and economic growth, a few studies have shown that foreign capital input affects economic growth in emerging nations.

Singh's (1998) analysis of 73 least developed economies, FDI has relative impact on industrial or GDP in emerging nations. The same is true for a sample of 41 emerging nations; according to Hein (1992), the impact of foreign capital influx on intermediate national transformation per capita is negligible. Herzer et al. (2008) examined FDI-driven growth theories by applying the ECM and the Engle-Granger Co-Integration Test to short-term dynamics in a study of 28 emerging nations. In several other least developed economies, the study revealed no correlation, either short- or long-term, between foreign capital intake and economic growth. According to Ojewumi et al. (2017) a recipient economy's projections for development may suffer because of FDI. Substantial reverse flows include transfer of earning back home,

particularly when capital is moved via dividends and transfer prices, or when transnational corporations (TNCs) make major concessions to the host countries.

Nabila et al. (2015) employed the Panel ARDL technique to analyze the connection amid economic growth and the quality of institutions in selected Asian-tiger economies. The study revealed that there is a sustainable connection amid institutional quality and GDP, with high-quality institutions stimulating the economies of developing nations. Hayat (2019) asserts that a nation's institutional quality has a substantial influence on promoting economic progress. This study aims to investigate the relationship between 104 developed and developing nations' GDP growth and foreign direct investment (FDI) and institutional quality. The study assesses the positive and negative effects of institutional quality on GDP by employing an advanced method called GMM to investigate FDI-induced GDP. The study concludes that higher FDI and higher-quality institutions lead to sound economic growth, especially in low- or middle-income countries where FDI is the main driver of economic expansion. Essentially, the paper shows that FDI impedes economic progress in high-income countries.

Asghar et al. (2020) investigated the impact of institutional quality on economic development in 13 rising Asian nations between 1990 and 2013 using the panel ARDL test. They developed an institutional quality indicator using principal component analysis. The results of the study show that institutional quality and monetary improvement are emphatically associated. Economic growth and institutional quality are causally related, according to the panel causality test. These findings demonstrate how important it is to raise institutional quality to support monetary development in non-industrial Asian countries. The impact of sector-specific unfamiliar guide and institutional quality on monetary development in 74 non-industrial nations in Asia, South America, and Africa from 1980 to 2016 was examined by Maruta et al. (2020). Three sectors of foreign aid flows were examined in the study: education, agriculture, and health. The results demonstrated that the greatest influence on recipient nations comes from aid for education. The effect, however, differs according to the area and the current state of institutional quality. While aid for agriculture in Africa and education in South America is more beneficial, health aid is more effective in Asian countries. The study also demonstrated that while the benefits of aid for education rise with greater institutional quality, the impact of agriculture and health aids decreases. These findings have significant policy ramifications for donor nations and international aid organizations.

Method

The purpose of this time-series data on the South African economy from 1986 to 2021 is to investigate the connections amid FDI, inflation, institutional quality, education spending, and GDP in the country. The availability of data for these countries led to the selection of this time frame. The World Bank's online data repository provides the GDP growth (annual percentage) data for economic growth, while WDI provides the net inflows (percentage of GDP) data for foreign direct investment. The Worldwide Governance Index (WDI) provides data on the quality of institutions, and the WDI provides data on inflation and consumer prices (annual percentage).

The study used the Autoregressive Distributed Lag (ARDL) bounds testing technique, as described in Pesaran et al. (2001), to confirm the integration order and determine the long-term relationship between the variables. Compared to previous cointegration techniques, this strategy offers several advantages. It might be applied, for instance, to small sample sizes and mixed integration orders. Additionally, endogeneity problems can be fixed by utilizing the appropriate lag in the model architecture. An infinite error correction model was used to estimate the ARDL bounds testing method.

$$Gdp = f(Inst, Fdi, Inf, EdE) \quad 1$$

$$Gdp = \phi_1 + \phi_2 Inst + \phi_3 Fdi + \phi_4 Inf + \phi_5 EdE + \mu \quad 2$$

$$\begin{aligned} \Delta Gdp = & \phi_0 + \sum_{m=1}^J \phi_{1m} \Delta Gdp_{t-n} + \sum_{m=1}^J \phi_{2m} \Delta Inst_{t-n} + \sum_{m=0}^J \phi_{3m} \Delta Fdi_{t-n} \\ & + \sum_{m=0}^J \phi_{4m} \Delta Inf_{t-n} + \sum_{m=0}^J \phi_{5m} \Delta EdE_{t-n} + \partial_1 Gdp_{t-1} + \partial_2 Inst_{t-1} \\ & + \partial_3 Fdi_{t-1} + \partial_4 Inf_{t-1} + \partial_5 EdE_{t-1} + \mu \end{aligned} \quad 3$$

$$\begin{aligned} \Delta Gdp = & \phi_0 + \sum_{m=1}^J \phi_{1m} \Delta Gdp_{t-n} + \sum_{m=1}^J \phi_{2m} \Delta Inst_{t-n} + \sum_{m=0}^J \phi_{3m} \Delta Fdi_{t-n} \\ & + \sum_{m=0}^J \phi_{4m} \Delta Inf_{t-n} + \sum_{m=0}^J \phi_{5m} \Delta EdE_{t-n} + \partial_1 Gdp_{t-1} + \partial_2 Inst_{t-1} \\ & + \partial_3 Fdi_{t-1} + \partial_4 Inf_{t-1} + \partial_5 EdE_{t-1} + \epsilon_t \end{aligned} \quad 4$$

According to the ECM, the error correction term accurately captures the short-term dynamics of the adjustment process that leads to the long-term equilibrium. The rate at which the long-

term equilibrium is being attained is indicated by the ECM coefficient, represented by ξ . It should be negative and smaller than one; a bigger magnitude indicates a faster corrective process. To track changes in causal linkages over time, we also employed the time-varying exogeneity causality test. This strategy works better than other approaches for two reasons. It does this by first removing the requirement to run a unit root test to verify the variable's stationarity. Second, there is no need for cointegration between the variables. According to the ECM, the error correction term accurately captures the short-term dynamics of the adjustment process that leads to the long-term equilibrium. The rate at which the long-term equilibrium is being attained is indicated by the ECM coefficient, represented by ξ . It should be negative and smaller than one; a bigger magnitude indicates a faster corrective process. To track changes in causal linkages over time, we also employed the time-varying exogeneity causality test. This strategy works better than other approaches for two reasons. It does this by first removing the requirement to run a unit root test to verify the variable's stationarity. Second, there is no need for cointegration between the variables.

Results And Discussion

4.1. Bound Testing

Table 2 F-statistic value shows that there is a long-term connection amid economic growth, institutional quality, FDI, and other independent variables since the F statistic value is greater than upper bound value in Table 2. The work evaluated the ARDL model after empirically proving the existence of cointegration.

Table 2: ARDL Bound Testing

Test Statistic	Value	K
F-statistic	6.116708	4
C-V Bounds		
Significance	Lower-B	Upper Bound
10%	3.56	4.63
5%	3.97	5.13
2.5%	4.36	5.60
1%	4.85	6.17

Source: Author's Computation, 2024

4.2 ARDL Long run Estimation

The exact relationship between institutional quality, FDI and economic growth in South Africa is also confirmed by the study using the ARDL technique. This method looks at the short- and long-term effects of external factors on endogenous factors. The long-term results of ARDL for analyzing the quality of connection institutions, FDI, and economic growth in SA are shown in Table 3. The correlation is highly significant, as evidenced by the institutional quality's coefficient value of 5.5 and probability value of 0.00. These findings suggest that institutional quality plays a major role in understanding long-term shifts in economic growth. At the point when any remaining elements are held consistent, the study's results are consistent with those of Shabbir et al. (2021), Khan et al. (2022). According to Mehmood et al. (2023) and Uddin et al. (2023), there is an ongoing connection between a one-unit improvement in institutional quality and an increase of around 5.5 units in the reliant factors, which is the growth of the South African economy. These studies have shown that institutional qualities are crucial for any nation's GDP because, FDI which provides the newest technology to the host countries, lowers manufacturing costs, boosts economic productivity, and generates employment and money, is drawn to high-quality institutions. With a P-value of 0.26 and a long-run coefficient of 0.4, FDI is a substantial part in justifying variations in the endogenous variable and SA economic growth. It can be concluded that for every unit change in FDI, SA economic growth changes by 0.4 units. It implies that FDI contributes significantly to the growth of the South African economy. The results of Shabbir et al. (2021), Rehman et al. (2021), Liang et al. (2021), Odhiambo (2022), and Sunde (2023) are all supported by the findings of this study. The study's findings show a robust connection amid FDI and a country's GDP. More FDI results in faster economic growth. When local investment is insufficient, FDI fills the void, which is essential for economic growth. The low p-value of 0.02 and the long-term coefficient of education spending of 0.13 indicate that education spending has a significant role in explaining the deviation in the endogenous variable of SA economic development. The study's outcome supports the findings of the following studies: Ayele et al. (2023), Khan et al. (2023), Nadilla et al. (2023), Iqbal et al. (2023), and Sekwati et al. (2023).

With a very low p-value of 0.03 and an inflation coefficient of 0.13, inflation is highly significant and has long-term effects on SA endogenous variable and economic growth. It shows that inflation is a key factor in determining the long-term growth of the South African economy, with a 0.13-unit change in growth for every unit change in inflation. The study's

findings are consistent with those of Sun et al. (2023), Nguyen et al. (2022), Sohail et al. (2023), and Ha and Thuy (2021). According to these studies, the main factor influencing economic growth is inflation. It is the cornerstone of growth theories. To create more productive capability, resources must be distributed. The findings of these studies indicate that a rising rate of inflation in the economy is advantageous since it boosts economic growth because of unchecked prices and rising production costs, which make it harder to buy and use these materials.

Table 3: Long Run Coefficients

Variable	Coefficient	Std. Error	t-Statistic	Prob.
INST	5.547791	0.608968	9.110150	0.0003
FDI	-0.453848	0.362382	-1.252404	0.2658
INF	0.130758	0.097880	1.335905	0.0392
EDE	0.133930	0.075611	0.017711	0.0266
C	0.221113	0.550976	0.401312	0.7048

Source: Author's Computation, 2024

4.3. ARDL Short-run Output

Table 4 shows the short-run ARDL results to examine the effects of FDI and institution quality on South Africa's economic growth. The correlation is highly significant at the 3% significance level, as indicated by the institutional quality's coefficient value of 19.61 and P-value of 0.03. This suggests that institutional quality plays a considerable role in providing a short-term explanation for the fluctuations of the dependent variable. This suggests that, with a low probability value of 0.03, a one unit increase in institutional quality is associated with a short-term increase in SA economy growth of roughly 19.61 units. With a probability value of 0.02 and an FDI coefficient of 0.36, foreign direct investment is a highly significant short-term factor of SA's economic growth. Inflation, with a coefficient of 0.53 and a P-value of 0.05, explains the short-term fluctuations in the dependent variable. It demonstrates that inflation is a key factor in determining the short-term growth of the South African economy. Education expenditure (EDE) has a significant impact on South Africa's economic growth, as indicated by the coefficient of education expenses of 0.30, probability value of 0.3, and P-value of 0.01. The positive value shows a direct correlation between EDE and SA's economic growth, with every unit increase in EDE translating into a short-term increase of 0.3 units in SA's economic growth. Furthermore, the findings demonstrate the significance of the ECT term and the dynamic stability over time of the relationships among EDE, FDI, institutional quality,

inflation, and economic growth in South Africa. The negative sign of the coefficient and its size of -2.95 suggests that the association's adjustment effect is -2.95 units, and the model is dynamically stable. Additionally, it concludes that the model is short-term dynamically stable.

Table 4: Short-run Estimation

Variable	Coefficient	Std. Error	t-Statistic	Prob.
D(GDPC(-1))	0.976732	0.759915	1.285318	0.2550
D(GDPC(-2))	1.288936	0.738492	1.745361	0.1414
D(INST)	-7.884917	4.806527	-1.640460	0.1618
D(INST(-1))	19.615028	9.051347	2.167084	0.0324
D(INST(-2))	10.590564	5.718851	1.851869	0.1233
D(FDI)	-0.518724	0.328349	-1.579795	0.1750
D(FDI(-1))	0.364872	0.425092	0.858337	0.0299
D(INF)	0.502621	0.306736	1.638609	0.1622
D(INF)	0.539378	0.234757	2.297600	0.0500
D(EDE)	0.025788	0.126967	0.203109	0.8471
D(EDE(-1))	0.301780	0.152147	1.983474	0.0141
D(EDE(-2))	-0.271155	0.163563	-1.657806	0.1583
CointEq(-1)	-2.952600	0.994373	-2.969309	0.0312

Source: Author's Computation, 2024

Stability Test

The Cumulative Sum of Squares (CUSUM SQ) was used to evaluate the stability of the long-run and short-run coefficients. The absence of structural break was often shown by the model's stability tests, which used the CUSUM and CUSUM SQ tests.

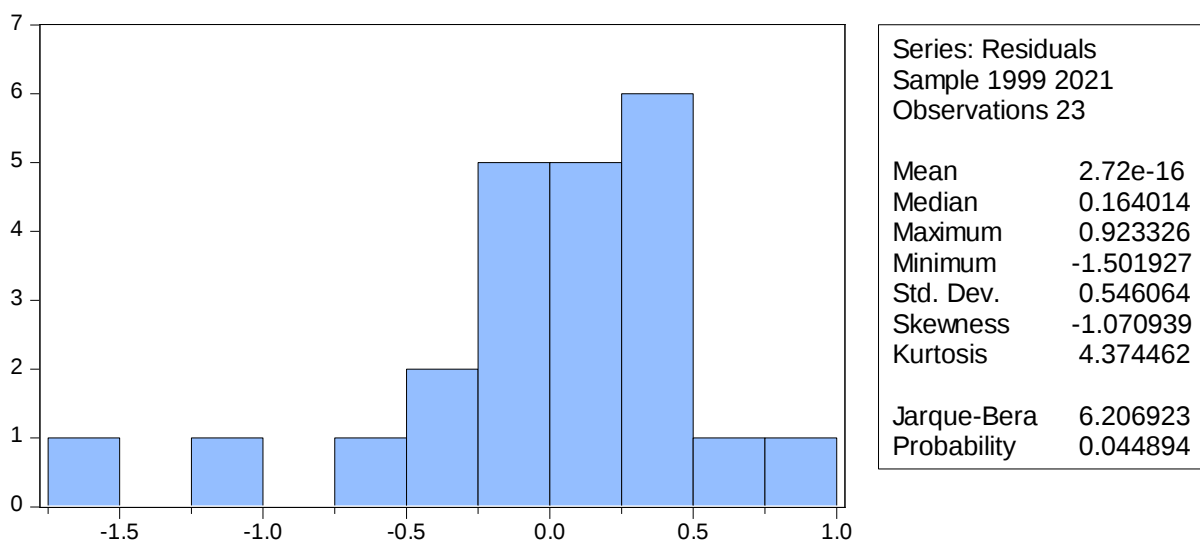


Figure 1: Normality Test (Source: Author's Computation, 2024)

Breusch-Godfrey Serial Correlation LM Test:

F-statistic	6.448691	Prob. F(2,3)	0.0820
Obs*R-squared	18.65966	Prob. Chi-Square(2)	0.0001

Source: Author's Computation, 2024

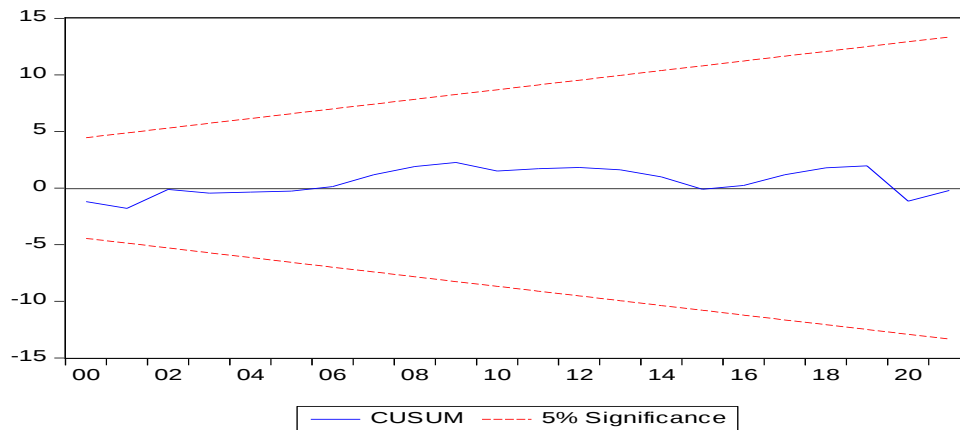


Figure 2: Cusum Sum (Source: Author's Computation, 2024)

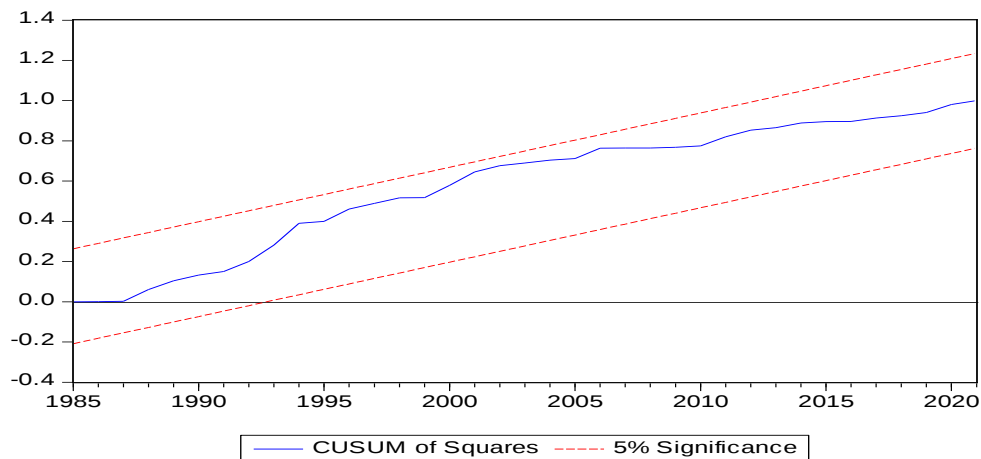


Figure 3: Cusum of Squares (Source: Author's Computation, 2024)

Conclusion

This study's primary goal is to assess how FDI and institutional quality affect South Africa's economic growth. Various econometric techniques are employed to examine the short- and long-term effects of these variables on SA economic growth. The existence of a unit root is checked using the ADF and DF unit root tests. The results of the test indicate that variables are integrated into diverse sequences and that some variables have unit root problems. After the

unit root is present, it is crucial to determine if connection or a sustainable equilibrium association amid the variables exists. For this, the cointegration methods are applied, and the results of these analyses demonstrate the existence of equilibrium relationships. The long- and short-term impacts of FDI and institutional quality on SA's economic growth are determined using the ARDL technique. The results of the test show that inflation, EDE, FDI, and institutional quality all positively affect SA economic growth over the long and short term. Inflation has both short-term and long-term positive effects on the growth of the South African economy, according to the results, which show that FDI, EDE, and the quality of institutions are all very important factors that determine the country's economic growth. Therefore, special attention must be paid to attracting FDI by improving the quality of institutions and increasing the EDE in the economy. According to the study's findings, extra care should be taken to lower inflation to accelerate South Africa's economic growth. Furthermore, the main objective should be to improve the quality of the institution. Governments must fight corruption, bolster the rule of law, and provide a transparent and predictable regulatory environment in order to draw in both foreign and domestic investors. These programs have the potential to create jobs, facilitate technology transfer, and boost economic growth. To ensure policy continuity and consistency in economic management, it is advised that political stability be improved. Long-term economic strategy may be developed and implemented with political stability, which boosts investor confidence and draws in foreign direct investment. Make establishing an atmosphere that is conducive to investment a top priority by making sure that regulations are transparent, clear, and safeguard property rights. Political stability encourages companies to make long-term investments, which boosts the economy and creates jobs. Future studies might include extending the period, adding more nations, and adding a variety of factors to the model for study. Additionally, other pertinent econometric approaches can be used to guarantee the results' robustness.

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