EAGER
Policy Brief
NUMBER 49 / JANUARY 2001

Ethnicity and Investment Promotion: A Thorny Path for Policy Makers

Existing economic literature shows that foreign direct investment (FDI) is a strong impetus to growth in trade, GDP and social welfare. Yet some countries are having difficulty attracting foreign investment, often confounded by ambivalence toward foreign ethnic groups.

This study used Granger causality tests to examine the relationships between foreign and domestic investment on a 110-country investment database, using both annual data and five-year averages for the period 1970 to 1996. Analysis showed that FDI has a strong impact on domestic investment. To the team's surprise, in developing countries there was no converse stimulation of foreign investment by spurts in domestic investment.

Three case studies of Mauritius, Uganda and Kenya, demonstrated the intricacies of investor relations and investment policies on the ground. All three have officially had FDI promotion policies since independence. These were often not coherent with other policies, however. Each country has experienced periods when macro-economic policies and/or ethnic tensions counteracted investment incentives. Asians, for example, have been "invisible investors" in Uganda and Kenya, as far as investment policy is concerned.

Two related themes come from the recent theoretical literature on social capital as it relates to factors in investment decisions, and these were born out by our case studies: one was the negative impact of ethnic fragmentation per se on economic growth and the other was the importance of sound institutions in counteracting that negative influence. The negative impact of ethnic fragmentation as a variable accounted for one-third of the growth differential between East Asian and African economies between 1965 and 1990. (Easterly and Levine, 1996) Ethnic fragmentation was, in turn, correlated with low school attainment, political instability, weak financial sectors, black market exchange rate premia,

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Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division
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government deficits, inadequate infrastructure, lack of respect for property rights and inefficient bureaucracies, all of which negatively affect both growth and investment. The institutional factors capable of neutralizing that effect include: (1) the rule of law, (2) the viability of the financial sector, and (3) the quality of educational institutions. We group under the rubric of "rule of law" such concerns as access to land, respect for private property, government intrusion or lack thereof in private business, fairness of the courts and the amount of street crime.

Many African intellectuals have responded to this literature with frustration, arguing that it is useless to know of negative impact by a variable such as ethnic fragmentation that is inherent in the political geography of a country. If one cannot do anything about it, what good does it do to know of the relationship?

Countries **can** do something about their ethnic situations. That argument is fallacious. When one looks at investor relations, the problem and solutions become clearer. Countries that overcome their ethnic resentments attract foreign investment far more easily than those with festering ethnic tensions. Ethnic violence is a death knell for investors (other than those attracted by mineral resources).

The keys to positive policy are in two courses of action: 1) creating ethnic bridges and a climate of tolerance, and 2) building the institutions that guarantee every individual, regardless of ethnicity, rule of law, security of person and property, educational and economic opportunity, and fair business practices.

The countries in our case studies all had high ethnic fragmentation ratings at independence, and a high probability of ethnic conflict. Kenya, Uganda and Mauritius rank among the 20 most fragmented countries in the world (Tanzania ranks no.1).

Ethnicity has been handled delicately in Mauritius, in surprising contrast to analysts' predictions at independence. Fifty percent of the population was Hindu, and these were in turn fragmented into Tamil and non-Tamil, low and high caste. Seventeen percent were Muslim, mainly from South Asia, some from China. The 29 percent "General Population" included the Franco-Mauritian elite and a large mulatto population. Four percent were of Chinese origin, speaking a variety of languages and practicing different religions. (Benedict, 1965) The few dozen Franco-Mauritian sugar families who controlled the economy at independence in 1968 faced the classic South African nightmare of being washed into the sea. The majority of the new electorate comprised landless descendants of cane-cutters brought in from the Indian subcontinent as contract labor. Yet Mauritians found a stable accommodation, in both politics and the economy. The constitution explicitly recognizes ethnic minorities, providing for 10 percent of parliamentary seats to go to "also rans" from ethnic minorities that would otherwise not be represented.

The tiny new polity attained in two decades an economic transition from mono-crop sugar island to a balanced economy in which textiles, tourism and sugar are the pillars. New forays are being made into off-shore business services, information technology and other diverse export products. Indo-Mauritians are still minimally represented as entrepreneurs, though they dominate the civil service. Sino-Mauritians, hitherto concentrated in small-scale commerce, enhanced their status through association with Hong Kong and Taiwan industrialists whose knowhow and investment initiated the textile sector. Economic tensions are worked out in annual tripartite negotiations between labor, government and employers, most of whom are Franco-Mauritians.

Sound institutions have played a critical role in the process. The rule of law has prevailed consistently. The sturdy financial sector, led by Mauritius State Bank since 1828, provides investment capital to both domestic and foreign investors. The British-tradition schools graduate fully bilingual, often tri- and quadrilingual students, whom employers find a great asset in the new global economy.

Another factor has been a conscious decision not to fight over the economy, to welcome even investors others might consider odious (land-owners who monopolized the land, South Africans during sanctions). Pride in this conscious openness was expressed by Mauritians of every ethnic background, and many linked openness directly to economic success. Thailand's early success in attracting investment is reportedly similarly linked to a conscious policy, beginning in 1959, ending the stigmatization of overseas Chinese in its economy and their treatment as second-class citizens. (Muscat, 1994)

Uganda and Kenya have been less successful than Mauritius in attracting foreign investment. Despite formal policy platforms favoring foreign investment since independence, both countries have periodically indulged in the politics of ethnic rivalry which creates negative social capital. It makes for an ambiance that, in practice, has outweighed formal investment incentives. Moreover, the sound institutions that might have counteracted this negative trend have eroded over the years, rather than developed.

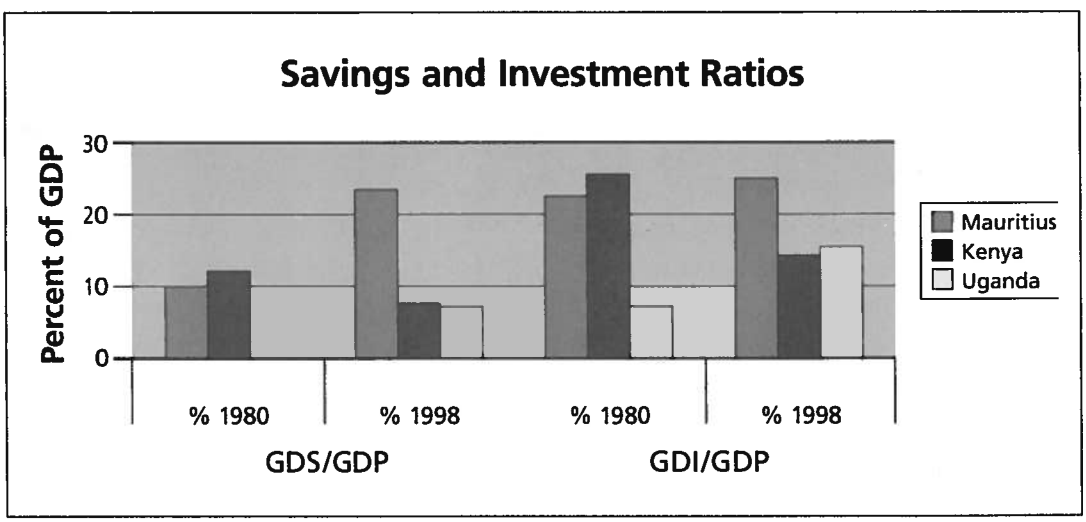
The politics of investment promotion in both countries is complicated by the predominance of Asians from the Indian subcontinent as both foreign and domestic investors. Tensions built in East Africa throughout the years following independence, as it became clear that wrenching control of government from Britain had not brought with it control of the economy. Both Kenya and Uganda expropriated lands and firms of whites and Asians, and tried state capitalism in the 1960s and 70s. Alongside these acts, official investment promotion policies appeared more and more incoherent. Idi Amin's regime in Uganda actually enacted an investment promotion law shortly before unleashing what are now known as the 1972 Economic Wars, attacks on Ugandan Indian commercial and industrial interests that drove them from their homes and businesses.

The military government of Idi Amin was overthrown in 1979. Although an elected government came into power in 1980, foreign investors remained wary of the country, mostly on account of past expropriations and continuing instability. Uganda's landlocked position and high costs of transportation and energy were also factors.

Economic recovery, and building a viable investment climate, has proved a complex and daunting task for Uganda. The Museveni government has taken critical steps that are recognized worldwide. It is credited with good macroeconomic performance (low inflation, high growth rates, convertible currency, etc.) and the creditworthiness (risk rating) has improved (Collier, 1997). Political stability was restored in most of the country, and generous investment incentives enacted. The government is known for its commitment to private sector development. In 1990, government offered to return Asians' seized properties. This brought many back, and the respect for private property that it reflected encouraged others. Returnees, however, have found that high energy and transport costs and other remaining economic distortions make it difficult to compete.

Linkages between foreign and local firms have created a strong pro investment opinion among Ugandan business people, who are often more open than their political leaders. The most important linkages reported allowed local firms to access technology, management, equity capital and training. Firms also indicated that linkages with foreign firms were beneficial in helping them gain access to export markets. Local sourcing has been more important for services than for parts and other inputs, although both parties are working to improve that situation.

Kenya was chosen as a case study because of concern among private and public-sector policy-makers there that investment is falling off. Despite its



Source: World Bank, World Development Indicators, 1999.

much larger and well educated population, Kenya has domestic savings and investment rates similar to Uganda's in 1998 and far below those of Mauritius (see Figure 1 above). Kenya also shares with Uganda the primordial role of the "invisible investor." Most of Kenya's investors, both foreign and local, are of Indian descent. A recent analysis showed that from the colonial period through the 1980s, the percentage of firms owned by Kenya Indians varied from 71 percent to 85 percent, with European, African and other firms lagging far behind. (Himbara, 1994) Yet foreign investment promotion efforts target Europe, and local business promotion efforts target Africans.

Kenya was a popular investment destination in the decade before and after independence in 1961. It experienced in the 1960s and 1970s:

- Average GDP growth of about 6.5% per year,
- Average GDP per capita growth of about 3% per year,
- Minimal inflation (less than 3% per annum), and
- Current account balanced with minimal external debt burden.

This situation was conducive to the first wave of foreign investment under the import substitution strategy. In 1980, it outranked Mauritius in both savings and investment. Since the 1980s, however, it has experienced macroeconomic instability, with negative GDP growth rates, rapid population growth, double-digit inflation, large current account imbalances and external indebtedness, all of which have been deterrents to foreign investment.

Africanization of the economy was attempted through several means under Kenyatta's government: creation of state corporations, repossession of white settler farms in the highlands, and forced Africanization of firms. The Trade Licensing Act of 1967 banned non-African merchants from all but central business districts. Over the next few years thousands of small-town dukawala owners in rural areas were forced to close or sell out. Many emigrated to the UK, India, Canada or the US. This struggle for control was more peaceful and less sweeping in Kenya than in Tanzania and Uganda. Nevertheless, in the end it was no more successful. Rural consumers complained of poor service, and Asians returned to the commercial sector within a few years.

Shortly after the breakup of the East Africa Confederation, the current President Daniel arap Moi came to power in 1978, supported by a coalition of smaller ethnic groups that pointedly excluded the formerly dominant Kikuyu. The Kalenjin ethnic group from which the new President came, and his Masai allies, were initially more interested in consolidating their positions in the state apparatus and civil service than in expropriating firms. The result was a more laissez-faire economy in Kenya beginning in the late 1970s.

Ironically, the Kikuyu and their allies, who had dominated in founding President Kenyatta's time, as they lost positions in the civil service, moved into the private sector. In this more complex new phase, a few African manufacturers were able to get a start: 5 percent of the firms started in the 1980s were Kenyan African owned, and 6 percent of the total created over the whole period 1964-1990 were Kenyan African owned. Kenya European industrial investment had dried up by this time, and has not reappeared. Instead, there was a surge of foreign/joint venture firms in the 1980s.

Freed by the Ndegwa Commission report in 1971 to combine business with civil servants, top civil servants held an interest in many "joint venture" corporations and used their offices to protect and advance their firms. In some key sectors, both foreign and local investors hesitate for good reasons to try to compete with well connected firms, giving them de facto monopolies. The Ndegwa Commission Report has been discredited for having created widespread conflicts of interest, in effect 'legalising' corruption in the country. It is credited with generating little or no new manufacturing investment.

The investment wave of the 1980s dwindled in the 1990s, as the institutions that had protected both the economy and body politic from arbitrary intervention were eroded. In the last two decades, appeals to ethnic bases have become more overt in Kenyan politics and the economy. The groups in power are smaller in size, and have built fewer horizontally linked organizational bridges to other ethnic groups. The trend represents a reinforcement of negative social capital.

From the point of view of investors, the key negative trends have been (Harvard Institute for International Development/World Economic Forum, 1999):

- Inappropriate government spending, particularly allowing Kenya's initially good infrastructure and the educational systems to decay,
- A high regulatory burden on business, diminishing its competitiveness,
- A high percentage of senior management's time spent negotiating permits/licenses,
- Lack of enforcement of regulations (rule of law eroded),
- Prevalence of tax evasion, and
- Lack of perceived competence in the public sector.

Kenya's most pressing challenge is restoring the institutions and infrastructure that buoyed its initial economic growth. General law enforcement, thus physical security of people and property, and judicial support for commercial contracts has worsened over time according to investors surveyed. New strict conflict-of-interest standards need to be established and enforced. Financial probity in both government and corporations needs to be re-established.

Tensions over the role of Asians need to be resolved. The first step is enacting and enforcing more precise fair trade legislation, so that unfair practices by individuals can be eliminated instead of blaming a whole group. Then, conscious efforts at outreach are needed on all sides.

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This policy brief is based on EAGER Discussion Paper Number 67, *Foreign and Local Investment in East Africa: Interactions and Policy Implications,* 2000, by Lucie C. Phillips [lcphillips@ibi-usa.com], International Business Initiatives, Marios Obwona [eprc@imul.com], Economic Policy Research Centre, Margaret McMillan [mmcmilla@emerald.tufts.edu], Tufts University, with Aloys B. Ayako [econuon@arcc.or.ke], University of Nairobi.

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