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Political Risk and Foreign Direct Investment in Nigeria

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Abstract
The study broadly seeks to investigate the impact of political risks, specifically corruption and government effectiveness, along with Gross Domestic Product (GDP), on Foreign Direct Investment (FDI) in Nigeria. The research was based on secondary sources of data, with 25 observations from 2000 to 2024. The Ordinary Least Squares (OLS) regression was applied to achieve the objective. The regression analysis revealed that the Corruption Index has a significant negative impact on FDI, indicating that higher levels of perceived corruption deter foreign investors. Conversely, the Government Effectiveness Index demonstrated a significant positive impact on FDI, suggesting that improved governance structures attract more foreign capital. Furthermore, Gross Domestic Product (GDP) also exhibited a significant positive impact on FDI, highlighting the attractiveness of a growing economy for foreign investors. The model explained approximately 39.17% of the variation in FDI. Conclusively, the underlying variables of the study show that FDI in Nigeria is greatly affected by these factors, responding according to their established relationships. The study recommends, among other things, that the Nigerian government should intensify its anti-corruption efforts, continuously work to enhance government effectiveness, and foster sustainable economic growth to create a more conducive environment for attracting and retaining foreign direct investment.

Keywords: Gross Domestic Product (GDP), Foreign Direct Investment (FDI), insecurity, risks

1.0 Introduction

Foreign Direct Investment (FDI) has long been recognized as a critical driver of economic development and globalization. It involves a firm establishing a significant degree of control over a business enterprise in a foreign country, typically through ownership or management of foreign subsidiaries (Dunning, 1980). FDI contributes to host countries not only through capital inflows but also via technology transfer, employment generation, infrastructure development, and integration into global value chains (UNCTAD, 2020). Over the decades, the volume of FDI has increased exponentially, paralleling the liberalization of international markets and the reduction of trade and investment barriers.

The influx of FDI surged primarily in the 1980s when lending by commercial banks to the developing economies dried up, which forced most countries to ease restrictions and offer tax

incentives and subsidies to attract foreign capital. Consequently, FDI contributes positively to the Gross Domestic Product (GDP) of the host countries by bringing in foreign exchange reserves and improvement of the Balance of Payment (BoP) for the local economies. The rate of technological progress enhances with FDI since foreign firms bring in more advanced technology and management practices to the host countries (Findlay 1978).

Romer (1993) further adds that FDI can ease the transfer of technological and business know-how to the less developed economies with the consequent reduction of the 'idea gaps' between rich and poor countries. In addition, the new ideas can 'spill over' to other sectors and segments of the economy which are not FDI recipients; thereby, boosting the productivity of more firms in the process (Rappaport 2000). Despite its benefits, FDI flows are highly sensitive to the political and economic environment of host countries. Political stability, governance quality, legal protections, and institutional strength are key determinants influencing multinational corporations' decisions regarding where to invest (Busse & Hefeker, 2007). Historically, countries with stable political systems and predictable policies tend to attract higher levels of FDI, while countries experiencing political turmoil or instability often see reduced investment inflows.

Thus, the relationship between political risk and FDI has garnered significant academic interest, especially as globalization has increased the interconnectedness of economies. Political risk encompasses a broad spectrum of potential adverse events, including expropriation, civil unrest, policy shifts, corruption, and instability of government. These risks threaten the security of investments and can lead to substantial financial losses, discouraging foreign investors from entering or expanding in risky environments (Kobrin, 1979).

The importance of political risk is particularly pronounced in developing economies, where institutional weaknesses and political volatility are more prevalent. Many emerging markets and resource-rich countries often experience fluctuations in political stability, which directly influence foreign investment decisions. For example, countries such as Venezuela and Zimbabwe have faced expropriation and civil unrest, leading to significant declines in FDI (O'Neill & Pearce, 2020). Conversely, nations with stable political climates, transparent governance, and effective legal systems tend to attract higher FDI levels, fostering sustainable economic growth.

Historically, some scholars have postulated a negative correlation between political risk and FDI, suggesting that higher risks deter foreign investors (Jensen, 2003). However, others argue that the relationship is more nuanced, with sector-specific and firm-specific factors mediating the impact of political risk on investment decisions. For instance, natural resource sectors may be more resilient to political risks due to the high returns involved, leading firms to accept higher risks in pursuit of lucrative opportunities (Asiedu, 2006). Additionally, multinational corporations often employ risk mitigation strategies such as political risk insurance, joint ventures, or diplomatic engagement to reduce exposure (Calderon & Liu, 2007).

The global landscape has also evolved with the introduction of international organizations and treaties aimed at reducing political risk and promoting foreign investment. Institutions such as the World Bank's Doing Business report and regional trade agreements have sought to improve the investment climate in developing countries, though challenges remain. Political risk continues to be a significant barrier to FDI in many regions, particularly in areas plagued by conflict, corruption, or weak governance.

Furthermore, recent geopolitical events, such as trade wars, sanctions, and regional conflicts, have underscored the importance of political stability in international investment decisions. The COVID-19 pandemic has also highlighted vulnerabilities in global supply chains and the need for resilient investment strategies amid uncertain political and economic environments (UNCTAD, 2020). As a result, understanding how political risk influences FDI is more critical than ever for both policymakers aiming to attract foreign investment and multinational corporations seeking to navigate complex global markets.

1.2 Statement of the problem

Despite numerous studies identifying determinants of FDI, one factor remains to receive much attention owing primarily to high quality data – political risk. Logically, it should be the case that political risk would have a significant negative impact on FDI. Political instability increases uncertainty in the economic environment, thereby lowering the incentives for foreign investors to invest in the host country. The International Country Risk Guide (ICRG) has identified twelve

different political risk indices, highlighting the importance of understanding how political risks impact FDI flows (ICRG, 2023).

Indeed, FDI plays a crucial role in fostering economic growth, technological advancement, and employment across nations. However, the level and stability of FDI inflows are significantly influenced by the political environment of the host country. Political risks such as government instability, corruption, civil unrest, policy unpredictability, and expropriation can deter foreign investors and limit investment opportunities. Despite the recognized importance of political stability, many countries—particularly in developing regions like Nigeria—continue to face challenges in attracting and retaining FDI due to volatile political conditions.

Although existing research confirms a general negative relationship between political risk and FDI, there remains a gap in understanding how specific dimensions of political risk influence investment decisions across different sectors and regions. The evolving geopolitical landscape, recent conflicts, and economic disruptions further complicate this relationship, warranting further investigation. Addressing this knowledge gap is crucial for policymakers to design effective strategies that mitigate risks and create a more stable environment for foreign investment. Therefore, the problem this study seeks to address is: How does political risk influence foreign direct investment flows in Nigeria.

2.1 Theoretical framework

2.1.1 Institutional theory

The Institutional Theory has roots in the broader field of sociology and organizational studies, but its application to international economics and FDI was significantly advanced by Douglass North in the late 20th century. The theory posits that institutions—comprising formal rules (laws, regulations) and informal norms (cultural practices, traditions)—create the framework within which economic activity occurs. Strong, transparent, and predictable institutions reduce uncertainties, transaction costs, and risks, thereby fostering a more conducive environment for FDI (North, 1990). Conversely, weak or corrupt institutions increase political risks such as expropriation, policy reversals, or civil unrest, which deter foreign investors.

Here, institutional quality directly influences investor confidence. Countries with well-established legal systems, property rights, and effective governance mechanisms tend to attract higher levels of FDI because they mitigate risks associated with political instability (Globerman & Shapiro, 2002). Poor institutional frameworks, on the other hand, heighten concerns over expropriation, regulatory unpredictability, and civil unrest, thus increasing the perceived political risk.
Empirical studies have shown that institutional quality is a significant determinant of FDI inflows. For example, Busse and Hefeker (2007) found that institutions such as rule of law, corruption control, and political stability positively impact FDI. Similarly, Alfaro et al. (2008) demonstrated that institutional development enhances economic growth driven by FDI, underscoring the importance of strong institutions in reducing political risks.

Applying the Institutional Theory to Nigeria's context, political risks such as corruption, weak legal enforcement, and government instability significantly influence foreign investors' decisions. Effective reforms aimed at strengthening institutions could, therefore, reduce perceived risks and attract more FDI, fostering sustainable economic growth.

2.2 Empirical review

It should be noted at the outset that very few authors have tried to measure the impact of risk factors on FDI. The primary hindrance associated with risks is their quantitative measurements. Click (2005), in an attempt to measure political risk, deducted financial risks from total country risks to calculate political risks. The standard deviation of each country's regression residuals was assumed to provide a measure of the unexplained country risk, i.e. the unobserved political risk. The study showed differences in Return on Assets (ROA) related to measurable financial risk variables. To further examine whether country risk captured political risk, correlations of residual deviations were computed by the author with other country and political risk indicators. Consequently, it was revealed that the correlation between residual deviations and average Euro money, Institutional Investor and ICRG ratings was moderately high, establishing the notion of a significant correlated relationship. The author concluded that political risk is unrelated to ROA of the companies.

On the other hand, other studies have deployed "corruption" as a measure of political risk and calculated its subsequent impact on FDI. Corruption is defined by Getz and Volkema (2001) as the abuse of public roles and resources for private benefit or the misuse of public office for non-official ends. Corruption has a disincentive effect on investment since it increases the risk and uncertainty encountered by potential investors (Getz and Volkema 2001), thereby, discouraging investors to make further investments in such political risky economies. Another barrier or disincentive for foreign investors to invest in host countries can be imposed by corruption in the form of distortionary effects (monies paid for bribery being inefficiently allocated) (Goudie and Stasavage 1997).

Robertson and Watson (2004) studied the impact of corruption on changes in levels of FDI from a strategic perspective. They incorporated strategic decisions which managers of multinational companies (MNCs) need to adopt in the presence of political risks. In addition, they introduced the culture of uncertainty avoidance and masculinity; masculinity referring to masculine values of assertiveness, aggressiveness, and materialism that lead to high levels of corruption, which tend to be more social (Hofstede 1997). The study used the Corruption Perceptions Index (CPI) for 1999 and 2000, while uncertainty avoidance and masculinity measures were taken from Hofstede (1997) cultural dimension scores. Employing a simple OLS hierarchical regression analysis with control variables such as GNP per capita, GNP and consumption, results of the study indicate that the more rapid the rate of change in FDI, the higher is the level of corruption. Additionally, the culture traits of uncertainty avoidance and masculinity and also associated with higher levels of perceived corruption.

Focusing on the same issue, Habib and Zurawicki (2002) examined the impact of corruption on FDI for 89 countries over the 1996-1998 periods. The analysis displayed a negative impact of corruption on FDI. Moreover, the study found a negative effect due to the difference in corruption intensity between the host and home countries. The results suggested that foreign investors generally avoid corruption because of moral obligations and also the operational inefficiencies that arise due to corruption. More importantly, foreign investors avoid corruption because it can be difficult to manage, and is risky and costly at the same time. However, the study relied on the

perception-based measure of corruption, which fails to capture the different forms of corruption exerting varying impacts on FDI.

Wei (2000) analyzed data on FDI in the early 1990s from 12 source countries and 45 host countries. Corruption revealed to have a significant and negative effect on FDI. Mauro (1995) also found corruption to have a negative impact on investment, thus resulting in diminished economic growth. In fact, papers such as Campos and Nugent (2002) point out that the negative impact of political risk on economic growth is now regarded as 'stylized fact'. They state that political instability increases uncertainty in the economic environment, thereby disrupting production and reducing capital investment, which, in turn, affects economic growth.

However, studies such as Nye (1979), found that corruption has a positive impact on economic growth and development while Hines (1995) derived a non-significant relationship. Hence, it can be deduced that the relationship between political risk (via corruption) and economic growth is still ambiguous. Thus, the present study aims to explore the political risk indices and learn the respective indicator's impact on FDI. Khan and Akbar (2013), attempted to study the relationship between political risk and Foreign Direct Investment (FDI), accounting for 94 countries over a span of 24 years from 1986-2009. It was found that most of the political risk indicators have a negative relationship with FDI for the world as a whole and also, the high-income countries but the relationship was the strongest for the upper middle-income countries.

Despite the extensive literature on this topic, there remains a gap in understanding the effects of political risk, on the influence of FDI. Many studies have focused on broad macroeconomic indicators, but the nuanced interactions between political risk dimensions and investment flows warrant further investigation. Thus, this study seeks to address these gaps by providing a comprehensive analysis of the relationship between political risk and FDI, considering recent data from Nigeria.

3.0 Methodology

This study employs ex-post facto descriptive research design to examine the impact of political risks on foreign direct investment in Nigeria controlling for GDP. Data was collected from Central Bank of Nigeria Bulletin and World Bank Database whereas it is to be noted that the data for two political risk components used were collected from UNCTAD and OECD over a span of 25 years from 2000-2024.

The model for the study is specified as:

$FDIit = \alpha + \beta 1CORit + \beta 2GEF + B3GDPit + eit$…….(1)

where, FDI = Log of FDI measured in current prices

GDP = Log of GDP measured in current USD (control variable)

PRk = Log of the Political Risk component (PRk), where k refers to two of twelve different indices namely corruption index and government effectiveness index.

The technique of analysis used in this study is the descriptive and inferential statistics technique of the data analysis conducted using Multiple Regression to test the hypotheses with the aid of Eviews 12.0 statistical software and Descriptive statistics was used to understand the trend behavior of the data during the period under investigation.

4.2. Data analysis

4.2.1 Descriptive statistics

Descriptive statistics has conducted for the dependent variable and independent variables to show the trend behaviour of these variables from 2000 to 2024. From the analysis depicted, the mean FDI is approximately 1.37, while the median is slightly higher at 1.52. This suggests a slight leftward skew, which is supported by the positive skewness value of 0.13. The range of FDI is from -0.04 (the minimum) to 2.90 (the maximum), showing some variation in the data. With a standard deviation of 0.81, the data points are relatively spread out from the mean. The kurtosis of 2.05 indicates the distribution has lighter tails than a normal distribution. The Jarque-Bera statistic of 1.02 and its high probability of 0.60 suggests that the FDI data is likely normally distributed. The sum of FDI values is 34.33.

For corruption index (COR), the mean is about 0.16, and the median is 0.15, indicating the data is fairly centered. The minimum value is 0.12, and the maximum is 0.23, a relatively small range. The standard deviation is very small at 0.029, suggesting the data points are tightly clustered

around the mean. The skewness of 1.30 shows a strong positive skew, meaning there's a long tail on the right side of the distribution. The kurtosis of 3.64 indicates the distribution has heavier tails and a sharper peak than a normal distribution. The Jarque-Bera statistic of 7.48 and its low probability of 0.024 indicate that the COR data is not normally distributed.

Furthermore, the mean GEF is -1.04, and the median is -1.03. The minimum value is -1.21, and the maximum is -0.85, showing a narrow range. The standard deviation is 0.10, indicating a moderate spread of data around the mean. The negative skewness of -0.10 suggests a slight leftward skew, but it's very close to zero. The kurtosis of 2.09, similar to FDI, suggests the distribution has lighter tails than a normal distribution. The Jarque-Bera statistic is 0.90, and with a probability of 0.64, it's highly probable that the GEF data is normally distributed.

Table 1

Result of descriptive statistics

	FDI	COR	GEF	GDP
Mean	1.373579	0.156331	-1.039060	4.871902
Median	1.523782	0.150314	-1.026958	5.307924
Maximum	2.900249	0.227055	-0.847907	15.32916
Minimum	-0.039127	0.124415	-1.213150	-1.794253
Std. Dev.	0.815454	0.028933	0.100646	3.664373
Skewness	0.134918	1.302156	-0.104461	0.472843
Kurtosis	2.050219	3.636140	2.095071	4.126131
Jarque-Bera	1.015516	7.486580	0.898484	2.252596
Probability	0.601843	0.023676	0.638112	0.324231
Observations	25	25	25	25

Source: E-views 12.0 statistical software

Lastly, the mean GDP is 4.87, but the median is significantly higher at 5.31, suggesting a negative skew. This is contradicted by the positive skewness of 0.47, which indicates a slight rightward skew. The range of GDP is quite wide, from a minimum of -1.79 to a maximum of 15.33. The standard deviation is 3.66, which shows a large spread in the data. The kurtosis of 4.13 suggests the distribution has a sharper peak and heavier tails than a normal distribution. The Jarque-Bera statistic is 2.25, and its probability of 0.32 suggests that the GDP data is likely normally distributed.

4.2.2 Regression results

The Ordinary Least Squares regression is a statistical method used to model the relationship between a dependent variable and one or more independent variables. It aims to minimize the sum of the squared errors (residuals) between observed and predicted values, providing a linear equation that best fits the data. OLS is widely used due to its simplicity, interpretability, and applicability in various fields, including economics, finance, and social sciences. In table 3 below, the OLS regression result with FDI as the dependent variable and COR and GEF, as independent variables controlled by GDP, suggests that these variables collectively explain about 39.17% of the variation in Foreign Direct Investment (R-squared = 0.391684). The adjusted R-squared is 0.304782, which accounts for the number of predictors in the model.

Table 2

OLS Regression

Dependent Variable: FDI
Method: Least Squares
Sample: 2000 2024
Included observations: 25

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.156234	1.934835	-0.080748	0.9364
COR	-6.392045	5.243052	-1.219146	0.0230
GEF	0.325447	1.461269	0.222716	0.0125
GDP	0.114171	0.039436	2.895107	0.0087

R-squared	0.391684	Mean dependent var	1.373579
Adjusted R-squared	0.304782	S.D. dependent var	0.815454
S.E. of regression	0.679924	Akaike info criterion	2.211975
Sum squared resid	9.708224	Schwarz criterion	2.406995
Log likelihood	-23.64968	Hannan-Quinn criter.	2.266065
F-statistic	4.507177	Durbin-Watson stat	1.120759
Prob(F-statistic)	0.013640		

Source: E-views 12.0 statistical software

Regarding the individual variables, the coefficient for Corruption Index (COR) is -6.392045, which means that for a one-unit increase in the Corruption Index, FDI is expected to decrease by approximately 6.39 units, holding other variables constant. This relationship is statistically

significant, as shown by the p-value (Prob.) of 0.0230, which is less than the conventional 0.05 significance level. This suggests that higher corruption is associated with lower foreign direct investment.

Contrarily, the Government Effectiveness Index (GEF) has a coefficient of 0.325447, indicating that a one-unit increase in the Government Effectiveness Index is associated with an increase in FDI of about 0.33 units, holding all other variables constant. This effect is also statistically significant, with a p-value of 0.0125, which is below 0.05. This implies that more effective government policies and institutions tend to attract more foreign direct investment. For the control variable, Gross Domestic Product (GDP) has a coefficient of 0.114171, suggesting that a one-unit increase in GDP is associated with an increase in FDI of roughly 0.11 units, with other variables held constant. This relationship is statistically significant, with a p-value of 0.0087, which is well below the 0.05 threshold. This finding supports the idea that countries with higher economic output are more attractive destinations for foreign investment.

Overall, the model is statistically significant as a whole, demonstrated by the low Prob (F-statistic) of 0.013640, which is less than 0.05. This indicates that at least one of the independent variables has a significant impact on FDI. The Durbin-Watson statistic of 1.1201 would then be evaluated in the context of potential autocorrelation, with values close to 2 indicating no autocorrelation. The standard error of the regression was about 0.6799, providing an estimate of the typical deviation of the observed FDI values from those predicted by the model. Additionally, the model's Akaike Information Criterion (AIC) of 2.11, was the lowest in this case, which is useful for comparing this model's performance with alternative specifications.

Conclusion

Based on the analysis of the variables, it was concluded that both corruption and government effectiveness (proxies for political risks) are significant determinants of Foreign Direct Investment (FDI) in Nigeria. The findings provide strong support for the hypotheses that corruption has a significant negative impact, while government effectiveness has a significant positive impact on FDI. Specifically, the negative coefficient for the Corruption Index indicates that foreign investors are deterred by corruption, underscoring the need for robust anti-corruption policies and

institutional reforms. Conversely, the positive coefficient for government effectiveness highlights that a stable, transparent, and efficient governance structure is a key factor in attracting foreign capital. Overall, the results concluded that political risks have a negative implication for the inflow of foreign direct investments into the country's mainstream economy.

5.3 Recommendation

Based on the findings of this study, the following recommendations are made:

1. The Nigerian government should intensify its anti-corruption efforts. This should include strengthening legal frameworks, ensuring the independence and effectiveness of anti-corruption agencies, and promoting greater transparency in public procurement and government contracts.
2. Policy makers should focus on institutional reforms to enhance its administrative capacity and service delivery. This includes streamlining bureaucratic procedures to make it easier for foreign businesses to start and operate, improving the efficiency of the judicial system to ensure the swift enforcement of contracts and resolution of disputes, and providing a stable and predictable policy environment.
3. The government should continue to implement policies that promote sustainable economic growth. This can be achieved by diversifying the economy away from over-reliance on oil, supporting small and medium-sized enterprises (SMEs), and investing in key infrastructure projects like power, transportation, and telecommunications.

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