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The impact of institutional inefficiencies on FDI in Africa

Master in International Business

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Abstract

The goal of this study is to investigate the impact of institutional inefficiencies on Foreign Direct Investment (FDI) in Africa, while also examining liberal democracy as a moderating variable measured through civil liberties, to assess whether democratic environments influence how institutional frictions affect foreign investment decisions. Institutional inefficiencies – such as bureaucratic delays, weak regulatory enforcement, corruption, and governance instability – increase uncertainty and operational risks, potentially discouraging foreign investment in Africa. The study adopts a quantitative approach using panel data and employs Ordinary Least Squares (OLS) regression analysis to examine the relationship between institutional inefficiencies and FDI inflows. The analysis includes several control variables commonly associated with FDI determinants, namely GDP per capita, trade openness, inflation, human capital, and gross fixed capital formation. The empirical framework utilizes a dataset comprising G7 home countries (Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States) and 48 African host countries. The findings indicate that institutional inefficiencies significantly reduce FDI inflows into African countries, confirming that weak institutional environments discourage investment from G7 multinational enterprises. Contrary to the initial expectations, liberal democracy was found to strengthen rather than mitigate the negative effects of institutional inefficiencies on FDI, suggesting that greater transparency and public accountability may increase the visibility of governance shortcomings and institutional risks.

Keywords: Foreign Direct Investment (FDI), Institutional Inefficiencies, Liberal Democracy, Africa

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List of Abbreviations and Acronyms

Est.	Estimate
ESTG	School of Technology and Management
FDI	Foreign Direct Investment
FCPA	Foreign Corrupt Practices Act
GDP	Gross Domestic Product
IB	International Business
MNEs	Multinational Enterprises
OLS	Ordinary Least Squares
RQ	Research Question
IMF	International Monetary Fund
WDI	World Development Indicator

1. Introduction

Foreign Direct Investment (FDI) plays a crucial role in promoting economic growth, technological transfer, employment creation, and integration into global markets, particularly in developing economies. Although the stock of FDI in Africa increased significantly between 1980 and 2000 (Srinivasan, 2002), the continent has continued to face considerable challenges in attracting and sustaining foreign investment over time. Compared to other emerging regions, Africa still receives a relatively limited share of global FDI inflows.

One of the major reasons for this situation is that Africa continues to be perceived as a high-risk business environment. According to Aizenman and Spiegel (2006), several structural and institutional factors increase the difficulty and cost of doing business across many African countries, particularly for foreign firms. Weak governance structures, bureaucratic inefficiencies, corruption, inconsistent regulatory enforcement, and limited institutional transparency create an "unofficial tax" that raises operational costs and uncertainty for multinational enterprises (MNEs). In addition, political instability and economic uncertainty in several African economies discourage long-term productive investment in the real sector, often redirecting foreign capital toward short-term and more volatile portfolio investments.

More recently, the institutional perspective has gained increasing relevance in explaining differences in FDI attractiveness across countries. New institutional economists emphasize the importance of institutions such as property rights protection, rule of law, economic freedom, and regulatory quality in facilitating investment and economic development (Collier & Gunning, 1999). Similarly, Bénassy-Quéré et al. (2007) and Alfaro et al. (2004) argue that foreign investors prefer countries characterized by political stability, lower corruption levels, and stronger protection of property rights. In contrast, weak institutional environments increase uncertainty and reduce investor confidence, discouraging foreign investment inflows.

Within the International Business literature, institutions are recognized as critical determinants of multinational enterprises' location decisions. However, as noted by Jackson and Deeg (2008), institutional analysis in International Business has often remained relatively "thin," with limited attention given to the specific mechanisms through which institutional inefficiencies affect firm behaviour. Existing studies have largely examined institutional inefficiencies in a broad and generalized manner (Dikova & Brouthers, 2016), while limited attention has been given to how democratic conditions may influence this relationship, particularly in Africa.

Although the relationship between democracy and FDI has been widely explored in the literature, less attention has been devoted to understanding democracy as a moderating factor in the relationship between institutional inefficiencies and FDI in Africa. This gap is particularly important because African countries exhibit significant variation in democratic governance, transparency, accountability, and institutional quality. In this context, liberal democracy may influence how multinational enterprises perceive institutional inefficiencies and investment risks. Democratic institutions may reduce uncertainty by strengthening checks and balances, limiting arbitrary government intervention, improving transparency, and protecting property rights (North & Weingast, 1989; Li, 2009).

Therefore, this study seeks to investigate the impact of institutional inefficiencies on FDI in Africa, while examining the moderating role of liberal democracy. The study contributes to the International Business literature by providing a more context-specific understanding of how institutional conditions shape multinational enterprises' investment decisions in African markets. Understanding these dynamics is particularly relevant for policymakers, international investors, and researchers seeking to improve Africa's attractiveness as an investment destination. Based on the importance of this topic, the following research question is proposed:

RQ1: What is the impact of institutional inefficiencies on FDI in Africa?

This dissertation is structured as follows. First, the literature review discusses the institution-based view, institutional inefficiencies, democracy, and FDI and its role and theory, institutional distance and asymmetry between G7 and African economies. Second, the conceptual model and research hypotheses are presented. Third, the methodology section describes the sample, variables, and statistical procedures used in the analysis. The empirical results are then presented and discussed. Finally, the dissertation concludes with the main theoretical contributions, limitations, and suggestions for future research.

2. Literature Review

2.1. Institution Based of View

The institution-based view has emerged as one of the leading theoretical perspectives in the fields of Strategic Management and International Business (IB), particularly within the broader intellectual movement of new institutionalism (North, 1990; Ostrom, 2005; Scott, 1995; Williamson, 2000). Unlike traditional approaches that focus mainly on firm-specific or industry-specific factors, the institution-based view emphasizes the importance of institutional environments in shaping firm behaviour, strategic decisions, and organizational performance.

The term “institution-based view” was first introduced by Peng (2002), who argued that institutions represent a critical pillar in explaining firm strategy and performance, particularly in emerging and transition economies. Since then, the institution-based view has gained increasing relevance in International Business research and is now considered one of the dominant perspectives in the literature (Opper, 2023). Several studies have contributed to the development and consolidation of this perspective, including Meyer and Peng (2016), Peng (2005, 2014), and Peng et al. (2008, 2009, 2018).

According to North (1990, p. 3), institutions can be understood as the “rules of the game” that structure political, economic, and social interactions. Similarly, Scott (1995, p. 33) defines institutions as “regulative, normative, and cognitive structures and activities that provide stability and meaning to social behaviour.” These definitions highlight the role of institutions in reducing uncertainty, establishing behavioural expectations, and facilitating economic activity.

Within the institution-based view, institutions are generally classified as formal and informal. Formal institutions include laws, regulations, property rights, governance systems, and political structures, while informal institutions involve social norms, cultural values, ethical standards, and behavioural conventions (North, 1990). Together, these institutions shape the environment in which firms operate and influence strategic decisions, particularly in international markets characterized by institutional uncertainty.

The institution-based view in International Business draws from both sociological institutionalism (DiMaggio & Powell, 1983; Scott, 2014) and economic institutionalism (North, 1990; Williamson, 1985). From this perspective, institutions play a fundamental role in reducing uncertainty, guiding decision-making processes, and shaping firm behaviour (Scott, 2014). As argued by Peng, Sun, Pinkham, and Chen (2009, p. 66), the institution-based view "focuses on the dynamic interaction between institutions and organizations and considers strategic choices as the outcome of such an interaction."

This perspective is particularly relevant for understanding multinational enterprises' (MNEs) investment decisions in emerging economies such as Africa, where institutional conditions often differ significantly across countries. Institutional inefficiencies, including corruption, weak regulatory enforcement, bureaucratic delays, and governance instability, create uncertainty and increase transaction costs for foreign firms. As a result, institutional environments become critical determinants of Foreign Direct Investment (FDI) location decisions.

In the African context, where institutional quality remains uneven, the institution-based view provides an important theoretical framework for understanding how institutional inefficiencies influence FDI attractiveness. Multinational enterprises entering African markets must adapt their strategies to varying institutional environments, balancing investment opportunities against risks associated with weak governance structures and institutional uncertainty. Therefore, this perspective is highly relevant for examining the relationship between institutional inefficiencies and FDI in Africa.

2.1.2. Types of institutions

We closely follow the widely accepted classification of North (1990), which distinguishes:

Formal institutions - refer to explicit and codified rules that govern economic, political, and social interactions within a society. These include laws, regulations, property rights protection, governance systems, contracts, and regulatory frameworks (Dunning & Lundan, 2008; Meyer et al., 2009). Formal institutions are established and enforced by governments, legal authorities, or official organizations, providing guidelines that regulate individual and organizational behaviour.

According to North (1990), formal institutions play a critical role in reducing uncertainty by creating stable and predictable rules for economic transactions. In the context of International Business, strong formal institutions are particularly important for multinational enterprises because they help ensure contract enforcement, regulatory stability, property rights protection, and transparency. These factors reduce operational risks and transaction costs associated with foreign investment decisions. In African countries, however, formal institutional quality varies considerably. Weak regulatory enforcement, bureaucratic inefficiencies, corruption, and governance instability often undermine the effectiveness of formal institutions. As a result, foreign investors may perceive higher levels of uncertainty and risk, which can negatively affect FDI inflows. Therefore, formal institutions are highly relevant for understanding the attractiveness of African countries as investment destinations.

Informal institutions - refer to socially shared norms, values, traditions, customs, beliefs, and cultural practices that shape interactions within a society (North, 1990). Unlike formal institutions, informal institutions are not codified through official laws or regulations, but are instead transmitted across generations through socialization, imitation, and cultural practices (Boyd & Richerson, 1995). Religion, trust-based relationships, traditions, language, and ethical norms are examples of informal institutions (Dunning & Lundan, 2008).

In the African context, informal institutions play an important role in shaping business relationships and economic interactions. In environments where formal institutions may be weak or inconsistently enforced, informal networks, personal relationships, and social norms often become important mechanisms for facilitating business operations and reducing uncertainty. However, reliance on informal institutions may also increase unpredictability and create challenges for multinational enterprises unfamiliar with local institutional environments.

2.2. Institutional Inefficiencies

The institution-based view has been widely employed in International Business (IB) research to explain how institutional environments influence firms' strategies, behaviours, and performance across countries (Jackson & Deeg, 2019; Peng et al., 2008). Institutional differences and institutional inefficiencies have received increasing attention because they shape the risks and uncertainties faced by multinational enterprises (MNEs) operating internationally (Dikova & Witteloostuijn, 2007; Meyer et al., 2009). A business environment characterized by institutional inefficiencies is often described as weak, underdeveloped, or difficult for firms to operate in (Cuervo-Cazurra & Genc, 2008; Dikova & Witteloostuijn, 2007; Meyer & Estrin, 2011; Shi et al., 2012). Institutional inefficiencies include problems such as weak rule of law, ineffective contract enforcement, corruption, bureaucratic delays, political instability, weak protection of property rights, and inconsistent government treatment. According to Falaster et al. (2021), institutional inefficiencies represent dysfunctions within institutional environments that make them less effective and more costly for firms. Similarly, Luo (2005) and Meyer (2001) argue that institutional inefficiencies reduce the ability of institutions to minimize transaction costs and uncertainty.

According to North (1990), institutional inefficiencies arise when governments or powerful actors avoid implementing effective regulations that may conflict with political or economic interests. These inefficiencies are often more severe in emerging economies, where institutional systems tend to be weaker and less stable than in developed countries. Problems such as ineffective legal systems, corruption, weak judicial enforcement, and political interference increase uncertainty and create unequal conditions for firms (Esquirol, 2008; Godinez & Liu, 2015; Helmke & Levitsky, 2006). As a result, firms may face unpredictable institutional environments where rules are applied inconsistently, and advantages are often distributed arbitrarily. In the African context, institutional inefficiencies remain a major challenge for attracting and sustaining Foreign Direct Investment (FDI). Many African countries continue to experience governance instability, corruption, administrative inefficiencies, regulatory uncertainty, and weak institutional enforcement. These conditions increase operational risks and transaction costs for multinational enterprises, discouraging long-term investment decisions. Institutional inefficiencies also contribute to information asymmetries, limiting firms' access to reliable market information and reducing investment confidence (North, 1990).

Previous International Business studies have identified different dimensions of institutional inefficiencies. For example, Rodriguez et al. (2005) distinguish between the pervasiveness and arbitrariness of corruption. Pervasiveness refers to the extent to which firms are likely to encounter corruption in their interactions with public officials, while arbitrariness refers to the unpredictability associated with bribery demands and outcomes. These forms of corruption have been shown to influence firms' entry strategies, relationships with governments, firm performance, and FDI flows (Cuervo-Cazurra, 2008; Lee & Oh, 2007; Petrou, 2014; Uhlenbruck et al., 2006).

Institutional inefficiencies are prone to creating information asymmetries and to reducing the payoffs for firms as a result (North, 1990). While institutional inefficiencies can exist in both developed and emerging economies, they are often more pronounced and severe in emerging economies (Ees), which often have a weaker institutional environment than developed economies (Meyer et al., 2009; Mingo et al., 2018).

Institutional inefficiencies encompass different sectors of the institutional spectrum, namely political, economic, physical infrastructure, and human capital. Political institutional inefficiencies refer to the failure of political institutions to establish and implement an effective legal system, regulatory governance, and political stability (Chan & Du, 2022; North, 1990; Rodriguez et al., 2005). Inefficiencies within the legal system mean absence or ineffectiveness regarding the rule of law (Helmke & Levitsky, 2006), legal enforcement, property rights protection, the judicial system, transparent laws (Esquirol, 2008), etc. Where regulatory governance is lacking, there is more bureaucratism and corruption, arbitrariness in dealing with the government, poor contract enforcement mechanisms (Falaster et al., 2021), and lack or deficient market-oriented policies (Chan & Du, 2022; Cuervo-Cazurra et al., 2019). Economic institutional inefficiencies refer to the absence of efficient market intermediaries and infrastructures that facilitate or provide access to resources and support for labour, product, and capital markets (Chan et al., 2008). Market infrastructures encompass physical, human, and technological infrastructures in addition to labour forces and facilities (Chan & Du, 2022). Economic institutional inefficiencies also refer to a difficulty accessing reliable information and resources related to financial and capital markets (Khanna & Palepu, 2000; Shinkle & McCann, 2014). Other types of inefficiencies include voids within physical infrastructures and human capital, where general and technical skills and knowledge within the society and government institutions are lacking (Wang & Cuervo-Cazurra, 2017).

Recent studies have further refined the concept of institutional inefficiencies by distinguishing between generalized and arbitrary institutional inefficiencies (Falaster et al., 2021). Generalized institutional inefficiencies refer to explicit deficiencies in the formal rules of the game that affect all firms operating within a given environment, such as weak regulatory frameworks, ineffective legal systems, or pervasive corruption. In contrast, arbitrary institutional inefficiencies arise from inconsistencies in the application of those rules, whereby some firms may be privileged or disadvantaged through discretionary treatment by public authorities.

This distinction contributes to a more nuanced understanding of how institutional environments affect firm behaviour. However, because the institutional inefficiency indicator employed in this study captures the overall quality of the institutional environment rather than specific dimensions of inefficiency, the analysis focuses on institutional inefficiencies in an aggregated manner. Consequently, while the distinction proposed by Falaster et al. (2021) is theoretically relevant, the empirical analysis does not separately identify generalized and arbitrary institutional inefficiencies.

2.3. Foreign Direct Investment and its roles

In an increasingly globalizing economy, many firms are driven by the need to expand business to international markets, e.g. to seek market share, critical resources, cost efficiency or strategic assets. Country selection is an important component of the firm's internationalization efforts because of the impracticability of attempting entry into a great number of countries at the same time. Furthermore, not all countries have the same market potential. Companies, therefore, need to carefully choose where to expand their efforts and limited resources (Alon, 2004).

Foreign Direct Investment (FDI) is widely recognized as one of the most important forms of international economic integration. According to the Organisation for Economic Co-operation and Development (2016), FDI occurs when a foreign investor acquires at least 10% of the voting power of a foreign enterprise, reflecting a lasting interest and a significant degree of influence in the management of the company. Similarly, the World Bank (2016) defines FDI as an investment made to acquire a controlling interest in a company located outside the investor's home country. This includes both greenfield investments, involving the establishment of new operations, and mergers and acquisitions (M&A), which involve the acquisition of existing firms.

According to the International Monetary Fund (IMF), FDI is the investment made for the acquisition of a lasting or long-term interest in companies operating outside the investor's economy, considering that the investment is direct because the investor, who may be an individual, a company or a group of entities, intends to control, manage, or have significant influence over the foreign company. FDI can be divided into two types: vertical and horizontal: The first arises when the multinational fragments the production process internationally, locating each stage of production in the country where it can be done at the lowest cost. And horizontal direct investment occurs when the multinational produces the same product or service in several countries (Aizenman & Spiegel, 2006).

According to Blomström et al. (2003, p. 20) “Foreign direct investment can play an important role in raising a country’s technological level, creating new jobs and promoting economic growth”. The authors explain that although several countries are actively trying to attract foreign investors to promote their economic development, designing efficient incentive programs is a complicated task since it is not always possible to increase national welfare in an efficient manner. In the African context, FDI plays a particularly important role due to the continent’s development challenges, infrastructure gaps, and need for external capital. Foreign investment can contribute to industrialization, job creation, infrastructure development, and economic diversification across African economies.

2.3.1. Theories of FDI

Several theories have been developed to explain why firms engage in Foreign Direct Investment (FDI) and international production activities. These theories attempt to explain the motivations behind multinational enterprises’ (MNEs) decisions to invest abroad and the factors influencing the choice of host countries. According to Faeth (2008), there is no single theory capable of fully explaining FDI determinants, particularly in developing and emerging economies, where institutional, political, and economic conditions vary significantly. This limitation is especially relevant in the African context, where institutional inefficiencies often shape foreign investment decisions.

One of the earliest approaches used to explain FDI is the neoclassical microeconomic theory. This theory dominated FDI analysis until the 1960s (Dunning, 1993) and argues that international capital movements are driven by differences in interest rates and returns on capital across countries (Aggarwal, 1984). Under conditions of perfect competition, capital is expected to flow from countries with lower returns to countries with higher returns (Iversen, 1953). From this perspective, capital is treated as a commodity whose allocation depends primarily on profit maximization.

However, this theory has been criticized for its inability to explain the role of multinational enterprises in international production and investment decisions. Critics argue that the neoclassical approach focuses mainly on capital allocation and financial returns, while ignoring important aspects of FDI such as managerial control, strategic behaviour, and production capabilities. Consequently, the theory is considered more suitable for explaining portfolio investment rather than long-term FDI.

Another important perspective is the intangible capital or monopolistic advantage theory. According to Lall (1980), firms invest abroad when they possess specific advantages or intangible assets that provide a competitive edge over local firms in foreign markets. These advantages may include technological capabilities, managerial expertise, production techniques, organizational knowledge, and access to international networks. The theory suggests that multinational enterprises engage in FDI when these firm-specific advantages can be transferred and exploited more efficiently through direct ownership rather than through licensing or contractual arrangements.

Internalization theory also provides an important explanation for FDI decisions. According to Rugman (1986), firms engage in FDI to internalize transactions and reduce the costs associated with operating through external markets. This theory argues that multinational enterprises prefer to control foreign operations directly when market imperfections, transaction costs, or institutional uncertainties make external contracting inefficient. From an International Business perspective, internalization allows firms to reduce uncertainty, protect proprietary knowledge, and improve operational efficiency across international markets.

Although these traditional theories contribute significantly to understanding FDI, they are limited in explaining why investors choose specific host countries, particularly in emerging economies such as those in Africa. More recent studies emphasize that FDI decisions are not determined solely by economic factors, but also by institutional and governance conditions within host countries. Consequently, increasing attention has been given to the role of institutions, political stability, regulatory quality, and governance effectiveness as determinants of FDI attractiveness.

2.4 Institutional Distance and Asymmetry between G7 and African Economies

Recent International Business literature increasingly argues that multinational enterprises react differently to institutional inefficiencies depending on their country of origin and the degree of institutional distance between home and host countries. Institutional distance refers to the differences in regulatory systems, governance quality, legal enforcement, and institutional frameworks between countries (North, 1990; Kostova, 1999).

In this regard, multinational enterprises from developed economies such as the G7 are generally more sensitive to institutional inefficiencies in emerging and vulnerable economies because they originate from institutionally stable environments characterized by strong rule of law, transparency, and regulatory effectiveness. Consequently, high institutional distance increases transaction costs, uncertainty, and adaptation difficulties for firms from advanced economies (Dacin et al., 2002).

Recent studies suggest that multinational enterprises from emerging economies, particularly China and India, tend to demonstrate greater tolerance toward institutional inefficiencies in Africa because they are more accustomed to operating in institutionally volatile environments (Cuervo-Cazurra & Genc, 2008). For example, Mohamued et al. (2022) found that Chinese multinational enterprises are less discouraged by institutional distance and may even achieve investment efficiency under weak institutional environments in Africa. Similarly, Tang and Buckley (2022) argue that emerging-market multinational enterprises often possess strategic capabilities that allow them to navigate institutional voids more effectively than firms from advanced economies.

Multinational enterprises from G7 countries are particularly sensitive to institutional inefficiencies because they typically operate under highly developed institutional frameworks characterized by strong legal enforcement, regulatory transparency, investor protection, and accountability mechanisms. When investing in African countries with weaker institutional environments, these firms face greater institutional adaptation costs and a higher liability of foreignness (Zaheer, 1995). Institutional inefficiencies such as corruption, bureaucratic delays, weak contract enforcement, and regulatory uncertainty increase transaction costs and make it more difficult for firms to transfer organizational practices developed in their home countries (Meyer et al., 2009). Furthermore, G7 multinational enterprises are often subject to strict anti-corruption regulations and corporate governance requirements in their home countries, such as the U.S. Foreign Corrupt Practices Act (FCPA) and similar legislation in Europe. Consequently, operating in environments characterized by weak institutions may expose these firms to higher legal, financial, and reputational risks. As a result, institutional inefficiencies in African host countries are likely to be perceived as more significant barriers by G7 multinational enterprises than by firms originating from emerging economies.

This distinction is particularly relevant for the present study because the empirical analysis focuses specifically on FDI flows originating from G7 countries into Africa. Therefore, institutional inefficiencies in African host countries may generate stronger negative reactions among G7 multinational enterprises due to the significant asymmetry between the institutional environments of developed home countries and African host economies.

2.5. Foreign Direct Investment in Africa

Foreign Direct Investment (FDI) plays a particularly important role in African economies due to the continent's development challenges, limited industrialization, and dependence on external sources of capital. Compared to other developing regions, many African countries continue to face high poverty levels, infrastructure deficits, weak industrial bases, and limited access to international financial markets. As a result, FDI is often viewed as an important mechanism for promoting economic growth, employment creation, technological transfer, and infrastructure development across the continent.

According to the World Bank Development Indicators (WDI, 2017), Sub-Saharan Africa (SSA) remains one of the poorest regions in the world, with lower income per capita and higher poverty rates than most other developing regions. These structural challenges increase the importance of external investment flows for financing economic development and supporting productive sectors. In this regard, FDI is considered particularly relevant because many African countries have limited domestic savings, underdeveloped capital markets, and weak tax collection systems, which constrain governments' ability to finance investments in infrastructure, education, healthcare, and technology (Asiedu et al., 2009).

Despite its importance, FDI inflows into Africa remain relatively low compared to other emerging regions and are highly concentrated in the extractive industries, particularly oil, gas, and mining. According to the African Development Bank Group (ADBG, 2020), a large proportion of FDI entering Africa is directed toward natural resource extraction rather than manufacturing or high value-added sectors. This concentration limits the broader developmental impact of FDI because resource-based investments often generate fewer employment opportunities and weaker linkages with domestic industries. Similarly, Morisset (2000) argues that many African countries attract FDI primarily due to natural resource endowments and market size rather than institutional quality or industrial competitiveness. Countries such as Nigeria and Angola historically attracted high levels of FDI due to oil resources, despite experiencing political and economic instability.

Although Africa experienced stronger economic growth during the 2000s compared to the "lost decade" of the 1980s, concerns remain regarding the sustainability and diversification of this growth pattern. According to the International Monetary Fund (2013), many Sub-Saharan African economies achieved average annual growth rates close to 5% over nearly two decades. However, the World Economic Forum Africa Competitiveness Report (2013) warned that many African economies remain excessively dependent on commodity exports, making them highly vulnerable to external shocks and commodity price fluctuations.

More recently, some African economies with limited natural resources have also experienced significant growth, suggesting that factors beyond natural resource abundance increasingly influence investment attractiveness. In this context, institutions have become an important determinant of FDI inflows. Institutional quality, governance effectiveness, political stability, regulatory enforcement, and transparency are increasingly recognized as critical factors influencing multinational enterprises' investment decisions. According to Wei (2000), institutional quality, including governance and corruption control, significantly affects FDI flows, while institutional inefficiencies tend to discourage foreign investors due to higher uncertainty and transaction costs. Agbloyor et al. (2014), Ndikumana and Verick (2008), and the United Nations Conference on Trade and Development (UNCTAD, 2007) argue that FDI in Sub-Saharan Africa remains heavily concentrated in natural resource sectors, limiting its overall developmental impact on the broader economy.

Political conditions also play an important role in shaping FDI flows into Africa. While foreign investors may not necessarily prioritize a specific political regime, they are highly sensitive to political instability and governance uncertainty. Malikane and Chitambara (2017), in their study of Southern African countries, argue that democracy contributes positively to economic growth and that the impact of FDI on economic performance depends partly on the level of democracy within host countries. Strong democratic institutions may improve transparency, accountability, and policy stability, thereby increasing the positive effects of FDI spillovers.

Africa represents both significant opportunities and substantial institutional challenges for multinational enterprises. The continent possesses abundant natural resources, a growing consumer market, and increasing regional integration opportunities. However, institutional inefficiencies continue to reduce investment attractiveness by increasing uncertainty, transaction costs, and operational risks for foreign firms. Therefore, understanding how institutional inefficiencies affect FDI in Africa, and how democratic institutions may influence this relationship, remains highly relevant for both academic research and business practice.

Recent literature suggests that the structure of FDI in Africa has gradually evolved beyond its traditional concentration in extractive industries. While natural resources remain important recipients of foreign investment, growing inflows have increasingly targeted sectors such as telecommunications, financial services, information and communication technologies (ICT), digital platforms, and financial technology (FinTech) (UNCTAD, 2023). The expansion of mobile banking, digital payments, e-commerce, and telecommunications infrastructure across several African countries has attracted multinational enterprises seeking opportunities in rapidly growing consumer markets. Unlike resource-seeking FDI, these sectors are highly dependent on regulatory quality, institutional efficiency, legal certainty, and effective governance frameworks. Consequently, institutional inefficiencies such as regulatory uncertainty, bureaucratic delays, weak enforcement mechanisms, and governance instability may represent particularly important barriers for foreign investors operating in service-intensive and technology-driven industries. This evolution reinforces the relevance of examining institutional inefficiencies as a determinant of FDI in contemporary African economies.

Africa presents both significant opportunities and substantial institutional challenges for multinational companies, especially those from G7 countries. Beyond its abundant natural resources, the continent is increasingly characterized by expanding digital markets, financial innovation, telecommunications development, and a growing middle class. However, the success of these sectors depends heavily on the quality of institutions, regulatory effectiveness, and governance capacity. Therefore, understanding how institutional inefficiencies affect FDI in Africa and how democratic institutions can influence this relationship remains highly relevant for both academic research and business practice.

2.6. Democracy

Democracy constitutes a system of governance where the authority of the state resides with the people or the general population. Alternatively, it represents a form of government where authority rests in the hands of the people, either directly or through their elected representatives. In a democratic setup, citizens possess the right to engage in decision-making processes that impact their lives, commonly exercised through participation in free and fair elections (Ajide, 2024).

Some argue that democracy provides secure property rights and a fair competitive environment conducive to efficient markets, whereas others argue that democracy reduces monopolistic advantages and undermines the illicit profit benefits that multinational corporations may derive from less competitive environments (Okafor et al., 2011).

This study considers liberal democracy, measured through civil liberties, as a moderating variable in the relationship between institutional inefficiencies and Foreign Direct Investment

(FDI) in Africa. It combines electoral processes with the protection of individual rights and the rule of law. This form of democracy offers a higher degree of legal certainty and protection of property rights, which are crucial for attracting FDI, as it reflects the extent to which countries guarantee civil freedoms, transparency, accountability, freedom of expression, and access to information. In African countries, where institutional quality and governance structures vary significantly, democratic institutions may affect how firms evaluate institutional inefficiencies and investment risks. Furthermore, multinational enterprises are highly sensitive to institutional uncertainty because weak institutions increase transaction costs, operational risks, and the liability of foreignness faced by foreign firms (Zaheer, 1995). In more liberal democratic environments, higher levels of transparency and freedom of information may increase the visibility of institutional inefficiencies, potentially strengthening their impact on FDI decisions.

Multinational companies commonly invest abroad to benefit from cost of capital disparities (Lall, 1980), or from the efficiencies to be derived from ownership, location or internalisation advantages (Dunning, 1981, 2001, 2008). However, because FDI investment is typically considered to be long term and difficult to divest from, companies engaged in FDI may be exposed to varying levels of political risk associated with rent seeking, intervention and contract default (Jensen, 2008). Thus, so as to minimise risk, FDI should be attracted to more democratic countries because democratic institutions enforce property rights protection, ensure policy and regulatory stability, and reduce corruption and possible expropriation (Li, 2009). With regards to civil liberties, democratic regimes provide an environment where the laws are clear, available and enforced universally by independent judiciaries (Diamond &Morlino, 2004). In contrast, less democratic regimes have legal systems that are prone to government abuse, are less capable of protecting property rights, and of enforcing government commitments and obligations (North & Weingast, 1989; Merkel, 2004; Acemoglu, 2008). Thus, countries with well-developed civil liberties have entrenched electoral oversight, which strengthens property rights protection, provides checks and balances on elected officials and reduces the risk of arbitrary government intervention (Globerman & Shapiro, 2002, 2003). Hence, countries that protect individual freedoms are more likely to attract FDI (Harms & Ursprung, 2002).

Furthermore, democratic institutions contribute to policy credibility, regulatory accountability, and governance quality, which are essential factors influencing international investment decisions (Rodrik et al., 2004). Therefore, democracy is not treated merely as an independent political factor, but rather as a contextual condition that shapes the relationship between institutional inefficiencies and FDI in African economies.

However, the relationship between democracy and FDI remains far from consensual in the International Business literature. While democratic institutions are often associated with stronger governance, accountability, and investor protection, several scholars argue that democracy may also generate outcomes that discourage foreign investment. Li and Resnick (2003) argue that democracy simultaneously creates conditions that both attract and deter FDI. Although democratic regimes strengthen property rights and constrain arbitrary government intervention, they may also increase political competition, redistributive pressures, and policy uncertainty, which can reduce the attractiveness of a host country for foreign investors.

This debate is particularly relevant in the African context, where many democratic systems remain relatively young and institutionally fragile. Liberal democracy is associated with greater freedom of expression, media independence, and public accountability. While these characteristics are generally considered beneficial for governance, they may also increase the visibility of corruption, bureaucratic inefficiencies, regulatory failures, and political instability. Consequently, foreign investors may become more aware of institutional weaknesses that would otherwise remain less visible in more authoritarian environments.

Furthermore, multinational enterprises from developed economies, particularly those originating from G7 countries, tend to be more sensitive to institutional risks because they operate in highly predictable and institutionally mature environments (Jackson & Deeg, 2008; Dikova & Brouthers, 2016). When investing in African countries, these firms may react negatively to the public exposure of governance failures, even when democratic institutions are present. In this sense, democracy may not necessarily offset institutional inefficiencies; instead, it may amplify investors' awareness of institutional weaknesses and increase the perceived risks associated with long-term investments.

3. Conceptual Model

Drawing on the Institution-Based View (Peng et al., 2008; Peng et al., 2009), this dissertation argues that foreign investors decisions are shaped by the institutional conditions of host countries. Consequently, institutional inefficiencies represent important barriers to FDI because they increase transaction costs, uncertainty, and operational risks for multinational enterprises. These challenges may be particularly relevant for multinational enterprises originating from G7 countries, which operate in institutionally mature environments and are therefore more sensitive to institutional inefficiencies and governance risks in host countries (Jackson & Deeg, 2008; Dikova & Brouthers, 2016).

3.1. Barriers to FDI in Africa

Barriers to Foreign Direct Investment (FDI) have been widely discussed in the international business and internationalization literature since the 1960s. Early studies by Bilkey (1978) identified several obstacles affecting firms' international expansion, including bureaucratic procedures, difficulties in finding reliable distributors, non-tariff barriers, compliance requirements, and communication challenges (Pinho & Martins, 2010). Over time, the literature has increasingly recognized that institutional conditions play a central role in shaping foreign investors' decisions, particularly in developing and emerging economies.

Many developing countries have attempted to attract higher levels of FDI by reducing restrictions on foreign firms and offering investment incentives (Anyanwu, 2012). However, barriers to investment remain significantly higher in developing economies than in developed countries. Regulatory uncertainty, burdensome administrative procedures, weak institutional frameworks, and unstable tax systems continue to discourage foreign investors. As a result, the quality of the investment climate has become a critical determinant of FDI attractiveness.

In the African context, institutional inefficiencies are widely recognized as one of the main barriers to attracting FDI. The poor quality of institutions in many African countries has frequently been associated with Lucas's (1990) paradox, which questions why capital does not naturally flow from rich countries to poorer economies where returns on investment should theoretically be higher. According to Aleksynska and Havrylchyk (2013), weak institutional quality discourages foreign investors because it increases uncertainty, operational risks, and transaction costs. Several dimensions of institutional inefficiencies contribute to reducing FDI inflows into African countries. Corruption, for example, imposes additional financial and operational costs on firms and increases uncertainty regarding future investment returns (Belgibayeva & Plekhanov, 2019). Similarly, weak protection of property rights, inefficient judicial systems, and risks of expropriation discourage multinational enterprises from engaging in long-term investment projects (Meyer et al., 2009). Political instability also plays an important role, as unstable political environments increase uncertainty and reduce investors' confidence in the continuity and predictability of government policies (Brada et al., 2019). Consequently, countries characterized by stronger institutional quality tend to attract more FDI, while weak institutional environments discourage foreign investors (Fiodendji, 2016).

Corruption is considered one of the most significant institutional barriers affecting economic development and investment in Africa. Mbaku (2007), drawing on Alam (1989), identifies different forms of corruption, including cost-reducing, cost-enhancing, benefit-enhancing, and benefit-reducing corruption. Regardless of its form, corruption increases inefficiencies within the business environment and undermines investor confidence. Similarly, Mauro (1995) argues that corruption negatively affects investment and economic growth by reducing efficiency and increasing uncertainty. These institutional inefficiencies are particularly problematic for multinational enterprises because they increase the costs of operating in foreign markets and intensify the liability of foreignness faced by international firms.

In this study, institutional inefficiencies - including corruption, weak rule of law, bureaucratic red tape, governance instability, and weak regulatory systems — are considered major barriers to FDI inflows in Africa. Inefficient institutions create environments characterized by uncertainty, high transaction costs, and operational risks, reducing the attractiveness of African economies as investment destinations. Furthermore, these institutional weaknesses contribute to broader development challenges across the continent, including low industrial diversification, weak human capital formation, public sector inefficiencies, and structural economic fragility (United Nations Conference on Trade and Development, 2018).

Hypothesis 1: The high level of institutional inefficiencies negatively affects FDI in Africa.

3.2. The Role of Democracy as Moderator

Building upon the competing perspectives discussed previously, this dissertation argues that democracy may influence the relationship between institutional inefficiencies and FDI in different ways. From a positive perspective, democratic institutions may weaken the adverse effects of institutional inefficiencies by improving governance quality, strengthening policy credibility, enhancing accountability mechanisms, and protecting investors' rights. In this view, democratic institutions function as safeguards that reduce uncertainty and increase confidence among foreign investors, even when institutional shortcomings persist.

However, an alternative perspective suggests that democracy may amplify investors' sensitivity to institutional inefficiencies. Greater civil liberties, media freedom, and access to information increase the visibility of corruption, bureaucratic inefficiencies, weak regulatory enforcement, and governance failures. As a result, multinational enterprises from G7 countries may become more aware of institutional risks and react more negatively to institutional shortcomings that would otherwise be less visible. This argument may be particularly relevant in African countries where democratic institutions coexist with persistent governance challenges and limited state capacity.

Given these competing theoretical arguments, democracy is expected to play an important moderating role in the relationship between institutional inefficiencies and FDI. Following the dominant view in the literature, this dissertation proposes that democratic institutions are more likely to mitigate the negative effects of institutional inefficiencies by promoting better governance, stronger protection of rights, and a more predictable business environment.

Hypothesis 2: Institutional inefficiencies can be positively mitigated by democracy through the protection of rights and economic development in Africa.

The figure 1 represents the model of institutional inefficiencies in FDI in Africa and how it impacts on its relation.

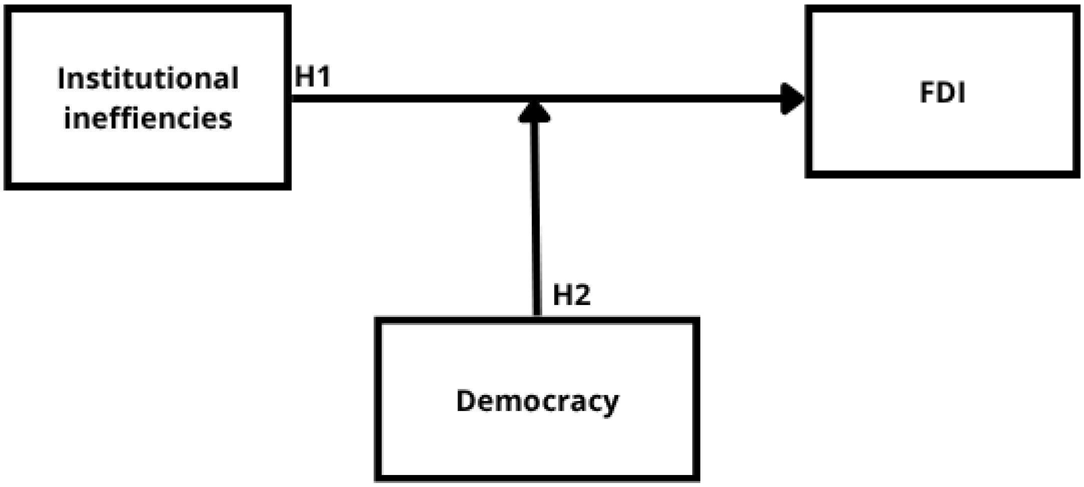

Figure 1 - Conceptual Model

4. Method

4.1. Sample and Data

The study delves into the impact of institutional inefficiencies on FDI in Africa. Therefore, the dataset is structured as a country-pair panel, where each observation represents FDI flows from a given G7 group countries home, namely (Canada, France, Germany, Italy, Japan, United Kingdom, and United States) to 48 African countries selected based on data availability for all variables included in the analysis over the periods 2009-2023. This structure allows capturing variation across both source and destination countries.

To collect the data we use secondary data, this is a common data sources for FDI and institutional inefficiencies include the World Bank, UNCTAD, and various national government reports.

4.2. Variables

Dependent Variable

The dependent variable *Foreign Direct Investment* is measured as net inflows and expressed in period $\mathrm{N}+1$ to mitigate potential endogeneity concerns. Using a lagged structure allows for a more accurate assessment of how institutional conditions affect subsequent investment decisions.

FDI is widely used as a key indicator of international capital flows and reflects the attractiveness of a country to foreign investors (Dunning, 1993). It captures long-term investment decisions and is particularly sensitive to institutional quality, macroeconomic stability, and political conditions (Borensztein et al., 1998).

Independent Variable

The main independent variable is *Institutional Inefficiencies* which captures the extent of inefficiencies in institutional structures, including, corruption, bureaucratic delays, weak governance, and regulatory burdens, ineffective enforcement of contracts, loose property rights, unevenness of treatment by the government, political instability among others.

Institutional inefficiencies are expected to negatively influence foreign direct investment to African countries, increasing transaction costs, create uncertainty, and reduce the overall attractiveness of a country as an investment destination. From an International Business perspective, institutional inefficiencies increase the liability of foreignness faced by multinational enterprises, raising operational costs and uncertainty. These inefficiencies can complicate market entry, contract enforcement, and day-to-day operations.

As argued by North (1990), institutions shape the rules of the game in economic interactions. When these rules are inefficient or unreliable, firms face higher risks, which can discourage FDI.

Empirical evidence shows that weak institutions deter FDI by increasing risks and reducing investor confidence (Kaufmann et al., 1999).

Moderating Variable

Liberal Democracy proxied by civil liberties is included as a moderating variable. Civil liberties reflect the degree of individual freedoms, transparency, and accountability within a political system. This measure reflects a liberal democracy perspective, focusing on transparency, accountability, and the protection of individual rights, which are particularly relevant for multinational enterprises when evaluating investment environments.

The moderating role of democracy is examined through an interaction term between institutional inefficiencies and civil liberties. Democratic institutions can influence how investors perceive risks, as higher transparency and accountability may either mitigate uncertainty or increase the visibility of institutional weaknesses (Rodrik et al., 2004).

Prior studies suggest that political institutions play a crucial role in shaping investment decisions and may condition the effect of economic and institutional variables on FDI (Jensen, 2003). The data were retrieved from variety of democracy (V-DEM).

Control Variables

A set of control variables commonly used in the FDI literature, we included an extensive set of control variables that may influence foreign direct investment in Africa. Therefore, we use *GDP per capita* taken from the World Development Indicators of the World Bank as a proxy for market size and economic development in African countries. Larger and more developed economies tend to attract more FDI due to greater market potential (Dunning, 1993).

Another variable is *Trade openness* which measures the degree of integration into the global economy. More open economies are generally more attractive to foreign investors (Razin et al., 2007). *Inflation* captures macroeconomic stability. High inflation is associated with uncertainty and may deter foreign investment.

Human capital reflects the level of education and skills in the workforce. A more skilled labour force attracts efficiency-seeking FDI (Borensztein et al., 1998). *Gross fixed capital formation* serves as a proxy for infrastructure and domestic investment, both of which are essential for supporting foreign investment activities (Alfaro et al., 2004).

Statistical Approach

To examine the impact of institutional inefficiencies on foreign direct investment in African countries, this study employs a quantitative research design based on panel data analysis.

The analysis is conducted using Ordinary Least Squares (OLS) regression, which allows estimating the relationship between institutional inefficiencies and FDI inflows while controlling for relevant country-level characteristics. To perform an OLS regression test, it is essential to meet certain assumptions, including linearity, independence of errors, homoscedasticity, and normality of residuals. Additionally, the model should not exhibit multicollinearity among independent variables. Considering the various requirements of the OLS test, the model should verify that there is linearity between the independent and the dependent variable, which can be verified by the F-Value (Fox, 2015).

The empirical analysis follows a hierarchical modeling approach. First, a baseline model including only control variables is estimated to capture the general determinants of FDI in African countries. Second, the independent variable, Institutional Inefficiencies is introduced to assess its direct effect on FDI. Third, the moderating variable, Democracy is included to account for the political environment. Finally, an interaction term between institutional inefficiencies and democracy is added to test whether the effect of inefficiencies on FDI depends on the level of civil liberties. The statistical analysis was carried out using SPSS software and we conclude that all the requirements were validated.

5. Results

5.1. Descriptive Statistics and Correlations

We reported the descriptive statistics and correlations of all variables in table 1, which presents the descriptive statistics for all variable used in the analysis. The results show substantial variation across countries and over time. FDI exhibits considerable dispersion with a mean value of 56.814 and a standard deviation of 381.024. The minimum value as negative (-475.959), indicating the presence of disinvestment in some observations, while the maximum reaches 4921.183, suggesting large inflows in certain countries and years.

The institutional inefficiency variable has a mean of zero and a standard deviation of 1, reflecting its standardized construction. Its value ranges from -1.735 to 2.504, indicating significant variation in institutional quality across African countries.

Regarding GDP per capita (gdp_pc), it presents a wide range from 250.544 to 18,262.712, with a mean of 2417.296, highlighting differences in economic development among the sample countries. Trade openness (trade_op) also varies substantially, with a mean of 74.122 and values ranging from 19.944 to 347.720, indicating different levels of integration into the global economy. The Inflation displays notable variability, with a mean of 7.574 and a standard deviation of 10.232, suggesting that some countries experience instability. Human capital (human_cap) shows relatively less dispersion, with a mean of 0.424 and a standard deviation of 0.073. Gross fixed capital formation (gfcf) has a mean of 24.418 and varies between 7.995 and 52.829, reflecting differences in domestic investment levels.

Overall, the descriptive statistics indicate significant heterogeneity across the sample, which justifies the inclusion of control variable in the regression analysis.

Table 1. Descriptive statistics

Variable	N	Minimum	Maximum	Mean	Std. deviation
Foreign Direct Investment	202	-475,959	4821,183	56,814	381,024
Institutional inefficiencies	336	-1,735	2,504	0,000	1,000
Liberal democracy	329	0,005	0,703	0,307	0,194
Gross domestic product per capita	336	250,544	18262,712	2417,296	3138,535
Trade openness	301	19,944	347,720	74,122	56,150
Inflation	329	-1,800	47,643	7,574	10,232
Human capital	308	0,317	0,657	0,424	0,073
Gross fixed capital formatiom	287	7,995	52,829	24,418	10,454
Valid N (from list)	161				

5.2. Correlation Matrix

Table 2 reports the Pearson correlation matrix among the variables. Overall, the correlations are relatively low to moderate, suggesting the absence of severe multicollinearity. Therefore, the correlation between inefficiencies and FDI is negative (-0.095), indicating that higher levels of inefficiencies are associated with lower FDI inflows, although the relationship appears weak at the bivariate level. On the other hand, GDP per capita shows a positive correlation with FDI (0.118), indicating that more developed economies in Africa tend to attract higher levels of foreign investment. Similarly, human capital with FDI show a positive correlation suggesting that better skilled labour forces may be associated with increased investment inflows.

Trade openness and inflation display weak correlation with FDI (-0.023 and -0.044, respectively), suggesting limited direct linear association at this stage. Regarding correlations between among independent variables, GDP per capita and human capital exhibit a relatively high positive correlation (0.733), which may indicate some overlap in capturing economic development. Inefficiencies are moderately correlated with GDP per capita (0.553) and human capital (0.425), suggesting that institutional quality is related to broader development indicators. However, none of the correlations exceed the commonly accepted threshold of 0.8, indicating that multicollinearity is unlikely to be a serious concern in the regression analysis.

Table 2. Correlation matrix							
	fdi (N+1)	**Innef _ Factor**	**Dem_Lib**	**gdp_pc**	**Trade_op**	**Inflation**	**Human_cap**
Institutional inefficiencies	-0,095						
Liberal democracy	0,131	-0,114					
GDP per capita	0,147	0,553	0,356				
Trade openness	-0,023	0,159	0,069	0,395			
Inflation	-0,044	-0,016	0,004	-0,151	-0,156		
Human capital	0,118	0,425	0,354	0,733	0,436	-0,107	
Gross fixed capital formation	-0,123	-0,109	-0,086	-0,067	0,219	-0,119	-0,106

Note: This table reports Pearson correlation coefficients between the variables used in the analysis. FDI is measured as net inflows in period $N + 1$. Innef_Factor captures institutional inefficiencies, and Dem_Lib represents the civil liberties dimension of democracy. All other variables are defined as described in the methodology section.

5.3. Linear Regression Models

The OLS regression models are present in Table 3. Thus, in this table, we provide 3 models. Model 1 includes only the control variables, namely *GDP per capita, Trade openness, Inflation, Human capital and Gross fixed capital formation*. Model 2 combines the control variables with the independent variable *Institutional inefficiencies*. Model 3 presents the full model, by including the moderating variable *Liberal democracy* to the previous model and, consequently, the interaction between the moderating and the independent variable.

For all the models, the estimated coefficients and respective standard error of each variable were displayed, as well as the *p-value*.

In model 2 of Table 3, we test hypothesis 1. Hypothesis 1 predicts that the high level of institutional inefficiencies negatively affects FDI in Africa. According to model 2, the variable Institutional inefficiencies have a negative and statistically significant effect on Foreign Direct Investment inflows in African countries. We can see that the coefficient of innef_Fact is negative and significant (β = -112,954, p = 0,005), suggesting that the higher levels of institutional inefficiencies are associated with lower FDI inflows, thus providing support for hypothesis 1. This result is consistent with theoretical expectations, as weak institutions increase uncertainty and transaction costs, discouraging foreign investors.

In model 3 of Table 3, we test hypothesis 2. Hypothesis 2 predicts that institutional inefficiencies can be positively mitigated by democracy through the protection of rights and economic development in Africa. To test moderating effect of democracy, an interaction term between institutional inefficiencies and democracy (Inter_2_Lib) was included in the regression model. The results show that the interaction term is negative and statistically significant (β = -554.651, p = 0,004). Therefore, this finding indicates that democracy does not mitigate the negative effect of institutional inefficiencies on FDI. On the contrary, the negative and significant coefficient suggests that the adverse impact of inefficiencies on FDI becomes stronger in more democratic contexts, thus, hypothesis 2 is not supported.

Table 3. OLS Regression

Variables	*Model 1*		*Model 2*		*Model 3*	
	Est.	*P*	*Est.*	*P*	*Est.*	*P*
Const.	158,810 (272,377)	0,560	103,429 (267,375)	0,699	0,531 (273,758)	0,998
GDP per capita	0,028 (0,018)	0,124	0,044 (0,018)	0,018	0,066 (0,020)	0,001
Trade openess	-1,840 (1,323)	0,166	-1,573 (1,298)	0,227	-1,167 (1,343)	0,386
Inflation	-1,500 (2,792)	0,592	-0,559 (2,754)	0,839	-2,247 (2,810)	0,425
Human capital	45,621 (623,197)	0,942	29,839 (610,125)	0,961	131,656 (632,999)	0,836
Gross fixed capital formatiom	-2,380 (3,597)	0,509	-2,555 (3,521)	0,469	-0,478 (3,643)	0.896
Institutional inefficiencies	-		-112,954 (40,078)	0,005	50,447 (84,672)	0,552
Liberal democracy	-		-		-265,649 (242,988)	0,276
Institutional inefficiencies x Liberal democracy	-		-		-554,651 (273,758)	0,004
R2	0,044		0,089		0,140	
Adjusted R2	0,014		0,055		0,095	
F-Statistic	1,462		2,595		3,104	
Observations	161		161		161	

6. Discussion

This study examined the impact of institutional inefficiencies on Foreign Direct Investment (FDI) in Africa, with liberal democracy acting as the moderating variable. Therefore, based on the institution-based view, the findings confirm that institutional conditions are highly relevant in shaping G7 multinational enterprises' (MNEs) investment decisions across African countries, since the empirical results provide important insights into how weak institutional environments influence foreign investment attractiveness and how democratic institutions may alter this relationship.

Regarding Hypothesis 1, which proposed that the high level of institutional inefficiencies negatively affects FDI in Africa, the findings clearly show that higher levels of institutional inefficiencies are associated with lower levels of foreign direct investment. This result is consistent with the institution-based view (Peng et al., 2008; North, 1990), which argues that firms' strategic decisions are strongly influenced by the institutional environments in which they operate. Institutional inefficiencies such as corruption, weak rule of law, bureaucratic inefficiencies, governance instability, and poor regulatory enforcement increase transaction costs, uncertainty, and operational risks for multinational enterprises. Consequently, foreign investors may perceive African countries with weak institutions as less attractive investment destinations.

Consistent with prior empirical evidence, the findings are also aligned with previous studies emphasizing the negative effects of weak institutional quality on FDI. For example, Wei (2000) argues that corruption significantly discourages foreign investment by increasing uncertainty and reducing business efficiency. Similarly, Asiedu et al. (2009), and Daude and Stein (2007), found that institutional weaknesses and political instability negatively affect FDI inflows into developing economies. The results therefore reinforce the argument that institutional quality constitutes an important location-specific advantage influencing multinational enterprises' internationalization strategies. Thus, the findings suggest that multinational enterprises from G7 countries are particularly sensitive to institutional risks when investing in Africa. Given the substantial institutional distance between developed home countries and African host economies, institutional inefficiencies generate higher adaptation costs, uncertainty, and liability of foreignness for G7 investors. This finding supports the institutional distance perspective, which argues that firms originating from institutionally advanced environments face greater difficulties when operating in countries characterized by weaker institutional frameworks (Kostova, 1999; Dacin et al., 2002).

This institutional distance creates an additional layer of liability of foreignness for G7 multinational enterprises operating in African markets. Firms originating from institutionally advanced economies are generally accustomed to environments characterized by predictable regulatory frameworks, effective contract enforcement, transparent administrative procedures, and strong protection of property rights. When operating in host countries where such institutional arrangements are weaker or inconsistently enforced, these firms face greater difficulties in interpreting local rules, interacting with public authorities, and anticipating policy outcomes. Consequently, institutional distance increases the costs of gathering information, monitoring transactions, negotiating contracts, and ensuring regulatory compliance. It also raises the risk of opportunistic behaviour, unexpected administrative delays, and contractual disputes, thereby amplifying both transaction costs and operational uncertainty. As argued by Zaheer (1995), these disadvantages constitute manifestations of the liability of foreignness, which may reduce the attractiveness of institutionally distant host countries for multinational enterprises from developed economies.

Contrary to the initial expectations of Hypothesis 2, the empirical results indicate that the interaction term between institutional inefficiencies and liberal democracy was negative and statistically significant. Therefore, democracy does not mitigate the negative effect of institutional inefficiencies on FDI inflows in Africa. Instead, the findings suggest that the adverse impact of institutional inefficiencies on FDI becomes even stronger in more democratic contexts. This result may be explained by the fact that liberal democratic environments, particularly those characterized by greater civil liberties, freedom of information, and media independence, increase the visibility of institutional inefficiencies. In such contexts, institutional inefficiencies such as corruption, bureaucratic delays, weak governance structures, and policy instability become more visible to multinational enterprises and international investors.

This finding may also be explained by the substantial institutional distance between G7 home countries and African host economies. Multinational enterprises from advanced economies are generally accustomed to operating in environments characterized by strong legal enforcement, regulatory transparency, and institutional stability. Consequently, when democratic institutions reveal persistent governance weaknesses in African countries, G7 investors may perceive these inefficiencies as particularly costly and difficult to manage. This argument is consistent with the institutional distance literature, which suggests that larger institutional asymmetries increase uncertainty, adaptation costs, and the liability of foreignness faced by multinational enterprises (Kostova, 1999; Dacin et al., 2002; Cuervo-Cazurra & Genc, 2008).

The results also provide support for the transparency argument found in parts of the democracy and FDI literature. Liberal democracies typically promote freedom of expression, independent media, and greater public scrutiny of government actions. While these characteristics are generally associated with better governance, they may simultaneously expose corruption scandals, bureaucratic inefficiencies, and regulatory failures more clearly to international investors. Consequently, multinational enterprises may react more strongly to institutional inefficiencies in democratic environments because institutional risks become more observable and measurable.

Moreover, this result is consistent with recent International Business literature suggesting that multinational enterprises from developed economies tend to be less tolerant of institutional inefficiencies than firms originating from emerging economies. While multinational enterprises from countries such as China and India often develop capabilities to operate under conditions of institutional uncertainty and institutional voids, G7 firms are generally accustomed to stable regulatory environments and strong legal enforcement mechanisms. Consequently, institutional weaknesses in African countries may be perceived as more costly and risky by G7 investors, leading to a stronger negative response to corruption, bureaucratic inefficiencies, and weak governance structures (Cuervo-Cazurra & Genc, 2008; Tang & Buckley, 2022; Mohamued et al., 2022).

These findings partially diverge from studies such as Jensen (2003, 2008), Li and Resnick (2003), and Busse and Hefeker (2007), which generally argue that democracy attracts FDI by strengthening property rights protection and reducing arbitrary government intervention. However, the present study suggests that, in the African context, democracy alone may not be sufficient to offset the negative effects of institutional inefficiencies. Instead, when democratic institutions coexist with corruption, weak bureaucratic capacity, poor regulatory enforcement, and governance instability, foreign investors may become even more sensitive to institutional weaknesses. This result is particularly relevant in Africa, where several countries have experienced democratic transitions without corresponding improvements in institutional effectiveness. In such contexts, democratic openness may expose governance failures more clearly without necessarily providing the institutional efficiency required to facilitate business operations. Therefore, the findings indicate that regardless of the existence of democratic structures, institutional quality remains fundamental for attracting FDI.

Overall, the findings contribute to the International Business literature by suggesting that the moderating role of democracy is more complex than traditionally assumed. While democratic institutions are often expected to enhance investor confidence through stronger accountability and protection of rights, the results indicate that democracy may also increase the visibility of institutional weaknesses, thereby intensifying the negative impact of institutional inefficiencies on FDI. This effect appears to be particularly relevant for G7 multinational enterprises, whose investment decisions are influenced by the substantial institutional distance separating developed home countries from African host economies.

Regarding the control variables, the results indicate that economic and structural conditions also influence FDI inflows into Africa. Variables such as trade openness, GDP growth, human capital, and infrastructure may positively affect foreign investment attractiveness by improving market conditions and reducing operational barriers for multinational enterprises. These findings are consistent with previous international business and development literature suggesting that foreign investors are attracted to countries characterized by economic openness, market potential, skilled labour, and better infrastructure conditions.

7. Conclusion

7.1. Theoretical contributions

This study analyses the impact of institutional inefficiencies on FDI in Africa. It will contribute to the International Business literature by extending the institution-based view to the African context and by analysing democracy as a moderating variable rather than merely as an independent determinant of FDI. While previous studies have extensively explored the direct effects of democracy and institutions on FDI, fewer studies have examined how democracy influences the relationship between institutional inefficiencies and foreign investment in Africa. Therefore, the findings provide additional evidence that institutional quality and governance conditions remain central to understanding multinational enterprises' location decisions in emerging economies.

A second contribution relates to the incorporation of the institutional distance perspective into the analysis of FDI in Africa. By focusing on investment flows originating from G7 countries, the study highlights how multinational enterprises from institutionally advanced economies may be particularly sensitive to institutional inefficiencies in African host countries. This finding supports recent International Business literature suggesting that larger institutional asymmetries between home and host countries increase uncertainty, adaptation costs, and the liability of foreignness faced by multinational enterprises (Kostova, 1999; Dacin et al., 2002; Cuervo-Cazurra & Genc, 2008).

Another contribution emerges from the unexpected findings regarding democracy. Contrary to the initial hypothesis, liberal democracy intensified rather than mitigated the negative relationship between institutional inefficiencies and FDI. This result contributes to the ongoing debate on the democracy–FDI nexus by providing evidence that democratic institutions do not necessarily compensate for weak institutional environments. Instead, greater transparency, media freedom, and public accountability may increase the visibility of governance failures, leading foreign investors to react more negatively to institutional inefficiencies. Therefore, the study contributes to a more nuanced understanding of democracy in emerging and vulnerable economies by showing that democratic openness may simultaneously enhance transparency and increase the perceived risks associated with weak institutional environments.

7.2. Managerial Implications

From a managerial perspective, the study is important because it expands the literature on political risk and FDI, alerting multinational enterprises (MNEs), international investors, policymakers, and business practitioners interested in operating in African markets. Since institutional inefficiencies negatively affect FDI inflows, managers should incorporate institutional risk assessment into their internationalization and location-selection strategies. According to North (1990), institutions reduce uncertainty by providing the “rules of the game” within an economy. Therefore, weak institutional environments characterized by corruption, bureaucratic inefficiencies, weak enforcement of contracts, and political instability increase transaction costs and operational uncertainty for foreign investors. In adittion, the governance failures are easily exposed to the world, reason why managers should carefully assess whether democratic structures are accompanied by effective governance and institutional enforcement mechanisms before committing long-term investments.

The results are particularly relevant for multinational enterprises originating from G7 countries. Given the substantial institutional distance between developed home countries and many African host countries, G7 firms may face greater adaptation costs, higher uncertainty, and stronger liability of foreignness when operating in institutionally weak environments (Kostova, 1999; Zaheer, 1995). Consequently, managers should carefully evaluate the institutional compatibility between home and host countries and develop risk mitigation strategies capable of addressing governance-related challenges. Furthermore, the findings regarding the moderating role of democracy suggest that managers should not automatically interpret democratic institutions as a guarantee of a favourable investment climate. Although democratic systems are generally associated with transparency, accountability, and protection of rights, the results indicate that democratic environments may also increase the visibility of corruption, governance failures, and institutional weaknesses. Therefore, managers should assess not only the existence of democratic institutions but also the effectiveness with which these institutions function in practice.

The findings also generate important practical implications for policymakers in African countries. Improving institutional quality through stronger governance systems, anti-corruption measures, transparent regulatory frameworks, and effective legal enforcement may significantly improve Africa's attractiveness to foreign investors. Furthermore, strengthening democratic institutions may contribute to reducing uncertainty and enhancing investor confidence. Given the importance of FDI for economic diversification, industrialization, and employment creation in Africa, institutional reforms remain essential for promoting sustainable economic development across the continent.

7.3. Limitations and Future Research

First, the sample was restricted to 48 African countries due to data availability constraints regarding FDI flows from G7 countries. Although these countries represent the vast majority of African economies receiving G7 investment, the exclusion of some countries may limit the generalizability of the findings to the entire African continent. Future research could benefit from broader datasets covering a larger number of African economies and longer time periods.

Second, the study focused on G7 investment flows into Africa, meaning that investment patterns from emerging economies such as China or India were not included. Such comparisons would allow researchers to further explore whether multinational enterprises from emerging economies are less sensitive to institutional inefficiencies due to lower institutional distance and greater experience operating in institutionally challenging environments.

Third, institutional inefficiencies were measured through aggregate indicators capturing broad dimensions of governance and institutional quality. While this approach allows for a comprehensive assessment of institutional environments, it does not distinguish between specific dimensions of institutional inefficiencies, such as corruption, regulatory quality, bureaucratic effectiveness, or rule of law. Future research could investigate these dimensions separately to identify which institutional factors have the strongest impact on FDI inflows into African countries.

Future research could further investigate the moderating role of democracy in the relationship between institutional inefficiencies and FDI in Africa, particularly considering the unexpected finding that liberal democracy strengthened rather than mitigated the negative effects of institutional inefficiencies on foreign investment inflows. Future studies may explore whether this relationship differs across different types of democratic systems, levels of governance effectiveness, or regional contexts within Africa. Additionally, researchers could examine whether increased transparency and public accountability in democratic environments make institutional inefficiencies more visible to multinational enterprises, thereby influencing their investment decisions more negatively.

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