FINANCIAL DEVELOPMENT, RULE OF LAW AND DOMESTIC INVESTMENT IN WEST AFRICA

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ABSTRACT

This study examined the impact of financial development and rule of law on domestic investment in West Africa. Secondary Data were obtained from World Bank development indicators database for the 16 West African countries from 2000 to 2021. Fixed effects Model Regression and Two-step System GMM were used to analyze the data. The study found that financial development, rule of law and interaction between financial development and rule of law had positive, significant effects on domestic investment. The study concluded that developing financial sector and maintaining sound rule of law are necessary for enhancing domestic investment. It was recommended that financial institutions particularly, commercial banks in West African countries should increase their lending to private sector for productive investment.

1. INTRODUCTION

Domestic investment is essential for economic growth as it boosts output, creates jobs, and advances the economy as a whole. The activities of local individuals, companies and institutions in terms of investments underscore the significance of domestic investment in any economy. The catalytic role of domestic investment has made governments of most countries to put measures in place for promoting such investment with the aim of diversifying economy and reducing its dependence on certain products. Domestic investment in many countries of West Africa, has been catalytic to economic growth and development which has been a bedrock for diversification and reducing the country's dependence on oil (Obayori, et al., 2018). As a matter of fact, efforts have been on in recent years, in boosting domestic investment across the region.

In Nigeria for instance, initiatives like the Nigeria Investment Promotion Commission (NIPC) were brought up towards enhancing domestic investment atmosphere. The development aimed at attracting investments, promoting ease of doing business, and creating conducive environment for local and foreign investors (Ogunjinmi, 2022). Similarly, governments of West Africa countries have put in place measures to deepen financial sector in order to enhance domestic investment. According to Abbas et al. (2022), the growth of any country however depends on financial development, market stability,

government policies, and access to finance. Well-developed financial sector helps in facilitating flow of funds from savers to investors, as well as fosters availability of funds for domestic investment. In other words, countries will have opportunities to attract more investment, spur innovation and entrepreneurship, and ultimately drive economic growth and development with improved financial sector.

However, financial development may not be able to automatically promote domestic investment without sound rule of law. That is, rule of law, goes a long way in determining how domestic investment is facilitated by financial development. Rule of law creates a stable and predictable environment that encourages businesses as well as individuals to invest their resources within the country (Ogunjinmi, 2022). This means that countries with sound rule of laws are more likely to attract domestic investment due to reduced risks and uncertainties, as well as greater confidence of investors in the overall business environment.

Noting the role of such investment in the economy, governments of West African countries, have at different times, implemented various policies and programmes and regulatory reforms to address the identified factors and encourage more investments by local investors (Sennuga et al., 2021). Such policies are necessary as effective public governance through institutions, laws, and policies are needed to encourage domestic investments. The policies are mechanisms focusing on lowering political risks and compliance expenses through sound governance.

Despite the efforts of successive governments in West Africa, domestic investors still faced with of lack of access to adequate finance probably due to underdevelopment of financial market in some West African countries (Sennuga et al., 2021). Similarly, regulatory bottlenecks and poor rule of law have hindered the inflow of investments and discourage local investors from putting their money into productive sectors of the economies.

Financial development, the rule of law, and domestic investment have all been the subject of several studies (Ojo et al., 2023; Ogunjinmi, 2022). However, previous researches have not achieved a consensus regarding the direction of the relationship between these factors, partly because they did not take into account the interaction between the rule of law and financial development. This study therefore uniquely considered the interactive effect of these variables on domestic investment.

2. Theoretical and Empirical Review

2.2.1 Supply-Leading Theory

The argument over the role of financial development in economic growth via investment, dated back to Walter Bagehot's groundbreaking work in 1873 (Čihák et al., 2012). Prominent economist Bagehot believed that a strong finance sector was an essential precondition for a country's successful industrialization. Schumpeter (1911) however expanded the idea in his treatise, underscoring the need of a healthy financial system. According to Schumpeter (1911), this kind of system is essential to the real sector, promoting investment, growth and eventually resulting in economic development.

The supply-leading theory provides straightforward framework for comprehending how financial deepening can serve as an engine for economic expansion. This hypothesis highlights how important financial deepening is for promoting economic growth (Hurlin & Venet, 2008). In other words, effective distribution of resources, according to proponents of the theory, is a direct result of financial sector development. Studies like Said and Hammam (2024), Chow et al. (2018), Mansur and Nazar (2023) have all validated the supply leading hypothesis in their various research works.

In relation to domestic investment, the supply-leading theory posits that increases in financial development can bring about enhanced domestic investment. This theory suggests that a more developed financial system provides the necessary infrastructure and resources for firms and individuals to access funding and invest in productive endeavors (Mansur & Nizar, 2023). A well- developed financial system is able to efficiently allocate capital, facilitate risk-sharing, and reduce information asymmetries. In summary, the supply-leading theory suggests that domestic investment tends to be propelled by financial sector development, especially, when necessary, infrastructures are provided to boost fund accessibility and productive investment.

2.2.2 Theory of Institutional Economics

This study is also underpinned by the theory of institutional economics which could be traced back to the work of Shleifer and Vishny (1993). The theory of institutional economics holds that growth is largely determined by its rule of law (Shleifer & Vishny, 1993). The performance of a country is directly impacted by its institutional environment, structure, trend, and reasonable basic institutions. Corruption is a significant issue, the institutional system is flawed in the majority of emerging nations, and ineffective institutions limit the potential for economic growth. A nation or region's rule of law is another benefit that can effectively boost economic growth and resource allocation efficiency. However, the institution's effects on nations varied depending on their level of development (Qiang & Jian 2020).

The core tenet of the theory is that since institutions have a significant impact on human behavior, they are also very relevant to the expansion and advancement of nations. Although there is currently no comprehensive and widely recognized definition of institutions, there is a very wide agreement in the literature regarding what institutions are, as well as their main purposes and impacts. Institutions are frequently regarded as essential factors that determine economic prosperity or well-being. Research in the fields of domestic finance and growth has benefited greatly from the new analytical approaches that institutional theory offers. The idea of equilibrium as a permanent condition in neoclassical economics necessarily deviates from institutional theory due to the economy's complexity and change. According to the institutional economic theory, organizations can influence organizational behavior, particularly when they offer incentives related to financial interests. Most scholars and many researchers are of the opinion that institutions are decisive for the increase in domestic investment and the general wellbeing of economic environment. Studies like Salman et al. (2019) and Abid (2017) have adopted the theory of institutional economics in explaining the impact of rule of law on some selected variables of interests.

In relation to this study, domestic investment hypothesized to have been significantly influenced by rule of law. This is because good rule of law can effectively improve efficiency in allocation of scarce resources.

2.3 Empirical Review

Ameer et al. (2020) examined how the rule of law increased domestic public and private investment in industrialized and emerging nations between 1996 and 2017. Cross-sectional-autoregressive-distributed lag (CS-ARDL) was used for data analysis. Result of the analysis revealed that rule of law encouraged the creation of private capital.

In the like manner, Ogbuabor et al. (2020) examined the impact of rule of law on economic growth in West Africa. The study gathered data using a panel of 13 nations. For the analysis, the panel two-stage least squares estimation approach and the system generalized method of moments were both used. The findings showed a strong inverse link between West African growth and the rule of law.

Vu et al. (2022) examined how the rule of law affected foreign investment in Vietnamese domestic companies. Using unbalanced panel data, the study examined over 61,600 Vietnamese manufacturing companies between 2012 and 2017. A regression analysis was performed, and the findings showed that the rule of law had a favorable effect on foreign investment in domestic companies.

Moreso, Izadkhasti (2023) analysed the effect of rule of law, among other variables on regional gross domestic product per capita in oil exporting countries. For the study, data was gathered between 2011 and 2021. The Levin-Lin-Chu test was used to assess the variables' dependability. The influence of the explanatory factors on gross domestic product per capital was assessed using the Random Effects regression technique. According to the study, the rule of law has significantly and favorably impacted GDP per capita at the 1% level.

Khalid et al. (2023) related domestic investment to governance in Asia. Phillips-Peron (PP) and Augmented Dicky-Fuller (ADF) tests were used for the analysis. Ultimately, the data was analyzed using the fully modified least squares method. The findings showed that regulatory quality, voice and accountability, government efficacy, and corruption control all significantly boosted domestic investment.

Empirical evidence indicated that numerous studies like Ogbuabor et al (2020), Izadkhasti (2023), and Khalid et al. (2023), have been conducted on financial development, rule of law and domestic investment. However, previous researches failed to integrate rule of law and financial development as explanatory variables in a single model. Some of the studies only incorporated the variables related to the rule of law, while others only took financial development into account. There may have been some estimation bias as a result of the exclusion of the rule of law or financial development variables. This is because the model's fitness may be impacted if certain significant factors that have been shown to have a theoretical link with the dependent variables are left out. This study therefore combined financial development and rule of law variables in the model while explaining their impacts on domestic investment in West Africa. Additionally, prior research did not take into account the ways in which financial development and the rule of law interact. This study filled this gap by considering how the two factors interacted to affect domestic investment in West Africa.

3. METHODOLOGY

Ex-post facto research design was adopted for this study. Ex-post factor research design was employed because the fact of the study has occurred prior to the commencement of the study. Hence, the researcher has no influence on the fact of the study. The population of this study consists of all African Countries. The study focused on West Africa, and 16 West African countries (United Nations, 2024) were selected for the study via purposive sampling technique. The sample, selected based on data availability consists of all the 16 West African countries because the relevant data are available on the World Bank development indicators database. Secondary data were collected from World Bank development indicators database from 2000 to 2021. Fixed Effect regression analysis was used for the inferential analysis. Hausman test was used to choose between fixed effect and random effect models because the study is panel in nature. Generalized Method of Moments (GMM) technique was also utilised for robustness check.

Specification of Research Model

This underlining theory for this study is that of theory of institutional economics which assumes that the growth of a country or advancement of a domestic investments depends on the country's institutions i.e. it depends on the rule of law in that country. Hence, the model of this study was specified as follows:

$DOI_{it} = \beta_0 + \beta_1 FD_{it} + \beta_2 ROL_{it} + \beta_3 ROL*FD_{it} + \beta_4 INT_{it} + \beta_5 EXR_{it} + \mu_{it}$ *eqn1*

Where:

DOI = Domestic investment,
FD= Financial Development (measured with Credit to Private Sector to GDP ratio),
ROL = Rule of Law,
ROL*FD = interaction of FD and ROL,
INT = Interest rate,
EXR = Exchange rate and
μ_{it} = random error term

Table 1: Measurement of Variables

S/N	Variable	Proxy	Measurement	Source(s)
1	Domestic investment	DOI	Log of gross domestic investment	Obafemi et al (2016)
2	Financial development	level of Financial Development (FD)	Private sector credit to GDP ratio	Doan (2019)
3	Rule of Law	ROL index	A measure of IQ	Ogbuabor et al (2020)
4	Interacting variable	ROL*FD	Financial Development multiply by ROL index	Author's initiative
5	Interest rate	Real interest rate (INT)	Real interest rate	Akanbi (2012)
6	Exchange rate	Exchange rate (EXR)	End of year exchange rate	Dinga et al. (2023)

Source: *Author's compilation (2025)*

4. RESULTS AND DISCUSSION OF FINDINGS

Table 2: Summary Statistics

Variable	Obs	Mean	Std Dev.	Min	Max
DOI	352	7.310193	1.022100	-2.27773	29.40000
FD	352	13.86750	12.74092	0.00000	73.19206
ROL	352	0.73900	0.01200	-3.166595	2.282343
ROL*FD	352	2.227547	18.0012	-67.4064	99.60447
INT	352	14.087593	8.272902	3.948460	33.46679
EXR	352	627.944	1450.851	264.0000	9565.082

Source: *Author's computation (2025)*

Table 2 shows the mean as the average values of the data relating to financial development, rule of law and domestic investment variables for 16 West African countries over 22 years from 2000 to 2021. The selection of 16 countries for 22 years means that the total number of observations is 352 as displayed in the Table. The table shows the mean value of domestic investment as 7.31 with standard deviation of 1.022. The minimum and maximum values of DOI were also reported as -2.28 and 29.40 respectively.

According to Table 1, financial development (FD) which was measured by credit to private sector to GDP ratio, recorded mean value of 13.867, and standard deviation of 12.74. This indicate that on average, bank credit to private sector in selected countries accounts for about 13.87% of the respective countries Gross domestic Product. The average FD shows a low level of financial development as the financial markets are still evolving, across the region. The standard deviation of 12.74 indicates that the spread around the mean value was about 12.74%. In other words, the expected size of financial development in the selected countries of West Africa, tends to deviate from the actual size with plus or minus 13%. The minimum level of financial development was reported as 0.000 which means that some of the countries almost zero percent of credit to private sector to GDP ratio over the period of the study. The minimum value also testifies to low financial development in West Africa. However, 73.192 was reported as the maximum value of financial development (FD). it means that the largest value of credit to private sector in any of the countries in West Africa, from 2000 to 2021, was around 73% of GDP of the country. Such result could be assumed to have come from a country whose economy relies more on its financial sector.

Rule of law (ROL) is another variable that was used to explain domestic investment in this study. From Table 1, ROL has mean value of 0.739 with standard deviation of 0.012. The minimum and maximum values of ROL are -3.167 and 2.28 respectively. The mean value of 0.739 indicates a very low level of rule of law with dispersion of 0.012. Also, the dimension of rule of law ranges from -3.167 to 2.282 at the minimum and maximum value. The implication of these statistics is that compliance with rule of law is low in many of West Africa countries. Inconsistencies regarding rule of law tend to affect justice and equity, and breed corruption, with long run consequence on investment.

However, interacting rule of law with financial development, the interactive variable (ROL*FD) produced some descriptive statistics that were analysed to examine their possible effect on the dependent variable. According to Table 1, the interactive (Rule of Law and Financial Development) variable (ROL*FD) showed a mean of 2.23 and standard deviation of 18.00. The high standard deviation indicates that the dispersion from the mean value of ROL*FD is very large. The large dispersion means that the actual interactive effect could be significantly larger than expected. In other words, the mean value of interaction behaves largely in an uneven pattern. Other important parameters of interest are minimum and maximum values of ROL*FD presented in Table 1. The minimum value is -67.406 and maximum value is 99.604. The wide range from minimum and maximum values buttressed the large dispersion of the interactive variable displayed by the standard deviation.

Concerning the control variables, interest rate across the West Africa region, has mean value of 14.087 with spread of 8.273. The descriptive statistics of mean shows that over the 22 years of the study, the average interest rate in the West Africa countries remains at approximately 14%. the standard deviation of about 8.3% indicates that the actual interest rate is quite different from the average value with a dispersion around the mean of about 8.3%. Minimum interest rate is 3.95% and maximum rate of interest is 33.47%. The range of interest between 3.95 and 33.47% means that some countries had high interest rates while others have lower interest rates during the period under investigation. The implication of is that domestic investment would most likely be higher in high-interest paying countries than the low-income paying ones. This is because investors are rational and would normally prefer higher to lower returns on their domestic investments.

Exchange rate is another control variable that was introduced into the model. In Table 1, exchange rate (EXR) showed mean value of 627.9 with stand deviation of 1450.85. The minimum value is 264 and maximum is 1450.85. The behaviour and movement in exchange rate in different countries across Africa, can have effect on domestic investments in the countries.

4.1 Multicollinearity Test

Table 3: Pair-wise correlation

Variable	FD	ROL	ROL*FD	INT	EXR	VIF
FD	1.0000	0.1753	0.2872	-0.0212	-0.1339	1.13
ROL	0.1753	1.0000	0.5417	-0.1488	0.1173	3.75
ROL*FD	0.2872	0.5417	1.0000	-0.0229	0.0452	3.84
INT	-0.0212	-0.1488	-0.0229	1.0000	-0.1374	1.08
EXR	-0.1339	0.1173	0.0452	-0.1374	1.0000	1.06

Source: *Author's computation (2025)*

Table 3 presents pair-wise correlation results among the variables. Gujarati (2004) states that when the correlation coefficient between two independent variables is higher than 0.8, the relationship between them becomes problematic. In other words, a strong correlation of more than 80% between a pair of explanatory variables will result to multicollinearity problem, and a result from regression analysis that is marred with multicollinearity tends to be unreliable. However, Table 3 makes it clear that none of the coefficients even approach 0.8. Therefore, there would be no issues with multicollinearity when using the variables in the regression model. Since the test result established the absence of multicollinearity, regression model was then established to determine the effect of the explanatory variables.

Table 4: Regression Results

	OLS			Fixed Effects			Random Effects		
Varia.	Coeff.	T	p-val	Coeff.	T	p-val	Coeff.	Z	p-val
FD	0.29	6.05	0.000	0.43	6.23	0.000	0.33	6.05	0.000
ROL	2.25	2.02	0.044	2.10	2.75	0.019	2.24	1.85	0.064
ROL*FD	0.07	1.18	0.240	0.09	3.36	0.015	0.08	1.30	0.195
INT	0.15	0.20	0.841	0.07	5.86	0.000	0.04	0.53	0.594
EXR	0.01	2.51	0.013	-0.10	-0.77	0.442	0.01	1.37	0.171
Constant	15.02	15.2	0.000	13.83	11.30	0.000	14.53	11.99	0.000
F-test of Homo.				2.92		0.002			
BP-CW test				1.25		2.44			
Hausm test				48.20		0.000			
Av. VIF				2.17		-			

Source: *Author's Computation (2025)*

In Table 4, F-test of homogeneity, which displays a statistic value of 2.92 and a p-value of 0.002. The F-test of homogeneity is based on the presumption that panel members are not heterogeneous. The test statistic's significance indicates that there is heterogeneity in the panel observations, which means the homogeneity null hypothesis is rejected. To put it another way, there is diversity among the panel members. Pooled OLS regression's applicability for the analysis was further evaluated using the Breusch-Pagan/Cook-Weisberg (BP/CW) test for heteroskedasticity. With a p-value of 0.244 and BP/WC statistics of 1.25, Table 4.5 indicates that the hypothesis of constant variance was rejected. This indicates that the model estimation process was not suitable for the Pooled Ordinary Least Squares (POLS) approach, which presumes homogeneity among panel members. Therefore, fixed or random effects heterogeneous panel approaches were used.

However, Hausman test was used to choose between the Fixed Effects and Random Effects Models. With a p-value of 0.000 and a statistic value of 48.20, the Hausman test result was statistically significant. The hypothesis put forth by the Hausman test was that there was no systematic difference between the coefficients of the fixed and random effects results. The outcome of random effects would be preferred in that scenario. However, the results of the Hausman test, which are shown in Table 5, suggested that the Fixed Effects model estimates were better suited for interpreting regression results.

Regarding the explanatory variables, the result shows that financial development (FD) which was measured by credit to private sector as percentage of Gross Domestic Product (GDP), had positive relationship with domestic investment (DOI) of West African Countries. The result was determined to be statistically significant at the 5% level of significance, and the coefficient of 0.43 indicates the direction of this association. The t-value of 6.23 and the p-value of 0.000 corroborated the result's significance. The effect of Rule of Law (ROL) on domestic investment (DOI) was also found to be significantly positive. According to Table 4.5, increase in ROL index by 1 unit would result in a rise of domestic investment by 2.10%. This finding suggests that increasing equity and social justice will boost domestic investment. The t-statistic of 2.75 and the p-value of 0.019, both of which are below the 0.05 level of significance, indicate that the result is significant.

By interacting financial development measure with rule of law, result of analysis showed that ROL*FD had positive and significant effect on domestic investment. An increase of 1% in value of interaction variable will bring about 0.09% increase in domestic investment. The positive relationship between ROL*FD and DOI was found to be statistically significant as indicated by t-stat and p-value of 3.36 and 0.015 respectively.

On the two control variables, mixed results were reported in Table 5. Interest rate (INT) had positive and significant relationship with DOI, while the relationship between exchange rate (EXR) and DOI was negative and insignificant. In the case of INT and DOI, coefficient, t-statistic and p-value of 0.07, 5.86 and 0.000 respectively, were reported. Conversely, the negative and insignificant relationship between EXR and DOI was confirmed by t- statistic of -0.77 and p-value of 0.442.

4.3 Discussion of Findings

Regression analysis results showed that West African domestic investment was positively and significantly impacted by financial development. It implies that increase in the volume of credits extended to private sector by financial institutions will provide investors with access to more funds. This fund accessibility will in turn enhance the propensity to invest within the local economy. The results of this study on the connection between domestic investment and private sector credit as a measure of financial development are in line with those of Dinga et al. (2023), who found that private sector credit had a favorable and significant impact on domestic investment. Findings of the work regarding financial development and domestic investment is in line with the propositions of supply- leading theory, that increase in financial development leads to higher levels of domestic investment.

Regarding rule of law, negative, significant effect was found on domestic investment. Unfortunately, this finding goes against the theory of institutional economics which that held good institution quality provides comparative advantage and effectively improve the efficiency of resource allocation, propel domestic investment and promote economic growth. A plausible explanation that could be provided to the discrepancy between the result of this study and theoretical explanation is that improved rule of law could have discouraged sharp practices in the investment climate are reduce opportunity for abnormal gains. As a result, investors were discouraged from increasing their investment in the local economy.

The report of this work on rule of law is not only against the theory but also inconsistent with Berggren et al., (2015) that rule of law promotes domestic investment.

However, the rule of law and financial development interacted to have a major impact on domestic investment. The combination of the rule of law and financial development has a positive and noteworthy impact on domestic investment. As a result, investors are more confident in the financial system and the economy as a whole. This suggests that better rule of law fosters justice and equity. With this, financial institutions will be able mobilize more savings for productive domestic investment. This finding support both the theory of institutional economics and supply leading theory.

On the control variables, it was discovered that interest rates had a big influence on domestic investment. This study implies that high interest rates tend to encourage local investors to invest domestically in the hopes of earning a higher rate of return. The results of this study are consistent with Ajisafe and Okunade (2020), who found a positive and significant association between the factors. Nevertheless, the study did not discover any meaningful connection between domestic investment and the exchange rate. In other words, exchange rate is not among the variables of impact when it comes to explaining variations in domestic investment. This implies that making local investment might not call for consideration of exchange rate, especially if the local investment climate is good and stable.

5. CONCLUSION AND RECOMMENDATIONS

Data analysis and study results showed that while rule of law had no substantial negative impact on domestic investment in West African countries, credit to the private sector and the relationship between financial development and the rule of law had positive, significant benefits. Based on these results, the study concluded that increasing domestic investment in West Africa requires financial development and high-quality institutions that uphold the rule of law. The study recommends that financial institutions, especially commercial banks in West African nations, expand their loans to the private sector for more profitable investments in light of the results and conclusions derived from them. This will improve domestic investment, expand the size of the financial sector's expansion, and increase access to investible money. Also, governments across West Africa region should strive to improve rule of law by strengthening legal institutions, rules and regulatory provisions. This will promote social equity and justice, improve investors' confidence and propel domestic investment. Finally, monetary authorities across West African countries should put measures in place to always ensure stability and competitive market rates of interest. This will go a long way in reducing uncertainty regarding investment opportunities and encourage investors to put their funds in the local markets.

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