

Business Environment and Domestic Private Investment in sub-Saharan Africa

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Abstract: A good business environment is an essential support of a country's strategy to enhance domestic private investment, which in turn will create opportunities for people to have more productive jobs and higher income. A poor business environment obstructs private firms from bringing ideas to the market and hurts innovation and growth. This paper examined the effect of business environment on domestic private firms in sub-Saharan African countries. Ease of doing business indicators were used and the sample covered forty countries in sub-Saharan Africa (SSA) from the period 2004 to 2018. System-General Method of Moment (system-GMM) of panel data method of estimation was employed. The results revealed that business environment variables such as starting a business, registering a business, enforcing a business contract and closing a business affect private domestic investment negatively with a coefficient of -0.103, -0.019, -0.005, -0.136 respectively while only starting a business is significant at 5%. This finding implies that, doing business in SSA is not always encouraging as the regulations to enhance private investment are hostile and this unfriendly business environment will eventually affect economic growth adversely. The coefficients of other investment climate variables: such as infrastructure, access to credit, and obtaining a permit were however positive.

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I. Introduction

Developing countries are increasingly concerned about enhancing country competitiveness and productivity, as they face the increasing pressures of globalization and attempt to improve economic growth and reduce poverty. Among such countries, business environment have become the standard way for the World Bank to identify key obstacles to country competitiveness¹. A significant component of country competitiveness is having a good business environment. Most economists agree that sustained economic growth is the most critical factor in alleviating poverty. There is also a general consensus among the development community that the private firm is an engine of economic growth². According to³, one of the key determinants of economic growth is investment. Besides, most of the countries that grow rapidly invest a considerable portion of their Gross Domestic Product (GDP). In contrast, countries that experience slow growth with low investment are those with consequent poverty⁴. In the sustainable development goals launched in 2015, private investment is a major tool to achieve many of the socio-economic goals of the developing countries⁵. A poor business environment obstructs private firms from bringing ideas to the market and can hurt innovation and growth.

Developing countries mostly in sub-Saharan African (SSA) rely on private investment to solve their economic problems. Private investment increases employment opportunities; attracts foreign investors living and working abroad to invest in the country and increases new technology in the country⁶. Investment Climate reforms, which seek to improve the overall and firm-level business enabling environment, are an essential component of private firm development, productivity and investment, which are key determinants of growth⁷. Business environment, as defined in the World Development Report⁷, is "the set of location-specific factors shaping the opportunities and incentives for firms to invest productively, create jobs and expand."⁸ also identified the vital variables that collectively define the business climate as; infrastructure, access to finance, security (absence of corruption and crime), the regulatory framework, including competition policies and the protection of property rights.

The impact of business environment improvement on private and foreign investment has been the focus of many studies^{9,10}. The unfavourable business environment in many sub-Saharan countries results from poor governance, institutional failures, macroeconomic policy imperfections and inadequate infrastructure, as well as rampant corruption, bureaucratic red tape, weak legal systems and a lack of transparency in government departments. These and other factors have made it difficult for the continent to attract foreign capital and mobilise adequate and sustained levels of domestic private investment to attain the levels of growth necessary

for massive job creation and poverty reduction¹¹. A good business environment provides opportunities and incentives for investors to invest profitably, create jobs, and expand national output thereby increasing private investment and economic growth¹². In the ^{7,13} noted that improvements in the business environment in developing countries are bases to increasing the flow of investments and, thus, a higher level of economic growth and development. A weak business climate will not only discourage investment, it can also lead businesses to take expensive or counterproductive steps to defend themselves from the consequences of its weaknesses. Thus, business environment needs to be friendly and attractive enough in order to encourage investment¹⁴.

Doing business is challenging in a large number of countries across the sub-Saharan African continent. Investors face difficulties in starting a business, getting requisite licenses, hiring and firing workers, registering property, obtaining credit, protecting investments and enforcing contracts. Achieving higher levels of investment in sub-Saharan African countries is subject to an improvement in the macroeconomic environment, combined with an improvement in public infrastructure. The latter is critical for business to lower production and transaction costs. ¹⁵provides information on business environment in sub-Saharan Africa countries. Table 1 presents information from the EDBS on starting a business, obtaining licence, getting electricity, registering a business, getting credit, paying tax and enforcing contracts in sub-Saharan Africa. Starting business in Namibia will take(66 days), Chad (60 days) and Zimbabwe (61days) as compared to other countries like:Ghana, Mali, Angola, Nigeria, Rwanda and Zambia which takes less than two months to start a business.

In Zambia and Burundi it will take just 5 and 4 days respectively to start a business while it will also take less than 10 days to start a business in Senegal, Sao Tome and Principe Togo, Rwanda, Mauritania, Liberia,Guinea Bissau and Cote d’Ivoire. Access to finance in any economy depends both on country’s regulatory policy and size of the industry. The enterprise survey, investment climate survey and ease of doing business provide explanatory information about the availability and efficiency of finance in various countries and economies.

Table 1: Ease of Doing Business in Selected sub-Saharan Africa 2018

| Counties | Starting a business(days) | Dealing with Licenses(days) | Getting Credit(legal right index) | Price of electricity (US cents per kWh)Rating | Registering property(days) | Getting Credible (legal right index) | Paying tax(total tax rate % of profit) | Enforcing Contract s(days) |
|-------------------|---------------------------|-----------------------------|-----------------------------------|---|----------------------------|--------------------------------------|--|----------------------------|
| Angola | 36 | 173 | 152 | 6 | 170 | 1 | 49.1 | 1296 |
| Benin | 8 | 88 | 90 | 20.7 | 120 | 6 | 57.4 | 750 |
| Bostwana | 48 | 102 | 77 | 13.2 | 27 | 5 | 25.1 | 660 |
| Burkina Faso | 13 | 121 | 169 | 23.3 | 67 | 6 | 41.3 | 446 |
| Burundi | 4 | 70 | 158 | 11.1 | 23 | 2 | 41.5 | 832 |
| Cameroon | 16 | 135 | 64 | 17.1 | 86 | 6 | 57.7 | 800 |
| Chad | 60 | 6 | 67 | 23.2 | 44 | 6 | 63.5 | 743 |
| Comoros | 16 | 108 | 120 | 27.4 | 30 | 6 | 216.5 | 506 |
| Congo | 49 | 164 | 134 | 10.6 | 55 | 6 | 54.3 | 610 |
| cote d'Ivoire | 8 | 162 | 55 | 12 | 30 | 6 | 50.1 | 525 |
| Ethiopia | 33 | 149 | 95 | 4.1 | 52 | 3 | 37.7 | 530 |
| Equatorial Guinea | 33 | 144 | 106 | 21.4 | 23 | 6 | 79.4 | 475 |
| Gabon | 33 | 276 | 148 | 19.4 | 102 | 6 | 46 | 1160 |
| The Gambia | 25 | 144 | 78 | 4.1 | 66 | 7 | 51.3 | 407 |
| Ghana | 14 | 170 | 79 | 24.6 | 47 | 6 | 32.2 | 710 |
| Guinea | 15 | 161 | 69 | 24.5 | 44 | 6 | 61.4 | 311 |
| Guinea Bissau | 8 | 143 | 257 | 26.9 | 48 | 6 | 45.5 | 1785 |
| Kenya | 22 | 159 | 97 | 20.2 | 61 | 7 | 37.1 | 465 |
| Lesotho | 29 | 183 | 114 | 10.9 | 43 | 5 | 13.6 | 615 |
| Liberia | 6 | 87 | 482 | 55.9 | 44 | 9 | 33.3 | 1300 |
| Malawi | 37 | 153 | 127 | 169 | 69 | 11 | 35.2 | 432 |
| Madagascar | 8 | 185 | 450 | 18.5 | 100 | 2 | 38.1 | 871 |
| Mali | 11 | 124 | 120 | 13.9 | 29 | 6 | 48.3 | 620 |
| Mauritania | 6 | 104 | 67 | 19.5 | 49 | 2 | 67 | 370 |
| Moszambique | 17 | 118 | 54 | 8.8 | 43 | 1 | 36.1 | 950 |
| Namibia | 66 | 160 | 37 | 15.3 | 44 | 5 | 20.7 | 460 |
| Nigeria | 19 | 112 | 149 | 16.8 | 91.7 | 9 | 34.8 | 453 |
| Niger | 7 | 91 | 97 | 22.1 | 36 | 6 | 47.8 | 430 |
| Rwanda | 4 | 113 | 4 | 16.4 | 7 | 10 | 33.2 | 230 |
| Sao Tome | 7 | 67 | 89 | 17.9 | 52 | 0 | 37.2 | 1185 |

| | | | | | | | | |
|---------------|----|-----|-----|------|-----|----|------|-----|
| and principle | | | | | | | | |
| Senegal | 6 | 177 | 75 | 17.7 | 56 | 6 | 45.1 | 740 |
| Seychelles | 32 | 138 | 77 | 31 | 33 | 2 | 29.8 | 915 |
| Sierra Leone | 8 | 182 | 82 | 24.1 | 56 | 5 | 31.7 | 515 |
| South Africa | 45 | 155 | 109 | 15.1 | 23 | 5 | 28.9 | 600 |
| Sudan | 36 | 240 | 70 | 5.4 | 11 | 3 | 45.4 | 810 |
| Tanzania | 29 | 184 | 109 | 13.4 | 67 | 5 | 44.1 | 515 |
| Togo | 6 | 163 | 66 | 18.4 | 288 | 6 | 48.5 | 588 |
| Uganda | 24 | 159 | 66 | 16.5 | 42 | 5 | 33 | 490 |
| Zambia | 5 | 189 | 117 | 4.7 | 45 | 11 | 15.6 | 611 |
| Zimbabwe | 61 | 258 | 106 | 12.7 | 36 | 5 | 32.3 | 410 |

Source; Complied from World Bank Ease of Doing Business, 2018

Figure 1 shows that, ranking access to finance in SSA using legal index ranking from 1 to 12, with a rank of 1 representing the lowest ranking and 12 representing the highest ranking according to World Bank Ease of Doing Business, (2018). Zambia and Malawi has the highest ranking (11) followed by Rwanda (10) while, Mozambique and Angola has the lowest ranking (1) for access to finance. Rwanda and Zambia were ranked number (3) out of 189 economies in the World this might be as a result of reform on access to credit in Rwanda and Zambia that were put in place.

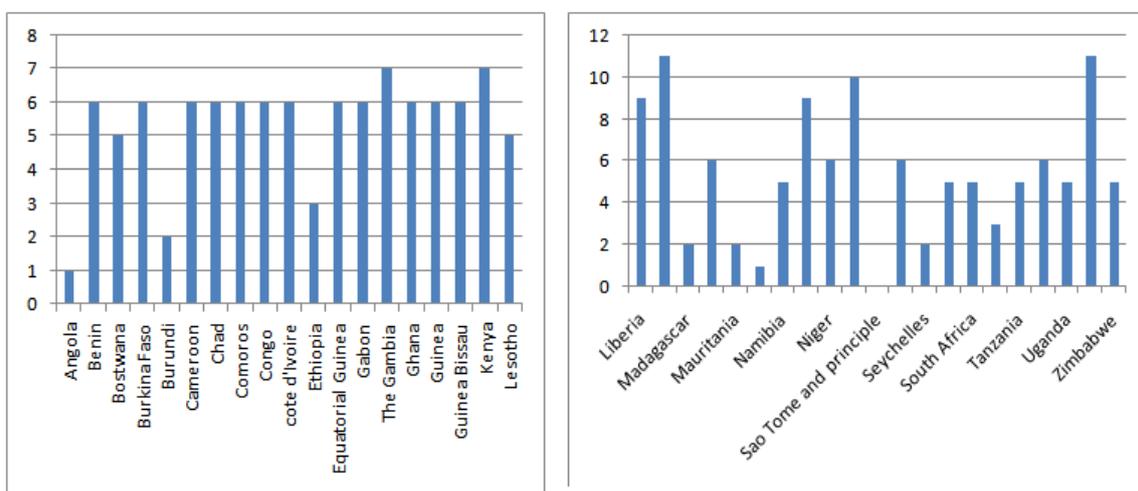


Figure 1: Access to credit in Selected Sub- Saharan Africa

Source: World Bank Ease of Doing Business, 2018

Enabling business environment will enhance the starting-up and growing of Private firms which consequently will help to create employment, reduce poverty and promote economic growth. Despite the importance of domestic private investment, it is not always actively encouraged especially in most developing countries through dedicated business regulatory policies.

Most of the literature examine the relationship between total or output productivity and investment climate, firms’ performance and investment climate at the firm or country level using cross country panel data which lumped together countries of heterogeneous characteristics and size^{16,17,18,19}. However, there is little research on business environment and domestic private investment especially for sub- Saharan African countries. This paper analyse the effect of business environment on domestic private firms and identify which investment climate variables have greater influence on domestic private investmentat the country level for selected sub-Saharan African countries. The dearth of empirical evidence at the country level on the effect of business environment on domestic private investment in developing countries especially in sub-Saharan Africa instigated this paper.

II. Literature Review

i. Theoretical Framework

The theoretical framework adopted in this paper is rooted in the acceleration principle of investment theory suggested by²⁰ and is well known for its applications by²¹ to business cycles. The accelerator approach is often associated with a Keynesian approach which is primarily due to its assumption of fixed prices. The accelerator model states that firms’ desired capital-output ratio is constant. The model begins with the concept that a certain amount of capital stock (K) is required to support a given level of economic activity. This

relationship can be defined as being proportional to output (Y), that is, $K_t = kY_t$ such that net investment is proportional to change in the desired output:

$$K_t - K_{t-1} = I_t = k\Delta Y_t \quad (1)$$

Where k is the desired capital-output ratio, Y is output, I is net investment, K_t is the capital stock in period t while K_{t-1} is the stock of capital at the end of period $t-1$. That is, the simplest accelerator model predicts that investment is proportional to the increase in output in the coming period. However, the simple accelerator approach is criticized for assuming that firms respond to changes in demand such that investment is always sufficient to keep the desired capital stock equal to the actual capital stock. That is not necessarily true. In addition, the model also assumes that the ratio of desired capital to output is constant, however it varies with a variation in the cost of capital and technology

ii. Empirical Review

Increasing domestic private investment levels is fundamental to poverty reduction. A high rate of investment is one of the key differentiating features of countries that have sustained high rates of growth. In high-growth countries, investment typically exceeds 25% of GDP, whereas it struggles to reach 20% in low-growth countries. Where investment is low, the productive capacity of the economy fails to increase²². Whether they are large, medium or small, domestic or foreign, private firms are at the heart of the development process. Motivated by profits, they invest in new ideas and new facilities that reinforce the foundation of economic growth and prosperity¹².

Public policy on investment will affect the contribution of private firms to economic growth. Thus, improving government policies and behaviours that determine the business environment promotes growth. Private sector development requires the development of markets that comprise the interplay between public policies, laws, regulations, and norms. These components create a market in which private investors make their choices²³. Increasing private investment levels requires an understanding of the conditions that influence the flow of domestic and foreign investment otherwise known as the business environment. There are three key features of the business environment according to²². The first of these is the cost of investment, which can be affected by many factors. Some of the most common are the regulatory burden and red tape, taxes, levels of corruption, infrastructure services, labour market regulation, and the cost of finance. The second feature in the business environment is risks. Policy predictability, property rights, and contract enforcement affect investment risks. The third are the barriers to competition. This is affected by the regulations controlling business start-up, competition law, and entry to finance and infrastructure markets. Thus, the components that comprise the investment climate cover a broad field of development interests.

²⁴in their study titled entry regulation and intersectoral reallocation show that the potential effect of entry restrictions on productivity through impeding intersectoral factor reallocation slow down the entry of new firms in response to shocks and therefore block intersectoral factor reallocation towards globally expanding industries. Also, countries where new businesses can be incorporated more quickly have seen faster employment growth in globally expanding industries both in the 1980s and the 1990s.¹⁴, in his work on impact of business environment on investment and output of manufacturing firms in Senegal found that poor business environment has sizeable negative impact on output and investment of the country.²⁵ also revealed that the profits of innovative firms are less negatively affected compared to non-innovative firms, when non-regulatory factors of the business climate are poor. The evidence suggests that the profits of innovative firms suffer more than that of non-innovative firms when regulatory or governance aspects of the business environment are weak.²⁶ aimed to determine the factors of private investment in Turkish economy. The author estimated the long run private investment function by using ARDL approach to cointegration. The significance of the coefficients of real GDP, real exchange rate, ratio of private sector credit to GDP, private external debt, inflation and trade openness confirmed these factors to be the long run determinants of private investment in Turkey. Likewise,²⁷ investigates the determinants of private investment over the period of 1970-2000. The study indicated that public investment, real income and foreign aid flows positively affected private investment, while credit to private sector showed a negative impact.

III. Methodology

i. Sources of Data and Method of Analysis

Secondary data was used for this paper. The data were obtained from different sources and these include Enterprise Surveys Data in developing countries (ESD) conducted by the World Bank, Doing Business Indicator Data (DBI) and World Development Indicator data (WDI). The enterprise survey data was developed to provide information on aspects of the business environment faced by firms as well as information on firm performance. While doing business data are developed from surveys which are sent out to experts in each country and in each year, the results are summarized in Doing Business Reports in the following year. The survey period used for the business environment study covered 2004-2018. The study focuses on business

environment components and policy variables that can affect domestic private investment in sub-Saharan Africa. Forty countries in sub-Saharan Africa was used and these include: Angola, Benin, Botswana, Burkina Faso, Burundi, Cameroon, Chad, Comoros, Congo (Democratic Republic), Cote d'Ivoire, Equatorial Guinea, Ethiopia, Gabon, The Gambia, Ghana, Guinea, Guinea Bissau, Kenya, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Namibia, Niger, Nigeria, Rwanda, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, South Africa, Swaziland, Tanzania, Togo, Uganda, Zambia and Zimbabwe. Gross capital formation was used as a proxy for domestic private investment.

The System Generalised Method of Moments (System-GMM) estimators of panel data developed by ^{27,28} were employed for the analysis technique in this paper. The System-GMM allows one to control for unobserved country specific effects and possible endogeneity problem of specific variables. Two specification tests was conducted to address the consistency of System-GMM estimator, the serial correlation test and sargan test of over identifying restrictions that examines the overall validity of the instruments.

ii. Model Specification

The model for the paper was based on the flexible accelerator model. Following the previous studies such as: ^{27,29} this study modifies the accelerator model specifically with regard to data availability to capture some of the business environment components of SSA countries that determine domestic private investment. The model for domestic private investment can be specified in the general form as:

$$\text{LnPDINVT}_{it} = \delta_i + \beta_1 \text{LnX}_{it} + \varepsilon_{it} \quad (2)$$

For $i = 1, \dots, 40$ and $t = 1, \dots, 15$ and where LnPDINVT is the log of domestic private investment, δ_i are the unobserved country characteristics that are constant over time and influence private investment, β_1 is variable coefficients, ε_{it} is the stochastic error term with constant variance and the usual properties, the subscripts i and t denote country and time, respectively. X_i stands for a vector of explanatory variables that influence domestic private investment as shown in equation (3).

$$X_i = (\text{STAR}, \text{ELEC}, \text{CRED}, \text{REGB}, \text{OBTCP}, \text{ENFCON}, \text{TRAD}, \text{TAX}, \text{INSLV}, \text{INT}, \text{INFL}) \quad (3)$$

Thus, we incorporate business environment variables into domestic private investment model

From equation (3), using GMM, the models can be estimated as follows:

$$\text{LnPDINVT}_{it} = \beta_1 + \beta_1 \text{Lnstar}_{it} + \beta_2 \text{Lnelec}_{it} + \beta_3 \text{Lncred}_{it} + \beta_4 \text{Lnregb}_{it} + \beta_5 \text{Lnobtcp}_{it} + \beta_6 \text{Lnenfcon}_{it} + \beta_7 \text{Lntrd}_{it} + \beta_8 \text{Lntax}_{it} + \beta_9 \text{Lninslv}_{it} + \beta_{10} \text{Lnint}_{it} + \beta_{11} \text{Lninf}_{it} + \varepsilon_{it} \quad (4)$$

Where: PDINVT = Domestic private investment; IC = Investment climate variables which are: STAR = Starting a business, ELEC = infrastructure (Getting electricity), CRED = Access to credit, REGB = Registering a business, OBTCP = Dealing with construction permits, ENFCON = Enforcing contract, TAX = Tax rate, and INSLV = Closing of business; TRD = Trade; INT = interest rate; INF = inflation

IV. Results And Discussion

The determinant of domestic private investment in SSA was estimated and tested using equation 4 and the results from the System-GMM dynamic panel estimator, which allows us to control for the possible endogeneity problem of specific variables is also presents in table 2. To measure the validity of the specifications, some diagnostic tests are conducted. Specifically for the estimates to be valid the model should not be over-identified and there should be no serial correlation in the error term to attain consistent estimators. In all our specifications in table 2, there is no second order serial correlation in the differenced residuals thus the disturbance terms are not serially correlated as indicated by the p-value (0.441) for AR (2), which confirms the consistency of the coefficients. That is, AR (2) p-value is insignificant, suggesting no second-order autocorrelation, which makes the GMM estimator consistent. Also, a critical look at the panel system-GMM result presented in table 2 revealed that F- statistics is highly significant at 17.84(0.000), suggesting that the model can be used in making policy decisions. The test of over-identifying restrictions (Sargan test), showing whether the instruments as a group are uncorrelated with the error process, gives acceptable p-value (0.142). The Sargan test shows that the instruments are valid. Thus, the results are reliable and consistent.

Most investment climate indices which denote business regulations, have negative signs except getting electricity which was used as a proxy for infrastructure, access to credit, obtaining contract /license permit and tax indices that have a positive and not statically significant which only tax that is significant impact on domestic private investment (Table 2). There is evidence in the literature that infrastructure contributes significantly to economic growth. The literature established a robust relationship between infrastructure investment, private investment and economic growth ^{12,30}.

Table 2: System- GMM Estimation Result

| INDEPENDENT VARIABLES | COEFFICIENT | t- STATISTICS | PROBABILITY |
|--|-------------|---------------|-------------|
| Logstar | -0.103 | -2.31 | 0.023** |
| Logelec | 0.059 | 1.37 | 0.173 |
| Logcred | 0.131 | 1.71 | 0.089 |
| Logregb | -0.019 | -0.49 | 0.628 |
| Logobtcp | 0.019 | 0.98 | 0.330 |
| Logenfcon | -0.005 | -0.11 | 0.909 |
| Loginsolv | -0.136 | -1.79 | 0.076 |
| Logtax | 0.142 | 3.19 | 0.002** |
| Logtrad | 0.109 | 1.81 | 0.072 |
| Int | -0.001 | -0.47 | 0.642 |
| Infl | -0.005 | -2.14 | 0.034** |
| Lag of pdinv = 7.30 (0.000) Constant = -0.3655076 f- Statistics = 17.84(0.000)*** Panel (hetero) test = 18.87(0.0635)* Number of instruments Arellano-Bond AR(1) test p-value = -2.71(0.007)*** Arellano-Bond AR(2) test p-value = -0.77(0.441) Sargan test = 48.50(0.142)* | | | |

Source: Author’s computation

The p- value is significant at *, **,and *** represents 10%, 5% and 1% respectively

It suggests that investment will be low in SSA since some of the factors that should encourage investment are negatively related to it. This result is consistent with the previous findings that explained adverse effect of strict government regulations (red tape)^{24,31,24} noted that countries with lower registration times have experienced more entry. A healthy investment climate is not driven by reduction in regulation per se, but rather appropriate regulation that can be implemented without decreasing investment incentives or unduly increasing costs³¹. The result imply that, the number of permits and approvals that businesses need to obtain, and the time it takes to obtain them, are most cases expensive, slow and time consuming in SSA³². In addition, the coefficient of trade is positive and the finding collaborate the finding of^{26, 33}, who found positive relationship between private investment and trade openness. Both interest rate (INT) and inflation (INFL) have negative effect on domestic private investment. Low interest rates and high inflation discourage savings, it lower the real return on the invested capital, which in turn leads to declined investment.

V. Conclusions

The main contribution of this paper was the establishment of empirical evidence that complements the body of existing literature on the effect of business environment on domestic private investment in SSA. Also, most studies used one or two sets of component of business climate for their study but this paper uses eight components of business climate. The study aims at establishing the relationship between business environment and domestic private investment in SSA countries. To achieve this, the paper used system-GMM panel data estimator so as to control for the endogeneity problem among the variables used in the model. The findings from this paper show that different business environment variables have different relationships with the private investment. Starting a business, registering a business, enforcing a business contract and closing a business has a negative relationship with private investment and they are not statistically significant. This finding implies that, doing business generally in SSA is not encouraging as the regulations to enhance private investment are hostile and this unfriendly investment climate will eventually affect economic growth adversely. The coefficients of other investment climate variables: infrastructure, access to credit, tax and obtaining a permit are however positive, but only tax was found to be statistically significant. Furthermore, inflation and interest rate showed negative relationship, and are statistically significant. It can be concluded that unfavourable business climate will negatively affect private investment and then economic growth.

VI. Recommendations

Domestic private investment is one of the most important drivers of job creation and economic growth. While importance of domestic private investment for achieving reduction in poverty level, getting out of ravaging recession and overall economic growth cannot be overemphasised. Domestic private investment is not actively encouraged in most SSA countries through sound policy. Governments and policymakers need to reduce business costs and risk through improving registration procedures and reducing the fees to register a company, removing regulatory and institutional obstacles to starting a business, providing infrastructure such as

power; increasing access to finance; reducing and eventually eliminating corruption, crime and insecurity that are undermine investor confidence in SSA economies. There is also need to ensure a functioning and enduring business climate, captured by a strong competitive policy, in order to encourage domestic private investment for positive economic growth in SSA countries³⁴. Eight out of ten business climate variables in the ease of doing business indicators were used due to unavailability of date for other two variables for the countries considered in this study, further work can employed all the ten variables to see their effect on domestic private investment for all sub-Saharan Africa countries.

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