

# Institutional structures and the strength of investor confidence in Africa

Strength of investor confidence in Africa

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## Abstract

**Purpose** – This paper aims to examine the role of country-level institutional structures in strengthening the level of investor confidence in Africa while controlling for real GDP growth, interest rate spread, inflation and country credit rating.

**Design/methodology/approach** – The paper uses panel data for the period 2009-2013. It takes into account the rule of law, political stability, regulatory quality, voice and accountability, control of corruption and property rights as potential institutional drivers of the level of investor confidence. These factors are based on their relative relevance from the extant literature. Correlated panels-corrected standard errors model was used to establish the relationship between the institutional structures and the strength of investor confidence.

**Findings** – The overall results show that rule of law, voice and accountability, property rights and political stability exhibit significant positive relationship with the strength of investor confidence in African economies. This implies that asking African economies to strengthen these institutional structures will result in enhanced investor confidence in their economies. This suggests that the establishment of these institutional structures is an effective tool to enhance investor confidence in African economies.

**Practical implications** – In addition to the long-term goal of promoting economic reforms, a corresponding long-term goal of strengthening institutional structures in African economies should be taken into consideration. Instead of waiting for their economic reforms to take effect, governments in African countries can, to some degree, attract investors into their economies by establishing credible institutional structures.

**Originality/value** – This paper contributes to the knowledge on how country-level institutional structures influence the level of investor confidence in the context of Africa.

**Keywords** African countries, Institutional structures, Investor environment, Strength of investor confidence

**Paper type** Research paper

## Introduction

Recent studies on corporate governance across the length and breadth of the globe have revealed a number of striking evidences that supports the view that firm performance is associated with the adoption and implementation of sound corporate governance structures by firms. However, there are differences in these revelations in relation to issues such as the level of investor confidence in countries. The differences in the institutional structures of countries explain the divergence in the degree of investor confidence in countries (La Porta *et al.*, 2000). This is because a company situated in a country which is characterized by weak institutional structures would probably be unable to make up for such weak institutions by integrating stronger mechanisms to safeguard its investors. Shleifer and Wolfenzon (2002)



contend that firms on their own are unable to ensure sound governance or good legal environment without the assistance of sound institutional structures at the national level.

Weak institutional structures deter investors with the fear that there are no measures to safeguard their investments and rights. For example, on the one hand, investors may not initially have confidence in firms situated in some countries, but if they found out that institutional structures in such countries are strong, they would be more likely to consider investing in such firms with the hope that the protection of their investments and interests is guaranteed. On the other hand, if the institutional structures are proved to be weak, such firms would be less attractive to investors.

Indeed, there is an argument that the increased cognizance of the relevance of investor confidence and protection of investors' interests, as well as the reference of international governance principles, has necessitated for strong institutional structures in countries. Relevant amendments in relation to enhancing investor confidence were introduced recently by some countries into their institutional structures (e.g. South Africa, Russia, Moldova, Uzbekistan and Armenia). While this progress is receiving increased deliberations, the analysis of the outcomes of these institutional structures in the field of investor confidence has been sketchy. Thus, it will be the task of this study to examine how country-level institutional structures influence the strength of investor confidence.

While a number of studies have examined how corporate governance structures influence investor confidence, the majority has tended to concentrate on how internal governance structures influence investor confidence (Easterbrook and Fischel, 1996; Kang and Shivdasani, 1995; Stafsudd, 2009; Jadhav and Katti, 2012; Hasan *et al.*, 2014). Notwithstanding the incremental interest in how external governance structures such as institutional structures influence investor confidence, studies concerning this matter are limited. The few studies in relation to this issue are mainly on Europe or North America (La Porta *et al.*, 2000; Shleifer and Wolfenzon, 2002; Klapper and Love, 2004), with little emphasis on developing countries, particularly African countries. The institutional structures in African countries differ from those in other regions, thus limiting generalizability of research outcomes resulting from studies on other regions to Africa. It is evident that the level of investor confidence is affected by institutional structures of countries (Castrillo *et al.*, 2010; Hasan *et al.*, 2014). As African countries are making every effort to attract investors by establishing investor confidence in their economies through the strengthening of institutional structures, analyses of the impact of certain institutional structures on investor confidence are imperative. This makes it fundamentally empirical for these countries to become conscious of whether their attempts of strengthening investor confidence through the strengthening of institutional structures are becoming a reality or otherwise. Therefore, in this study, we propose to examine how country-level institutional structures influence the level of investor confidence.

The remainder of our study is organized as follows: The next section presents the review of the related literature and the development of hypotheses. We then proceed to highlight the methodology of the paper. Ensuing is the analysis. Finally, the conclusion, recommendation, limitations and areas for further studies are presented.

### **Literature review and hypotheses development**

Governance is dependent on both country- and firm-specific governance structures. Whilst the former entails institutional structures or governance structures that put into effect the laws of every country, the latter explicates the operating mechanisms within companies. It is argued that institutional structures (such as rule of law and property rights) tend to impose specific preferences of governance features, which ultimately explain why a company in a

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particular country has specific governance structures (Aggarwal *et al.*, 2009). They are also considered relevant in ensuring investor confidence and the protection of minority shareholders' interests (La Porta *et al.*, 1997, 1999, 2000). Strong institutional structures create an enabling environment that dissuades corporate managers from being self-centred and opportunistic, mitigate the risk of mismanagement and thus enhance investor confidence (Shleifer and Wolfenzon, 2002; Castrillo *et al.*, 2010). This is because if corporate managers have it at the back of their minds that should they mismanage the affairs of their companies, they would not be able to circumvent the lubricated institutional structures that serve as external disciplinary measures, then they would end up being circumspect in their dealings.

Firms situated in developing countries characterized by weak institutional structures will have a difficulty in raising capital and "be a magnet" for investors or capital providers. This implies that strong institutional structures more often than not signal the citizenry, the private sector and the investors about the seriousness attached to governance reforms by governments (Saidi, 2004). Naceur *et al.* (2007) contend that an economy with strong institutional structures decreases agency cost and promotes effective and efficient monitoring of corporate managers, which eventually ensures the enhancement of investor confidence. Examining the role of some institutional structures and internal governance structures on 95 newly privatized companies, they found out that companies become more productive in environments characterized by improved property rights measures. The authors further noted that the positive impact of privatization requires the reinforcement of comprehensive institutional reforms. Bishara (2011) also highlights that weak institutional structures can deter potential foreign investors from taking risk in investing in what could otherwise be attractive to firms. We, therefore, argue that the issues of investor confidence remain relevant in economies, and these issues transcend the soundness of macroeconomic environment to include institutional structures.

#### *Hypotheses development*

Political stability is an outcome of a political structure characterized by an absence of coups and takeovers and by continuity and dependability of government policies, and it recently included the absence of domestic social unrest (Chaze, 2011). The strengthening of investor confidence relies largely on an acceptable amount of certainty that promising and stable political environment will persist in the future. Investors, foreign and domestic, are less likely to inject capital into economies where risk of investment and protection of their interests are high as a result of political instability (Genna and Hiroi, 2014; Chaze, 2011). By maintaining political stability, economies can therefore promote economic growth by inducing investors to inject capital into their economies and assuring them that their investments and interests are secured; this effort ultimately discourages capital flight (Akongdit, 2013). This implies that the possibility of political instability is more likely to undermine investor confidence and rights of shareholders, which will eventually minimize investment.

Studies on the relationship between political instability and strength of investor confidence have revealed inconclusive results. On the one hand, some studies have contended that while instability in the political terrain will probably happen, this will perhaps not be adequate to represent political risk (Kobrin, 1976). A military coup, for instance, will probably increase or minimize the risk, depending on who is ousted from office and who assumes power. This means that it is not always the case that investors will be dissuaded to invest in economies characterized by political instability with the fear that their interests will not be protected. A study by Kobrin (1976) on the environmental determinants

of foreign investment found no significant relationship between political instability and the level of investor confidence proxied by foreign investment. Also, [Green and Cunningham \(1975\)](#) in a study on 25 economies indicated that market potential factors are the most relevant determining factors of foreign investment, whereas political instability was found to not be significantly related to investor confidence proxied by foreign investment.

On the other hand, studies contend that political stability strengthens investor confidence and enhances shareholder rights, which ultimately encourages investors to invest without any fear of losing their possessions. A study by [Obwona \(2001\)](#) on the determinants of investment confidence in Uganda found that political stability plays a significant role in inducing capital providers to inject their capital in the Ugandan economy with the hope that their investments and interests are safeguarded. A similar study by [Levis \(1979\)](#) on developing countries found a significant negative relationship between political instability and investor confidence.

This discussion appears to point to an inconclusiveness or contradiction on the relationship between political instability, strength of investor confidence and protection of shareholders' rights. Thus, there is a need for further examination of the association between political instability and the strength of investor confidence. Hence, we hypothesize that:

*H1.* Political stability positively influences the strength of investor confidence in an economy.

Property rights are special authority possessed by property owners (be it locals or foreigners) in an economy to sell, consume, mortgage, rent, exchange and transfer their properties. They are regarded as a key element in markets ([Smith, 1976; knight, 1971](#)). This is because economic activity improves when individuals have the ability to protect the value of their work in a lawfully secured asset. Property rights help in strengthening the level of investor confidence and safeguarding their interests in an economy ([North, 2003; Rosenberg, 1994](#)) by creating a system through which individuals can reorganize their assets into more useful combinations ([De Soto, 2006](#)). In making share-buying or investment decisions, investors look out for proof that they would get returns on their investments and want assurance of protection of their interests and investments. Measures that limit transfers can have a negative influence on the strength of investor confidence and protection of shareholder rights, as well as international investment inflows ([OECD, 2006](#)). This overtly implies that the creation of property rights in an economy is imperative. By this, developing countries can develop or grow quickly in that; this system ultimately induces foreign investors to have confidence in these economies with the hope that their interests would be protected. The World Bank in a study on this issue on more than 60 countries found that insecure property rights can directly influence growth of economies through the choice of production process and efficiency with which production is carried out, which eventually reduces the level of investor confidence ([Keefer and knack, 2000](#)). Thus, we hypothesize that:

*H2.* Property rights is positively associated with the strength of investor confidence.

There can be little or no question that perceptions of excessive levels of corruption in a particular economy can deter many potential investors. A study by the World Bank provides persuasive evidence that economies with perceived high levels of corruption are losing out on prospective investors, which in turn is thwarting their economic growth and development ([The World Bank, 1997](#)). Corruption undermines the reliability of corporations and governments by distorting the allotment of both private and public resources, which makes the public administration unreliable, and thus reducing the strength of investor

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confidence in economies (OECD, 2006). Even where foreign companies and investors have chosen to take a risk of investing in an economy plagued with high levels of corrupt practices, they can become so irritated by excessive demands for bribes by officials, which could ultimately deter them from further investing in such an economy. This was, for example, the reason for which Unilever stopped its operation in Bulgaria in 1998 (The Economist, 1999). This means that corruption is regarded as a sort of taxation; it not only decreases the level of investor confidence but also sort of decreases investors in an economy (Dunning, 1993). We, therefore, hypothesize that:

*H3.* Control of corruption is positively associated with the strength of investor confidence.

The rule of law theoretically mirrors the extent to which citizens of a particular country are willing to embrace the established institutions to ensure law and order (Biswas, 2002). An economy premised on a strong rule of law will, ultimately, strengthens its level of investor confidence. This is because where economic opportunities and political stability exist, the existence of the rule of law as an institutional structure increases the level of investor confidence in an economy (La Porta *et al.* 1997; Levine, 1999; Busse, 2004; Li, 2006). The predictability and stability of a country, which eventually provide a sound investor environment stem from the promotion of the rule of law. Firms may shy from a market where the rule of law is always overlooked. Investors, understandably, fear to inject their capital or resources into an unpredictable legal environment.

Empirical analyses suggest that good and generalized rule of law tend to attract investors into an economy (La Porta *et al.*, 1999; Levine, 1999). In the similar vein, industry-level studies have established a close relationship between the rule of law and the willingness of outside investors to invest in firms by sourcing funds for expansion (Carlin and Mayer, 1999; Demirguc-Kunt and Maksimovic, 1998; Rajan and Zingales, 1998). In addition, Globerman and Shapiro (2003), in their study, found that foreign investors from the USA mostly prefer investing in economies characterized by efficient rule of law system. In sum, we argue that better institutional structures in terms of rule of law should strengthen the level of investor confidence in economies. Thus, we hypothesize that:

*H4.* The rule of law is positively associated to the strength of investor confidence.

Voice and accountability measures the extent of participation of an economy's citizens in the choice of government, lack of restrictions in expression, freedom of association and independence of the media. It is another important element of good governance which ensures the strengthening of investor confidence in an economy. Lack of voice and accountability reduces the level of investor confidence in economies (Globerman and Shapiro, 2002; Kaufman *et al.*, 2003). The presence of voice and accountability in an economy provides free investor environment, which prevents violations of the rights of investors. La Porta *et al.* (1997, 1999) contend that enhancing rules regarding corporate governance and the quality of accounting and auditing standards strengthen the level of investor confidence. In the face of this, the sufficing measure for sound economic growth and enhanced investor confidence in a country is the credibility of the institutional structure of voice and accountability. Some empirical studies have established a positive relationship between voice and accountability and the level of investor confidence in economies. A study by Stasavage (2002) on African economies, found a strong positive relationship between voice and accountability and investor confidence. In addition, Chaib and Siham (2014), in their study, found a significant positive relationship between voice and accountability and the level of investor confidence in the Algerian economy. Thus, we hypothesize that:

*H5.* Voice and accountability positively influence the strength of investor confidence in an economy.

Regulatory quality is about “regulations that are efficient in terms of cost, effective in terms of having a clear regulation and policy purpose, transparent and accountable” (OECD, 2006, p. 236). Regulations can create benefits for businesses and investors by setting market structures in which transactions concerning commercial activities can take place in an efficient environment. However, poor regulations can result in slow investor responsiveness, cause a diversion of both public and private resources away from productive ventures, reduce the creation of jobs and eventually lower the level of investor confidence in an economy. Nothing constitutes more to investor cynicism about regulation than failures in regulations. This implies that quality regulations in an economy boost investor confidence that these regulations are set up to safeguard their interests. A study by OECD (2006) reveals a positive association between regulatory quality and the level of investor confidence across a sample of countries. However, Kirkpatrick (2006) argues that sometimes the regulatory institutions in economies are considered not independent of the government and susceptible to political interference, and thus investors may be discouraged from committing huge sums into such economies. We, therefore, argue that, all other things being equal, quality regulations matter for the level of investor confidence in economies. Hence, we hypothesize that:

*H6.* Regulatory quality is positively associated with the strength of investor confidence.

### Methodology

Our sample is based on 39 African countries which have available data to test our hypotheses. Our sample covers the time span 2009 to 2013 and includes 194 observations. We obtained five of the six examined institutional structures from the broadest of country-level governance ratings by the World Bank. We gathered data on the strength of investor confidence and property rights from the Global Competitiveness Report by the World Economic Forum. The dependent variable in our study is the strength of investor confidence, and the independent variables that are expected to influence our dependent variable are carefully selected, based on extant literature and availability of data for the sample period. The independent variables in our estimation are the rule of law, political stability, voice and accountability, regulatory quality, property rights and control of corruption.

To establish the relationship between the strength of investor confidence and our chosen institutional structures, we controlled for four economic variables that could possibly have influence on the strength of investor confidence in an economy. These are real GDP growth, country credit rating, inflation and interest rate spread. The study used these economic variables, as macroeconomic stability also plays a critical role in attracting foreign investors into an economy. A stable macroeconomic environment fosters the strength of investor confidence by showing less investment risk (Anyanwu, 2012). Table I provides further description of the variables and their sources.

### Summary statistics

Table II highlights descriptive statistics for the full sample of our study. Means, medians, minimums, maximums, standard deviation and number of observations of our variables of interests are presented. On average, the strength of investor confidence in the 39 African countries during the period in review recorded 4.77. This is on the average side. This

| Variable                        | Description  | How it is measured   | Source   |
|---------------------------------|--|--|--|
| Strength of investor confidence | Reflects perceptions of investor protection  | Investor protection index  | World Competitiveness Review                     |
| The rule of law                 | Reflects perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular, the quality of contract enforcement, property rights, the police and the courts, as well as the likelihood of crime and violence | Measured as perceptions of the extent to which agents have confidence in and abide by the rules of the society     | The World Bank Governance indicators             |
| Regulatory quality              | Reflects perceptions of the ability of the government to formulate and implement sound policies and regulations that permit and promote private sector development   | Measured as the perceptions of the quality of government to formulate and implement sound policies and regulations | The World Bank Governance indicators (2009-2013) |
| Voice and accountability        | Reflects perceptions of the extent to which a country's citizens are able to participate in selecting their government, as well as freedom of expression, freedom of association and a free media  | Measured as people's perceptions on the quality of governance in the country                                       | The World Bank Governance indicators (2009-2013) |
| Control of corruption           | Reflects perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests  | Measured as perceptions of the extent to which public power is exercised for private gains                         | The World Bank Governance indicators (2009-2013) |
| Property rights                 | Is an exclusive authority possessed by an owner of property to consume, sell, rent, mortgage, transfer and exchange their property   | Measured as the authority possessed by an owner of property  | The World Bank Governance indicators             |
| Political stability             | It describes the perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism   | Measured as perceptions of the likelihood of political instability in the country                                  | The World Bank Governance indicators             |
| Interest rate spread            | It describes interests charged on borrowings by financial institutions   | Measured as interests charged on borrowings by financial institutions  | Global competitiveness report                    |
| Real GDP                        | It describes country's economic progress and as an indicative of profitable investment opportunities   | Measured as nominal GDP adjusted for inflation   | Global competitiveness report                    |
| Country credit ratings          | Defined as the credit quality of a country's obligations or of an issuer's general creditworthiness  | Measured as a rank-ordering of creditworthiness, or expected loss  | Global competitiveness report                    |

**Table I.**  
Description of  
variables and sources

| Variables                       | Median | Mean  | Minimum | Maximum | SD    | No. of observations |
|---------------------------------|--------|-------|---------|---------|-------|---------------------|
| Strength of investor confidence | 5.00   | 4.77  | 2.00    | 8.00    | 1.32  | 194                 |
| The rule of law                 | 37.40  | 35.36 | 0.90    | 79.60   | 19.37 | 194                 |
| Regulatory quality              | 15.30  | 38.94 | 0.70    | 67.10   | 71.21 | 194                 |
| Voice and accountability        | 33.40  | 34.62 | 7.10    | 76.50   | 18.61 | 194                 |
| Control of corruption           | 34.20  | 38.65 | 1.44    | 29.10   | 35.06 | 194                 |
| Property rights                 | 3.80   | 3.94  | 2.20    | 8.30    | 0.87  | 194                 |
| Political stability             | 35.45  | 36.61 | 2.80    | 88.20   | 22.79 | 194                 |

**Notes:** This table presents descriptive statistics for the sample used in the analysis. This sample includes 39 African countries for the period 2009-2013. These are Ghana, Guinea, Gambia, Guinea-Bissau, Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Liberia, Mali, Mauritania, Nigeria, Senegal, Sierra Leone, South Africa, Botswana, Lesotho, Namibia, Swaziland, Kenya, Tanzania, Rwanda, Uganda, Burundi, Zimbabwe, Ethiopia, Mauritius, Mozambique, Madagascar, Malawi, Zambia, Seychelles, Cameroon, Angola, Chad, Gabon, Algeria, Morocco, Egypt and Tunisia

**Table II.**  
Summary statistics

indicates that the sampled African countries performed averagely as their score of their level of investor confidence is less than the maximum score (which is seven) as indicated in the global competitiveness report. The rule of law of the median economy was about 37.40 per cent. With respect to regulatory quality in these economies, the weakest country scored 0.70 per cent, whereas the strongest country recorded 67.10 per cent. Voice and accountability of the average economy was 34.62 per cent. In regards to control of corruption and property rights, the average economy recorded 38.65 and 3.94 per cent, respectively. Finally, the median country among the 39 economies recorded 35.45 per cent on political stability from 2009 to 2013.

Table III illuminates a correlation matrix for the strength of investor confidence and our exogenous variables (that is our variables of interest and control variables). We present a positive relationship between strength of investor confidence and our variables of interest (the rule of law, regulatory quality, voice and accountability, control of corruption, property rights

| Variables                       | 1     | 2     | 3     | 4     | 5     | 6     | 7     | 8     | 9     | 10    | 11   |
|---------------------------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|------|
| Strength of investor confidence | 1.00  |       |       |       |       |       |       |       |       |       |      |
| The rule of law                 | 0.39  | 1.00  |       |       |       |       |       |       |       |       |      |
| Regulatory quality              | 0.06  | 0.03  | 1.00  |       |       |       |       |       |       |       |      |
| Voice and accountability        | 0.39  | 0.39  | -0.02 | 1.00  |       |       |       |       |       |       |      |
| Control of corruption           | 0.26  | 0.28  | -0.05 | 0.40  | 1.00  |       |       |       |       |       |      |
| Property rights                 | 0.31  | 0.58  | -0.03 | 0.39  | 0.39  | 1.00  |       |       |       |       |      |
| Political stability             | 0.29  | 0.34  | -0.03 | 0.50  | 0.46  | 0.50  | 1.00  |       |       |       |      |
| Real GDP growth                 | 0.53  | 0.41  | 0.39  | 0.09  | 0.17  | 0.34  | 0.22  | 1.00  |       |       |      |
| Country Credit Rating           | 0.48  | 0.37  | 0.09  | 0.46  | 0.30  | 0.57  | 0.45  | 0.11  | 1.00  |       |      |
| Inflation                       | -0.15 | -0.16 | -0.08 | -0.11 | -0.09 | -0.07 | -0.21 | -0.17 | -0.07 | 1.00  |      |
| Interest rate spread            | 0.03  | -0.23 | 0.13  | -0.09 | -0.06 | -0.31 | -0.05 | -0.35 | 0.20  | -0.13 | 1.00 |

**Notes:** This table presents correlation matrix for the sample used in the analysis. This sample includes 39 African countries for the period 2009-2013. These are Ghana, Guinea, Gambia, Guinea-Bissau, Benin, Burkina Faso, Cape Verde, Côte d'Ivoire, Liberia, Mali, Mauritania, Nigeria, Senegal, Sierra Leone, South Africa, Botswana, Lesotho, Namibia, Swaziland, Kenya, Tanzania, Rwanda, Uganda, Burundi, Zimbabwe, Ethiopia, Mauritius, Mozambique, Madagascar, Malawi, Zambia, Seychelles, Cameroon, Angola, Chad, Gabon, Algeria, Morocco, Egypt and Tunisia

**Table III.**  
Correlation analysis



and political stability). Concerning our control variables, the correlation results show a positive correlation between the strength of investor confidence and them. These results, therefore, demonstrate that African economies, characterized by strong investor confidence, were associated with strong institutional structures under the period in review. In other words, the level of investor confidence was enhanced in African economies characterized by strong the rule of law, regulatory quality, voice and accountability, control of corruption, property rights and political stability during the period in review. Apart from the positive association between these institutional structures and the strength of investor confidence, the results divulge that real GDP growth, high country credit rating, low interest rate spread and low inflation induced investors to have confidence in African economies from 2009 to 2013. The magnitude of the relationships among the independent variables was low to medium, indicating that multicollinearity was not a major issue. In addition, the correlation among the independent variables falls within the threshold of at most 0.7, as suggested by [Kennedy \(2008\)](#).

### Regression analysis

In this section, we present results of our regression model. We used a panel data analysis to establish the relationship between country-level institutional variables and strength of investor confidence. Panel data entail the pooling of observations on a cross-section of units over a number of periods and offer results that are basically not palpable in studies that are purely cross-sectional ([Domowitz \*et al.\*, 1986](#)). Nonetheless, the most suitable estimation technique for estimating the basic models depends on the structure of the constituents of the disturbance term and also the correlation between the observed explanatory variables and the disturbance term ([Johnston and DiNardo, 1997](#)). Therefore, in the context of this study, we used correlated panels-corrected standards errors (PCSE) estimation technique. Essentially, this ordinary least squares technique comprises a dummy variable. This is as a result of the panel nature of the estimation, which is usually characterized by error processes. Hence, we used the PCSE, which mechanically corrects those oddities associated with the data.

[Table IV](#) reports the results of our models in which the strength of investor confidence is used as the endogenous variable to test our hypothesis. Our basic model to test our hypotheses is shown below. All the variables in the model are log-transformed:

$$\begin{aligned} \text{Strength of Investor Confidence}_{ijt} = & \beta_1 (\text{Rule of Law})_{ijt} + \beta_2 (\text{Regulatory Quality})_{ijt} \\ & + \beta_3 (\text{Voice and Accountability})_{ijt} \\ & + \beta_4 (\text{Control of Corruption})_{ijt} \\ & + \beta_5 (\text{Property Rights})_{ijt} \\ & + \beta_6 (\text{Political Stability})_{ijt} \\ & + \beta_7 (\text{Control Variables})_{ijt} + \varepsilon_{ijt} \end{aligned}$$

Model 1 contains the rule of law and the control variables; Model 2 comprises the variables in Model 1 and regulatory quality. Model 3 consists of the variables in Model 2 and voice and accountability. Control of corruption is added to Model 3 to form Model 4. Model 5 integrates the variables in Model 4 and property rights. Finally, Model 6 incorporates the variables in Model 5 and political stability.

**Table IV.**  
Regression relating  
strength of investor  
confidence to the rule  
of law, regulatory  
quality, voice and  
accountability,  
control of corruption,  
property rights and  
the control variables

| Variables                   | Endogenous variable = Strength of investor confidence |                   |                   |                   |                     |                     |
|-----------------------------|---|-------------------|-------------------|-------------------|---------------------|---------------------|
|                             | (1)   | (2)               | (3)               | (4)               | (5)                 | (6)                 |
| The rule of law             | 0.0174*** [2.123]                                     | 0.0174*** [2.122] | 0.0179*** [2.948] | 0.0116*** [2.389] | 0.0195*** [2.529]   | 0.0210*** [2.487]   |
| Regulatory quality          |   | 0.0003 [0.201]    | 0.00017 [0.135]   | 0.000024 [0.192]  | 0.00055 [0.478]     | 0.00057 [0.494]     |
| Voice and<br>accountability |   |                   | 0.011*            | 0.0112* [1.749]   | 0.0183*** [3.064]   | 0.0172*** [2.628]   |
| Control of corruption       |   |                   |                   | 0.004 [1.195]     | 0.0030 [1.033]      | 0.0293 [1.018]      |
| Property rights             |   |                   |                   |                   | 0.567*** [6.090]    | 0.567*** [6.084]    |
| Political stability         |   |                   |                   |                   | 0.0271*** [2.429]   | 0.0271*** [2.429]   |
| Interest rate spread        | -0.033*** [-2.94]                                     | -0.033*** [-2.80] | -0.034*** [-3.00] | -0.031*** [-2.66] | -0.0254*** [-2.34]  | -0.0254*** [-2.344] |
| Inflation                   | -0.104*** [-6.59]                                     | -0.103*** [-6.52] | -0.105*** [-6.63] | -0.105*** [-6.64] | -0.0792*** [-5.256] | -0.082*** [-5.251]  |
| GDP growth                  | 0.001 [0.812]   | 0.001 [0.832]     | 0.001 [0.822]     | 0.001 [0.794]     | 0.00234* [1.836]    | 0.00257* [1.853]    |
| Country credit rating       | 0.07*** [8.033]                                       | 0.07*** [8.01]    | 0.068*** [8.11]   | 0.069*** [8.196]  | 0.0359*** [3.803]   | 0.0356*** [3.736]   |
| <i>R</i> -squared           | 0.55  | 0.55              | 0.56              | 0.56              | 0.63                | 0.64                |
| Adjusted <i>R</i> -squared  | 0.54  | 0.54              | 0.54              | 0.54              | 0.62                | 0.62                |
| <i>F</i> -statistic         | 46.36   | 34.54             | 33.76             | 29.78             | 35.76               | 32.06               |
| Prob( <i>F</i> -stat)       | (0.00)  | (0.00)            | (0.00)            | (0.00)            | (0.00)              | (0.00)              |
| Durbin-Watson               | 1.95  | 2.1               | 1.98              | 2.8               | 1.97                | 2.01                |
| Observations                | 194   | 194               | 194               | 194               | 194                 | 194                 |

**Notes:** The details of definitions and sources of all the variables are reported in Table I. The table reports the estimates. The *t*-values are reported in parentheses. Significance at the 10%, 5% and 1% levels is indicated by \*, \*\* and \*\*\*, respectively

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Our results in our basic model are consistent with our hypothesis that country-level the rule of law is positively correlated with the strength of investor confidence. For instance, as depicted in Models 1, 2, 3, 4, 5 and 6, the coefficients on the variable *rule of law* are significantly positive at 1 per cent significance level. Our results, therefore, support the assertion that whilst favourable economic conditions can help attract investors and enhance investor confidence in economies, the rule of law as an institutional structure is considered a powerful drive that bolster investor confidence (Franck, 2007).

As shown in Models 2, 3, 4, 5 and 6, the coefficients on the variable *regulatory quality* are all positive but insignificant in influencing the strength of investor confidence in African countries. We, therefore, argue that this insignificant relationship could possibly stem from the frequent interferences of most African countries' governments into the affairs of regulatory bodies. This is because, in economies where regulatory bodies are considered not independent of the state and are always susceptible to political interference, investors may be deterred from investing in such economies (Kirkpatrick *et al.*, 2006).

We also find that African economies with strong voice and accountability are characterized by high level of investor confidence. The coefficients on voice and accountability in Models 3, 4, 5 and 6 demonstrate that voice and accountability significantly influences strength of investor confidence positively in African economies. Therefore, these results give support to our hypothesis that voice and accountability positively influences the strength of investor confidence in an economy. Our findings reinforces the argument by La Porta *et al.* (1997, 1999) that enhancing corporate governance rules (in terms of voice and accountability) and the quality of accounting standards leads to greater investor confidence. In addition, the results corroborate the findings of Stasavage (2002) that voice and accountability enhance investor confidence in some African economies.

The results about the relationship between control of corruption and the strength of investor confidence did not support our hypothesis that control of corruption strengthens investor confidence in African economies. In Models 4, 5 and 6, the coefficients on control of corruption are positive and insignificant. The resulting explanation could be that though the sampled African economies are characterized with corruption, the extent of their corrupt practices has not got to a point, which can reduce investor confidence (Castro and Nunes, 2013). Further, another possible explanation could be that most investors from corrupt countries are inclined to invest in economies that are characterized by corrupt practices. These investors believe that it is normal for them to engage in corrupt practices in other economies to facilitate their operations or gain an unfair advantage. This result is consistent with the findings of Abed and Davoodi (2002), Akcay (2001), and Wheeler and Mody (1992).

The relationship between property rights and the strength of investor confidence is significantly positive. In Models 5 and 6, the coefficients on property rights exhibit a significantly positive relationship between property rights and investor confidence. These results thus support our hypothesis that high property rights aid in strengthening investor confidence in African economies. They also reinforce the argument that property rights help in strengthening the level of investor confidence in an economy (North, 2003; Rosenberg, 1994) by creating a system through which individuals can reorganize their assets into more useful combinations (De Soto, 2000). In addition, the results are in line with the findings of Keefer and Knack (2000) that insecure property rights can directly influence growth of economies through the choice of production process and efficiency with which production is carried out, which eventually reduces the level of investor confidence.

Further, Model 6 demonstrates a significantly positive relationship between *political stability* and the *strength of investor confidence* in African economies. Hence, our hypothesis that political stability positively influences the strength of investor confidence is supported.

This finding unambiguously implies that by maintaining political stability, economies can therefore promote economic growth by inducing investors to inject capital into their economies, as well as assuring them that their investments are secured (Akongdit, 2013). This result is consistent with the findings of Obwona (2001) that political stability plays a significant role in inducing investors to inject their capital in the Ugandan economy with the hope that their investments are safeguarded. In addition, our result reinforces a study by Levis (1979) on developing countries, which documents positive significant relationship between political stability and investor confidence.

In regards to the control variables, our results in all the models establish a significant negative relationship between interest rate spread and the strength of investor confidence in African economies. This implies that a rise in interest rate spread discourages investment, making investors less willing to take out risky investments in African economies. In addition, our results show a significant negative association between inflation and the strength of investor confidence. With the exception of Models 1, 2, 3 and 4, our results in Models 5 and 6 illuminate that real GDP growth significantly influences the strength of investor confidence positively in African economies. Finally, our results also document a significantly positive association between country credit rating and the strength of investor confidence in African countries.

### **Robustness check**

The association established with the study's model between institutional structures and the strength of investor confidence could possibly be misleading. We thus examine the robustness of our study results in this section. Countries tend to be at variance in regards to their opportunities and challenges that they face over time. To make sure the results obtained from the PCSE estimation are robust, we conducted the following robustness check. First, we lagged the independent variables by one year and re-estimated our basic model. We believe that investor confidence could be strengthened based on historical data, and as a result, all the independent variables that are supposed to have influence on the strength of investor confidence will become more visible next period onwards. Thus, we present the findings of which all the independent variables are lagged by one period. The results (as presented in Table V) were similar to the PCSE results. Also, as country-level institutional structures and the strength of investor confidence are jointly determined by unobserved country-specific variables, which makes it difficult for PCSE estimation to capture, the study used fixed-effect model to address this issue and also to validate the results obtained from the PCSE estimation. Consequently, the results obtained from the estimation of the fixed-effect model were similar to the PCSE results, as demonstrated in Table V.

### **Conclusions and policy implications**

Several African countries are now making a conscious effort to improve regulations, strengthen corporate governance, promote best business practices and enhance the quality of their investor environment, which ultimately will lead to the strengthening of investor confidence in these economies. However, it is worth noting that as these economies are making the very effort to attract investors in their economies, the establishment of sound institutional structures is imperative. It is argued that economic reform measures that are tailored to attract investors are likely to be a mere cosmetic in economies with weak institutional structures (Castrillo *et al.*, 2010). This is because the strengthening of the level of investor confidence depends on not only economic; their effectiveness is also determined by the soundness of institutional structures in economies (Castrillo *et al.*, 2010).

| Lagged independent variables and strength<br>of investor confidence |                   | Fixed-effect model |                    |
|---|-------------------|--------------------|--------------------|
| Variables   | Coefficients      | Variables          | Coefficients       |
| ROL_1   | 0.0136** [1.98]   | ROL                | 0.00012** [1.92]   |
| RQ_1  | 0.00031 [1.09]    | RQ                 | 0.00672 [0.85]     |
| CC_1  | 0.0033 [0.54]     | CC                 | 0.000514 [0.90]    |
| VOA_1   | 0.0023*** [3.03]  | VOA                | 0.00118** [1.95]   |
| PR_1  | 0.0782*** [2.84]  | PR                 | 0.739590** [1.98]  |
| PS_1  | 0.0108* [1.7]     | PS                 | 0.000479*** [2.45] |
| IRS_1   | 0.0294** [1.99]   | IRS                | 0.01312*** [3.46]  |
| INF_1   | 0.0730** [1.89]   | INF                | 0.01566* [1.78]    |
| GDP_1   | 0.00603*** [4.32] | GDP                | 0.000546*** [4.23] |
| CCR_1   | 0.01098*** [5.04] | CCR                | 0.016208*** [2.78] |
| $R^2$   | 0.409             |                    |                    |
| $F$ -(statistic)  | 9.638             |                    |                    |
| Prob( $F$ -stat)  | 0.000             |                    |                    |

**Notes:**  $t$ -values are reported in parenthesis. Significance at the 10%, 5% and 1% levels is denoted by \*, \*\* and \*\*\*, respectively; where ROL is rule of law, RQ is regulatory quality, CC is control of corruption, VOA is voice and accountability, PR is property rights, PS is political stability, IRS is interest rate spread, INF is inflation, GDP is GDP growth and CCR is country credit rating

Thus, we examined the relationship between institutional structures and the strength of investor confidence in African economies over the period 2009 to 2013. We used the rule of law, regulatory quality, voice and accountability, property rights, control of corruption and political stability as the institutional structures. Data on 39 African countries suggest that the rule of law positively affect the strength of investor confidence in African economies. In addition, voice and accountability, property rights and political stability were found to have significant positive influence on the strength of investor confidence in African countries. These findings give support to the relevance of strong institutional structures when economic policies are fashioned out to boost investor confidence in economies.

Our findings suggest that in addition to the long-term goal of promoting economic reforms, a corresponding long-term goal of strengthening institutional structures in economies should be taken into consideration. Therefore, governments in African countries should strengthen their institutional structures. Instead of waiting for their economic reforms to take effect, governments in African countries can, to some degree, attract investors into their economies by establishing credible institutional structures.

Our study is associated with some limitations. First, the study used data from 39 African countries and therefore, generalizing the results to those African countries that were not examined in this study is difficult. However, the results can be generalized to African countries with characteristics similar to the examined economies, in an analytical sense through inductive reasoning. In addition, the study focused on institutional structures of the rule of law, regulatory quality, property rights, control of corruption, voice and accountability and political stability, but institutional structures such as intellectual property rights, protection of minority shareholders' rights and public trust in politicians are probably also important in African economies. Further studies should expand our model by incorporating these alternative institutional structures and

examining how these institutional structures interact to influence the level of investor confidence in African economies.

In sum, our findings indicate that institutional structures of the rule of law, voice and accountability, property rights and political stability are positively related to the strength of investor confidence in African economies and that the relationship is controlled by some economic variables, such as interest rate spread, real GDP growth, inflation and country credit rating. We finally propose further research to examine how these institutional structures influence the protection of minority shareholders' rights in African economies.

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