Foreign and Local Investment in East Africa, Interactions and Policy Implications: Case Studies on Mauritius, Uganda and Kenya

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Lucie C. Phillips, International Business Initiatives
Marios Obwona, Economic Policy Research Centre
Margaret McMillan, Tufts University
with Aloys B. Ayako, University of Nairobi

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For information contact:

Yoon Lee, Project Officer
USAID
AFR/SD/SA (4.06-115)
Washington, D.C. 20523
Tel: 202-712-4281 Fax: 202-216-3373
E-mail: ylee@usaid.gov

Lisa M. Matt, Senior Advisor
BHM International
P.O. Box 3415
Alexandria, VA 22302
Tel: 703-299-0650 Fax: 703-299-0651
E-mail: lmatt@eagerproject.com
Contract AOT-0546-Q-00-5271-00

J. Dirck Stryker, Chief of Party
Associates for International
Resources and Development (AIRD)
185 Alewife Brook Parkway
Cambridge, MA 02138
Tel: 617-864-7770 Fax: 617-864-5386
E-mail: dstryker@aird.com
Contract AOT-0546-A-00-5073-00

Sarah Van Norden, Project Administrator
Belfer Center for Science & International Affairs
John F. Kennedy School of Government
79 John F. Kennedy Street
Cambridge, MA 02138 USA
Phone: 617-496-0112 Fax: 617-496-2911
E-mail: sarah_van_norden@harvard.edu
Contract AOT-0546-A-00-5133-00

Authors:

Lucie C. Phillips [lcphillips@ibi-usa.com], president and owner of International Business Initiatives, holds a Ph.D. from Columbia University and has 25 years of experience in development economics, sociology, academics, and diplomacy. Her recent research interests include African trade and investment policy and political economy, minerals markets, and socioeconomic impacts of major infrastructure and extractive projects.

Marios Obwona [eprc@imul.com] is a Senior Research Fellow with the Economic Policy Research Centre at Makerere University in Kampala, Uganda.

Margaret McMillan [mmcmilla@emerald.tufts.edu] is an expert in Trade and Investment Policy in developing countries. With a PhD in Economics from Columbia University, she has also worked at the World Bank on theories of trade reform. Dr. McMillan has also written on monetary policy, particularly the recently troublesome issue of capital flows. She brings insight on how the relationship between foreign and local investment in Africa affects economic policies, the institutions and the people in developing countries.

Aloys B. Ayako [econuon@arcc.or.ke] is a professor at the Department of Economics of the University of Nairobi in Kenya. He also teaches at the management institute for the Bank of Kenya and the Ministry of Finance.

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EXECUTIVE SUMMARY

Policy-makers throughout the world are devising strategies to attract a share of the new global capital flows, frequently in the form of foreign direct investment. Local business people are often ambivalent about their governments' courting foreign business, particularly in countries with fledgling private sectors recently liberated from statist economic management. Some fear that foreigners will take away business opportunities that locals might have had, or that foreign firms will have privileged access to capital and foreign exchange, reducing their own access. These are particularly acute questions in Africa today. The World Trade Organization is negotiating and implementing agreements designed to "create a level playing field." Those who have less access to capital, education, technology and market connections fear that they will not be able to compete.

This study was designed to explore whether foreign direct investment squeezes out locals, or conversely opens up opportunities for them. The team also hypothesized that local investment might sometimes take the lead, that an improvement in the business climate which stimulated local investment might act to attract FDI. McMillan examined these questions statistically using a worldwide fifty-year database. Phillips, Obwona and Ayako conducted three case studies in Mauritius, Uganda and Kenya, to explore in more depth what these trends represented to actual firms and national economies. This study is part of a series of demand-driven policy studies aimed at maximizing growth and socioeconomic equity, funded under the United States Agency for International Development Equity and Growth through Economic Research/Trade Policy Cooperative Agreement (EAGER/Trade).[1]

The review of the literature showed agreement that investment is critical to the growth process and hence social welfare. The pressing question is, what kinds of investment are most beneficial and what are the most cost-effective and socially harmonious ways to stimulate investment?

Historically the overwhelming majority of investment in both developed and developing countries, has been and continues to be domestic. Yet many developing countries despair of stimulating local investment, pointing to national statistics showing very low domestic savings rates. This creates some problems and confusion in investment promotion programs. For example, FDI tends to be more expensive than local private investment because governments often make major concessions in order to compete for foreign investment. Programs designed to privilege foreign investors have frequently been tried. They generally provoke an outcry from domestic investors, who then succeed in having the same or better incentives extended to domestic investment. The ethnic dimension frequently further complicates policy debates. Ethnic groups who have experienced colonization and discrimination in the past argue that affirmative action is

[1] The findings and views expressed here are those of the authors, and should not be attributed to USAID or the US government. We thank the many friends, officials and business people who so kindly assisted the team on this study, but please do not blame them for opinions expressed here or for any errors.

needed to compensate, to provide them with a share of the national cake. There is resentment against both the colonizing country and immigrant commercial classes—Asians from the Indian subcontinent in East Africa, overseas Chinese in much of Asia, and middle easterners in other areas.

Economic theory points to at least two distinct channels through which FDI may affect both private and public domestic investment in the recipient country. First, FDI may have an impact on the profitability of domestic investment. For example, foreign investors may be directly involved in providing infrastructure such as transportation and telecommunications thus increasing the profitability of domestic investment. In contrast, FDI may reduce domestic investor's earnings by taking market share away. Second, FDI may alter the ownership structure of total investment in the host country and/or make domestic investment possible by providing additional funding. For example, a privatization sale to a foreign firm in itself has no impact on total investment but will release local funds for domestically financed investment. Sales are normally also contingent on substantial investment by the foreign buyer to modernize the firm.

The theory of social capital proved relevant to this study, as a context for analyzing ethnic aspects of investment. Early social capital writers suggested that organizations and social networks were a social good in themselves, reducing transaction costs and improving productivity. Portes and Landholt (1996) argued that some organizations have negative aspects, as they seek to monopolize resources and/or political/military power.

Two related sub-themes emerged from the literature on factors in investment decisions, and 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 1994) Ethnicity was in turn correlated with low school attainment, political instability, weak financial sectors, black market exchange rate premia, government deficits, inadequate infrastructure, lack of respect for property rights and inefficient bureaucracies, all of which negatively impact both growth and investment. The institutional factors capable of neutralizing that effect includes (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.

Findings

The statistical analysis for the present study found that foreign direct investment (FDI) does act as a catalyst for local private investment. A one-percent increase in FDI as a percent of GDP is followed by 0.8% in Africa and as much as a 1.17 percent increase in future domestic investment as a percent of GDP in Latin America. In fact, there is an interesting asymmetry between the OECD countries and the developing countries. In the

OECD countries, lagged FDI and lagged domestic investment have a similar impact on current domestic investment. A one- percent increase in either domestic investment or FDI as a percent of GDP increases future domestic investment as a percent of GDP by about .5%. For the developing regions however, the impact of lagged FDI on domestic investment is more than two times the impact of lagged domestic investment on domestic investment.

There was no robust correlation in the opposite direction, however, no evidence that surges in domestic investment attracted FDI.

The statistical analysis in this study established that foreign investment takes the lead in stimulating domestic investment, and, more generally, economic growth. Those who argue that it squeezes out domestic investment are wrong as far as the big picture is concerned. The case studies showed how and why this is the case. In countries, such as Mauritius, where foreign investment has been a strong stimulus to growth, domestic investors reported unanimously foreign investment was a good thing, as linkages with foreign investors allowed them to benefit as well. In fact, even in Uganda and Kenya, nearly all African business leaders interviewed favored foreign investment, and recognized that it offered them economic opportunities. The few policy-makers who still oppose foreign investment tend to be politicians, not business leaders, playing on nationalist or ethnic sentiments.

Mauritius Case Study

In the Mauritius case study the team found a firm-level understanding of why foreign investment takes the lead and produces so many positive repercussions. Mauritius is unique in having had a wealthy class of sugar plantation owners who were actively seeking to diversify their investments in the first years of independence. They have experimented with horticultural and industrial exports, as well as with tourist facilities, for many years. It took the arrival of Hong Kong and Taiwan textile firms to get industrialization going, however. And South African hotel chains first brought the tourist facilities up to world class standards. Why couldn't they do it alone? The key missing ingredient was the much vaunted keystone of the "new economy:" knowledge. Mauritian investors lacked the depth and breadth of knowledge needed to create viable industry and tourism on their own.

The overseas Chinese and South African investors brought in-depth knowledge of how to run an efficient firm. They also had intimate knowledge of customers and their preferences, as well of what the competition was offering. They were able to train the Mauritian workforce, interspersing production lines with faster Chinese workers and more flexible Indian ones to bring up productivity. Domestic investors, whether the sugar barons or more locals of more modest and ethnically diverse origins, unanimously reported that they were not squeezed out by foreign investment. On the contrary, they worked with, learned from, and in many cases bought out foreign investors.

Ethnicity has been handled delicately in Mauritius, in surprising contrast to analysts' predictions at independence. The few dozen Franco-Mauritian sugar barons who controlled the economy at independence in 1970 faced the classic South African nightmare of being washed into the sea. The majority of the 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 monocrop sugar island to a balanced economy in which textiles, tourism and sugar are the pillars. New forays are being made into 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.

Uganda

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 and infrastructure that might have counteracted this negative trend have eroded over the years, rather than developing. 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 tried state capitalism in the 1960s and 70s alongside official investment promotion policies that became 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 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 of foreign investments. Uganda's landlocked position, and high costs of transportation and energy were also factors. The ratio of FDI to gross fixed capital, which measures the importance of inward FDI to an economy, was negative 0.2 between 1981 and 1985 compared to a ratio for tropical Africa as a whole of 2.3 during the same period. (World Financial and Statistical Tables, 1995) In order to correct this bad image, a bill was presented to and passed by the parliament to return the properties of the foreign investors. However, it was not implemented until 1990 by a new government under the National Resistance Movement (NRM).

Economic recovery, and building a viable investment climate, as 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. It has enacted a liberal foreign exchange regime, simplified import and export procedures, and removal of restrictions on the movement of capital into and out of the country.

Linkages between foreign and local firms have created a strong proinvestment 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.

Offering to return Asians' seized properties did bring many back, and the respect for private property that it reflected encouraged others. Returnees, however, have found high energy and transport costs make it difficult to compete, even for the import-substitution industries that still predominate. Initial interest is far stronger than actual investment, as the conversion rate of planned to implemented investments hovers around 40 percent. Rebuilding institutions in Uganda needs to be a high priority, as the legal system, the financial sector, schools and healthcare have all suffered through the years of civil conflict.

Kenya

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 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 (GDS/GDP: Uganda 6%, Kenya 7%, Mauritius 24%; GDI/GDP: Uganda 15%, Kenya 14%, Mauritius 24%). Kenya also shares with Uganda the fact that most of its 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)

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. 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 far sweeping in Kenya than in Tanzania and Uganda. In the end it was no more successful nevertheless. The man then responsible for enforcing the Africanization policy of the 1970s, Mr. Sam Waruhiu, who by 1994 was chairman of Barclays Bank, commented looking back:

> When the window was opened for African businessmen through the Trade Licensing Act, and various schemes such as the [Industrial and Commercial Development Corporation] ICDC at independence they had no experience. . . . The experiment was not only a major failure from the perspective of African businesses, it backfired in another respect. The Act forced the Indians into the more challenging section of the economy—manufacturing especially. After their largely successful movement into this sector, they came back, ironically, with a much larger base and reclaimed the retail and wholesale sector. (Interview with Himbara, [1994, 61])

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. (See Figure 8.6) 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.

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. International pressure to rectify this situation seems ironically to have intensified the problem, as it has focused on demands that Kenya open up its one-party political system to allow for an effective opposition. In the absence of horizontal bridging organizations of other types, the result has been to intensify appeals to ethnicity. Mistrust between groups has reached new levels, and means of building trust and intergroup cooperation are becoming thinner. Moreover, government policies of all sorts have moved into a logic that benefits the few at the expense of the larger society and economy. From the point of view of investors, the key negative trends have been:

- 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.

Among donors new attention is being paid to programs designed to reinforce civil society by providing grants and training to the media and non-governmental organizations. In theory, stronger civil society will provide the necessary linkages that foster cooperation over the medium and long term. The timing may have been wrong enough to subvert the process, however. Once ethnic appeals have been allowed to permeate the multi-party political process, re-establishing trust and cooperation is a complex process.

Kenya's most pressing challenge is restoring the institutions and infrastructure that bouyed 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. Key decisions removed the checks and balances from Kenya's political system. Parliamentary oversight of financial probity in the executive branch was breached immediately after independence. The controller and auditor general reported on this, but nothing was done.[2] Autonomy of judicial and regulatory agencies was undermined when Kenyatta lifted the traditional life tenure, and made the attorney general, controller, justices of the high court and other regulatory officials serve at the President's pleasure.

[2] Himbara: 1994, 116-141; Leys: 1982, 183.

The Ndegwa Commission in 1971 opened the way for a new form of obligatory joint venture by authorizing civil servants to be in private business simultaneously with their public service. Parliamentarians and members of the executive branch immediately created firms, or took shares in firms created by others. Firms with such connections customarily benefited from official decisions and policies. The 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.

Summary of Conclusions and Recommendations

1) FDI has a strong stimulus effect on domestic investment, and on economic growth--but it is not a panacea.

2) Governments that focus on fostering linkages between foreign and domestic firms enhance the benefits to both.

One of the best means of enhancing growth in domestic firms is to encourage domestic sourcing and subcontracting by both firms and government itself. This should start with removing obstacles and disincentives to local sourcing, such as duty-free agreements with major investors that exclude imports, but not locally sourced supplies, from import duties and VAT. A second common obstacle, at present, is slow payment of small contractors by government. Lack of liquidity caused by delayed payment can be a crushing burden for small contractors.

Fostering linkages can also be a means of affirmative action to enhance business opportunities for historically disadvantaged groups. The experience with quotas and required ownership percentages has been negative from the point of view of both investors and all but a few domestic business people. Fostering business opportunities, as contrasted with imposing them, requires a lighter hand by regulators. Government tenders already allow African-owned businesses a 10 percent cost advantage in bidding on government contracts in Kenya and Uganda. Investment agreements with large companies might also require this cost advantage. Uganda also lets local investors qualify for investment incentives with lower capital and employment levels than for international investors. Kenya puts them on an equal footing.

Another option for improving business opportunities for locals is working out voluntary plans whereby multinationals package procurement in small tenders, instead of mega-contracts that only other multinationals are capable of filling. Often multinationals are willing to work with local contractors as part of their social responsibility commitments if they can ensure that it does not diminish their own competitiveness in their core business. Local contractor training and contract supervision services programs exist in some countries to facilitate this process, by improving quality control and timeliness by local contractors.

3) The new global economy offers opportunities in that capital now flows quickly to interesting investment opportunities. On the other hand, the new economy is information based—and the information gap is growing. Countries that favor modern, cheap telecommunications and transport will have an advantage.

4) A holistic approach to encouraging investment is needed. Investment incentives can be a waste if not combined with a sound economic environment. Investment policy has to take into account how each country compares on the five key factors:

- Access to resources,
- Secure mobility of people, goods, information and capital into, around and out-of the country,
- Sound institutions—stable government, security of life and property, rule of law, viable financial services, and modern education and health systems,
- Economic characteristics of the location,
- Investment incentives and business facilitation, and
- The regional and international policy environment.

5) Priorities and sequencing will be different for each country and sector, depending on how it measures up to the competition.

In Kenya and Uganda the priorities need to be institution building, infrastructure, security and cost reductions. Within those categories there are nuances: in the security area, Kenya needs to focus on a high crime rate, while Uganda concentrates on making peace with rebels in the north and west. Each country will need to do its own institutional evaluation and reform plan. Mauritius is doing well, but has lost its competitive edge in textiles. It needs to focus on more efficient bureaucratic procedures and reducing transport costs.

All three countries have mostly got their macroeconomic framework right now. Unfortunately that is not enough, as most of the rest of the world's countries have done likewise.

6) Multilateral investment frameworks such as debated by the WTO will probably not help the three case study countries attract investment.

Draft multilateral investment frameworks tell policy-makers what investors want, but not how to get their country there ahead of the rest.

7) Politicians and business people need to explore the positive and negative social capital theory together. They need to focus on the role of sound institutions in overcoming ethnic fragmentation.

Participation in professional and voluntary associations and other actions that contribute to positive social capital are growing in all three countries. Many of the behaviors contributing to ethnic particularism and other forms of negative social capital are gratuitous. The better people understand the difference, the benefits of openness and the longterm costs of particularism, the better they can change those negative behaviors.

Similarly, civic efforts are continuously underway to improve institutions. People may not have realized the impact of institutions on investment and economic growth, however. Respect for property rights, sound banking systems, courts, educational and health systems have a hitherto neglected impact on economic growth.

8) The factors above provide a framework for monitoring by each country.

Instead of relying on low level investment promotion units to market their countries, governments need to do regular self-evaluations, based on internal and external dialog and monitoring. Evaluations can be led by groups like the Presidential Forum in Uganda. Similar task forces can be created in each country. They should report at least quarterly to government on how the country ranks in each area. Each report should conclude with recommended policy priorities and adjustments to implementation where needed.

In practice, the main theme of dialog with investors is often protection from competition. Both the members of monitoring forums and the personnel of economic ministries need to be continuously reeducated to recognize investors pleas for protection, consider the trade-offs and favor policies designed to foster competitive firms in a dynamic economy.

9) When countries are prepared to give investors access to resources, and have their macro economic policies, infrastructure, institutions and security situation in order, proactive investment marketing pays off.

Investment promotion funding prior to government getting the other factors right has less impact. Kenya and Uganda have seen much of their expenditure on investment promotion unproductive in the last two decades, largely because promotional efforts are working at cross purposes to other policies and practices.

1. INTRODUCTION

Policy-makers throughout the world are devising strategies to attract a share of the new global capital flows, frequently in the form of foreign direct investment. Local business people are often ambivalent about their governments' courting foreign business, particularly in countries with a fledgling private sector recently liberated from statist economic management. Some fear that foreigners will take away business opportunities that locals might have had, or that foreign firms will have privileged access to capital and foreign exchange, reducing their own access. These are particularly acute questions in Africa today. The World Trade Organization is negotiating and implementing agreements designed to "create a level playing field." The generally accepted sense of that term is to establish the same rules for everyone, and let them compete. Those who have less access to capital, education, technology and market connections fear that they will not be able to compete.

This study was designed to explore whether foreign direct investment squeezes out locals, or conversely opens up opportunities for them. Turned the other way around, it hypothesized that an improvement in the business climate that stimulated local investment might act to attract FDI. The team examined these questions statistically using a worldwide fifty-year database. It also conducted three case studies, to explore in more depth what these trends represented to actual firms and national economies. The three countries chosen were Mauritius, Uganda and Kenya.

The study is part of a series of demand-driven policy studies aimed at maximizing growth and socioeconomic equity, funded under the United States Agency for International Development Equity and Growth through Economic Research/Trade Policy Cooperative Agreement (EAGER/Trade).[3]

The first part of the study analyzes historical international financial statistics for 110 countries, both developing and developed. This is complemented by three in-depth case studies, in Kenya, Uganda and Mauritius conducted using existing country data and a rapid survey of about a 5 percent sample of firms. The main research question addressed is: Does foreign direct investment (FDI) act as a catalyst for local private investment, is it vice-versa, or do both respond to similar investment climates?

One of the team's hypotheses was that domestic investors might, at least in some countries, lead investment spurts, in turn attracting foreign investment. Domestic investors are usually alert to improvements in the investment climate that might emerge through policy changes or newly emerging economic opportunities. Prior research conducted by several team members on domestic investors in specific countries suggested that they faced obstacles to efficient business operation similar to those that concern foreign investors: currency controls, weak financial sectors, poor infrastructure,

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political instability, etc. If our hypothesis proved true, it would be an important finding, as it would imply that policy-makers should focus at least some of their efforts on promoting domestic investment.

Why is determining the timing of FDI, private and public domestic investment important? It is important because economic policy can influence investment decisions and because investment is critical to the growth process, and hence, social welfare. Specifically, recent work by Sachs and Warner (1995) indicates that at least 1% of the 3.4% difference in growth rates between East Asia and Africa can be accounted for by low investment. In addition, evidence suggests that private domestic investment plays a much larger role than public domestic investment in the growth process (Greene and Villanueva 1990). Yet, private domestic investment has been heavily taxed in Sub-Saharan Africa, both directly and indirectly. (Adam and O'Connell 1997) And finally, while private domestic investment is taxed, special incentives designed to attract FDI are common in Sub-Saharan Africa. (World Investment Directory, 5 1996)

Historically, the overwhelming majority of investment in both developed and developing countries has been and continues to be domestic. Yet, many developing countries despair of stimulating local investment, pointing to national statistics showing very low domestic savings rate. This creates some problems and confusion in investment promotion programs. For example, FDI tends to be more expensive than local private investment because governments often make major concessions in order to compete for foreign investment. Programs designed to privilege foreign investors have frequently been tried. They generally provoke an outcry from domestic investors, who then succeed in having the same incentives extended to domestic investment. The ethnic dimension frequently further complicates policy debates, as ethnic groups who have experienced colonization and discrimination in the past argue that affirmative action is needed to compensate enough to provide them with a share of the national cake. There is resentment against both the colonizing country and immigrant commercial classes—Asians from the Indian subcontinent in East Africa, overseas Chinese in much of Asia, and middle easterners in other areas.

If FDI and local private investment are both engines of growth, and if stimulating local investment is less expensive and more politically popular, then poor economies in Sub-Saharan Africa with limited resources might be better off following a strategy that places primary importance on the role of the local business community. If both foreign and local investors are responding to the same economic conditions and incentives, it is generally much easier for governments to learn what these are by consulting local investors than foreign for the simple reason that they are identifiable and present for regular consultation.

When the colonial era ended in Africa, and Africans occupied the seats of power formerly held by Europeans, the next challenge was the transfer of economic roles. As Kwame Nkrumah put it, "Seek ye first the political kingdom, and all else shall be added unto it." (Nkrumah, Kwame 1971) Yet, success in business has not really come. The first assault on the citadels of economic power came in the form of state capitalism. State enterprises, in most countries, were given monopoly control of every major area of business activity. In the same period, the 1960s through 1980s, foreign investment there tended to be on a monopoly basis. Both public and private monopoly capitalism collapsed in a debt-riddled heap in the 1980s and 1990s. Four decades after independence, as governments privatize the last key sectors, ethnic accounting enters into decisions on every level. There is strong pressure to preserve jobs, economic opportunities and access to capital and markets for nationals (and, on a narrower plane, to nationals of one's own ethnic group).

The economic model on which pressure groups and policy-makers alike often operate, however, is a stagnant one: how to divide up the cake. In reality economies are dynamic: the size of the economy grows every time money, goods or services change hands. In the new information economy the total body of knowledge is experiencing explosive growth as new means of communicating and organizing information emerge. In this real economic context, we asked, in countries that have experienced investment booms, do foreign and local investment compete or are they complementary? In which areas? How do different elements of the local business community feel about foreign investors? What is the role of local investors from immigrant ethnic minorities, namely Asians in East Africa, Chinese in Mauritius? What role do ex-colonials play?

This study is presented as follows. Chapter 2 outlines the related theoretical and empirical work. Chapter 3 describes our methodology. Chapter 4 describes the statistical results. Chapter 5 explains our case study methodology. Chapters 6-8 present findings from the case studies. Implications of the findings and concluding remarks are presented in chapter 9. The conclusions and recommendations are summarized in chapter 10.

2. LITERATURE REVIEW

Over the past decade, worldwide foreign direct investment (FDI) has increased dramatically. The ratio of FDI to world GDP has grown twice as fast as the ratio of world imports and exports to world GDP, suggesting that the increasing interdependence of the world economy is being driven, to a large extent, by the expansion of international production. (UNCTAD 1998)

Developed countries control 90 percent of FDI outflows and receive two-thirds of FDI inflows. Although developed countries dominate global FDI, inflows to developing countries have risen steadily. FDI, despite accounting for a relatively small portion of total investment, is believed to be a potential catalyst to economic growth such that many developing countries, in connection with overall economic liberalization programs, have adopted policies designed to attract FDI. While the current view of FDI's potential impact on economic growth is optimistic, the growing emphasis on FDI raises significant issues for policymakers in developing countries regarding the management of FDI to promote economic growth.

Historically, efforts to assess the overall welfare effects of FDI on developing countries have been inconclusive. (Chenery and Srinivasan 1988) Large multinational enterprises (MNEs) are the principal source of FDI. Critics of FDI argue that the profit seeking motives of MNEs are often inconsistent with the objectives of developing countries. MNEs are typically involved in visible and influential activities within developing countries. While the benefits of FDI for MNEs are easily quantified, the potential host country benefits are less apparent.

In the past, FDI was concentrated in primary sectors, which, in light of the mercantilist/colonial legacy in many developing countries, led many to view FDI as exploitative and detrimental to the development process. More recently, however, advances in technology, transportation and production methods have allowed MNEs greater freedom to internationalize manufacturing and consequently, the sectoral composition of FDI has shifted toward manufacturing and service sectors. While the exploitative view of FDI has not vanished, the movement of FDI into a variety of sectors has contributed to a changing perception of the potential host country benefits of FDI.

In its simplest formation, FDI theory suggests FDI can promote economic growth through increases in the capital stock, tax revenue, trade, wage levels and employment. The supply of more effective management, technology and more sophisticated market information may also produce favorable externalities such as productivity enhancing technology growth. In addition, backward linkages may promote the development of supplier industries.

Several theoretical frameworks have been advanced to analyze the impact of FDI. Early neoclassical models are based upon the premise that FDI involved international capital arbitrage - a capital flow between nations resulting from differential rates of return. (Chenery and Srinivasan 1989) General equilibrium analyses vary assumptions more widely than earlier models. However, general equilibrium models assume perfect competition in product and factor markets, which is inconsistent with modern theories of FDI and with empirical observation of market conditions. These analyses, actually relate more directly to capital flows rather than FDI. They have uncovered circumstances in which capital inflows may reduce welfare in the capital-importing countries due to domestic distortions that limit income gains to less than the cost of external capital. (Chenery and Srinivasan 1989)

While the two frameworks described above examine the impact of FDI on the host country, more recent work has originated from industrial organization theory which views MNEs as single firms operating in several countries. The OLI (Organization/ Location/Internationalization) framework, originally advanced by Dunning, is conceptually distinct from earlier work in two important ways. First, it attempts to account for market imperfections categorized as either structural or transactional. Structural market imperfections include economies of scale, knowledge advantages, distribution networks, product diversification and credit advantages that give rise to certain ownership advantages. (Dunning 1985) Structural distortions may also include the actions of governments. Transactional imperfections may afford multinational enterprises greater benefits through FDI than arms-length transactions. Arms-length transactions cannot perform as efficiently nor provide firms, in external markets, with the capacity to capture the transactional benefits arising from common governance. (Narula 1996) OLI theory is also distinct in that it integrates host and home country determinants of FDI, recognizing the impact of individual actors on investment decisions as well as the limitations of host country policymakers seeking to alter FDI flows.

Within the OLI framework, it is understood that three conditions must be present simultaneously in order for FDI to take place. The inclination of firms to engage in international production depends, first, on the perceived existence of ownership-specific advantages. Ownership-specific advantages exist if firms possess, or can gain access to, asset(s) that significantly enhance their competitiveness. If the advantage is exploited optimally, firms can compensate for the costs of establishing international production facilities and can overcome the competitive disadvantages vis-à-vis local firms. (Narula 1996)

Assuming the existence of ownership-specific advantages, firms must then determine the extent to which it is in their interest to utilize them through internationalization. In other words, firms may believe that they will gain greater benefits through FDI rather than arms-length transactions. Such internationalization advantages may exist because markets for assets or production inputs may be imperfect and may involve significant transaction costs. In addition, firms may wish to retain exclusive rights to assets or proprietary information that may afford them competitive advantages such as monopoly rents. (UNCTAD 1998)

The presence of ownership-specific and internationalization advantages will prompt the MNE to invest abroad rather than undertake production at home. MNEs engage in a location selection process that suggests there must exist natural endowments, created assets or structural advantages (reliable infrastructure, lower resource costs, larger markets, etc.) that influence the decision to invest in a particular foreign country. It is in promoting such locational advantages that economic policy has the greatest impact on FDI.

To capture location-specific advantages, policymakers must view FDI determinants in a dynamic context. While certain locational advantages may remain constant, the relative importance of different determinants changes as the economic environment evolves over time. For example, as industries develop, labors cost tend to rise. The initial cost advantage associated with cheap labor is lost and policymakers must identify alternative strategies to promote FDI.

Recently, the diversification of FDI into manufacturing and high-tech industries has created new opportunities for developing countries. In many industries, a more systemic internationalization of production has taken place as changes in the economics of competition have significantly altered market structure. Lead firms increasingly engage in outsourcing and contract manufacturing, seeking to take advantage of the huge scale economies of international procurement. This allows them to focus internally on core competencies such research and development and product design. The formation of international production networks has precipitated the movement of developing country firms into more sophisticated types of manufacturing and encouraged the development of related supplier service industries. (McMillan, Pandolfi, and Salinger 1999)

In addition to the employment/income opportunities resulting from the formation of international production networks, recent empirical work suggests that FDI produces many of the spillover effects contemplated by FDI theory. In particular, there is increasing evidence that FDI promotes not only direct technology transfer in which a foreign firm make a conscious effort and commits resources to transfer technologies to local firms, but also indirect or informal technology diffusion as a result of interaction among foreign and local firms. Case studies examining the role of technological capabilities and export growth have identified three important forms of indirect technology transfer: 1) learning facilitation that results from exposure to foreign firms' qualification processes including quality testing and technical expertise, 2) knowledge spillovers that include product design specification, access to R&D systems and market information, and 3) investment inducement relating to investments in the formation of technological capabilities undertaken by the local firm because its relationship to the foreign firm reduces the perceived risk of such investments. (Ernst, Ganiatsos, and Mytelka 1998)

Both the literature and empirical work regarding the impact of FDI on host countries are extensive and the potential benefits/linkages of FDI have been thoroughly developed. While empirical evidence is not definitive there is a building consensus that FDI is generally welfare enhancing for developing countries. As discussed above, economic policy can, under certain circumstances, influence investment decisions. The goal for policymakers in developing countries is to understand, within a dynamic framework, the likely impact of policy decisions on FDI, domestic economic conditions and subsequently, economic growth.

To draw meaningful policy implications, we have focused specifically on the interrelationship between FDI and the domestic investment climate. The effects of FDI on domestic investment are of critical importance as the level and effectiveness of domestic investment is ultimately a more influential determinant of economic growth. In Africa, the relationship between foreign and local investment takes on added significance when examined from a historical perspective. In many countries, the economics and intellectual legacies of colonialism have produced a degree of political ambivalence toward foreign investors the policymakers must still reconcile. Moreover, most foreign investors (as well as most domestic investors) during the post-colonial period have been from minority ethnic groups such as Asians in East Africa or French and Chinese in Mauritius who gained a strong position in commerce during the colonial period. Indigenous majority ethnic groups sometimes view Europeans and Asians as relics of colonialism and press for protection and privileges on a nationalistic basis.

2.1 Why Would FDI Stimulate Domestic Investment?

Economic theory points to at least two distinct channels through which FDI may affect both private and public domestic investment in the recipient country. First, FDI may have an impact on the profitability of domestic investment. For example, foreign investors may be directly involved in providing infrastructure such as transportation and telecommunications thus increasing the profitability of domestic investment. In contrast, FDI may reduce domestic investor's profits by taking market share away. Second, FDI may alter the ownership structure of total investment in the host country and/or make domestic investment possible by providing additional funding. For example, a privatization sale to a foreign firm in itself has no impact on total investment but will release local funds for domestically financed investment. Sales are normally also contingent on substantial investment by the foreign buyer to modernize the firm. These potential links between FDI and domestic investment are summarized in Table 2.1.

Empirical evidence can be grouped into two broad categories: macroeconomic studies and microeconomic studies. The macroeconomic studies typically use aggregate measures of investment to study either one particular country or a panel of countries. For example, (Fry 1993) uses macroeconomic data for a sample of 16 countries to show that FDI can have a positive or a negative impact on domestic investment depending on the level of trade barriers and financial regulations imposed by the host country. The microeconomic studies include case studies and studies that use firm level panel data for specific countries. One particularly interesting paper along these lines is Aitken and Harrison's "Do Domestic Firms Benefit from Foreign Direct Investment?", March 1997.

Table 2.1: Inward Foreign Direct Investment and Domestic Capital Formation: The Theory

Impact on Domestic Investment	**Mechanism**	**Source(s)**
(+) Increase Profitability	♦ build infrastructure (roads, telecommunications etc.)	Cardoso & Dornbusch 1988
	♦ supply scarce inputs	Helleiner 1988
	♦ demand creation (local input suppliers, labor income, complements)	Cardoso & Dornbusch 1988
	♦ positive externalities (training, managerial skills, technology, access to overseas markets, market information)	Blomstrom 1989
	♦ additional tax revenue invested in public goods	Cardoso & Dornbusch 1988
(-) Reduce Profitability	♦ increase wages and/or cost of other locally supplied inputs	Lall & Streeten 1977
	♦ worsen terms of trade	Bhagwati, Brecher, Findlay 1981,1983
	♦ stifle domestic competition	Helleiner 1988
	♦ negative externalities (tariff-jumping FDI, corruption)	Brecher & Diaz-Alejandro 1977
(0) New Financing	♦ new projects financed by FDI have no impact on existing domestic	Fry 1993
(-) Replacement Financing	♦ privatization and/or buyouts replace domestic with foreign	Fry 1993

Using a panel of more than 4,000 Venezuelan firms, the authors show that the impact of FDI on domestic investment depends on the ownership structure. In particular, FDI that participates with domestic firms in a joint venture arrangement enhances the profitability of the domestic investment. By contrast, FDI negatively affects the productivity of firms with 100% domestic ownership. On balance, they find that FDI has a positive impact on domestic investment. Evidence from this and other empirical work is summarized in Table 2.2.

Table 2.2: Inward Foreign Direct Investment and Domestic Capital Formation: Empirical Evidence (1975 - present)[1]

Date	Author(s)	Data	Methodology	Results
1997	K.K. Mbekeani	South Africa Macro	2SLS Error Corr. Model	+
1997	Brian Aitken Ann Harrison	Venezuela Firm level data	Time Series Panel & Fixed Effects	+ Joint Venture - No local partner
1997	Maxwell Fry	46 country panel	Time Series Structural Model 3SLS	+
1993	Louis T. Wells	East Asia	Case Studies	+
1993	Wells & Warren	Indonesia	Case Study	+
1993/94	Maxwell Fry	Macro 16 countries 1966-88	Time Series Structural Model 3SLS	+ /- depends on policies in place[2]
1992	Katikati	Ghana	Time Series Granger Causality	-
1992	Faroque & Bougrine	Morocco	Structural Model Time Series	-
1989	Rhee & Belot	Asia & Africa Latin America	11 country case studies	+
1986	Encarnation & Wells	Asia	Case Studies	+/- depends on policies in place[2]
1977	Matos	Venezuela	Case Study	-

Notes: (1) Prior to 1975, several studies were done on the impact of MNCs in Latin America. Most of these are case studies and it would be impossible to list all of them in this table. For a good summary of these see Grieco, 1986. (2) For example, Encarnation & Wells find that where FDI substitutes for imports because it is "tariff-jumping", the overall impact on the host country is negative.

One thing that these tables should make clear is that neither the theoretical work nor the empirical evidence provides a definitive answer as to the impact of FDI on domestic investment. On balance, however, the empirical work seems to suggest that FDI has a positive impact on domestic investment. Also clear from these tables is the fact that several of the ways in which FDI affects domestic investment have little to do with the "foreign" component of the investment. For example, most of the demand and supply side linkages could just as easily be a result of an increase or decrease in domestic investment. Imagine an economy that experiences an exogenous increase in the price of its exported good. This will increase the exportables sector's demand for labor, increase wages and reduce domestic investment in other sectors of the economy. The areas in which FDI seem to make a unique contribution related to its "foreignness" as compared to domestic investment are: technology, management, market-access and financing. This is important because it suggests very specific reasons for encouraging FDI relative to domestic investment.

2.2 Why Would Domestic Investment Stimulate FDI?

So little has been written about the impact of domestic investment on FDI that we are able to summarize it in a couple of paragraphs without resorting to tables. In theory, there appear to be several ways in which domestic investment might act as a catalyst for FDI. One obvious channel is public investment in physical and human infrastructure. The better the infrastructure, the more profitable FDI, therefore ceteris paribus, we would expect to see FDI follow increases in public domestic investment. Another plausible argument is that private domestic investors have more accurate information about the local business climate than do foreign investors. When information is incomplete, domestic investment acts as a signal about the state of the economy to foreign investors. Thus, we would expect to see domestic investment lead foreign direct investment.[4]

To be fair, several studies that look at the determinants of FDI include market size and/or expected GDP growth. Hence, to the extent that domestic investment determines GDP growth and/or market size, these papers indirectly include total domestic investment as a signal about the future profitability of foreign direct investment. (Harrison and Revenga 1995) explicitly include domestic investment as an explanatory variable but find that compared with the size of the local market and openness to trade domestic investment has no impact on FDI. (Fry 1993) in an empirical study of FDI in South Asia, argues that the best way to encourage FDI is to implement policies that generally improve the investment climate. According to Fry, "[w]here domestically financed investment is booming, FDI will seek to participate." Hence, he argues that as a general principle, policies that encourage domestic investment will also stimulate foreign direct investment.

2.3 Ethnicity and Institutional Factors

Two sub-themes emerged from the literature on factors in investment decisions as well as the case studies: one was the impact of ethnic relations on the investment climate and the other was the importance of sound institutions. The institutional factor includes (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

[4] A recent paper by Razin et al. argues just the opposite. In the presence of asymmetric information, FDI actually acts as a catalyst for domestic investment.

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.

A seminal recent paper on the impact of ethnicity and institutions on economic growth in general concludes that the two are interrelated in ways that are supported by the findings of our case studies. (Easterly and Levine 1996) The authors were seeking to explain what factors allowed East Asia to experience, on average, a 5 percent annual increase in real per capita incomes, while African countries averaged zero growth. They found that half of the differential between Asian and African economies from 1965-1990 could be explained by the following variables, all of which were in turn correlated with ethnic diversity:

- low school attainment,
- political instability,
- poorly developed financial systems,
- large black market exchange rate premia,
- large government deficits,
- inadequate infrastructure,
- poor property rights, and
- inefficient bureaucracy.

Overall, the factor labeled ethnic fragmentation[5] accounted for one-third of the growth differential. The study cites political economy models showing that polarized societies are prone to competitive rent seeking by the different groups and have difficulty agreeing on public goods like infrastructure, education and good policies, even where there is little communal violence. (Alesina and Tabellinin 1989, Alesina and Drazen 1991, Shleifer and Vishny 1993, Alesina and Rodrik 1994, Alesina and Spoalare 1995, Easterly and Levine 1996) Ethnic polarization apparently "creates positive incentives for growth-reducing policies, such as financial repression and overvalued exchange rates, that create rents for the group in power at the expense of society at large."

The only variable that the Easterly and Levine study found has the power to counteract the impact of ethnic fragmentation is sound institutions. Countries with clear property rights, rule of law, and an efficiently functioning bureaucracy overcame the effects of ethnicity. The authors' hypothesis is that these factors permit peaceful resolution of conflicts and limit counterproductive rent seeking.

A growing literature on social capital expands understanding of the institutional variable. Much of the research has been done under World Bank auspices and is summarized on its website. In the narrow sense, the importance of a sound financial services sector for investment is well understood, as is the importance of a good educational system. The negative consequences of weak financial institutions have been widely studied since the 1998 financial crisis in Asia, but for more than a decade before

[5] The variable was established based on the probability that any two random individuals belong to the same ethnic group. (Easterly and Levine: 1996)

that studies of national financial sectors in various African countries had shown that their fragility was a key obstacle to both foreign and domestic investment.

The World Bank presents this broad definition of social capital:

> Social capital refers to the institutions, relationships, and norms that shape the quality and quantity of a society's social interactions. Increasing evidence shows that social cohesion is critical for societies to prosper economically and for development to be sustainable. Social capital is not just the sum of the institutions which underpin a society – it is the glue that holds them together. (worldbank.org/poverty/scapital/)

The early literature in this field suggested that organizations and social networks were a social good in themselves, reducing transaction costs and improving productivity. (Portes and Landholt 1996) argued that some organizations have negative aspects, as they seek to monopolize resources and/or political/military power. A lesser negative influence can be exerted by organizations that are isolated and parochial, even if they do not attempt to exert control over others. They can inhibit access by their members to socially and economically useful information and opportunities.

3. METHODOLOGY

3.1 Econometric Methodology

In this paper we use econometric analysis of global data bases complemented by three empirical case studies. Used in tandem, these two approaches allowed statistical tests of causality on global data covering several decades to be confronted with the realities as seen by business people making decisions for their firms and policy-makers seeking national development strategies.

3.1.1 Statistical Analysis

We use data from the International Monetary Fund (IMF), the United Nations Commission on Trade and Development (UNCTAD) and the United Nations Statistical Office (UNSO) for the statistical analysis. Using the Generalized Method of Moments (GMM) techniques developed and implemented by Arellano and Bond (1998) for dynamic panel data, we establish empirically both the direction and the magnitude of causality between FDI, private domestic investment and public domestic investment.[6] This methodology is attractive for two reasons. First, it provides efficient and consistent estimates even in the presence of lagged dependent variables without having to rely on several time periods for consistency. Hence, we are able to estimate both short-run relationships using annual data and long-run relationships using period averages. And second, by using the optimal instrument matrix, we are also able to correct for the biases specific to panel data introduced by measurement error.

3.1.1.1 Econometric Theory

In this chapter, we will briefly outline the econometric theory used to derive the results. Only the special problems associated with performing causality tests on a panel are highlighted. A definition of the Granger causality test is provided in an appendix. The theory below is presented using general notation to keep the presentation as simple as possible and to keep the focus of the discussion on the methodology rather than the notation. Next, we specify the estimating equation based on the econometric theory. The results are discussed and a summary table of the main results is presented. Details of the estimation are provided in an appendix. Finally, we discuss some of the limitations of this analysis.

Performing causality tests on a panel introduces a unique set of problems (Holtz-Eakin, Newey and Rosen 1988). First, there are the usual complications associated with pooling data from different cross-chapteral units. At least, we must control for unobserved country-specific heterogeneity. Second, when lagged dependent variables appear as explanatory variables, as they do in this case, the maximum likelihood

[6] Several papers, both theoretical and empirical have examined the impact of foreign direct investment on domestic investment. However, to my knowledge, nobody has looked specifically at the impact of domestic investment on FDI.

estimator, even under the fixed effects formulation, is no longer consistent in the typical situation in which a panel involves a large number of individuals, but over only a short period of time. The problem arises because estimation of the coefficients by the least squares dummy variable (LSDV) approach eliminates the unknown individual constant from each observation. This, in turn, creates a correlation of order (1/T) between the explanatory variables and the residuals in the transformed model. Obviously, as T goes to infinity, this problem goes away. However, when the series is short, not correcting for this will bias the estimates downward.

To address the first set of issues, we use the following general model,

$$\begin{bmatrix} x_{it} \\ y_{it} \end{bmatrix} = \begin{bmatrix} d(L) & e(L) & a_3 \\ a(L) & b(L) & b_3 \end{bmatrix} \begin{bmatrix} x_{it} \\ y_{it} \\ fi \end{bmatrix} + \begin{bmatrix} e_{it} \\ d_{it} \end{bmatrix} \tag{5}$$

(i = 1, ... N; t=1, ... , T),

where N stands for the number of cross-chapteral units observed over T periods, and f_i are dummy variables to capture the unobserved heterogeneity of the cross-chapter units assumed to be fixed.

To address the problem created by the presence of lagged dependent variables, we use the generalised method of moments technique (GMM). The first step of this procedure involves taking first differences to eliminate the unknown fixed effect. The result of first-differencing is shown in equation (6). Here we see that first-differencing to eliminate the original problem creates a new problem i.e. the regressors are now correlated with the error term,

$$\begin{bmatrix} x_{it} - x_{it-1} \\ y_{it} - y_{it-1} \end{bmatrix} = \begin{bmatrix} d(L) & e(L) \\ b(L) & a(L) \end{bmatrix} \begin{bmatrix} x_{it-1} - x_{it-2} \\ y_{it-1} - y_{it-2} \end{bmatrix} + \begin{bmatrix} e_{it} - e_{it-1} \\ d_{it} - d_{it-1} \end{bmatrix} \tag{6}$$

(i = 1, ... N; t=1, ... , T-1).

Consistent estimates of the parameters of this equation can be obtained by using either x_{it-2}-x_{it-3} and y_{it-2}-y_{it-3} or x_{it-3} and y_{it-3} or both as instruments. However, in practice, using only the second lags of the first differences as instruments provides unsatisfactory results since the first-differencing introduces noise and reduces fit significantly. The technique pioneered by Arellano and Bond combines the moment conditions for equations in first differences and the equation in levels. This approach is an extension of Arellano and Bond (1991) and Arellano and Bover (1995) and is implemented in the revised version of the Dynamic Panel Data (DPD) program by Arellano and Bond (1998). This technique is also attractive because it provides consistent estimates even in the presence of measurement error. (Griliches and Hausman 1986)

3.1.1.2 Empirical Specification

Using both annual data and five-year averages for the period 1970 to 1996[7], we estimate the following system of equations:

$$F_{it} = a_0 + \sum_{j=1}^{4} \sum_{L=1}^{m} a_{Lj} R_j F_{it-L} + \sum_{j=1}^{4} \sum_{L=1}^{m} b_{Lj} R_j D_{it-L} + \sum_{i=1}^{n} h_i cdum_i + \sum_{t=70}^{96} dum_t + u_{it} \tag{9}$$

$$D_{it} = d_0 + \sum_{j=1}^{4} \sum_{L=1}^{m} d_{Lj} R_j F_{it-L} + \sum_{j=1}^{4} \sum_{L=1}^{m} g_{Lj} R_j D_{it-L} + \sum_{i=1}^{n} p_i cdum_i + \sum_{t=70}^{96} dum_t + v_{it}$$

where j denotes the region, m denotes the lag length and is chosen to ensure that the u_t and v_t are white noise error terms. The α' s , β 's , δ's and γ 's are the coefficients of the linear projections of F and D on a constant and past values of F and D. F and D represent foreign and domestic investment and are computed as a percent of GDP. [8] Unobservable, time-invariant country characteristics are denoted by *cdum* and *dum* controls for year to year cyclical fluctuations.

All estimates are computed with time dummies and regional slope dummies. Although not reported, it is possible to reject the hypothesis that slope dummies across regions are the same and it is possible to reject the hypothesis that the year dummies are jointly insignificant. Two sets of results are reported in each table. The first set of results (LSDV) controls for unobserved country heterogeneity and are based on equation (9). The second set of results (GMM) is based on first differences of equation (9) and instruments the lags to control for measurement error and the possible bias arising from the presence of lagged dependent variables. The two sets of results are reported as a robustness check and also to show the magnitude of the difference in coefficients between LSDV and GMM.

Correcting for the biases caused by measurement error and the presence of lagged dependent variables is particularly important for the estimations using 5-year averages. This is to be expected since the averaging significantly reduces the number of time periods aggravating the bias caused by the presence of the lagged dependent variable. Hence, all of the results discussed below are based on the GMM estimates. Regional estimates are computed to test the hypothesis that FDI might have a differential impact on domestic investment depending on the policies in place in the host country.[9]

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[7] For some countries, data is available for a longer time period (Canada for example has data on both types of investment all the way back to 1948) but the majority of countries do not have data on FDI prior to 1970.

[8] This was done mostly out of concerns about stationarity of the time series data on investment measured in levels. Estimates of the dollar impact of investment today on future dollars of investment may be derived using the following approximation, $\partial d_t/\partial f_{t-1} = \delta\ (y_t/y_{t-1}) = \delta(1+g_t)$, where g is growth of gdp, y is gdp and d and f are domestic and foreign investment.

[9] Of course different countries in different regions pursue different policies. But, as a first approximation, one could argue that regions with higher growth like East Asia generally had better policies in place.

3.2 Methodology for Rapid Appraisal of Firms

The team adapted rapid appraisal techniques for the case studies to assess investment climate issues in each of the three countries, and to get an initial overview of the experience of business and government leaders. A multidisciplinary team of senior researchers interviewed fifty to eighty firms and officials in each country. The team found that this approach added an invaluable qualitative dimension that could not be gleaned through data analysis or survey questionnaires. Qualitative assessments reveal historical elements, attitudes, values and beliefs that facilitate or hamper working relationships between different types of investors and government officials. The survey questionnaire approach is less appropriate for many reasons. First, firms are increasingly hesitant to participate. Secondly, surveys are costly and generally take a year or two to produce results. Third, although a survey can cover a larger sample of investors, the participants in the interviews, both questioner and firm-representative, are generally junior, or at most mid-level staff with limited business experience. Moreover, the aggregated data tends to mask the richness and interrelatedness of individual cases, and considerable depth of insight is forgone.

In designing the rapid appraisal, the team reviewed the methodological literature on participatory rapid appraisal, to determine which principles and approaches previously used in rural agricultural research, community development and health campaigns would be most useful in a business context. We retained as key elements the following:

- a multidisciplinary team (multinational as well, in this case),
- a thorough review and analysis of documentary literature,
- key informant interviews,
- semi-structured interviews with a wide range of firm leaders,
- the principle of triangulation (at least three independent sources to corroborate a point of information),
- daily feedback sessions for the team,
- drafting a common report on the spot, and
- offering it to participants for their comments and follow-up.

In Mauritius, the team was able to apply sampling methodology developed by survey research, which is not normally done in rapid appraisals. As a business community is more structured than rural communities, it was possible in Mauritius to construct a stratified sample of firms and interview a randomly selected sample within each stratum. The team all felt that this enhanced the results, as without this formal sampling process, the sample would have been biased towards successful firms. There was some cultural resistance to our interviewing less successful firms, and they were often hard to find, but we managed to do so. We also followed up with some foreign investors who had withdrawn, failed or sold out. This was necessary to compensate for the common bias in a one-off study resulting from hearing the good news from the survivors and missing a sense of historical processes—notably the views of those who failed.

From three databases, one on Export Processing Zone firms, one on Pioneer Zone firms, and another on hotels, we sorted firms by size, and interviewed a random sample in each size category. The sampling pattern used a combination of probability considerations, balancing the number of firms against the total amount of employment generated by the category. EPZ firms wore stratified by number of employees, as follows:

- <50 employees,
- 51-100 employees,
- 101-200 employees,
- 201-500 employees, and
- 500-4000 employees.

The sample thus selected included 59 EPZ firms, 6 hotels and 10 Pioneer Zone firms. The great majority of firms agreed to be interviewed, and over 50 interviews were conducted during a three-week period in October 1997.

Interviewing in Mauritius was done in two teams, with rotating membership of two researchers per team. Feedback sessions every evening served to processed the information, and record it in categories. Every researcher took notes during the interviews. During the feedback sessions a single researcher at a time noted key points on 5” x 7” note cards. Cards were topical and headers included the name of the firm, the speaker, the date, the subject and a sequential number. The feedback session cards thus became our combined data bank.

The report was written in the field, which allowed us to debrief and get feedback from key officials and participants before leaving. This is a very important component of the methodology. It tells the participants that the research is part of a two-way communications process. We continue to communicate drafts throughout the research process and follow-up, to exchange views and results with the participants.

Mauritius served as a methodological testing ground. There were several reasons for this: (1) Mauritius has experienced an investment boom, while the other two countries are still trying to encourage one; (2) It is important while mastering the methodology that the team be on an equal footing in terms of knowledge of local languages and investors. This would not be the case if we did the first test of the methodology in Kenya or Uganda; (3) The Kenyan and Ugandan research teams are much better informed and more persuasive in presenting their findings after their direct experience of the Mauritian model.

The Ugandan and Kenyan teams were not able to follow the exact same methodology in the end. Funds did not permit all three senior researchers to work in each country, so the Kenyan and Ugandan senior researchers recruited research assistants for the interviewing. The assistants had not participated in the Mauritian training. In the end the researchers conducted interviews on the same format as those in Mauritius, but without the sampling, feedback sessions and creation of a card-based data bank. In Uganda the sampling was done in the field, based on geographic distribution (in four zones of the country), and in Kenya a convenient sample of firms in the Nairobi area was interviewed. In both countries there was review and analysis of documentary literature and existing databases as well.

4. STATISTICAL RESULTS

4.1 Background

Table 4.1 highlights three important facts. First, FDI as a percent of total investment is minuscule when compared with private and public domestic investment. While there is some variation in the relative magnitude of FDI across regions, this is generally true for all regions of the world both developed and under-developed. Foreign investment tends to be counted as such only in the year in which capital enters the country. After that most expansion appears as domestic investment. Second, what distinguishes the developed regions from the underdeveloped regions is the percent of private domestic investment as a percent of total investment. For example, for the period 1970 to 1996 private domestic investment accounts for 53% of total investment in Africa while it accounts for 79% of total investment in the OECD countries. Third, the fastest growing developing region, East Asia, stands out for two reasons. Total investment as a percent of GDP is higher in East Asia than in any other developing region and public investment as a percent of total investment is lower in East Asia than in any other developing region.

So, why all the special attention to FDI? We examined the hypothesis that FDI acts as a catalyst for domestic investment. Several economists have argued that foreign investment was responsible for the surge in domestic investment in the garment industries in Mauritius and Bangladesh. (Rhee and Belot 1989) Others argue that foreigners will not invest in Africa until the Africans have proven that investment in Africa can be profitable. (Cockroft and Ridell 1990) In other words, it is domestic investment that will act as a catalyst for foreign investment. If this is true, policy should be designed primarily to encourage domestic investment. (Cockroft and Ridell 1990) In this chapter, our goal is to determine both the direction and the magnitude of causality between foreign and local investment.

Table 4.1: How Important is FDI as a Source of Capital?
(1970-1996)

	Total Investment as % GDP	Foreign Direct. as % total	Private Domestic as % total	Public Domestic as % total
Africa	.18	.03	.53	.44
South Asia	.17	.01	.64	.35
East Asia	.28	.07	.65	.28
Latin America	.21	.05	.62	.33
OECD	.21	.05	.79	.16

Sources: International Financial Statistics Tape, 1997. World Investment Directory, Volume V, Africa, 1996. Adam and O'Connell, 1997.

4.2 The Data

All data are annual and investment is as a share of GDP[10]. Data on total domestic investment, FDI and GDP come from the IMF's Balance of Payments Statistics Tape. Data on FDI for Africa were cross-checked with UNCTAD's data on foreign direct investment published in the World Investment Directory, Volume V, 1996. This was done because UNCTAD's data are more recent, accurate and complete. Data on public and private domestic investment come from UNSO's National Accounts tape. A complete definition of each of the series used is provided below. Summary statistics are provided in Table 4.2.

Technically, the definition of FDI includes equity capital, reinvested earnings and intra-company loans. However, there is a serious lack of comparability of the FDI data of different countries. This lack of comparability may result in discrepancies between total outflows and total inflows or between outward stocks and inward stocks. There are three main reasons for the lack of comparability and discrepancies. First, most countries depart in one way or another from the definitional conventions recommended by the IMF or OECD. Second, countries differ in their methods of data collection and, often rely on Central Bank records compiled for Balance of Payments purposes as opposed to company surveys. Thus, many countries are unable to account for reinvested earnings. Third, corporate accounting practices and valuation methods differ between countries.

Gross Fixed Capital Formation (GFCF) is the measure of total investment for each country and includes both private and public sector investment, and excludes changes in stocks. This series was obtained from the international financial statistics tape for all countries for which the data was available. Domestic investment is obtained by subtracting FDI from GFCF. Private & Public Gross Fixed Capital Formation is investment by ownership and also excludes changes in stocks. These series were obtained from the United Nations National Accounts database.

[10] This is done to avoid stationarity problems.

Table 4.2: Descriptive Statistics

Variable	Mean	Standard Deviation	Number of Observations
(All figures are as a percent of GDP)			
Foreign Direct Investment[1]			
Africa	.01	.03	638
East Asia	.03	.04	120
South Asia	.002	.004	116
Latin America	.01	.02	374
OECD	.01	.01	542
Total Domestic Investment[2]			
Africa	.18	.12	638
East Asia	.28	.06	120
South Asia	.17	.05	116
Latin America	.17	.06	374
OECD	.21	.04	542
Private Investment[3]			
Africa	.17	.06	115
East Asia	.23	.05	36
South Asia	.15	.04	67
Latin America	.17	.07	98
OECD	.19	.04	433
Public Investment[4]			
Africa	.05	.03	115
East Asia	.04	.01	36
South Asia	.04	.02	67
Latin America	.03	.02	98
OECD	.03	.02	433

Sources: (1) International Monetary Fund (IMF) and United Nations Commission on Trade and Development. Series is Inward Direct Investment meaning that it does not include FDI by host country nationals in foreign countries. (2) Source is IMF and series is gross fixed capital formation minus FDI. (3) & (4) Source is United Nations National Accounts.

4.3 Cross-Country and Regional Results

Table 4.3 on page 37 summarizes the main results from appendix tables A.1-A.4.

4.3.1 Does FDI stimulate domestic investment?

Generally speaking, FDI does seem to stimulate domestic investment. Table 4.3 shows that a one-percent increase in FDI as a percent of GDP is followed by as much as a 1.17 percent increase in future domestic investment as a percent of GDP in Latin America. In fact, there is an interesting asymmetry between the OECD countries and the developing countries. In the OECD countries, lagged FDI and lagged domestic investment have a similar impact on current domestic investment. A one- percent increase in either domestic investment or FDI as a percent of GDP increases future domestic investment as a percent of GDP by about .5%. For the developing regions however, the impact of lagged FDI on domestic investment is more than two times the impact of lagged domestic investment on domestic investment. For example, a 1% increase in FDI as a percent of GDP increases the following years' domestic investment as a percent of GDP by 1.17% in Latin America, .91% in Asia and .80 % in Africa.

These results are even more pronounced when five-year averages are used. In all regions, a one- percent increase in lagged domestic investment as a percent of GDP increases next year's domestic investment as a percent of GDP by about .5%. On the other hand, lagged FDI is now inversely related to domestic investment in the OECD countries. And, in the developing countries, lagged FDI has a positive and large impact on current domestic investment. An average one- percent increase in FDI as a percent of domestic investment over a five-year period increases domestic investment as a percent of GDP by an average of about 2% of GDP over the next five-year period.

To understand what is driving these results, we break domestic investment into its private and public components. This reduces the sample to 46 countries because for many countries the breakdown between public and private investment is not available. Panel B of Table 4.3 shows that lagged FDI has a strong positive effect on private domestic investment in developing countries. This is true both in the short-run and long run, however, the effects are more pronounced in the long run. An average one percent increase in FDI as a percent of domestic investment over a five year period increases private domestic investment by between 16.32% (Asia) and 2.52% (Latin America) of GDP over the next five year period. Panel C of Table 4.3 shows that lagged FDI also has an impact on public investment in the long run. On the other hand, FDI has no impact on public or private investment in the OECD countries.

In the aggregate, it appears that lagged FDI stimulates current domestic investment. Yet, a closer examination on a country by country basis shows that this relationship is not robust in all countries. Table 4.4 summarizes the results of such analysis. Although lagged FDI has a positive effect on current domestic investment in most countries (47 coefficients out of 60 are positive), this relationship is significant in only 23 cases (9 coefficients are significant on the 1% level, 13 on the 5% level, and 1 on the 10% level), most of them African countries. In Asia, FDI stimulates domestic investment significantly in only six countries, and in Latin America it does so in just five countries.

Table 4.3: Impact of a One- Percent Increase in Lagged Investment on Current Investment by dependent variable/explanatory variable

(All figures are % change in investment as a percent of GDP)		
A. Does FDI ↑ total domestic investment?	**short-run**	**long-run**
Africa	0.80	2.78
Asia	0.91	2.28
Latin America	1.17	2.19
OECD	0.54	no
B. Does FDI ↑ private domestic investment?	**short-run**	**long-run**
Africa	no	3.71
Asia	5.06	16.32
Latin America	1.01	2.52
OECD	no	no
C. Does FDI ↑ public domestic investment?	**short-run**	**long-run**
Africa	no	1.27
Asia	no	2.27
Latin America	no	1.04
OECD	no	no
D. Does Total Domestic Investment ↑ FDI?	**short-run**	**long-run**
Africa	no	no
Asia	no	no
Latin America	no	no
OECD	-.02	-0.12
E. Does Private Domestic Investment ↑ FDI?	**short-run**	**long-run**
Africa	no	-0.02
Asia	no	0.03
Latin America	0.46	-0.05
OECD	no	-0.21
F. Does Public Domestic Investment ↑ FDI?	**short-run**	**long-run**
Africa	no	no
Asia	-0.44	no
Latin America	-0.26	no
OECD	no	no

Sources: FDI is from International Monetary Fund (IMF) and United Nations Commission on Trade and Development. Series is Inward Direct Investment meaning that it does not include FDI by host country nationals in foreign countries. Investment is from IMF and series is gross fixed capital formation minus FDI. Private and public are from United Nations National Accounts. Short-run results based on annual data, long-run results based on 5-year averages and no means not significant at or above the 90% level.

Notes: "Short-run" refers to results obtained using annual data, and "long-run" refers to results obtained using five year averages. Point estimates reported in Table 4.3 are obtained from the tables in the appendix by adding the differential slope coefficient for each region to the coefficient on OECD. Only those estimates that are significant at or above the 90% level are reported in Table 4.3. Also, none of the results for the variables' own lag are reported in Table 4.3. This is because all four measures of investment are persistent in all regions as expected.

4.3.2 Does Domestic Investment Stimulate FDI?

It appears that domestic investment does not stimulate FDI. This is true for both the developing countries and the OECD countries. But, again there is a difference between the OECD countries and the developing countries. Panel D of Table 4.3 shows that in the developing countries domestic investment has no impact on FDI. For the OECD countries, the relationship between lagged domestic investment and FDI is negative both in the short-run and in the long run. Using the annual data, we find that a one- percent increase in domestic investment as a percent of GDP reduces FDI as a percent of GDP by .02 percent in the following year. The effect is magnified using the 5 year averages where a one percent increase in domestic investment as a percent of GDP reduces FDI as a percent of GDP in the next five year period by .26%. Looking at the breakdown between private and public, we see that the results are coming from the relationship between private domestic investment and FDI. Panel E shows that an average one percent increase in private domestic investment as a percent of domestic investment over a five year period reduces FDI as a percent of GDP by an average of about -.21% of GDP over the next five year period. The negative sign probably reflects the substitution of foreign capital for domestic capital rather than a reduction in the profitability of domestic capital in the OECD countries.

In addition, and somewhat surprisingly, panel F shows that public investment is not a catalyst for FDI in any region of the world in the short or long run. Although not shown in Table 4.3, public investment is also not a catalyst for private domestic investment, in any region of the world over either time horizon. In fact, in developing countries, there is a slightly negative relationship between public investment and FDI, which may reflect the privatization of public enterprises. While we know from empirical studies that government investment in infrastructure is essential to stimulate both foreign and domestic investment, it appears that public investment as a whole is not targeted to stimulate investment. In fact, during the period of creation of monopolistic state enterprises, it was explicitly and deliberately squeezing out private investment.

4.4 Digging Deeper: Country Specific Results

These results in the aggregate are consistent with the country by country analysis reported in Table 4.4. It is clear that lagged domestic investment has no critical effect on current FDI, as shown by the fact that only seven of the 62 coefficients are significant, three of which are negative. These cases are all in Africa, with the exception of Venezuela.

Table 4.4

	Dependent Variable: Domestic Investment			Dependent Variable: Foreign Direct Investment			
Explanatory Variables Country	lagged D	lagged F	D-W statistic	lagged D	lagged F	D-W Statistic	No. obs.
Argentina	.84*	1.19	1.93	-.06	.07	2.01	19
	(.21)	(1.69)		(.04)	(.33)		
Bangladesh	.68 *	53.44 **	2.18	.00	.32	1.63	19
	(.19)	(22.51)		(.00)	(.31)		
Benin	.01	-.62	1.94	-.01	.50 *	1.78	23
	(.22)	(1.67)		(.02)	(.12)		
Bolivia	.35	.68	1.60	.05	1.42 *	1.62	18
	(.22)	(.80)		(.06)	(.25)		
Botswana	.19	-.31	1.29	-.11	.37	1.92	19
	(.22)	(.30)		(.18)	(.23)		
Brazil	.11	6.14	2.19	-.01	.60 *	1.95	18
	21)	(5.72)		(.01)	(.17)		
Burundi	.75 *	5.51 **	1.61	-.01	.37 *	2.34	14
	(.23)	(2.01)		(.00)	(.03)		
Cameroon	.97 *	.09	2.38	-.02	.79 *	2.17	19
	(.10)	(.44)		(.04)	(.21)		
Central African Rep.	1.07 *	-.27	1.40	-.04	.32	1.90	9
	(.108)	(.80)		(.07)	(.46)		
Chile	.72 *	.53	1.70	.11	.28	1.96	19
	(.16)	(.41)		(.09)	(.22)		
Colombia	.35 ***	.25	1.80	.13	.23	1.96	26
	(.19)	(.34)		(.09)	(.22)		
Costa Rica	.53 **	-.66	1.89	.00	1.04 *	2.30	17
	(.25)	(.72)		(.05)	(.15)		
Côte d'Ivoire	.87 *	.50	1.56	.03	.39 ***	2.03	24
	(.10)	(.75)		(.02)	(.20)		
Dominica	.46 **	.05	1.69	-.00	.44 **	1.80	26
	(.20)	(.57)		(.07)	(.21)		
Ecuador	.63 *	-.54	1.80	-.02	.83*	1.95	19
	(.19)	(.65)		(.04)	(.15)		
El Salvador	.51 **	2.14 **	1.00	-.01	.24	2.17	18
	(.18)	(.85)		(.02)	(.23)		
Equatorial Guinea	-.94	-4.3	1.59	-.87	4.51	0.15	3
Ethiopia	.46	1.11	1.30	.23 ***	-.16	1.80	9
	(.41)	(1.10)		(.11)	(.32)		
Ghana	1.06 *	-1.07	1.61	.06 ***	.22	1.53	22
	(.17)	(1.16)		(.03)	(.19)		
Guatemala	.65 *	.71	1.97	-.02	.21	1.96	17
	(.14)	(.43)		(.09)	(.26)		
Guinea-Bissau	.30	-.85	1.15	-.19	-.55	2.80	6
	(.47)	(2.46)		(.12)	(.58)		
Haiti	.89 *	2.94 *	2.49	-.02	.86*	2.07	22
	(.08)	(.60)		(.01)	(.12)		
Honduras	.80 *	3.59 **	1.82	-.00	.55**	1.77	20
	(.14)	(1.40)		(.02)	(.21)		

India	.86 * (.08)	70.27 (70.00)	2.00	.00 (.00)	-.93 (3.85)	1.19	17
Indonesia	.91 ** (.26)	-1.40 (1.76)	2.06	.00 (.03)	1.09 * (.19)	1.70	13
Kenya	.31 (.18)	2.90 * (.82)	1.45	.06 (.04)	.20 (.20)	2.14	19
Korea	.80 * (.16)	7.60 ** (3.48)	1.15	-.01 (.01)	.25 (.28)	1.94	18
Lesotho	.83 * (.10)	4.42 ** (1.71)	2.31	.01 (.01)	.60 ** (.22)	2.04	18
Madagascar	.38 ** (.14)	-.27 (1.41)	1.58	.01 (.02)	.78 * (.16)	1.04	22
Malawi	.75 (.12)	1.92 * (.60)	1.78	-.01 (.03)	.66 * (.15)	2.22	24
Malaysia	.60 ** (.23)	.40 (.38)	1.11	-.01 (.12)	.64 * (.20)	1.70	19
Mali	.38 (.32)	.74 (.93)	1.93	.03 (.09)	.01 (.03)	2.02	13
Mauritius	.74 * (.10)	3.07 * (.90)	2.13	-.02 (.02)	.76 * (.18)	1.91	18
Mozambique	.36 (.30)	4.15 (6.37)	1.51	.01 (.01)	.87 * (.17)	1.81	14
Myanmar	.56 ** (.24)	-3.3 (3.15)	1.07	-.02 (.01)	.60 ** (.21)	1.74	15
Namibia	.99 * (.06)	3.14 * (.16)	0.91	-.56 (.01)	-1.40 * (.03)	1.95	4
Nicaragua	.16 (.37)	1.43 (2.32)	1.72	-.01 (.03)	1.42 * (.16)	2.06	10
Niger	.62 * (.12)	1.76 ** (.67)	2.31	.06 (.06)	-.10 (.23)	1.88	22
Nigeria	.77 * (.16)	.01 (.62)	1.58	-.03 (.03)	.51 * (.17)	2.16	21
Pakistan	.33 *** (.17)	1.30 ** (.61)	2.07	.03 (.03)	.93 * (.12)	2.04	17
Panama	.55 ** (.24)	.80 ** (.28)	1.34	-.47 (.30)	-.33 (.36)	1.61	15
Paraguay	.40 (.25)	.23 (.87)	1.60	-.04 (.04)	.93 * (.14)	1.82	18
Peru	.88 * (.16)	.40 (1.15)	1.54	-.03 (.02)	.06 (.23)	1.94	17
Philippines	.54 ** (.23)	.03 (.96)	1.37	-.06 (.04)	.62 * (.20)	2.08	17
Rwanda	.76 * (.11)	-.63 (1.05)	1.98	-.01 (.01)	.83* (.13)	1.99	23
Senegal	.46 *** (.25)	.70 (.52)	1.99	.256 (.17)	.00 (.31)	2.06	24
Seychelles	.90 * (.14)	.82 (.54)	2.32	-.09 (.06)	.24 (.23)	1.96	16
Sierra Leone	1.12 * (.39)	.82 ** (.44)	2.14	-.25 (.37)	.06 (.42)	2.03	24
Singapore	.87 * (.29)	1.13 * (.49)	1.41	-.10 (.18)	.05 (.33)	1.92	22

South Africa	.30	1.75 *	1.36	-.01	.34	1.80	18
	(.21)	(.57)		(.01)	(.24)		
Sri Lanka	-.06 *	3.57 *	1.52	.01	.24	1.75	19
	(.02)	(1.18)		(.04)	(.27)		
Sudan	.33	-.08	0.96	.00	-.26 *	1.63	11
	(.24)	(5.68)		(.00)	(.02)		
Tanzania	.69 *	-1.84	2.12	.00	2.23 *	2.06	17
	(.20)	(1.88)		(.00)	(.10)		
Thailand	.74 *	1.95 **	1.65	.00	.52 ***	1.97	19
	(.11)	(.75)		(.04)	(.26)		
Togo	.07	.78 **	1.68	.19 **	.06	1.99	23
	(.20)	(.36)		(.09)	(.22)		
Uganda	.92 *	-5.74	1.65	.02 ***	.04	1.96	12
	(.15)	(6.60)		(.01)	(.28)		
Uruguay	.66 *	.65 ***	1.17	-.07	.33	2.37	16
	(.18)	(.34)		(.10)	(.19)		
Venezuela	.55 **	.85	1.26	-.10 ***	-.67 *	1.42	24
	(.20)	(.59)		(.05)	(.17)		
Zaire	1.77 *	1.08 *	2.54	-.89 *	-.32	2.04	18
	(.15)	(.36)		(.29)	(.49)		
Zambia	.98 *	1.08	2.70	-.09 *	.06	2.16	23
	(.09)	(.48)		(.03)	(.21)		
Zimbabwe	.79 ***	4.7	0.85	.00	.18	1.98	13
	(.40)	(3.70)		(.03)	(.34)		

* Denotes significance at the 1% level
** Denotes significance at the 5% level
*** Denotes significance at the 10% level

4.5 Conclusion

In summary, we conclude that FDI is a strong catalyst for domestic investment in developing countries. The fact that lagged FDI has a stronger impact on private domestic investment than lagged private domestic investment itself suggests that FDI brings with it technological and managerial capabilities that make private domestic investment more profitable. This evidence is strengthened by the asymmetry between the developing countries and the OECD countries. The majority of FDI in developing countries is done by multinationals from technologically advanced countries. The majority of FDI in the OECD countries is also done by multinationals. The overall level of technological advancement between host and recipient, however, tends to be similar for the OECD countries. Hence, the scope for making private domestic investment more profitable via technological and managerial spillovers is limited in the OECD countries.

Although the evidence presented in this paper is not based on a structural model, the results obtained are interesting for four reasons. First, they suggest a strong dichotomy between the behavior of FDI and domestic investment. Second, by distinguishing between public and private domestic investment, we are able to show that the behavioral difference is coming from the relationship between FDI and private domestic investment. Third, by distinguishing between industrialized and developing countries, we are able to show that the relationship between FDI and private domestic investment holds only in developing countries. Hence, any more subjective interpretation of the results must be able to explain these three facts. And fourth, at the very least, these facts allow us to rule out hypotheses that link FDI to domestic investment in a negative way.

One way to interpret these facts is to argue that FDI provides positive spillovers to developing countries that make private domestic investment more profitable. The plausibility of this argument is strengthened by the fact that these benefits are only present in less developed countries where the potential for technological and managerial spillovers are greatest. An alternative interpretation might be that FDI is primarily undertaken by multinationals that have greater access to information and financial resources than most private investors in developing countries. Hence, they are able both to identify and take advantage of profitable opportunities more quickly than domestic investors. In order to nail down the "true" explanation more detailed analyses using case studies and/or firm level data are required.

5. CASE STUDIES

Case studies conducted in Mauritius, Kenya and Uganda provided insights into how the statistical relationship between foreign and local investment works, and why it works that way. They also illustrated how the economic literature on the importance of ethnic fragmentation, sound institutions and social capital, both negative and positive, manifest themselves in local realities. The policy implications of the study are analyzed for these three countries, each of which has a unique historical experience of policies towards foreign and local investment. They cover the full range, from Mauritius' fairly steady course of providing ever improving incentives to foreign investment to Uganda's extreme fluctuations—first incentivizing investment, then nationalizing and confiscating property and expelling much of the Asian business community during the arbitrary reign of Idi Amin. For the past decade both Uganda and Kenya have been trying to overcome investor concerns and improve their attractiveness. Policy-makers in both countries actively sought the assistance of the study team in understanding how this could best be done.

The country case studies offered many examples of how the "ethnic fragmentation" and "institutions" variables affect investment. All three countries inherited from British colonial rule relatively sound traditions of rule of law, banking and educational institutions. Mauritius had the added advantage of a bilingual educational system (French and English) and a high level of literacy. Its banking sector and bureaucratic efficiency were ranked higher by investors than either those of Uganda or Kenya.

An independent assessment of current business community rankings of government institutions is provided by the 1998 *Africa Competitiveness Report* prepared by Harvard Institute for International Development for the World Economic Forum. In overall competitiveness Mauritius was ranked top, with a positive 0.87 ratio, while Kenya and Uganda were 13th and 14th respectively, with –0.15 and –0.16 ratings. On the other hand questions concerning the direction of change showed Uganda leading African countries in overall improvement and more highly ranked than either Kenya or Mauritius on the optimism index (Uganda ranked 3rd of 20, Kenya 13th and Mauritius 14th). The institutional soundness of government is partly reflected in the questions on policies and actions vis-à-vis business, summarized for the case-study countries in Table 5.1 below:

Table 5.1: Institutional Factors: Case Study Countries Compared on Governance

Questions / Countries ranked	Mauritius nth/20-21	Kenya nth/20-21	Uganda nth/20-21	Top ranked country	Lowest ranked
Government regulations					
Government regulations do not impose a heavy burden on business competitiveness.	7	15	5	Botswana	Nigeria
Government regulations are precise.	5	12	11	Tunisia	Mozambique
Regulation Enforcement					
Government regulations are fully enforced.	4	17	7	Tunisia	Mozambique
State Interference					
Excepting the state-controlled sector, state interference in private business is minimal.	6	12	5	Burkina Faso	Zimbabwe
Public Sector Competence					
On average the competence of personnel in the public sector is higher than the private sector.	9	19	10	Ghana	Zimbabwe
Time for permits					
What percentage of senior management's time is spent with officials negotiating or obtaining licenses?	14	15	9	Burkina Faso	Zambia
Tax system					
The tax system enhances business competitiveness.	4	10	8	Botswana	Zimbabwe
Tax evasion					
Tax evasion is minimal.	3	16	15	Botswana	Cameroon
Government spending					
The composition of government spending provides necessary goods and services that the private market does not provide.	7	18	10	Botswana	Zimbabwe
Government Subsidies					
Government subsidies are directed towards future winners.	13	15	5	Namibia	Zimbabwe
AVERAGE RANKING	7.2	14.9	8.5		

Source: HIID/WEF 1998.

Mauritius and Uganda ranked near the top third of the 21 African countries surveyed, while Kenya ranked in the bottom third overall. Mauritius generally ranked high on the quality of its tax system and rule of law. Uganda did also, with the exception that its laws are not perceived as being precisely spelled out. Kenya's least worst ranking was for its tax structure, which was ranked average. On all other indices it ranked below average, and it was near bottom on public sector competence, inappropriate government spending, regulatory enforcement, tax evasion, and the regulatory burden on businesses. The negative view of business on government spending is born out by world development indicators that show private consumption grew only 2.5 percent annually between 1990 and 1998, while government consumption grew at an annual rate of 12.6 percent. (www.worldbank.org/data/databytopic/databytopic.html#MACROECONOMICS AND GROWTH, 9/23/00) On a per capita basis, private consumption in Kenya actually declined an average of 0.2 percent per year—that is the population grew faster than private consumption.

The soundness of the financial sectors can be gauged from Table 5.2 below, which combines objective data from the World Bank indicators with rankings provided by the African Competitiveness Survey. Here Mauritius clearly has an advantage over Kenya and Uganda. Its banking system inspires confidence, in both the investors interviewed during the case study and those surveyed for the competitiveness study. Kenya's financial sector ranks average for Africa, while Uganda's ranks in the bottom third. Local bank soundness is very highly ranked in Mauritius, while both Kenya and Uganda are seriously lacking in this regard. What the data below do not show, but was evident in the case studies, is that this gap is compensated by the presence of many international banks in Kenya, fewer in Mauritius, and still fewer in Uganda.

On more general educational and social indicators such as education, Kenya compares well to Mauritius' excellent record. Uganda, on the other hand, shows the devastation wrought by years of conflict and Idi Amin's distrust of intellectuals. Uganda was renowned for its educational system at independence. In 1998, its adult illiteracy rates were 46 percent for women and 24 percent for men. This is in sharp contrast to Mauritius and Kenya, where adult illiteracy is 20 and 27 percent, respectively, for women and 12 and 13 percent, respectively, for men.

Table 5.2: Institutional Factors: Financial Sectors in Case Study Countries

Questions / Countries ranked	Mauritius nth	Kenya nth	Uganda nth	Top ranked country	Lowest ranked
Gross domestic investment					
Investment as a percentage of GDP (source African Development Indicators, World Bank, 1997)	3	8	17	Tanzania	Zambia
Gross domestic savings					
Savings as a percentage of GDP (source, African Development Indicators, World Bank, 1997)	1	11	16	Mauritius	Malawi
Soundness of local banks					
Local banks are generally healthy with sound balance sheets	2	16	19	South Africa	Zambia
Domestic banks competition					
Domestic banks face competition from foreign banks	8	2	4	Tanzania	Ethiopia
Banks' service of smaller firms					
Banks and other lending institutions adequately service smaller, less established firms	1	4	8	Mauritius	Tanzania
Access to financing					
Adequate access to financing is not a difficult obstacle for businesses to overcome	3	9	13	South Africa	Cameroon
Interest rate gap					
The gap between interest rates on bank loans and interest rates received for deposits is smaller than international norms	8	19	16	Ethiopia	Mozambique
Lending decisions					
In general, banks and other lending institutions do not make loans based on existing personal relationships.	9	11	19	Burkina Faso	Nigeria
AVERAGE RANKING	4.4	10	14		

Source: HIID/WEF 1998.

Uganda and Kenya rank among the fifteen most ethnically fragmented countries in the world. (Taylor and Hudson 1972) Mauritius initially would have ranked as highly ethnically fragmented, but over the years has experienced consolidation into fewer ethnic, religious, caste and linguistic groups. Mauritians often remark that they have an advantage in that none of their ethnic groups is indigenous—none has a sense of territoriality that excludes the others. In East Africa ethnic tensions have caused more problems for investment. Anti-Asian violence and dispossession forced a massive wave of disinvestment in Uganda in 1972, from which it has taken more than two decades to begin to recover. In contrast, Kenya overcame the communal violence of Mau Mau to win a stable and promising first decade of independence. Thereafter, however, the pressures for rent seeking began to pervade and cripple both policies and institutions. Stated policies are contradicted by officials' behaviors to the point where investors, both domestic and foreign hesitate to move forward. The case studies will indicate in greater detail how these variables affected the evolving investment climate in each country, for both domestic and foreign investors.

To understand the degree of economic linkages and cooperation, the research team sought to develop profiles of foreign and local investors, their attitudes and strategies in relation to each other. It tried to identify successful and unsuccessful initiatives and analyze the reasons for their success or failure. It explored linkages between foreign and local investments, including access to new business opportunities, outsourcing of supplies and services, provision of inputs, training, hiring of one another's trained personnel, lobbying, and other links. Finally, it explored the theme that ethnic fragmentation has been found to have negative impact on economic policies and growth, while countervailing positive influence is provided by sound institutions. The goal was to better understand the statistical results so as to inform policy. In particular, the team tried to determine whether and how professional associations and/or government policies can enhance linkages between local and foreign investors.

The results of the individual case studies include lessons learned for investment policy generally, as well as policy findings specific to each country. The three combined case studies are compiled in a comparative policy analysis. This may be useful for policy makers interested in promoting FDI and local private investment The concluding chapter looks at the challenge of investment promotion today in the era of a global, mobile, information-based economy. The lessons from past approaches are only a starting point in preparing for the new economy.

6. FOREIGN AND LOCAL INVESTMENT IN MAURITIUS

Mauritius was chosen as a case study because it has a reputation as a country in which foreign investment has played a critical and unanticipated role in industrialization, driven largely by good policies. The case study bore this out, but added great complexity to the portrait. Ethnicity was a complicating factor that could have derailed growth, and sound institutions played as important a role as policies in its success.

6.1 An Overview of Investment Policy and Performance in Mauritius

In the 1960s as independence from Britain approached, James Meade and Burton Benedict published several studies that foresaw a bleak economic and political future for Mauritius.[11] Meade proposed strategies to improve the standard of living while taking into consideration projected continuing rapid population growth (then over 3% per year). He foresaw pressures of population growth on economic resources on this small volcanic isle and suggested several mitigating strategies, including increasing productivity, encouraging emigration and family planning. Burton Benedict challenged Meade’s proposed solutions, asserting that even if Meade's suggestions on ways to increase productivity were followed, this would not produce results strong enough to counter the population growth problem.

To the Malthusian logic in these first analyses, Benedict added concern over the future political stability of Mauritius. He analyzed the 1953 and 1962 censuses and documented the impact of ethnic, religious, caste and linguistic fragmentation on local politics—from the national level to the squabbles over a repair contract for a small town road. He began with the observation that Mauritians rarely identified themselves and others as Mauritians. In 1962 people from the Indian subcontinent were the majority, but did not comprise a single ethnic group. 50.5 percent of the population was Hindu and 16.2 percent Muslim Chinese comprised 3.4 percent of the population, and the “General Population,” mainly Creoles and Franco-Mauritians constituted 29.9 percent. Although Africans had been brought to Mauritius in slavery, African languages and ethnic groups had melded into a mixed population speaking the Creole French patois that gradually became a lingua franca of the Island. The Indo-Mauritian population was 63 percent Hindu Sanatan and 19 percent Muslim Hanafi. There were generally endogamous minority sects of both major religions (the largest of which were Arya Samaj and Ahmadiyya), as well as Indian Christians. Castes had consolidated into a bipolar mode. They had no corporate organization, but were generally endogamous. Chinese were nearly evenly split between Christians and Buddhists. Indo-Mauritians were further split by language, which sometimes had ethnic connotations. Hindi was the mother tongue of 36 percent of the total population and Urdu of 13.5 percent. Smaller Tamil and Telugu groups rarely intermarried with other Hindus. The “General population” of metisse, Franco-Mauritians and others was 96 percent Roman Catholic. The Franco-Mauritian families, are mostly descendants of French nobility who fled there during the French

[11] Meade, 1960; Benedict, [1965]; and, in preparation for independence, a commission report: Meade et al, 1968.

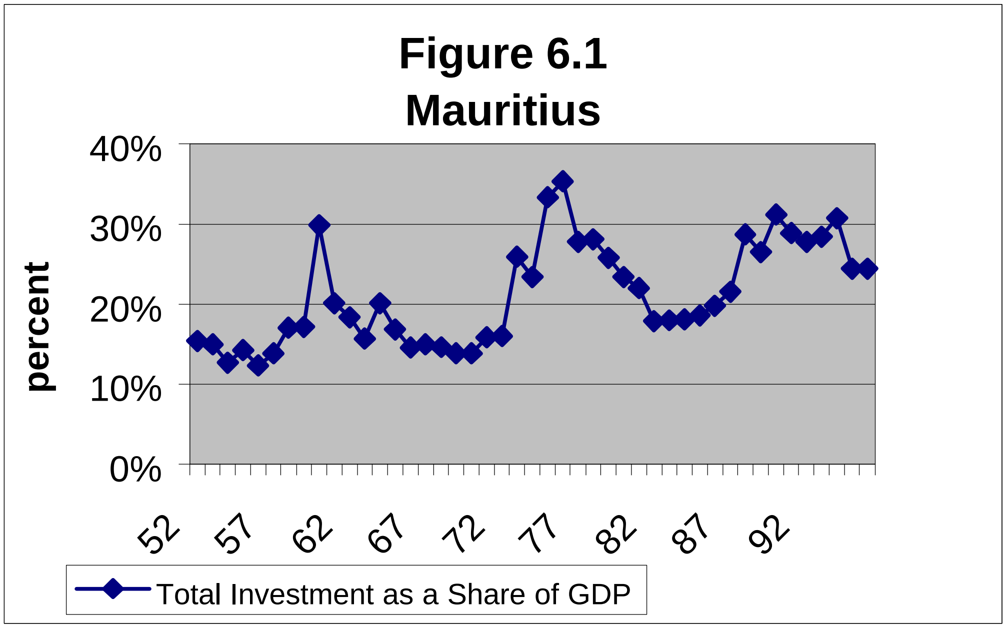
Revolution. The British gained control of the island during the Napoleonic wars and governed it until 1968, but the French families dominated the domestic society and economy.

For the dependency theorists of the 60s, Mauritius was an archetypical monocrop colonial economy. It depended on sugar for 99 percent of exports and one third of GDP. Cane fields occupied 90 percent of arable land. Of that, 55 percent was owned by 25 Franco-Mauritian families, often dubbed sugar barons. The remaining 45 percent of sugar estates were owned by 84,000 small farmers, predominantly of Indian origin. Almost no food was produced on the island. The majority who would dominate numerically in a democratic Mauritius was a land-poor population of former indentured laborers on sugar plantations from the Indian subcontinent. Until recently they had been considered transients, not counted as members of the population.

Benedict's complex analysis of the ethnic situation did little to lift the prevailing pessimism about Mauritius' future. The colonial government commissioned Meade to head an appointed commission to produce an economic strategy. The Meade Report was to strongly influence the government in creating its initial import substitution industrialization policy. The key recommendations in the Meade Report included tariff protection for certain local industries, a decrease of corporate tax from 40 to 30 percent, tax holidays for five of the first eight years of a company, priority of capital expenditure for projects leading to productive employment and the abolition of tariffs on importation of machine tools and equipment.

These policies already focused on investment promotion, a policy which successive Mauritian governments have consistently favored. Figure 6.1 attests to the success of these many governments in promoting investment. Even as early as 1960, investment in Mauritius reached 30% of GDP, a figure only recently achieved by the most successful economies in East Asia and largely unheard of in the developing world.

Figure 6.1: Mauritius



At this time, however, neither the new government of Mauritius, nor others in the developing world, had recognized the connection between investment policy and the larger political and economic context. A number of trends of the first government, which was dominated by the Mauritian Labour Party from independence in 1968 until 1982, limited the effectiveness of investment promotion incentives. One concern of foreign investors was political stability. There had been some communal violence just before independence, and the new Hindu dominated government maintained a fragile truce with minorities, including Muslim, Chinese and Franco-Mauritians. Other concerns centered around macroeconomic policies. Currency controls and protective tariffs designed to nurture import substitution industries [for the tiny national market], raised energy and transaction costs and times for potential exporters. The involvement of government in labor/ management negotiations and the creation of state corporations in key sectors led investors to take a wait and see attitude toward government. And the fledgling transport and telecommunications infrastructure was barely adequate. The idea of creating an export promotion zone (EPZ) was added to the policy mix in 1970, only two years after independence. It was inspired by the success of Taiwan. (See text box.) Within a year the EPZ legislation was passed. In a stroke of brilliance, industrial leaders and policy-makers realized that Mauritius, being a small island with readily controlled access, could declare the whole island an EPZ—it did not need to have a fenced area. This allowed investors to build in dispersed locations, to facilitate transport for their workers and/or their products. Only a few foreign investors took advantage of the EPZ law in the 1970s, however. Mauritius' isolated location in the Indian Ocean, its currency controls and uncertain political situation reportedly influenced the first investors to limit their commitments. What became the flagship textile firm, for example, was set up initially to do only the manufacturing—marketing and management were based in Japan and Hong Kong respectively.

By the end of the 1970s Mauritius was experiencing many of the same problems that other African countries had with state corporations, protective tariffs, and currency controls. With no petroleum resources, it had been hit hard by OPEC's escalation of oil prices and the global economic distortions that ensued. Government was running unsustainable annual deficits, the balance of trade was negative, industry was stagnant, and foreign exchange rationing slowed down all transactions.

A devastating cyclone catalyzed a change in direction and in government. An alliance of former opposition parties, the Mauritian Militant Movement (MMM) and Mauritian Socialist Party (PSM), won the 1982 elections, changing the dominant party position for the first time since electoral politics was introduced in 1947.

The new government scrapped the mixed strategy of the 1970s, liberalized the currency, retreated from subsidizing state corporations, and put its full efforts into voluntary structural adjustment and promoting export-led growth. In retrospect, a recent government report sees that decision as an inevitable logical consequence of Mauritius' geographic situation. The report, *Mauritius at Crossroads* (1995) explains that as a small island, physically limited by lack of arable land and relying solely on sugar for foreign exchange, "Mauritius was condemned to turn to an aggressive export strategy." Figure 6.2 shows the tentative start in foreign investment in the mid-70s when the EPZ law was passed. It is also apparent from Figure 6.2 that it was not until the early 80s that foreign investment actually took off. And, it appears, partly as a consequence so too did domestic investment take off.[12]

[12] Note that the series on FDI only starts in 1976 because data on inward direct investment prior to 1976 is not available.

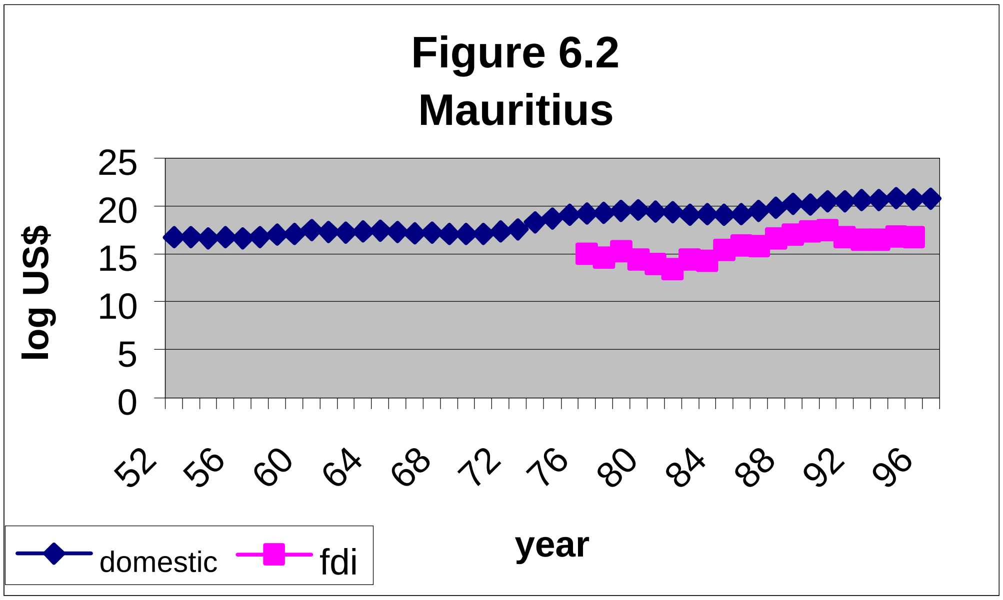


Figure 6.2: Mauritius

Today, according to *Mauritius at Crossroads*, every Mauritian is taught the concept "Export or Die." This philosophy has led to the development of a sound business environment which is friendly to investors, both local and foreign, and which offers an attractive investment incentives package to compensate for the lack of resources and the no-longer inexpensive labor force.

The older generation of industrial and government leaders also stresses that Mauritians have learned to make a virtue of their ethnic diversity. The switch to an export-led strategy came at a time of crisis. The ill-paid labor force was still predominantly of Indian origin, as was the government, whereas the industrial sector was led by Franco-Mauritians, Hong Kong/Taiwan investors and a few Sino-Mauritians. Several interviewees described the moment as if they had looked at one another, then at the surrounding hundreds of miles of ocean, and decided that they would sink or swim together. For the export strategy, Mauritius needed to reach out to Hong Kong and Taiwan textile magnates, who had the capital and skills to organize a competitive industry. Franco-Mauritian local capital and know-how, and contacts were needed to open up European markets. A cooperative, trainable labor force was needed to attract investors. And government needed to be fully committed to its investor-friendly strategy. Mauritius had hard-working bilingual predominantly male labor force. They were skilled in farming, not industrial work. Most analysts doubted that Hindu or Muslim women would ever come out of the home and into the workplace. Within six or seven years, Mauritius had full employment, and industrial workers were mainly women.

6.1.1 Investment Incentives

Policies were the main, but not the only factor in investment decisions. Promoting investment has been on the top of the government's industrial agenda throughout the different development phases, but the understanding of what works for investors, for government and for the society as a whole, has evolved continuously. The first clearly defined policy came in 1961, as the colonial government began to prepare for an independent Mauritius, with the Industrial Development Tax Relief Act. The Export Processing Zone took effect in 1971, as one of the first acts of the newly independent government. Support services for exporters were given a fillip in 1981 with the Export Service Zones Act. In 1985, the Mauritius Export Development and Investment Authority (MEDIA) was established as the executive arm of the Ministry of Industry. Its main responsibilities are to attract investment, promote exports and manage industrial estates.

Investors clearly weighed these incentives against the inconveniences created by location, lack of local food and fuel supplies and small market size. The only major policy disincentive for foreign investors is that they are not allowed to own land. Government has compensated by providing fully equipped industrial sites for lease. Hotel investors generally partner with a local landowner. In the 1980s Mauritius offered inexpensive labor, but within a decade the development of the textile and hotel sectors had brought wages to a middle level, by world standards. From the late 1980s through early 1990s, Mauritius experienced full employment. Rising wages have gradually priced the textile industry out of its mass-production T-shirt lines, and forced both government and industry to rethink development strategies.

The Industrial Expansion Act of 1993 was a partial response to this dilemma. Through it Mauritius confirmed its commitment to permanent zero tax rates for exporters, and added a bundle of new targeted incentive programs—providing for high technology investors, off-shore financial services and freeport services. The full range of incentive programs Mauritius now offers is shown in Table 6.1. To increase confidence in the industrial sector in general, corporate tax for manufacturers who do not qualify for the EPZ zero-rate was cut from 35 to 15 percent.

Table 6.1: Manufacturing - Fiscal Incentives

INCENTIVE SCHEMES	QUALIFYING ACTIVITIES	INCENTIVES
Export Enterprise (EPZ)	• All manufactured goods for exports • Produce of deep sea fishing (Including fresh or frozen fish) • Printing and publishing as well as associated operations • IT activities • Agro Industries	• No customs duty, or sales tax on raw materials and equipment • No corporate tax • No tax on dividends • No capital gains tax • Free repatriation of profits, dividends and capital • 60% remission of customs duties on buses of 15-25 seats used for the transport of workers. • Exemption from payment of half the normal registration fee on land and buildings by new enterprises. • Relief on personal income tax for 2 expatriate staff
Pioneer Status Enterprise	• Activities involving technology and skills above average existing in Mauritius and likely to enhance industrial and technological development. • Applicant companies may come under one of three broad categories: (a) new technology, (b) support industries and (c) service industries.	• No customs duty, or sales tax on scheduled equipment or materials. • 15% corporate tax • No tax on dividends • Free repatriation of profits, dividends and capital
Strategic Local Enterprise	• Local industry manufacturing for the local market and engaged in an activity likely to promote and enhance the economic, industrial and technological development of Mauritius.	• 15% corporate tax • No tax on dividends
Modernization and Expansion Enterprise	• Two broad categories: • Investment in productive machinery and equipment, such as automation equipment and processes and computer applications to industrial design, manufacture and maintenance (CAD/CAM) • Investment in anti-pollution and environment protection technology to be made within 2 years of date of issue of certificate.	• No customs duty on production equipment • Income tax credit of 10% (spread over 3 years) of investment in new plant and machinery, provided at least Rs 10 million are spent and this occurs within two years of date of issue of certificate. (This is in addition to existing capital allowances which amount to 125% of capital expenditures.) • Enterprises incurring expenditure on anti-pollution machinery or plant benefit from a further incentive, i.e. an initial allowance of 80% instead of the normal 50%
Industrial Building Enterprise	Construction for letting purposes of industrial buildings or levels thereof, provided floor space is at least 1000 square meters. Special conditions: The applicant can only be a company intending to erect an industrial building to be let to the holder of a certificate (other than an industrial building enterprise certificate) issued under this Act or to an enterprise engaged in the manufacture or processing of goods or materials except the milling of sugar.	• 15% corporate tax • No tax on dividends • Registration dues for land purchase: 50% exemption • There is also a non-fiscal incentive, namely the disapplication of the Landlord and Tenant Act, i.e. rent control

Source: Destination Mauritius, Mauritius Export Development and Investment Authority (MEDIA).

Table 6.2: Services - Fiscal Incentives

INCENTIVE SCHEME	QUALIFYING ACTIVITIES	INCENTIVES
Offshore Business	Conduct of business with non-residents and in currencies other than the Mauritian Rupee. Activities include: offshore banking, offshore insurance, offshore funds management, international financial services, operational Headquarters, international consultancy services, shipping and ship management, aircraft financing and leasing, international licensing and franchising, international data processing and other information technology services, offshore pension funds, international trading and assets management, international employment services	• No tax on profits • Free repatriation of profits • Complete freedom from exchange control • Concessionary personal income tax for expatriate staff • Complete exemption from taxes on imported office equipment • Complete exemption from import duties on cars and household equipment for two expatriate staff per company • No withholding tax on interest payable on deposits raised from non-residents by offshore banks • No withholding tax on dividends and benefits payable by offshore entities, no estate duty or inheritance tax is payable on the inheritance of share in an offshore entity, no capital gain tax.
Freeport	Transshipment and re-export trade, e.g. warehousing and storage, bulk breaking, sorting, grading, cleaning, mixing, packing and repacking, minor processing and simple assembly	• No corporate tax • Complete exemption from payment customs duty and sales tax on: a: all machinery, equipment and materials imported into a freeport zone for exclusive use in the freeport b: all goods destined for re-export, access to offshore banking facilities, warehousing and storage fees at preferential rates
Export Service Zone	Export oriented service companies, such as accountancy, law, medicine, international marketing, quality testing, pre-shipment services, civil engineering, management consultancy, re-insurance, entrepot trade, transshipment	• 15% Corporate tax • Exemption from payment of income tax on dividends • No customs duty on office equipment

Source: Destination Mauritius, Mauritius Export Development and Investment Authority (MEDIA).

Table 6.3: Others - Investment Incentives

INCENTIVE SCHEME	INCENTIVES
Agricultural Development Certificate	• 15% corporate tax • Exemption from payment of income tax on dividends • Free repatriation of capital, profits and dividends • Exemption from payment of customs duty on machinery and equipment • Exemption from payment of 50% of the normal registration fee on land and buildings purchased by the new enterprise.
Hotel Management Incentives	• 15% corporate tax • Tax free dividends for 10 years • Free repatriation of profit, dividends and capital subject to original investment being received "A" status from the Bank of Mauritius • Term loans and overdraft at preferential rates
Hotel Development	• 5% corporate tax • Tax free dividends for 10 years • Exemption of customs duty on importation of equipment as per approved list • Free repatriation of profit, dividends and capital subject to original investment being received "A" status • Term loans and overdraft at preferential rates

Source: Destination Mauritius, Mauritius Export Development and Investment Authority (MEDIA).

6.2 Factors in Investor's Decisions

6.2.1 Negatives

Four main factors initially tended to detract from Mauritius as an investment location: its size, isolation, lack of natural resources, and uncertain sociopolitical future. Mauritius is an isolated speck in the Indian Ocean. The nearest country, Madagascar, is some 500 miles to the West. Sri Lanka is 2000 miles in the East. The great distances from potential markets for its products tend to add to its transport costs, whether by sea or air.

The island is of volcanic origin and has no mineral deposits of any commercial value. The soils are shallow and poor in phosphates, and farming without fertilizers is impossible. The one natural resource Mauritius has been able to develop is its beaches. It has over 95 tourist hotels.

With independence in 1968, Mauritius inherited a fierce problem of unemployment and landlessness. The population skills were limited mainly to sugar plantation work. Moreover, a population of barely 700,000 constitutes a very small domestic market. The policies favoring import substitution industries clearly was based on political pressures and nationalism. Neither theories nor realities of international competition were well understood.

Furthermore, dependence of the economy on sugar, for 99 percent of exports and 70 percent of employment, meant that the economy was extremely vulnerable to fluctuations in world sugar prices and natural disasters like cyclone, drought and diseases.

With such a hostile beginning for investment, what factors then led to the choice of Mauritius as an investment location to foreign investors? How did local investors get started? What were the catalysts behind the investment boom in Mauritius?

6.2.2 Positives

Foreign investment was not a factor in the early years of independence. Local investment grew strongly from 1972 through 1978. Foreign investment only began to be recorded as a separate phenomenon in 1976. The registry of firms and oral interviews suggest that it was negligible until one year earlier. Domestic investment thus clearly led the investment boom in Mauritius, making it an exception to the global pattern. There was a brief three years of foreign investment from 1975 through 1977, a period when local investment also continued to grow. The first Hong Kong textile firm pioneered with the EPZ legal framework, but it struggled in the early years and inspired little imitation.

In the late 1970s and early 1980s came a series of economic, political and climatic crises that caused an abrupt falling off in new investment, both foreign and local. Sugar prices were down on the world market, the country was experiencing political tensions, and a major cyclone destroyed both the sugar crop and much of the island's infrastructure. The crisis of 1979-81 proved a turning point for Mauritius' economy, a time of rethinking that led to a renewed national consensus and common economic strategy.

The turn around came with the announcement of an appropriate structural adjustment strategy by the government. Unlike structural adjustment programs imposed elsewhere on unwilling and/or uncomprehending governments, Mauritians seem to have devised its own strategy and united behind it. The new policy stance grew out of a dynamic civic leadership on the part of local investors and government. Investors explained why the EPZ law was not sufficient to overcome the constraints, and worked together with government to plan a more liberal, more dynamic future.

By then the socio-political situation appeared more stable. Tripartite labor negotiations, held annually then as now, provide a forum in which all parties come to understand the economic dynamics affecting them and to reach a consensus on development strategy. When the government changed hands through peaceful elections in 1982 and the new government appeared even more committed to a market economy, foreign investors took note.

In the early 1980s, after more than a decade of misguided attempts at industrialization, it became clear that the limited size of the domestic market meant that an import substitution strategy could not be viable. The government opted for an outward-oriented strategy leading to export-led growth. Ironically, the EPZ legislation had been in effect from 1970, but only became a factor in Mauritius' development from 1983 on, when all parties agreed to try to make it work. Once the strategic planning and policy dialogue processes were established, they became a tradition. Three successive pillars have contributed to investment, the Export Processing Zone (EPZ), tourism and financial/business services. The EPZ was the main focus from 1983 through 1993, tourism from 1990 to the present, and financial/business services only in the past few years.

Once the new policies were clear and a peaceful national consensus was established, foreign investment came in a strong spurt from 1983 to 1990. Investors from Hong Kong and Taiwan brought know how essential for the development of the textile/garment industry. Local investors, mainly Franco-Mauritian with some Sino-Mauritians, welcomed them and openly sought to learn from them. While local investors had surplus capital to invest, they did not have the know-how to establish manufacturing industries such as textiles. They took advantage of the opportunity to learn from the foreign investors, and within a few years, they ended up buying out most of the foreign owners.

6.2.3 Foreign Investors

6.2.3.1 The 'Pull Factors'

The success of Mauritius in attracting foreign investment in the mid-1980s rested on creating the right economic and social climate by emphasizing the following factors:

- **Political stability and policy consistency**

Governments in Mauritius have changed several times since independence, without violence and without changes in investment policies. The long term strategy, the overall vision and economic policies have become increasingly stable and pro-investor. Investment incentives have gone from favorable to even more favorable.

- **Sound Institutions**

Sound institutions have been shown to be the one factor that can outweigh the negative influence of ethnic diversity on economic policies and economic growth. (Easterly and Levine 1996) Mauritius inherited a unique set of sound legal, financial and educational institutions at independence and has resisted the institutional deterioration experienced in most African countries. Mauritian institutions had French underpinning with a British superstructure. Napoleonic Code, for example, was overlaid with British common law and courts.

The unique constitution provides for ethnic and geographic balance in Parliament. Single member districts elect 62 of the 70 seats. This system favors local accommodation between representatives and their constituents of all ethnic origins, unlike the polarizing proportional representation system. In addition, the Mauritian constitution provides for up to eight seats to be awarded to ethnic minority candidates who place “next best,” if their group is not otherwise represented in Parliament.

A French patois is the lingua franca and formal French is taught in the schools, but the main language of instruction is English. At independence there was 70 percent literacy, generally in both English and French. Hindi, Urdu, Tamil, Tulugu, and several Chinese languages are spoken. Written literacy in these languages is less widespread, but the availability of native speakers of investors' own languages has made a wide range of investors feel comfortable in Mauritius. In the early years, basic literacy was sufficient. Today factory owners are pressuring the government to provide higher quality, better-targeted vocational and technical education.

A single bank served the island at independence, but it was a sound one, providing a range of financial services since 1828. Investors trusted their funds to it, and sometimes also benefited from local credit. Financial services today are comparable to the level in South Africa, a vastly larger economy. A wide range of supporting services including commercial, development and investment banks, insurance companies, auditing, accounting and consulting firms has developed to serve the new industrial economy. Mauritians use credit cards freely, whereas many African businesspeople lack access to credit cards. Automatic teller machines outside major banks provide cash and accept deposits after hours. These facilities reduce transaction costs, which is greatly appreciated by investors.

Economic development literature also emphasizes the importance of respect for private property rights and an efficient and honest bureaucracy. On this score Mauritius gets mixed results. There has been no history of expropriation and no evidence that investors had been required to give a percentage of their business to government officials, as happened in other African countries. On the other hand, two or three cases were found where major investments were abandoned at a loss by the original foreign investors. It was beyond the scope of this paper to investigate all of the reasons, but there clearly were some quite disappointed investors.

Business integrity can also be considered an institutional factor. Mauritian firms regularly publish audited accounts. This contributed to the trust necessary for government to allow an island-wide EPZ, and for banks to sustain the credit system. This basis for mutual trust is an important missing element in many business communities in Africa.

While the high rate of literacy provides a skilled labor pool for the civil service, surveys ranking the government on a number of indices indicate important shortcomings in overall effectiveness. The 1998 African Competitiveness Report for the World Economic Forum provides the most recent survey data, which is summarized for key countries in Table 6.4. (See Annex)

- **Cheap, trainable labor force**

In the early years, that is, before the investment boom, there was massive unemployment. Labor was therefore cheap compared to places like Hong Kong and Taiwan where the 1980s wave of investors in Mauritius originated. The adaptation was not simple, as Mauritians were initially slow in assembly line work and unreliable in their attendance. Factory owners use many combinations of carrot and stick to enhance their productivity. Some are trying team approaches to production. Several factories reported that they intersperse along the assembly line experienced Chinese workers, whose output is often three times the Mauritian average. They also bring in Indian workers with multiple task skills to fill in for absentees in different spots each day. After a few years, production reached an acceptable level of both productivity and quality in most factories. Several succumbed, however, during the early years. In those who survived, skilled contract Chinese and Indian laborers are still an important stimulus to productivity.

With a literacy rate of over 90 percent and most of the labor force having at least attended primary school, Mauritian workers could be trained relatively easily, especially as most of the techniques of production in sectors being targeted (textiles) were simple and labor-intensive. The firms benefited greatly from sales and office staff who were fluent in both Asian and European languages. Much credit goes to the good quality schools, in which students learn both English and French in addition to their mother tongues.

- **Good economic management**

After 1980, the government created a sound macroeconomic environment through judicious blending of policies. Inflation was kept at a low level and monetary policy was geared towards promoting a savings culture. The Rupee is convertible and the exchange rate against other currencies has devalued only slowly.

- **Infrastructure**

The Mauritius Government invested heavily in infrastructure. This involved the overhauling of the road network, the airport, extension of the telecommunications, electricity and water network. Fully operational industrial estates provided sites and services for lease, to minimize investors' start-up costs.

Mauritius Telecom has been one of the last to be privatized, so there is little competition in the sector. Nevertheless, it has consistently modernized and reduced costs of service.

- **Preferential market access**

Mauritius has preferential access to the European market through the Lomé Convention and Sugar Protocol and to the US through the Multi-fiber agreement. It also has a sugar quota with the United States. During the 1980 and early 1990s it joined the so-called "frontline states" surrounding South Africa in ignoring sanctions, for the sake of its own economic survival. This proved a boom, as South Africa became a major trading partner and source of tourists. Membership in regional economic cooperation groupings such as SADC is an advantage on which Mauritius is counting for the next phase of development.

- **Investment incentives and promotions**

Hong Kong investors described actively surveying potential investment sites. Most were eliminated after considering the above factors. When the final selection time came, investment incentives determined their choice of Mauritius from among the last two or three candidates.

- **The people**

The multi-ethnic, multilingual nature of Mauritian society has been an asset in providing a welcoming and friendly investment environment to foreigners. In particular, the Mauritians of Indian and Chinese origin have provided an environment which is 'home-like' to investors especially from India, Hong Kong, China and Taiwan. They feel safe, accepted and can trust the people around them while in Mauritius.

- **Strategic use of its location**

Mauritius has turned its lonely island location into a “gateway to Africa” in its promotional literature. Its first success came in attracting South African stopover flights and tourism during the sanctions period, when South Africans had nowhere else to go between home and Europe. For the textile industry, Mauritius’ location was an acceptable halfway between headquarters in Asia and markets in Europe, although without strong push factors, it is doubtful that they would have sought it out. More recently Mauritius’ offshore banking arrangements have targeted investors from India and Europe interested in the advantages offered by bilateral double-taxation treaties. Mauritian policy-makers believe that it can attract a significant volume of shipping by encouraging ships with containers full of Asian goods to stop and repackage mixed shipments for different African countries. This is a new concept and new facility, currently operating well below capacity.

6.2.3.2 The 'Push Factors'

Mauritius’ success is due in no small measure to alertness and ability to respond to external global events. This capacity for quick response is the newest new thing in strategic planning. Having indigenous leaders with close ties to Asia and Europe allowed Mauritius to understand and integrate lessons from the trends in each before the age of instant cheap global communications. The key events for Mauritians were the British decision to hand over Hong Kong to China and the international Multifiber Agreement, which together sent Hong Kong industrialists searching for new havens for capital and textile industry production.

- **The Sino-British agreement over Hong Kong**

When in 1985 Prime Minister Margaret Thatcher signed an agreement to end British rule over Hong Kong in 1999, and relinquish it to communist China, Hong Kong capitalists felt insecure. There was an atmosphere of uncertainty over what would befall

Hong Kong after its handover. Business people in Hong Kong were looking to diversify, if not relocate.

- **The Multifiber Agreement**

In the early 1980s, the multifibre agreement was signed and US further tightened its quota of textiles from Hong Kong and Taiwan. The overseas Chinese textile barons saw an opportunity to take advantage of the Mauritius unfulfilled US quota and the preferential textile market access to European market.

Hong Kong and Indian investors reported studying alternative investment locations, such as Madagascar and Sri Lanka which were also providing EPZ facilities. Madagascar had inadequate infrastructure and a poorly educated population, while Sri Lanka was riddled with insecurity due to the Tamil Tigers rebellion. Madagascar was considered unsafe and had unfavorable government policies towards investment. Mauritius offered a safe enclave with the people of the same cultures and way of life.

- **High labor cost in Hong Kong**

By the mid-1980s the maturing textile industry in Hong Kong and Taiwan was seeing wage pressure. In Mauritius, with its high unemployment, they hoped to find cheap labor that might be as efficient as that in Asia.

6.2.4 Local Investors

The factors that attracted foreign investors were equally import to local investors. However, local investors had additional considerations that served to catalyze their new investments in the 1980s. Among these, were the following:

- **Need to diversify**

A number of sugar barons had capital available for investment in the 1980s, and they knew better than anyone the concentrated risks of a monocrop economy. Moreover, new sugar investment was precluded by lack of land. They tried many non-traditional agricultural exports, such as cut flowers grown in ecological microclimates. Once shown the way by foreigners, however, they started reinvesting the sugar profits in textiles, and later tourism and other types of light industry.

- **EPZ scheme and government incentives**

Local investors seem to have been more motivated by the EPZ advantages than foreigners, perhaps because their economic activities were rooted in Mauritius. They could quickly calculate that having a significant—and possibly fluid—portion of their assets in tax-free corporations should be good business.

- **Local bank lending**

Banks played an important role in bringing up local investors by providing them loans at attractive rates. The State Bank of Mauritius, founded in 1828, was the mainstay of investment banking in Mauritius, although in recent years a half-dozen new banks have entered the scene. Local investors could finance up to 80 percent of their investment. Foreign investors could finance 50 to 60 percent locally. Interest rates at the time of the field research in October 1997 were 9-10 percent on long term loans.

- **Local population linkages with Europe, India and China**

Local investors could access the required technology, entrepreneurial skills, start-up capital and markets through linkages with Europe (France and Britain) and Asia.

- **The potential in tourist industry**

The Mauritians either working in hotel industries previously owned by foreign firms or wanting to break away from the monocrop culture identified tourism as a potential sector with growth prospects. Because of the land laws and local political influence, they had an edge over foreigners in acquiring plots along the beaches. The sugar barons, in the drive to diversify, started investing in the hotel industry.

- **Historical factors**

Many Mauritians credit the grit of immigrants for the national success. Immigrants in general develop a strong instinct to survive and have a spirit of adventure. Immigrants generally leave the motherland with the hope and determination of a better life. They arrive in a new land with all energies mobilized for survival, as there is little social safety net. Therefore the spirit of excelling is inherent in their lives. The fact that no group can claim territorial rights also helps blunt the edge of ethnic sentiments.

6.3 Linkages between Foreign and Local Investment

6.3.1 Linkages between Foreign and Local Partners

Local and foreign investors have been present from the start in both main sectors of economic diversification in Mauritius, industrialization and tourism. In most areas of both industrialization and tourism, local investors preceded foreign in the first efforts, but the real boom began when foreigners took the lead. Foreign investors had the technical manufacturing knowledge, factory management know-how and market contacts needed to succeed. Local investors were interested from the start, however. They brought land, management capability and capital to the table.

Similarly in tourism, there were some locally owned hotels early on. The real growth spurt, however, came when Sun International, then a South African based chain, brought international standards of architecture, services and entertainment to the business. They were a minority partner, Mauritian sugar interests having provided the majority of the capital and access to the land, but Sun managed the first luxury hotels. Local hotels quickly began innovating themselves, raising the overall quality in the sector. Today the most recent and most luxurious hotels are Mauritian owned and managed.

The EPZ law was passed shortly after independence, but many of the first industries catered to import substitution for the local market. At the end of the first decade there were only 100 EPZ firms. The import substitution industries were a good industrial apprenticeship for local investors, as the mass-market products produced required relatively simple manufacturing techniques, and quality was not at a premium in a protected market. Foreign investors were slow to decide on Mauritius in the first decade after independence, because its now renowned political and social stability was considered uncertain at the time. None knew whether the Hindu majority would nationalize land and industries or let the Franco-Mauritians and Sino-Mauritians continue to dominate the economy.

As exports industries began to expand in more complex and competitive industries from 1983 on, both local and foreign investors recognized that there was strong synergy between their enterprises. Kin and ethnic networks played an important role in forging viable partnerships.

Hong Kong manufacturers came looking for a safe haven for capital and quota-free access to markets. They knew the machinery, the factory organization, the worker training needs, and the customers' tastes. In fact they arrived with orders in hand. The first big firms, however, lacked sufficient confidence in Mauritius' social stability to transfer all of its operations here.

Purely local investors welcomed the foreign investors instead of seeing them as competition. Many local garment firms got their start doing commission work (cut, make up and trim) on shirt orders too big for a foreign factory to handle. They hired away skilled labor and managers from the foreign companies when they could. Buyers who came to deal with the foreign-owned firms stopped by to see what other factories were producing. Thus local firms acquired new customers.

The Fragile Early Years

Floreal Knitwear, one of the Island's current flagship firms, was established by Oriental Pacific Export (Hong Kong) in 1971 to do only manufacturing. Marketing was supposed to be handled by a Japanese firm. When that arrangement failed, Oriental Pacific sold out three years later rather than set up local marketing operations. Their successors believe that it was mainly because Mauritius was then experiencing a period of political tension, and that the investors feared for its future stability. In retrospect, they misjudged the political situation. The local firm created by the sugar interests which bought out Oriental Pacific has gone on to become a local and regional conglomerate.

Joint ventures were one means of collaboration, particularly at first. Today they are not the most common. Less than half of current foreign firms are joint ventures. Joint ventures are voluntary on both sides, and joint venture local partners always bring capital to the table. This is a major difference between obligatory joint venture schemes that have been tried, with little success, elsewhere in Africa. Often, in the latter, the capital subscribed by the African partner was a fiction—either lent him by the foreign partner or exacted as a political favor. Mauritius seems to have largely avoided this type of joint venture.

In the hotel sector similar relationships apply, although Mauritian investors have a strong advantage in their access to prime land. The sale of land to non-Mauritians is prohibited by law. Foreigners can overcome this by creating a local firm, which then has the right to buy land. In practice, however, most of the prime land for both tourism and industry is held by Mauritians. In the hotel sector one finds several hotels owned 80 to 100 percent by Mauritians but managed by foreign firms. There are also 100 percent foreign owned hotels, but they are not many and they report difficulty buying land.

6.3.2 Outsourcing/Jobbing

Many local firms reported that they got their start working on a contract basis for big foreign firms. When large firms have a rush order larger than they can handle, they commission smaller locally owned ones to cut, make and trim the pieces. The smaller firms reported that this is how they learned which models were selling and the quality of work that was required. The big firms would come work with them to ensure that the work was completed correctly. That way both they and their labor force received additional training.

6.3.3 Global Sourcing

The multiple ethnic linkages on the island created an instant international sourcing network before the age of globalization. The MEDIA spokesperson considers that Mauritius' garment industry has a major advantage over South Africa's much larger sector in this respect. South Africa's garment and textile industries are vertically integrated, which ties garment makers to high-cost mediocre quality fabrics in a limited range of styles.

In Mauritius, most of the local garment industry is knitwear rather than woven cloth. Knitwear involves several less steps than woven, as the fabric and garment are made in an integrated operation. Many knitting firms do their own spinning, getting their raw cotton mainly from India. Others source their yarn from India. Raw wool comes mainly from Australia and New Zealand, but specialty wools come from the UK. Dyes for both cotton and wool come mainly from Germany. Mauritian firms were able to compare global sources early on, and they quickly diversified whenever price/quality ratios change. In this area as well, local firms reported being glad to be able to learn from the bigger foreign firms.

There is some vertical integration in Mauritian textiles and garments, but it is at the high quality end and clearly mutually beneficial. Two ultramodern Mauritian textile firms produce shirting for garment makers supplying Marks and Spencers (UK) and other upscale firms. Both were created by garment makers working with top-end retailers seeking to integrate their operations upstream to ensure quality and availability. All of the woven cloth is sold to local garment makers, and demand exceeds capacity.

6.3.4 Training and Technical Assistance

Firms are conscious of the fact that they benefit from one another's efforts to train the workforce and from shared technical assistance. Technical assistants sent by a buyer to work with a large firm will sometimes also work with their smaller outsourcers. And all firms compete to recruit qualified personnel. Initially the Hong Kong firms provided much of the workforce training. At first they brought in line managers and most of a line of workers from Hong Kong workers to show the Mauritians the needed skills.

In the hotel sector, training has involved far less direct foreign technical assistance. The managers of Mauritian hotels, however, reported on-the-job experience working under foreign managers at local hotels.

6.3.5 Labor Force

In the early 1980s Mauritius was fifteen years into independence and still had 23-25 percent unemployment. Its one big advantage was that over 90 percent of adults were literate, and most secondary school graduates spoke both French and English. When the second wave of Hong Kong investors began to arrive in large numbers in 1984, they set up textile factories as they knew them, based on intense, rapid, accurate work at low wages.

Mauritius had a tripartite wage negotiation system, involving employers, unions and government. Government's votes came from the workers, but it seems to have helped them accept a gradualist approach, as the alternative appeared to be economic stagnation or decline. The unions swallowed hard and accepted. Alone in

Foreign Workers' Unique Role

There is a wide consensus among employers and government officials interviewed that Mauritian workers learn manufacturing skills quickly enough, but that they do not have the necessary persistence and speed to make firms competitive with Asian norms. They tend to work more slowly, resist overtime, take all of their 21 days of annual sick leave, and like their weekends and holidays.

Foreign workers have played an essential role in raising productivity. Both foreign and Mauritian firms customarily bring in foreign workers to work alongside the Mauritians. In the chain they speed up the work of the whole group. These "expatriate workers" as they are called, come on two or three year contracts. Employers must pay their round trip transport, lodging, food, cleaning services and work permits. Their total cost is double or more the wages paid a Mauritian worker, but a minority of such workers speeds up the whole line enough to more than compensate. Few African countries have been as flexible in their labor laws and practices as Mauritius.

the middle of the Indian Ocean, they saw no alternative. A little over a decade later the general consensus seems to be that it was a good arrangement on all sides. Wages started at 2 Rs per day, and have risen gradually to over 140 Rs per day in 1997. There is now full employment, despite a downturn in the textile sector in the late 1990s.

The labor force, initially almost entirely male, is now nearly equal in gender distribution. Women from conservative Hindu and Muslim families were not believed likely to move into industrial labor. The family benefits of having three or four instead of one wage earner quickly became apparent, however. Simultaneously, family planning took hold, and the population growth rate dropped from nearly 3 percent to just over 1 percent annually.

6.3.6 Mauritians Buy Out Foreign Firms and Hotels

The long-term goal of many foreign investment promotion programs is to see local businesses thrive to the point that they are able to buy out the foreigners. This may be a hidden agenda, but it is generally one element of nationalist sentiment whether or not it figures in official discussions. The role played by European, particularly British capital, in the industrialization of the United States is often forgotten today. It was not until World War I that the US was able to emerge as a creditor rather than a debtor vis-a-vis Europe. Mauritius is making this move much more rapidly. A number of the largest Mauritian textile/garment firms and hotels interviewed by the team had begun as joint ventures, or purely foreign firms, and been bought out by a local firm. Some foreign investors had also bought existing foreign or joint-venture firms. We asked why the original investor sold, and how and why the new firm was ready to take over. The answers involved many individual circumstances, but some major trends could be discerned. First was that foreign firms tended to have higher costs. Their expatriate managers were entitled to housing, transportation, schooling and travel allowances that were not customary for Mauritian managers.

Second was that Mauritians had a sharp learning curve. While Mauritian workers were learning to accept industrial discipline and pacing, Mauritian managers quickly mastered both the manufacturing and the managerial techniques necessary to succeed.

Capital availability and capital transfers were another factor. Sometimes local investors got a bargain. When a foreign investor went bankrupt and had to sell out, a fully functioning factory and labor force could sometimes be acquired for substantially less than the initial investment, with few start-up costs. Several of the investors we interviewed, both Mauritian and foreign, had worked their way up from the ranks in either the textile or hotel industries. They appeared able to both save capital and inspire confidence in local financial institutions. While on salary, they saved. When an industrial opportunity appeared, they were able to get bank credit to help them move into ownership positions.

6.3.7 Synergies between Industry, Local Commerce, Services and Tourism

The Mauritian economy grew rapidly within a few years of independence. In the early 1970s GDP growth accelerated from 4.9 percent in 1971 to an average of 11 percent over the next three years. Inflation immediately shot up, however, triggering a slowdown in 1975. By the late 1970s, when the EPZ began to flourish, it clearly led the next growth spurt. Its value added growth rate accelerated from 9.3 percent in 1977 to 25.8 percent in 1979. Again inflation rose rapidly, peaking at 42 percent in 1980 before dropping back the next year. For the last fifteen years it has fluctuated between 0.6 and 13.5 percent, with an average under 10 percent. The drop in inflation in 1980 is attributed to two combined external shocks: a worldwide recession and a very destructive cyclone in Mauritius.

At independence sugar generated 99 percent of Mauritius' exports. By the 1990s the EPZ surpassed sugar in export value, although sugar still generated more foreign exchange. The EPZ seems to have played several critical roles. First, it gave sugar factory owners an alternative economic activity, which carried them through agricultural crises. Second, it built confidence and increased wages in other sectors of the economy. As the population's average earnings increased, there was a larger local market. Commerce and business services grew. Third, it brought foreign investors, global business linkages, and new ideas that allowed Mauritians to modernize and helped build investor confidence in all sectors.

Since the late 1980s, tourism has also experienced accelerated growth. Again there are clear linkages between the EPZ and tourism. Buyers enjoy coming to Mauritius because it is a beautiful, safe, harmonious country. Tourists search for bargains (and find them) at factory outlet shops throughout the island, combining sight seeing with shopping. They often leave with bundles of Anthurium flowers, for which they have become a major export outlet.

Tourism has created substantial growth in local construction and commerce. All hotel managers interviewed reported buying construction materials, food and other supplies and accessories entirely on the local market. There is, for example, a well developing sector manufacturing and selling plumbing fixtures, cabinetry, carpeting, etc. Much of the materials are initially imported, but they pay duty and are sold on the local market. This generates revenue for both local merchants and the government.

Transportation services have developed to meet the needs of both the industrial and tourism sectors. Air Mauritius has negotiated agreements with selective other carriers (Air France, Lufthansa, Singapore Airlines, etc.). All, however, maintain high passenger tariffs--cheap charter flights are not allowed.

Shipping rates, especially for airfreight, are a controversial topic. Air Mauritius lost its position as the country's most profitable firm last year, with profits dropping to one tenth their 1995 level. Rising fuel costs were one reason, so it was just announced that freight rates would be "liberalized" and would rise. In a hegemonic market it is not clear what liberalization means. Air France announced the same rise in rates. Manufacturers argue that government must keep airfreight rates reasonable as a geo-economic strategy. Mauritius still suffers from the negative incentives of isolation and distance that make it difficult to remain competitive.

Mauritius opted for a full island EPZ rather than a segregated zone, for good reasons. It allowed manufacturers to locate wherever there were workers available. The time and cost of worker transportation that would have had to be absorbed by the industries, was thus minimized. Many workers do, nevertheless, travel across the island every day to work. A network of paved roads covers the island. Buses carry working class commuters to work. The elite have become accustomed to sitting in their cars through daily rush-hour traffic jams, shortly before 9 a.m. and at 4 p.m.

Communications are quite good both within Mauritius and between Mauritius and the rest of the world. Mauritius Telecom, which has a monopoly, has modernized at a reasonable rate. Costs are still quite high, and MT alternates with Air Mauritius as the country's most profitable firm. If Mauritius seriously wants to enter the informatics field that is one of the new focus areas, it may have to pay more attention to cost cutting than to profits from telecommunications.

6.4 Post Industrial Mauritius

Mauritius' industrial expansion slackened and then stagnated in the early 1990s. Firms found they were losing their competitive edge as labor become more expensive. This brought several responses: 1) a focus on productivity, and much experimentation with new technologies and management approaches to achieve it; 2) regional expansion in search of lower-cost labor areas for basic production, 3) new niches—high tech industries, off-shore businesses, and free port services.

Mauritian investors in textiles, sugar and hotels are currently branching out, or "delocalising" as they call it. The bigger groups are moving some of their investments to neighboring countries, chiefly the "Big Island" of Madagascar. Labor costs have risen continuously, and Mauritius is no longer a cheap labor country. Textile and garment makers cannot compete with Bangladesh, China, Viet Nam and other cheap labor countries in producing basic mass market T-shirts and moderate quality garments. Madagascar, Mozambique, and other SADC countries, however, still offer this possibility. Some firms are therefore transferring their "basic" garment production to low-wage countries and keeping their higher quality manufacturing here. One firm even has its production line in Madagascar on a computer network so that the progress of each order can be checked in real time. Marketing, design and financial management functions remain in Mauritius.

The Pioneer Zone legislation and high-tech industrial parks built since 1995 have not been an immediate success—but then neither was the EPZ. The PZ framework has attracted a few precision-tooling firms, but all seem to be quite small. The info-tech wired industrial parks sit more than half empty. It is difficult for the small group of Mauritian techies to stay on the cutting edge of information technology because the field moves so fast. With telephone services costing many times their US prices, the small group of Mauritians trying to keep abreast through the Internet has a daunting task.

Mauritius started offering offshore banking, trading and financial services in 1992. By 1997 6000 firms had taken advantage of this opportunity. Most had no more than a post office box and a bank account in Mauritius, but demand for financial management and auditing services increased.

Mauritius added freeport facilities as an option at about the same time. The idea is that firms slipping from India or China to relatively small African markets would use Mauritius as a gateway and transshipment point. Ships can break down container-loads there and repackage them with assortments of different goods from several origins. 450 firms have registered for these facilities, although only 150 licenses were operational as of mid-1997.

Coopers and Lybrand, after announcing its merger with Price Waterhouse in September 1997, also announced that it would transfer its southern African regional headquarters to Mauritius. This gave a fillip to the gateway theory, which has many doubters among the local economic leaders.

6.5 Problems and Opportunities Investors Face Today

6.5.1 Shared Problems

By the mid-1990s, Mauritians began to realize that their first phase of industrialization was over. It was no longer a cheap labor country. For the same reason both traditional and non-traditional agricultural exports were in trouble. The sugar cane, tea and flower export industries all had depended on cheap labor. Per capita income was $500 a year in 1970, but reached $3500 by 1997. In terms of purchasing power parity it was $8,852 by 1999. (World Bank 1999)

Moreover, Mauritius' original geographic handicap in being located far from both suppliers and markets was accentuated by rising freight costs. Local industries and their customers were shifting from traditional production and stocking patterns to production on order, with just in time delivery. Processing time for orders has shrunk in the last few years. Garment makers used to have several months between the time they received an order and the delivery date. Now they have six to eight weeks, sometimes less. The result was increasing demand for airfreight. Not only was it costly, it was unavailable at critical peak periods. This seems to be the main factor behind the failure of fruit and vegetable export efforts, and has seriously hampered flower exporters. Only the longest lasting flowers are viable for export, and then only the lightest of those. The result is that a single variety (Anthurium) is exported: chrysanthemums, roses, and birds of paradise having failed.

When businesses began to fail in larger numbers than usual, a national rethinking took place. Private sector leaders seem to have provided the initiative, but government has taken a prominent role.

Exporters report that they no longer feel that they have strong and imaginative backing from government, as was the case in several previous boom periods. Efforts to streamline the bureaucracy have born remarkably little fruit. Fifty odd permits are required to set up in business. Some permits, notably work permits for expatriate workers, take several months (62 days on average, according to a productivity report). MEDIA claims to help investors through this process, but the basic ministerial housecleaning necessary to establish transparency, reliability and accountability clearly has not been done. Corruption enters the picture on a far lesser scale than elsewhere in Africa, but it is there. Business people say it is mainly to speed up the process, not to deny government revenues due it. But the delays create substantial transaction costs for businesses. Computerization of customs has been underway for a decade, and is not yet operational.

The Minister of Industry is creating a joint public/private commission to determine what procedures need streamlining. The approach he envisaged was for his ministry to centralize permit requests, giving other ministries and agencies no more than two weeks in which to raise an objection. This has been tried elsewhere with little success. Agencies that are thus by-passed become less co-operative rather than more. On the other hand, several countries have succeeded in creating real streamlining by doing internal government information needs analysis. When bureaucrats determine what information is really needed for what purpose and by whom, they can often agree on simpler ways of obtaining it.

Government and the private sector both say that they are moving into the “second phase” of industrialization. One industry leader admitted frankly that they do not know what this second phase is, only what it is not. Several themes have emerged, however. One is restructuring of both industry and agriculture to modernize equipment and become more capital intensive. The agreed targets are greater productivity and improved quality. One finds quality and productivity campaign posters in every factory. The best ones have gone to fully integrated production lines with mechanical movers, reduced factor returns to well below international norms, and begun producing exclusively for upscale clients.

Many smaller locally owned and managed textile and garment firms, however, are unable to make the transition. The failure rate has been high in the last few years, and is likely to continue increasing.

The need to reach out and diversify is particularly acute as the expiration of international sugar quotas approaches early in the new millennium. Sugar quotas and protected markets that have kept prices artificially high are due to be phased out. Mauritian sugar magnates are seeking to position themselves, reaching out to the African continent and elsewhere in search of new lands and processing opportunities.

6.5.2 Opportunities

Both local and foreign investors speak of tourism as the most profitable and promising sector. Arrivals are nearing 1 million a year. Occupancy rates are over 90 percent for luxury hotels, and close to 80 percent for mid-level hotels.

Foreign investors in industry today are mainly European, and are interested in higher tech areas such as watch-making, model boats, jewelry, electronics and information technology. These are typically smaller firms with less than thirty employees, compared to textile firms that range up to 4000 employees. Local investors are also going into the same light industrial areas, and doing well.

Textile and garment manufacturers are reaching a divide. Some have modernized, increased productivity and upgraded their product line. A few of these still want to make basic T-shirts, but they are doing it or plan to do it in SADC countries where labor is still cheap.

Financial services, offshore and freeport activities are new growth areas, but it is not yet clear what macro economic impact they will have. Financial services, including banking, insurance, investment consulting and accounting, provide employment for a rapidly growing cadre of Mauritian professionals.

6.6 Conclusions and Policy Implications

6.6.1 Conclusions

Mauritius' structural limitations—size, isolation and lack of resources continue to threaten its competitive position. Added to these is the rising cost of labour and the intensification of global competition. Mauritius faces formidable challenges to sustain its rate of development.

Ironically, the country's geographical disadvantages, which are evident to all, may have turned to an advantage, in that it provided a shared incentive to strive for development and minimize social conflict. The immigrant factor appears also to have tempered conflicts and created a striving mentality.

The country's implementation of a stabilization and structural adjustment program since 1979 seems to have paid dividends. The country recovered well from the deep macroeconomic disequilibria introduced by the misguided policies of the 1970s. From the mid-1980s to the mid-1990s the country experienced a healthy macro-economic performance, moving from a low income to a middle income country; confounding the expectations of dependency theorists and the statistical predictions of ethnic fragmentation theorists.

Since the 1970s, the structure of the economy has been transformed. The monocrop sugar economy actually laid the foundation for the industrial boom, by fostering local capital accumulation. Manufacturing is now one of two main locomotive of development in the Mauritian economy, accounting for 30% of GDP, 40% of the workforce and 42% of gross export earnings.

The textiles and garments sector, which dominates the country's manufacturing sector in terms of number of EPZ firms (66%), EPZ exports (82%), total exports (57%) and employment is progressively adjusting to rising costs of labour and increased future competitions implied by the WTO Agreement. Its strategy involves increased productivity, modernization, shift to value added manufacturing, delocalisation, penetration of the COMESA and SADC regional markets and diversification into tourism sector and other emerging sectors.

Tourism and other services are the latest success story. By 1996 agriculture generated only 8 percent of GDP, industry 29 percent, and services 63 percent.

Despite its geographical disadvantages, Mauritius is becoming a world center of offshore activities. These take advantage of double taxation treaties, and make businesses comfortable with good accounting and consultancy services, sound financial and legal institutions, accommodating tourist facilities, and a reasonably efficient and reliable infrastructure.

Both local and foreign investment have been engines for growth in Mauritius. While local investors did precede foreign, the industrial push coincided with the inflow of foreign investment. Local firms welcomed the opportunity to learn by doing, and they eventually caught up to the level of the foreign investors. The incentives packages formulated by the government to attract foreign capital were also enjoyed by the local investors. Locals had the added benefit of the right to own land. Once local investors caught up in terms of know-how, they capitalized on this benefit. This can be seen in the fact that the majority of hotels are locally owned, even if the investor is foreign. In summary, it can be said that foreign investment did indeed act as a catalyst for local investment. As the local investors grew, they benefited from the same investment climate as well as added opportunities.

6.6.2 Policy Implications

Mauritians in the public and private sectors have done some extraordinarily creative thinking about their economic situation and the policies most apt to accelerate development. They enjoyed extraordinary success in the 1980s with export-led growth. Overall, they seem also be exploring appropriate responses to the challenge of transition to a second phase of economic growth, although implementing them has not yet fulfilled its promise.

Two neglected areas of policy and practice continue to create obstacles to renewed growth. One is an artificially high cost of transport and telecommunications, and the other is bureaucracy--complex, time-consuming government procedures. Investors, both foreign and local, complained strongly about both. One wit suggested that the campaign to enhance productivity ought to be applied first and foremost to the government.

In the short scope of this study, there was no opportunity to study the transportation and telecommunications sectors closely. In these critical infrastructure sectors government has kept monopoly or monopsony control, and delayed privatization. Both air and surface freight rates are maintained higher than necessary by government policies. These include, for example, payment of royalties and exclusion of firms likely to undercut Air Mauritius. The privatization measures being discussed under the BOT law would allow private construction of infrastructure and its future transfer to government.

Initially the team did not know how seriously one should take complaints about the bureaucracy. Business people worldwide complain about red tape. It seemed that a government so motivated and out front on policy reform must have speeded the issuance of permits and other such transactions. Not so. Many months are required to obtain the official list of permits necessary to set up in business.[13] The process of expediting airfreight requires entrepreneurs to cross the island to the airport and spend most of a day there. As elsewhere, there is talk of a one-stop shop in MEDIA and/or the Ministry of Commerce and Industry. In fact, MEDIA seems to be what investors elsewhere have come to refer to as a “one more stop shop.” Neither it, nor the Ministry has the authority to issue the required permits. If they are not forthcoming, the investor must follow through personally. This is also the major stumbling block for potential foreign investors who abandon the process. We were told of several who had abandoned after more than a year, without finally investing. Others invested and sold out before they were able to earn a profit. We were not able to obtain a conversion rate of applications to actual investments.

[13] One useful service MEDIA provides is a full list of required permits, together with the contact information for offices where they can be obtained. (MEDIA: *Destination Mauritius,* Appendix.)

7. FOREIGN AND LOCAL INVESTMENT IN UGANDA

Uganda was chosen as a case study partly because of its turbulent history with investors, in contrast with Kenya and Mauritius. There was also interest on the part of government, private sector groups, donors and researchers because of recent renewed interest in investing in Uganda by both foreigners and locals. The Ugandan and Kenyan cases, moreover, pick up themes of immigrant ties, domestic capital, ethnicity and institutions. Many of the same factors are present here as in Mauritius: British colonial rule, Indian and European immigration, and early domestic capital accumulation through agriculture and commerce. Uganda and Kenya, however, had large indigenous populations who fully occupied the arable land, and had a strong sense of territoriality. Indian immigrants in East Africa were rarely involved in agricultural labor, as they were in Mauritius. Rather, they were established as traders before and during British colonial rule, dominating first domestic commerce, then industry. Those who came as plantation labour quickly moved into commercial occupations. East Africa also differs from Mauritius in that it lacks the Chinese connection.

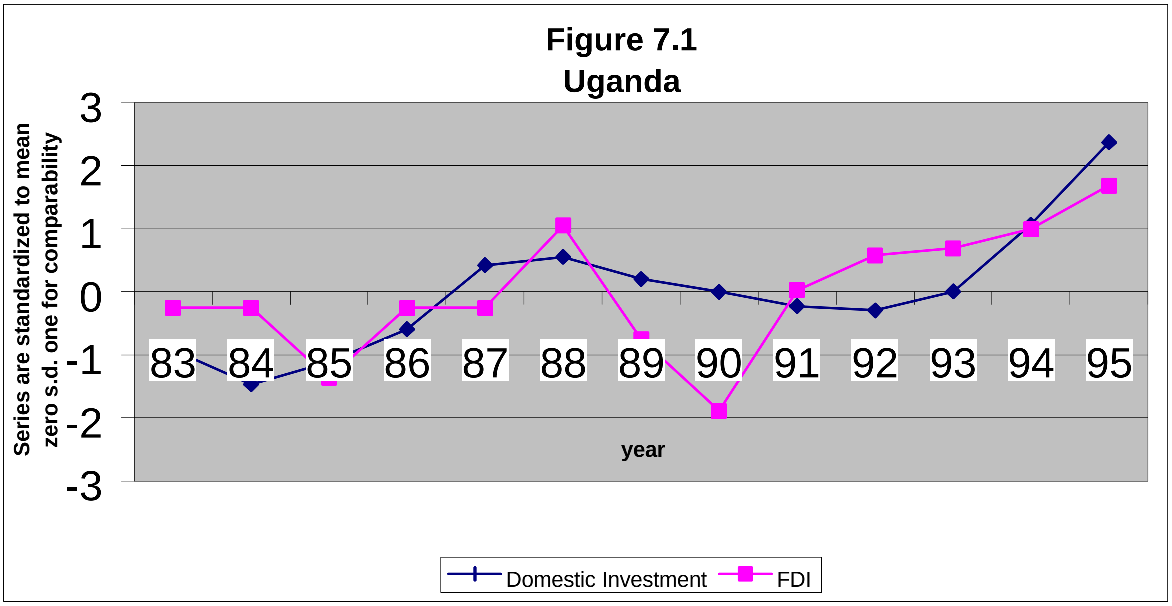
7.1 An Overview of Investment Policy and Performance in Uganda

The fate of investments in Uganda has oscillated through four phases, namely, the post-independence period up to 1970, the 1970s, the 1980s, and 1991 to-date. After an initial period of investment growth, government policy turned gradually turned against investors. At the nadir many investors of Asian origin were forced to flee the country and their enterprises were nationalized. Communal violence and arbitrary despotism destroyed the investment climate. Since 1991 government has worked to rebuild investor confidence and resurrect the economy.

Partly because of the disarray in Uganda during the 1970s, data on investment are only available beginning in 1980. Figure 7.1 below shows quite clearly that prior to 1990, both foreign investment and domestic investment were below average. It was only after 1990 that FDI picked up in Uganda[14].

[14] Because of the negative FDI numbers, we cannot use logs to compare the two series. Instead, we standardize both series to mean zero, standard deviation one by subtracting the mean from each year's investment figure and dividing by the standard deviation.

Figure 7.1: Uganda



7.1.1 The Post Independence Period Up To 1970

Before independence, particularly in the 1950s, Uganda enjoyed an investment boom led by both British and local Asian owned firms, and promoted by the colonial government. At that time, financing of development projects in Uganda came mainly from the British government which was the colonial authority. When the country became independent in 1962, the government had to look for alternative sources of funding including FDI and aid for her development programs. The newly independent government's attitude towards FDI was clearly demonstrated in the Uganda Industrial Act 1963, which put emphasis on the promotion of both foreign and local investors.

Independence marked the transfer of political power to the indigenous majority. It marginalized politically the Britons and Asians who elected to stay on. Unlike Mauritius' constitution, there was no provision for minorities. There was a widespread popular expectation that the wealth would also transfer to indigenous hands. But how, and to whom, were hotly disputed questions.

Government strategy sought to promote industrialization at the expense of agriculture, viewing the former as creating more salaried employment, having both backward and forward linkages, and a potential to create markets for the other sectors. Government role in industrialization process of the country was enhanced by the Uganda Development Corporation (UDC) formed by the British in 1952. A few local Asian private investors like the Madhvani and Mehta groups boosted the industrial growth of the country in the post independence era, as they had earlier. Early in the independence period, however, the state also began competing with private investors by creating state corporations.

The legal protection for FDI against compulsory acquisition by the state and rights to repatriate capital, interest and dividends were provided under the Foreign Investment (Protection) Act, 1964. However, this did not stop the government from slowly moving towards the nationalization of foreign investment in subsequent years. Towards this end, the UDC which was meant to start investments with big capital outlays and then sell them to private investors was given a legal right to control 51 percent in some of the businesses it had started and this included such projects like Tororo Industrial Chemicals and Fertilizers (TICAF), Uganda Cement Industries (UCI) and Nyanza Textiles Industries Limited (NYTIL).

The biggest step towards nationalization, however, came under the 1968 Common Man's Charter, which was viewed as a socialist stand. At this time the economy was predominantly controlled by a few British-Asians, who owned the commercial and industrial sectors of the country. Under nationalist pressure to open up opportunities for indigenous African Ugandans, government began to view this as unsustainable and therefore requiring change. The Common Man's Charter was followed by the 1970 Nakivubo Pronouncement, which spelt out strategies to implement the former. The Nakivubo Pronouncement increased government controlling interest from 51 percent to 60 percent in major private companies and manufacturing firms and excluded private enterprises from external trade. Foreign investors were not happy with this development. The business situation became tense and all indicators pointed towards political change. And indeed, in January 1971, the civilian government was overthrown by the army led by Idi Amin.

Who is a Foreign Investor?

International statistics on foreign investment follow one set of definitions of foreign investment. Local politics often provide another. If capital is locally held, investment is domestic by now standard statistical definitions. In practice, however, citizenship was a confusing question at independence, especially for minorities.

East African Asians, whose families settled in the area over the millennium of Indian Ocean trade, and moved into the interior in increasing numbers under British colonial rule, fall into definitional limbo. They were generally born in East Africa and had accumulated their capital there. After independence many initially kept British passports, sensing the precariousness of their position amidst the nationalist sentiment.

Many East African Asians had no passports, and found themselves rejected by Uganda, Britain and India when communal violence broke out in 1972. Tanzania nationalized Asian firms at about the same time. Kenya was the closest point of refuge, although it also enacted legislation in the sixties and seventies limiting trading to citizens. This forced some Asians into industry. Others left or coped by seeking obscurity and accommodation.

Today many East African Asians have acquired local citizenship in Kenya, Tanzania and Uganda. They still may be referred to as “foreigners” in opposition to the Kiswahili term *wananchi* meaning countrymen.

7.1.2 The Amin Era: 1971 to 1979

This period was marked by the 'Economic War' of 1972. The ultimately disastrous outbreak of economic and ethnic frustration resulted in the expulsion of the British-

Asians, expropriation of the assets and businesses of foreign investors, mostly Asians, and eventual collapse of the industrial and commercial sectors.

Immediately after the coup, the military government under Idi Amin revoked the Nakivubo Pronouncement which provided for 60 percent share-holding and reverted to 49 percent in some industries. But this was followed by the 'Economic War' which resulted into the complete nationalization of industries and other businesses belonging to foreigners. Some businesses were given to Ugandans to manage while others were put under UDC and government ministries. That marked the beginning of more chaos to come.

The investment climate for foreigners in Uganda during this period was quite hostile. For instance, the problems of political instability and insecurity, nationalization, the collapse of East African Community, were compounded by the requirement that a foreign investor be naturalized as an Ugandan to do business in the country! Failure to meet the set rules was considered sabotage and was liable for severe punishment that ranged from executions to deportation. So in effect, FDI was outlawed! The Ugandans who took over lacked capital, expertise and connections to continue, and the commercial and industrial sectors virtually collapsed.

There were shortages of almost everything. This led to price hikes. The country lacked foreign exchange and creditworthiness. Subsequently, even the military government began to realize the importance of FDI and tried to revive it through the 1977 Foreign Investment Decree, which exempted a foreign investor from import duty and sales taxes on plant and machinery for investment in an approved enterprise. The exemptions were not retrospective and only applied if the investment exceeded US$ 571,000[15]. Investors were reluctant to risk their money at that time because Amin was always unpredictable, so FDI continued to elude the country. The legacy of the military junta during this period haunted the country for a long time, driving away potential foreign investors.

There was also the problem of overvalued currency. An unrealistic exchange rate undermined investments by inflating the cost of imported inputs, equipment and spare parts. It had a negative impact on all investors' capital structure that included foreign hard-currency obligations. Access to foreign exchange at the official rate was strictly rationed. Delays and/or failures to obtain official foreign exchange in sufficient quantities had serious cost implications on companies. In an attempt to resolve this problem, many firms resorted to purchasing foreign exchange on the parallel markets, where they paid a premium rate.

7.1.3 The Attempted Recovery of the 1980s

The military government was overthrown in 1979. Although an elected government came into power in 1980, foreign investors remained wary of the country, mostly on account of

[15]1977 exchange rate was approximately US$ = 8 Ug. Shs.

past expropriations of foreign investments. Uganda's landlocked position and high costs of transportation and energy were also factors. The ratio of FDI to gross fixed capital, which measures the importance of inward FDI to an economy, was negative 0.2 between 1981 and 1985 compared to a ratio for tropical Africa as a whole of 2.3 during the same period (World Financial and Statistical Tables 1995). In order to correct this bad image, a bill was presented to and passed by the parliament to return the properties of the foreign investors. However, it was not implemented until 1990 by a new government under the National Resistance Movement (NRM).

The state and structure of enterprises by 1989

A 1989 Census of Industrial establishments the manufacturing sector revealed a classic "Import Substitution" industrial structure. Manufacturing is dominated by consumer goods industries. Industries producing foods, including sugar, beverages and tobacco, accounted for about 28% of the total number of industrial establishments and employed 45% of the labour force. The intermediate goods and engineering industries engaged in steel making, production of tools, hardware and metal products accounted for only 18% of the total establishments and employed 7% of the labour force. Textiles, apparel, leather and footwear accounted for 9% of the total establishments and employed 17% of the labour force.

Small scale and cottage industries play a prominent role in the manufacturing sector (Table 7.1). They account for almost 77% of the total number of 1,746 enterprises surveyed in 1989 although they employ only about 26.6% of the total manufacturing labour force of 62,555. The medium and large scale industries employing more than 36 people account for only 16% of the total manufacturing establishment.

The major weakness of the manufacturing sector is that there is little horizontal and vertical integration within and between the small scale, the medium scale and the large scale enterprises.

Production is characterized by duplication of efforts leaving idle capacities unutilized. This lack of vertical and horizontal integration has resulted in the virtual absence of the necessary forward and backward cross-sectoral linkages to forge national self-sustenance of the manufacturing sector. This would be possible, for example, through sub-contracting by large firms to small scale firms.

Table 7.1: Size distribution of manufacturing firms

Employment Group	No. of Firms	%	No. of employees	%
1-05	328	19.0	1,430	2.3
6-10	524	30.0	4,150	6.6
11-20	378	21.9	5,190	8.3
21-35	213	12.3	5,859	9.4
36+	285	16.5	45,926	73.4
Total	1,746	100.0	62,555	100.0

Source: Directorate of manufacturing establishments, MOIT, 1989.

7.1.4 The Period from 1991 To Present

The National Revolutionary Movement government which came to power under Yoweri Museveni in 1991 has reversed the downward trend in FDI inflows. The NRM government undertook a number of steps to restore the economy and promote Uganda as an investment location. Among these efforts, at the macroeconomic level, were wide ranging economic policy reforms such as foreign exchange rates reforms. Other measures have included the liberalization of the monetary and trade policy framework, the simplification of administrative procedures applicable to foreign investors, the conclusion of bilateral investment protection and promotion treaties, and accession to various multilateral treaties providing guarantees for international investment.

The Investment Code 1991 is the law governing investment in Uganda, which replaced earlier statutes relating to foreign investments, namely the Foreign Investment Decree 1977 and the Foreign Investment (Protection) Act 1964. Privileges and property rights enjoyed under previous legislation by holders of licenses were to continue and were to be reviewed under the Code. The mainly Asian owners of expropriated firms were invited back to reclaim and restart their firms. This proved a fillip to a much wider group of investors, giving them also confidence in the new government's seriousness.

The Investment Code 1991 provided for the creation of the Uganda Investment Authority (UIA) to facilitate the procedures for those interested in investing in the economy. It is a one-stop-center for investors.

The broad function of UIA is to promote, facilitate and supervise investments in Uganda. Specifically, among others, the functions of UIA include:

(a) to initiate and support measures which shall enhance the investment climate in Uganda for both Ugandan and non-Ugandan investors;
(b) to promote investment in Uganda through effective promotional means;
(c) granting approvals for the commencement of new businesses;
(d) to provide and disseminate up-to-date information on incentives available to investors;
(e) to assist incoming and existing investors by providing support services; and
(f) to recommend to the government national policies and programs designed to promote investment in Uganda.

In order to encourage foreign investors, a number of investment promotion missions have been organized abroad—the USA, Europe, India, Thailand, South Africa, etc. to explain the trade and investment opportunities available in Uganda, especially in agro-farming, fishing and forestry, minerals, power generation and tourism. Attractive incentives have been provided to prospective investors as well.

A survey of actual and potential foreign investors shows that reform of regulatory and incentive environment has made Uganda more attractive to investors than many African countries. The Heritage Foundation (a research center) in Washington DC in its

December 1996 Report, 'Index of Economic Freedom', published in the Wall Street Journal, ranked Uganda as number 64 out of 150 countries.[16] The ranking is based on the comparative analysis of economic freedom of a country in ten key areas, including: trade and taxation policy, wage and price controls, government consumption, monetary policy, capital flows and foreign investments, banking policy, property rights, regulations and the black markets.

Thus, although Africa's share of FDI flows to developing countries dropped from 11 percent in 1986-1990 to 6 percent in 1991-1993 and down to 4 percent in 1994, the upward trend of investment flow into Uganda is a promising indication of the newfound confidence in a greatly improved political economy. Table 7.2 provides the planned investment during the period 1991-1997.

Table 7.2: Planned investment of UIA licensed projects (1991-1997)

	1991		**1992**		**1993**		**1994**		**1995**		**1996**		**1997**	
	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%	Amt.	%
Local	53	82%	147.3	30%	369.5	59%	163.3	30%	230.4	31%	217.7	26%	86.1	19%
Foreign	1.5	2%	142	29%	147.5	23%	224.6	42%	250.9	34%	307.6	37%	207.3	45%
Joint	10.3	16%	205.8	42%	113.9	18%	150.4	28%	265.5	36%	315.7	38%	163	36%
Total	64.8	100%	495.1	100%	630.9	100%	538.3	100%	746.8	100%	841	100%	456.4	100%

Source: Uganda Investment Authority.

[16] Kenya and Tanzania were ranked 75th and 89th places, respectively.

Table 7.3: Sectoral distribution of licensed investors by 1996

Sector	Local	Joint Venture	Foreign	Total	Foreign %
Manuf.	58	35	58	151	14.3
Food proc.	47	30	15	92	8.7
Real estate	66	29	43	138	13.1
Prof. serv.	46	40	54	140	13.3
Agric.	98	53	38	189	17.9
Mining	8	9	12	29	2.8
Finance	7	13	9	29	2.8
Forestry	20	6	14	40	3.8
Pharm.	16	8	9	33	3.1
Infrast	29	24	21	74	7.0
Textiles	10	6	13	29	2.8
Tourism	57	24	18	99	9.4
Trade	2	3	5	10	0.1
Total	**464**	**280**	**309**	**1053**	**29.3**
Share (%)	**44**	**27**	**29**	**100**	

Source: Uganda Investment Authority.

Table 7.4: Employment generated by skill 1991-1996

Sector	Local	Foreign	Total	%
Management	3286	1042	4328	5.4
Administration	3749	267	4016	5.0
Skilled/Tech.	16908	384	17292	21.6
Unskilled	54543	55	54598	68.0
Total	**78486**	**1748**	**80234**	**100.0**
Share (%)	**97.8**	**2.2**	**100.0**	

Source: UIA Survey of licensed investors 1997.

Table 7.5: Employment created by sector 1991-1996

Sector	Local	Foreign	Total	Foreign %
Manufacturing	4,483	229	4,712	4.9
Food process	5,428	159	5,587	2.9
Real estate	4,317	169	4,486	3.8
Prof. services	7,697	258	7,955	3.2
Agriculture	36,828	343	37,171	9.2
Energy/mining	2,635	95	2,730	3.5
Fin. Services	905	79	984	8.0
Timber/forest	1281	69	1,350	5.1
Pharmacies	484	24	508	4.7
Infrastructure	8,563	105	8,668	1.2
Textiles	1,793	41	1,824	2.2
Tourism	3,928	168	4,096	4.1
Trade	154	9	163	5.5
Total	**78,486**	**1,748**	**80,234**	**2.2**
Share (%)	**97.8**	**2.2**		

Source: UIA Survey of licensed investors 1997.

Various in-house UIA surveys taken in 1993, 1994, 1995 and 1996 all had proposed/actual conversion rates between 38 and 40%. Breaking down the investment into years is difficult as most of the inflow is incremental over years and hard to trace with the somewhat unsatisfactory techniques of the UIA surveys.

While the above trend is encouraging, it is essential to note the wide disparity between the licenses granted to proposed investments and the actual investment on ground. The UIA promotional literature and independent assessment of Uganda's investment climate only observe the planned investment figures without showing the reality of the situation on the ground. The average conversion rate of approximately 38% is very low in relation to other developing countries outside of the Sub-Saharan Africa.

Explanations proposed for this low conversion rate include the hesitancy of investors, who may use a hedging strategy[17], the difficulty in passing through the discouraging bureaucratic impediments before implementation can commerce, and the investors discovery of the difference in the rhetoric of the promotional agency and the reality of the business environment encountered after the initial license is obtained. Each perspective has validity. The hedging strategy is when foreign investors obtain licenses yet continue to wait for further proof of stability before actual implementation takes place. They want

[17]Foreign investors obtain licenses yet continue to wait for further proof of stability before actual implementation takes place. They want to secure the incentives and the right to invest but want to gain more assurance about policy consistency before beginning. This may be a viable strategy for investors based in nearby Kenya or Tanzania, but for those from overseas it would make little sense. The initial time and costs invested would be unproductive, and the money would have been better spent on more dynamic opportunities.

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The sources of inward foreign investment coming into Uganda do not reflect the traditional domination of large Western multinational corporations (MNCs). Among investors looking to invest in East Africa, a slim 15 percent are major MNCs. (Economist Associati 1994)[18] Table 7.6 shows the sources of FDI into Uganda.

Table 7.6: Sources of licensed inward FDI into Uganda (as of June 1997)

Sources	**Number of FDI**	**Percent of Total**
UK	474	28
Kenya	283	17
India	219	13
Canada	136	8
South Africa	17	1
Others	586	34
Total	**1715**	**100**
From African Countries	425	25

Source: UIA, Operating Summary, June 1997.

The FDI coming from UK, Canada and Kenya can be misleading. Many of these investors are in fact Asians forced to flee Uganda in 1972. The Uganda business sector before 1972 was dominated by about 70,000 Asians, most of whom fled to UK, Canada and Kenya. The vast majority of FDI flowing into Uganda comes from firms with previous experience in Uganda or East Africa.

Investment serves one of the three general purposes: to extend vertical integration, to export to the region, or serve the domestic market. Typically, FDI exploits the raw materials and cheap labour of developing countries and exports abroad. Investment flowing into Uganda with little exception targets the domestic market. However, this trend is slowly changing.

The main sectors which attracted more investments in recent years are:

Manufacturing - (i) import substitution industries such as chemicals, cement, paints, etc.; and (ii) agro-processing, for example, food processing, edible oils, etc. UIA Survey of 1997 shows that most of the post-1991 investment is reportedly going into the manufacturing sector, which is accounting for 70% of on-ground investment. Ugandan manufacturers are largely producing import substitutes. About 40% of manufacturing investment has been agro-based. Overall, during 1991-96, investment has not been

[18]Economist Associati 1994, Vol. I, p. 12.

directed at export oriented activities. For example, just about 8% of manufacturing output was exported to regional markets in 1995.

Agriculture, forestry and fishing - dominated by coffee and rehabilitation of tea plantations; other non-traditional agricultural crop exports (in raw form or with minimal processing), fish products (now second to coffee in export earnings), floriculture and horticultural products, etc.

Construction and services - construction and renovation of hotels mainly for tourism subsector grew by 18 percent per annum during 1995, earning about US$90 million from US$73 million in 1994. The banking and insurance industry also witnessed some improvement though based mainly in Kampala.

Of the above three sectors, foreign investments are concentrated mainly in manufacturing because of the problem with the agriculture. An obsolete, over protective law preventing foreign ownership of land and limited leasing opportunities prevents large-scale foreign investment in the agricultural sector.

In addition to manufacturing, much of the foreign investment can be linked to donor-related projects. Unfortunately, there is not much information on the foreign projects linked to donor subsidies. Donor supported investment has been in projects in infrastructure such as road building, non-traditional exports, etc.

7.2 Factors in Investors Decisions

7.2.1 Negatives

- **Domestic and Regional Conflicts**

While central Uganda generally enjoys peace and security, this is not always clear from press coverage. The war in the North and western Uganda and the alleged involvement of Uganda in the civil war in neighboring Democratic Republic of Congo create an image problem for the country. Now with Internet communication and web-site facilities, information access is no longer a problem.

- **Energy cost and supply**

Inadequacies of the electrical grid and the high cost of fuel, due in part to taxation, were among the main complaints of business people. These are among the first factors foreign investors inquire about, as they affect every aspect of business. In a recent study of industrial competitiveness between Uganda and Kenya, Uganda ranked poorly on this index. (Siggel and Ssemogerere 2000)

- **Strength of the Uganda Shilling**

The appreciation of the shilling against the US dollars and other currencies has sharply eroded the competitiveness of Uganda producers of tradable goods while encouraging importers of finished products.

While the stronger shilling has reduced the cost of imported inputs, it has also meant lower prices for competing imports. Local manufacturers have therefore lost market share to importers.

The prevailing foreign exchange rate does not support local manufacturers and inhibits the promotion of exports in general. Uganda continues to have a large trade deficit.

- **Lack of capital**

The local investors in particular complain of acute shortage of working capital. This has arisen mainly because of the absence of a capital market through which the industries could float shares so as to mobilize the capital for expansion. This problem has also been aggravated by the weak banking sector, which is not investor friendly. For example, the lowest commercial interest rate charged is about three times higher than the inflation rate.

- **Inadequacy of utilities**

The competitiveness of Ugandan enterprises is seriously inhibited by unreliable, inaccessible and expensive infrastructure and utilities. The telecommunication system is poorly managed, plagued by poor billing, indiscriminate disconnections and expensive services. The high cost of electricity, coupled with irregular supply of power that sometimes blows up the machines constitutes a significant constraint to manufacturers, causing wastage, loss of revenue and use of expensive alternatives. Ugandan producers are paying a higher price for electricity than their competitors in Kenya, for example, while the state of their roads, telephones, water, etc. constitutes another cost disadvantage.

- **Taxation policy**

A good system of taxation combines fairness, simplicity and efficiency, ensuring that the tax structure and tax collection are transparent and that every tax payer knows his obligations in advance. Unfortunately, the tax system in Uganda fails to live up to this standard, leading investors to doubt Government's commitment to support local industry.

Periodic and uncoordinated changes in the tax regime[19] are a concern to long-term investors and inhibit their ability to price their products well and make strategic plans for their companies.

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[19]Investment incentives given under the Investment Code should not be subject to annual Ministerial adjustments (in the Budget) - `from midnight tonight' type of ministerial pronouncements.

- **Complaints of smuggling and dumping**

Local import substitution industries are squeezed by the newly liberalized trade rules. This contributes to the impression of an inadequate framework for new investment, even though it is an inevitable aspect of transition from the previous highly protective regime to an export-led strategy. Producers of foam mattresses, toilet paper, steel products, paint, blankets, soap and detergents, cooking and lubricating oils, etc. complain about the level of smuggling, dumping, under-declaration of imports and other forms of tax evasion which enable their competitors to under price their products. Local producers of these products report that prices of Kenya products on the Ugandan market are well below the level they should be, based on ex-factory price, transportation costs and taxes payable.

The textile industry that has been grossly affected by sales of second-hand clothing coupled with government procurement policies in favor of foreign suppliers. Dumping of expired drugs is steadily eroding the competitiveness of the local pharmaceutical industry. Imported drugs are cheap for several reasons: Export subsidies by India and Pakistan (Uganda's main suppliers) and the fact that drugs can be imported tax-free. The foam mattress industry is reporting an influx of sub-standard foam products from Kenya, coupled with tax evasion and smuggling of the same products.

- **Institutions**

Investors complain that the immigration office and the police inhibit or make recruitment of labour with special skills from abroad problematic. A number of investors express concern over the treatment by immigration officers or police harassment of foreign workers.

7.2.2 Positives

- **The changing enabling environment**

The most important enabling factors are simply lifting restrictions on the flow of private capital into the country and out. Along with sharp decline in expropriation risks, the 1990s have witnessed a progressive dismantling of barriers to capital account mobility in Uganda, as in other developing countries. Uganda has signed investment codes, bilateral treaties and multilateral agreements that emphasize the free flow of investment. They generally also contain provisions for the settlement of disputes, usually providing for several different mechanisms for their resolution - ranging from direct negotiations between disputing parties to arbitration proceedings in which investors and host states may participate on an equal footing. Examples include the General Agreement on Trade in Services (GATS) which sets standards for market entry and for the uniform treatment of firms - whether domestic or foreign; the Agreement on Trade Related Investment Measures (TRIMS), which imposes equal treatment of all firms (excluding services); and the Agreement on Trade Related Aspects of Intellectual Property Rights (TRIPS), which is beginning to address the protection of intellectual property rights, a concern that is particularly important for many high technology transnational companies.

- **Specific trends in Uganda**

- Good macroeconomic performance (low inflation, high growth rates, convertible currency, etc.) has been recognized and the creditworthiness (risk rating) has improved (Collier 1997).

- Political stability, guarantees for investors and generous investment incentives.

- Government commitment to private sector development. The government has taken measures to create an enabling environment for the private sector to act as an engine of growth and has pursued an aggressive privatization policy.

- Liberal foreign exchange regime, simplified import and export procedures, and removal of restrictions on the movement of capital into and out of the country.

- **Regional and international factors**

- Recent political drama of multiparty politics in Kenya and speculation about the after-Moi era have raised concerns about the security of investing there. Kenya served until recently as the main distribution point for the inland market, that is, the Great Lakes Region (Kenya, Tanzania, Uganda, Rwanda, DRC[20] and Southern Sudan). Problems in Kenya tend to hurt Uganda as an investment destination for overseas investors, because of these transport links. On the other hand, for Kenyan Asian investors, trouble at home can lead to a search for opportunities nearby.

- Americans have shown renewed interest in Africa and in particular the Great Lakes Region.

- The size of the market accessed by investors is increasing with the strengthening of regional organizations. Uganda belongs to the Common Market and East and Southern Africa States (COMESA), with a market of 300 million people and the East African Cooperation initiative. It tends to be the favored destination among the Great Lakes Region (with a population of about 200 million people).

- Institutions and good governance. There is increased accountability by government, freedom of the press and institutions like the parliament, courts, banks, etc. are beginning to function.

[20] Do not forget the American interest in DRC and Uganda is being used as a stepping stone.

7.3 Linkages between Foreign and Local Investment

7.3.1 Survey respondents

***Number of* employees**

The respondent firms were classified as small, medium or large based on the number of employees as follows: small firms have 5 to 20 employees, medium firms: 21 to 50, large firms 51 to 100 and very large firms have more than 100 employees. The categories of respondent firms were:

Small	17%
Medium	12%
Large	28%
Very large	43%
Total	100%

Year of establishment

76% of the respondent firms were established after 1991. This is an indication of increased investment activities after 1990. This is the period when macroeconomic policies adopted by government started bearing fruits. The breakdown of firms established after 1991 is as follows:

Small	100%
Medium	76%
Large	81%
Very large	63%

7.3.2 Linkages

A number of local firms in the sample have established linkages with foreign firms and see this as a beneficial relationship for their business. On a scale of 1 to 5, firms indicated that they have fairly important linkages with foreign firms in terms of accessing technology, management, equity capital and training. Firms also indicated that linkages with foreign firms were beneficial in helping them gain access to export markets.

The manufacturing, transport and communications sectors ranked access to technology as an important benefit arising from linkages with foreign firms. Subsidiaries of transnational corporations (TNCs) and firms with substantial foreign investment are able to source equipment and other technologies using the contacts and resources of their foreign partners on favorable terms negotiated on their behalf. As an example, Century Bottling Company was able to procure a new bottling line using financing and contacts from Coca-Cola International.

Management and equity capital were ranked by firms in the financial sector as important benefits from linkages with foreign firms. Invariably firms in the sample have had some form of foreign managerial input in their set-up and early operations, particularly the post of Chief Executive and Financial Controller. While this is an important measure to ensure that the foreign investors have firm control of the company, it has attendant benefits to the local firm as well, notably the world class planning, budgeting and management systems. Many local firms in the private sector and those owned by government, have historically been plagued by poor management, resulting in low productivity and hence, poor performance. Sound general and financial management is therefore a factor that has rendered most firms in the sample highly competitive in this market.

7.3.3 Technology

Only 15% of the sampled firms obtained their technology locally, an indication that Ugandan firms source the bulk of their technology from other countries. Imports accounted for 37% of technology acquisition, followed by sourcing from parent company (18%). Following the same pattern, 68% of the large and very large firms acquired their technology through imports while 45% of the small firms from their parent companies.

Turnkey, licensing and franchises (14% of the firms in the sample) are also potentially important sources of technology in the country. Metro Cash and Carry, a South African firm, is developing a network of franchisers for marketing the firm's products and sees this model as an efficient way of competing with already established brands and players in the market. The beverages sub sector (beer, spirits and soft drinks) has big international franchiser firms such as Coca Cola International, International Distilleries and Vintners and Pepsi Coal International, which have sold more than US$50 million worth of technology to their local franchisers in the last 3 years.

7.3.4 Sourcing of Intermediate Inputs

The analysis shows that firms are increasingly sourcing their intermediate inputs locally or developing firm level production capacity. 79% of the firms source some of their inputs locally. However, 76% of the firms imported more than 50% of their inputs in 1993 while the corresponding number for 1997 was 60%. 59% of the firms reported a decline in importation of inputs. Of these, 85% linked the decline to purchase of local inputs while 15% to increased firm level production of inputs.

The responses on procurement of intermediate inputs have to be interpreted with caution since 49% of the sampled firms were set up during the last 3 years and therefore could not have had the relevant historical data to answer this question. As a result, several firms omitted to answer this question while others supplied figures for 1997 only, making it difficult to identify meaningful trends.

Most firms indicated that they prefer to source intermediate inputs locally, if local suppliers could ensure them reliability of supply as well as quality and price with imported inputs. The difficulties and delays involved in importation of goods (for example, custom checks and delays, congestion at ports of entry and poor transport infrastructure systems) are an incentive for firms to develop networks of local suppliers for their inputs. One respondent (Britannia Products Limited) a large-scale producer of confectionery inputs, has developed a network of local suppliers for packaging materials. The firm, however, imports wheat flour the main input, because local production is below demand and imports are cheaper.

Nevertheless these are indications that as local suppliers improve on quality, price and reliability, firms will source more of their inputs locally. Many of the sampled firms have actually set up mutually beneficial relationships with their suppliers. North Bukedi Cotton Growers Ltd. and Kyagalanyi Coffee Processing Factory Ltd. obtain 90% of their inputs locally. The two firms helped local growers (of cotton and coffee, respectively) to improve the quality of their supplies by giving them better yielding varieties, providing training and by paying a high price for good quality supplies. Similarly, Metro Cash and Carry is introducing its household brand to local suppliers of eggs, chicken, beef and other fast moving consumer goods. Through training provided to groups of suppliers, the company aims to initially source 10% of its stock from local suppliers during 1998 and to improve this figure to 40% by the year 2000.

Indeed, 33% of these firms reported a decline in importation of intermediate inputs between 1993 and 1997. 47% had the same level of imports while 20% increased the level of importation during the same year.

From interviews it was noted that most firms prefer to concentrate on their core business. One respondent (CelTel Cellular Ltd) a mobile telephone operator, views air-time their prime commodity and contracts out (or encourages local suppliers to provide) other services and inputs.

The percentage of intermediate inputs sourced locally by most firms is low. Only 24% of the firms obtained more than 50% of their inputs locally during 1993 while the corresponding figure for 1997 is 40%. This is because many local suppliers are high cost producers or cannot assure their buyers of regular and consistent supply of quality products. Below are some of the typical responses on why firms import their raw materials:

- We continue to import sugar because imported sugar is cheaper and better suited to our production process (refined to suit our needs);
- Imported cooking oil is 10-20% cheaper than what we can get from Mukwano Oil Industries (a local manufacturer);
- We can source from local suppliers but only if their price and quality are competitive; and
- We source locally, but cannot obtain the quantities we require so we import the balance.

7.3.5 Training

Firms see training as a critical catalyst for production improvement and efficiency. 82% of the respondents have training programs for their staff. Of these, 48% do some of their courses abroad. The most common form of training is for the management category while the skilled labour category receives less attention from firms.

According to the interviews, one of the most common forms of training is through attachment. One option is for firms to second an expatriate Senior Manager (for example, a Chief Executive or Financial Controller) to work in Uganda during the initial 3-5 years of the project, and to groom a local to take over after the attachment period. Most foreign firms began with expatriate staff in the Senior Management posts and then replace them gradually with local staff.

In addition, companies contribute over 67% of their training program to the development of management and technical skills.

Type of training and budgeting

	Training abroad	Local training	Budget
Management	44%	24%	31%
Tech. skills	42%	37%	36%
Skills	13%	40%	33%

It is also common that a firm can second its senior staff for attachment at its TNC headquarters or to a firm/institution handling similar work abroad. This signifies that top leadership prefers exposure to international skills and qualifications that can be adapted to the local environment. There the trainee is exposed to the operations and demands of well-established and mature firm and is given assignments under supervision.

Most firms were not willing to disclose their training budgets, but those that did, had budgets ranging from US$3,000 to US$15,000.

7.3.6 Future Prospects

Of the firms, 86% were optimistic about their future and projected moderate (5 to 30%) to significant (>30%) increases in sales, export and investment patterns over the medium term. Specifically, firms in tourism, industry, and transport and communications were very optimistic in their outlook and projected growth in one of the three areas, namely: sales, exports and growth in investment.

Respondents in the fish sub-sector expect a decline in exports and thereby sales over the short term, because of the import ban on fish from the East African region by the European Union. Other firms that projected decline or stagnation of exports attributed this to either the stiff competition from cheaper imports, e.g. of bicycles from India and

China, and cement from Kenya and Tanzania, or to increasing competition in the market, e.g. in the financial services sector.

Firms noted that investment in physical infrastructure, streamlining customs procedures, lowering tariffs on components and providing more tax incentives are very important interventions the government could make to boost investment and business growth. Land tenure reform, institutional reform as well as streamlining business establishment procedures were considered less important interventions for productivity improvement.

Firms see market intelligence, expanding sales in the domestic market and linkages with overseas firms as pivotal in their business development over the medium and long term. These three factors go hand-in-hand; market intelligence would enable firms to identify market niches and customer preferences across the local and Great Lakes Region. The linkages with foreign firms already noted (capital, technology, managerial skills and access to markets) are seen as very important in enabling firms to attain business growth and development.

Access to credit is no longer a major constraint for foreign firms that enjoy good relations with international banks such as Standard Chartered Bank, Stanbic Bank and Barclays Bank. The issue is more about high interest rates that impede borrowing than it is about access, since many banks now have loanable funds and are looking for bankable projects to finance. In addition, these foreign firms are able to attract cheaper equity and loan capital from overseas.

7.4 Policy Implications

Uganda’s dilemma illustrates the difficulty of approaching investment promotion without considering the political and regional context. Government has done many things right, and investors have responded. But the trend is stalled, if not in decline.

The domestic and regional conflicts involving Uganda’s military appear to be a deterrent at present. Many investors will hold back from Uganda until those conflicts are resolved.

Defense expenditure, comprising about 20 percent of the total recurrent expenditure, is worrying and is a drain to already narrow resource base. This implies that less and less is spent on the most needed investment in infrastructure such as roads, power, etc. and social sector (education, health, etc.) for human development.

More immediately affecting those who have tried to invest and found it difficult going are problems of infrastructure and the weak financial sector. Ugandan business people suffer as much or more than Kenyan’s by the inadequacies of Mombasa port and overall transportation costs. Both countries were ranked in the bottom third of African countries on these questions in the African Competitiveness study. Investors also complained of electricity supply and cost and telecommunications infrastructure and costs in that study. (World Economic Forum/HIID, 1998)

Uganda's investment promotion strategy needs to take into account new macro-political evidence that ethnic fragmentation is only counteracted statistically by sound institutions. One of the most fundamental of these is respect for private property. The restoration of properties expropriated in 1972 raised Uganda's credit among investors throughout the world, as a sign of respect for property rights. Other aspects of the rule of law and order should receive similar attention, to ensure that fairness and transparent rules build confidence. This is particularly true for the financial sector and for education.

A concerted focus on improved infrastructure should be the next strategic priority. Without lower transport and energy costs, Uganda cannot compete.

In order to strengthen the competitiveness of Ugandan enterprises, the UIA should also encourage business to business linkages between Ugandan enterprises, both domestic, regional and overseas. Linkages with firms in South and South-East Asia may be particularly appropriate, to build on the ethnic ties and technological developments there.

The promotion of linkages constitutes a vital requirement for growth of efficiency and technology upgrading for local firms. During 1991-96, several such instances have taken place as in the case of assembly of computers/TV sets, telecommunications and in the production of bicycles and other manufactured goods.

Internal linkages will principally take the form of supply of raw materials or distribution and sales of final products or service functions such as construction, transport, etc. These linkages, which may often take place with micro enterprises from semi-urban and less developed districts in Uganda, will be vital for growth of micro and feeder industrial units to supply SMEs in Uganda.

External linkages will be primarily necessary to promote increased efficiency and competitiveness of enterprises in local, regional and international markets. Such linkages can take various forms, including investment linkages, involving foreign participation as in joint ventures, or technological linkages through licensing agreements of franchises, or marketing linkages such as buyback agreements, export sales agreements or external marketing contracts.

8. FOREIGN AND LOCAL INVESTMENT IN KENYA

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 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 (GDS/GDP: Uganda 6%, Kenya 7% , Mauritius 24%; GDI/GDP: Uganda 15%, Kenya14%, Mauritius 24%). Kenya also shares with Uganda the fact that most of its investors, both foreign and local, are of Indian descent. David Himbara noted that the dilemma extended from economics and politics into scholarship, remarking in his Prologue:

> This book began as in inquiry into Kenyan capitalism, a subject that seemed to be confused by the tendency to omit from consideration nonblack domestic capitalists, in particular Kenyans of Indian extraction, on the basis that they constitute "Asian capital." (Himbara 1994)

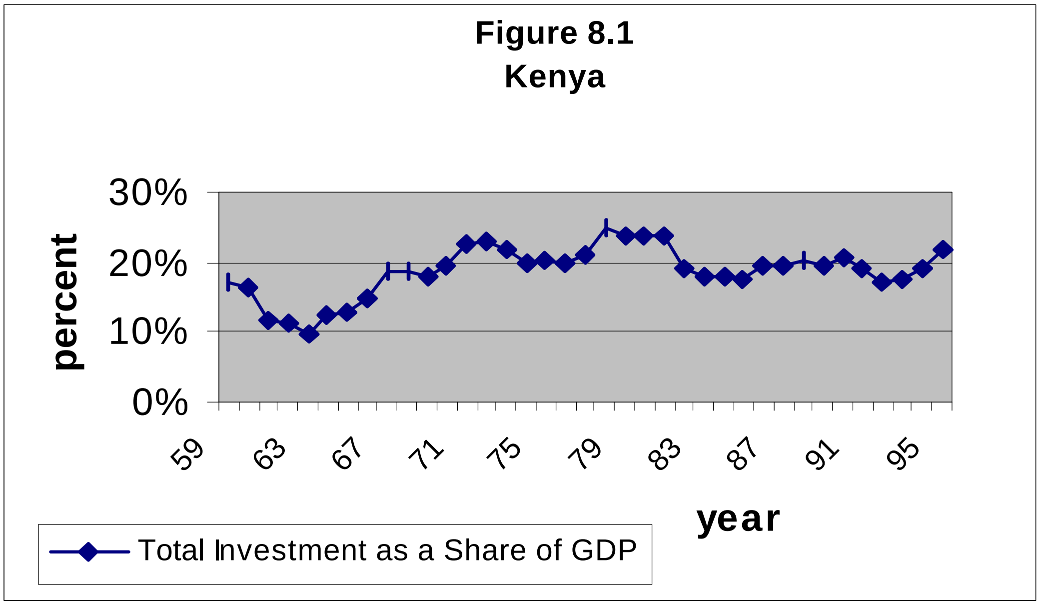
8.1 An Overview of Investment Policy and Performance in Kenya

Like Uganda and Mauritius, Kenya has experienced little mining investment. In the early colonial period, investment was concentrated in agriculture and commerce, and the railway and telegraph that linked the productive highland regions of the interior with the port of Mombasa on the Indian Ocean. World War II brought a stimulus to industrial investment, to manufacture substitutes for imports disrupted by war. After the war came the first strategic and institutional focus on economic development. A Ministry of Commerce and Industry was created in 1947-48. Several state corporations and boards were created for specific sectors, some on a national basis, but often serving Kenya, Uganda and Tanganyika under the East African High Commission.

In the post-war period, it became clear that white settlers and indigenous Kenyans were competing for land in the highlands and for political control of the future Kenya. The Mau Mau movement became the overt expression of that tension, from 1952 until shortly before independence in 1963.

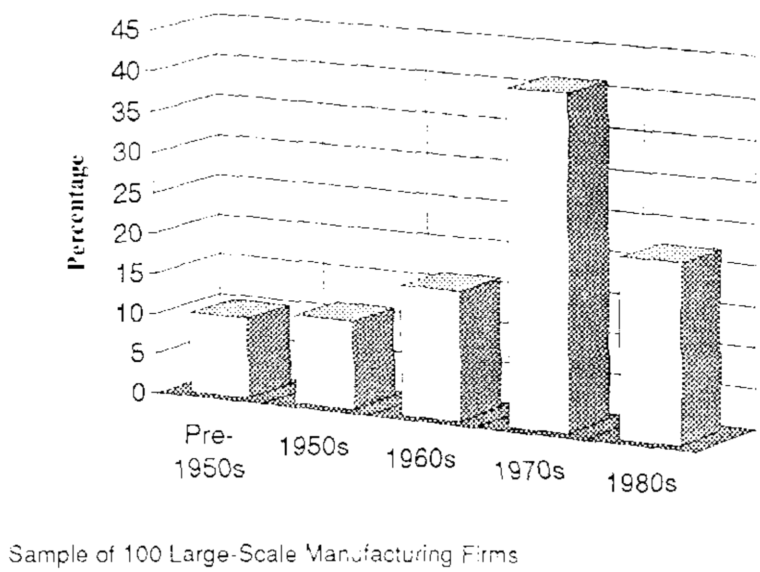
Despite the unrest, Kenya experienced investment growth in the period before and after independence. Figure 8.1 below indicates that between 1963 and 1982, investment as a share of GDP rose steadily. Although these figures aren't quite as impressive as those for Mauritius, they still represent a healthy investment to GDP ratio.

Figure 8.1: Kenya



Himbara's 1989-1990 retrospective survey of 100 large[21] manufacturing firms shows that the bulk of those successful firms were established in the 1970s. (See Figure 8.2 below)

Figure 8.2



Source: Himbara, 1994; 45.

[21] Large is defined as having over 50 employees. The sample of manufacturing firms valued at >Ksh 100 million in 1989 shows 86 percent Kenyan Indian, 4 percent publicly held, 6 percent state firms and 4 percent foreign/joint venture.

Figure 8.3

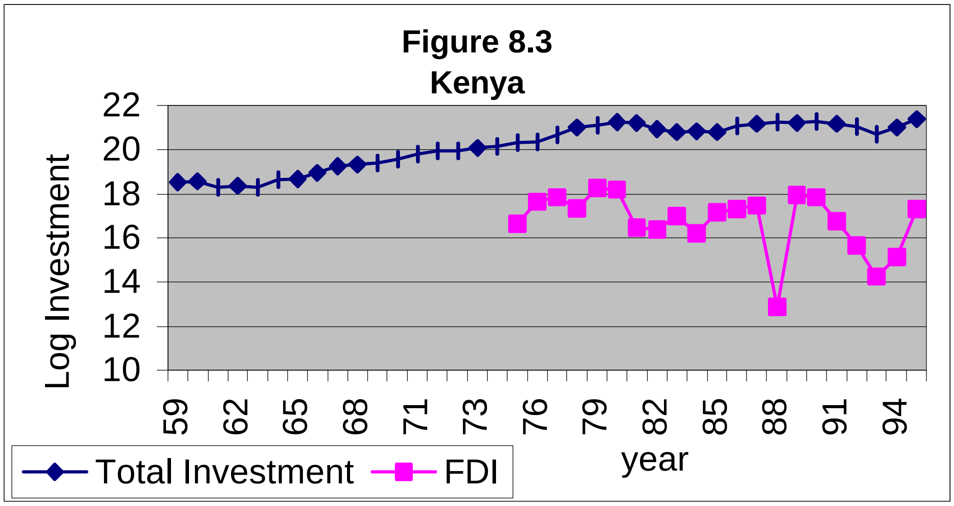
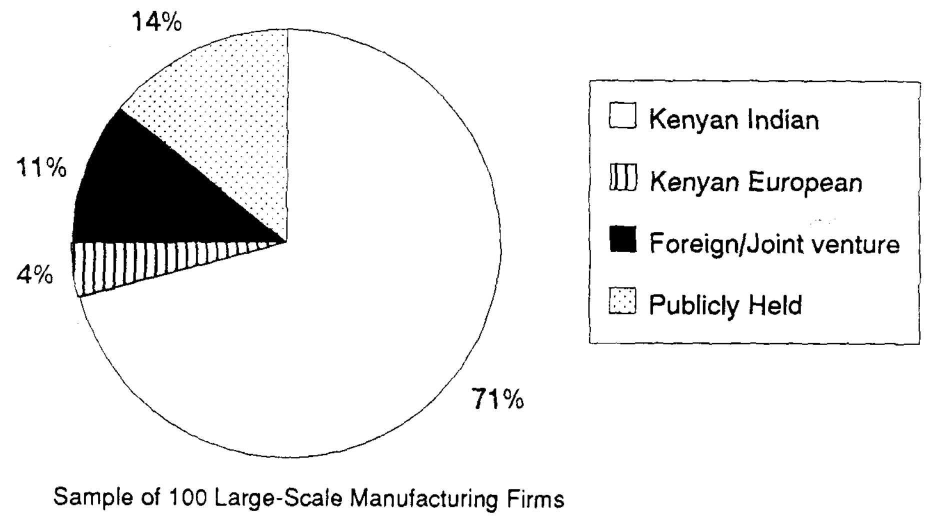


Figure 8.3 suggests that total investment in Kenya has been rising but less rapidly than it has risen in Mauritius. Also, unlike Mauritius, FDI to Kenya has been relatively volatile and on a slightly downward trend, at least until 1994.

Himbara's survey focused on the ethnic structure of investment in successive decades. Kenya Indians were predominant in terms of the numbers of firms established from before independence through the 1980s. Their proportion of the total started at 71 percent in the precolonial period, when publicly held corporations (colonial, transferred to independent Kenyan government) constituted 14 percent, foreign/joint venture corporations 11 percent and Kenyan European firms 4 percent. Many of the Kenya Indian investors had built their capital up in commerce, and then invested in manufacturing. European investment was initially diversified, but gradually came to be concentrated in agriculture. A survey of 58 manufacturing firms conducted in 1962 just before independence showed 67 percent Indian ownership and 24 percent European. Evidently some of those European firms have since sold or closed. Indigenous Kenyan investment was not yet on the horizon as independence approached, although 5 percent of firms were interracial partnerships. (Chandaria 1962, cited in Himbara 1994)

Figure 8.4: Firms Established Before Independence (1963)



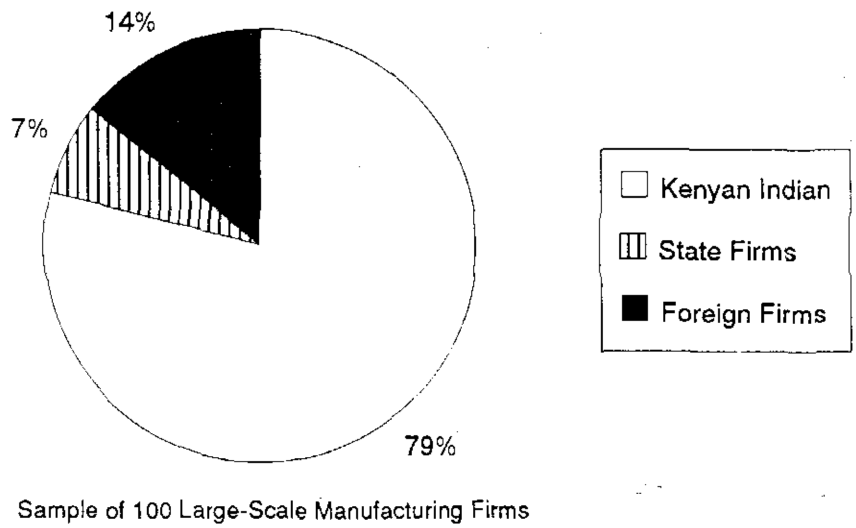
Source: Himbara: 1994, 46.

Independence brought African control of the political apparatus. It was widely assumed that access to wealth would follow. It has happened only slowly, however, and with much ethnic tension and rivalry. Himbara derides the various programs in the 1970s and 80s designed to transfer ownership of firms to Africans, claiming that the evidence shows that neither Africans nor Europeans were able to compete in commerce and industry with Asian-owned firms. (1994: ch.3) Unfortunately the crowing tone adopted in the book reflects the negative aspect of the social capital that Asian business people have brought to East Africa. Their very considerable achievements are undermined by racially exclusive social patterns and competitive strategies that reinforce inter-group mistrust.

Weak institutions and poor policies are clearly factors in both the inability of Kenya's leaders to take advantage of its economic growth potential and their inability to foster "indigenous" capitalism. One of the present authors has argued elsewhere that the paradigm of an economy held by African leaders at the time was an organic model based on the dual political/economic leadership roles exercised by chiefs and heads of family. A chief was responsible for ensuring that everyone in his group had work and food, and he normally supervised the distribution of both. (Phillips 1996) This imperative has continued to conflict with the capitalist economic model in which wealth is generated by the velocity and volume of flow of money between households and firms. Tensions grew between Indian and European firm owners, who generally adhere to the latter model, and Kenyan leaders trying to fulfil their people's expectations. Building a nation-state requires bridging organizations between tribal and racial groups, in business as well as the larger society. Kenya has attempted this organizational development, but as the mantle of leadership passed from Europeans to Kenyans in organizatioins such as the Kenya National Chamber of Commerce and Industry, Europeans and Asians tended to reduce their participation rather than truly integrating.

Africanization of the economy was attempted through several means: 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 far sweeping in Kenya than in Tanzania and Uganda, however. Many Kenya Indians stayed, and invested in industry, which was still open to them. They were actually joined in the late 1960s and early 1970s by an influx of Indian business people from Tanzania and Uganda, where conditions for them were worse. Manufacturing, small and large, flourished.

Figure 8.5: Firms Established in the 1960s



Source: Himbara: 1994, 46.

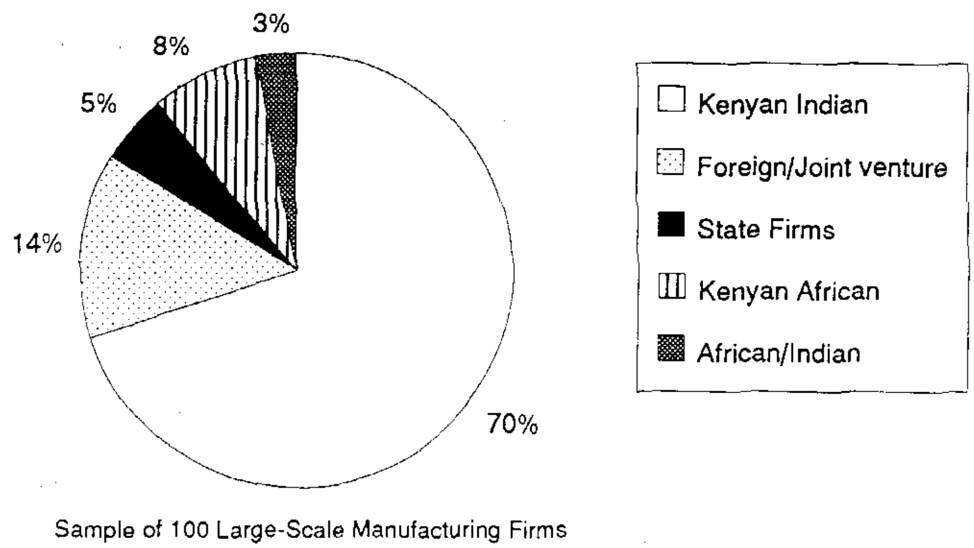
Ultimately, this approach to Africanization was deemed a failure by most Kenyans, although the aspirations are still strong. The man then responsible for enforcing the Africanization policy of the 1970s, Mr. Sam Waruhiu, who by 1994 was chairman of Barclays Bank, commented looking back:

> When the window was opened for African businessmen through the Trade Licensing Act, and various schemes such as the [Industrial and Commercial Development Corporation] ICDC at independence they had no experience. . . . The experiment was not only a major failure from the perspective of African businesses, it backfired in another respect. The Act forced the Indians into the more challenging chapter of the economy—manufacturing especially. After their largely successful movement into this sector, they came back, ironically, with a much larger base and reclaimed the retail and wholesale sector. The reason was simple and historical. The Asian businessmen were already established at the coast before the colonial rule, and they followed the railway to consolidate their position, despite the fact that they held no political power. At independence, they took advantage of their position in the economy. This is the single most important reason why the programme of assisting Africans' move into retail trade by inducing Asians' withdrawal completely backfired. . . . The mistakes made by us include the role played by our institutions such as they ICDC whose objectives included provision of capital and

technical know-how. Instead of assisting African,s the ICDC became an entrepreneur itself thereby taking away the critical input the budding African businessmen needed most—capital. Like all parastatals, it could not manage to do this well enough either. It is fair to conclude that the ICDC became a “white elephant” with its participation in sometimes trivial and small companies, including supermarkets; the whole policy was misguided. (Interview with Himbara 1994)

The sample of large manufacturing firms founded in the 1970s showed only a few survivors into the 1990s, among those transferred by fiat. (See figure 8.6). In 1977 the East African Confederation broke up, with Tanzanian troops moving into Uganda to rid the country of Idi Amin. This put a damper on foreign investment that shows as a sharp but short-lived dip. (see Figure 8.3 above)

Figure 8.6: Firms Established in the 1970s

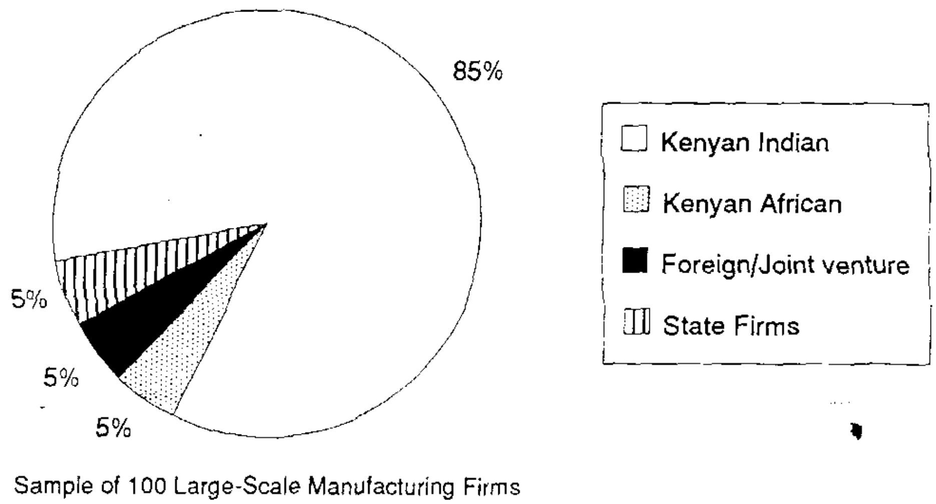


Source: Himbara: 1994, 47.

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, now faced somewhat the same situation as the Indians forced out of trade. As they lost positions in the civil service, they 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 in Himbara’s sample that were 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. (See Figure 8.6 above) 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.

Figure 8.7: Firms Established in the 1980s



Source: Himbara: 1994, 47.

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.

Negative Social Capital from Ethnic Rivalries

In the last two decades, appeals to ethnic bases have become more overt in Kenyan politics and the economy. Moreover, the groups in power are smaller in size, and have built fewer horizontally linked organizational bridges to other ethnic groups. The predominance of narrowly defined political strategies and ethnic appeals has been traced in studies of the political economy of Kenya, notably by Robert Bates. (1989; 1981) That trend can be seen as creating negative social capital. International pressure to rectify this situation seems ironically to have intensified the problem, as it has focused on demands that Kenya open up its one-party political system to allow for an effective opposition. In the absence of horizontal bridging organizations of other types, the result has been to intensify appeals to ethnicity. Mistrust between groups has reached new levels, and means of building trust and intergroup cooperation are becoming thinner. Moreover, government policies of all sorts have moved into a logic that benefits the few at the expense of the larger society and economy. From the point of view of investors, the key negative trends have been (see Chapter 5, Table 5.1):

- inappropriate government spending, particularly allowing infrastructure and the educational system 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.

Among donors new attention is being paid to programs designed to reinforce civil society by providing grants and training to the media and non-governmental organizations. In theory, stronger civil society will provide the necessary linkages that foster cooperation over the medium and long term. The timing may have been wrong enough to subvert the process, however. Once ethnic appeals have been allowed to permeate the multi-party political process, re-establishing trust and cooperation is a complex process.

Investors Interviewed in 1999

Investors interviewed for this study reported a reversal of Kenya's scores on various negative and positive factors over the years in Kenya. In the early years Kenya had had sound infrastructure and a more stable polity than its neighbours, but most entrepreneurs remembered the years of strong state intervention with distaste. Liberalization of the economy in the 1990s has brought some improvements in macroeconomic parameters and policies, but these are offset by rising costs, ethnic in-fighting and persistent corruption.

8.1.1 Foreign Investors

Kenya has over the years succeeded in attracting some foreign investment from South Asia, as well as Europe and South East Asia, a sampling of whom agreed to be interviewed for the present case study. The interviewees identified the following factors as influencing their decision to invest in the country.

- **Political stability and policy consistency**

Up to the early 1980s Kenya enjoyed political stability, a rare privilege in the African continent, under a one party political regime. By ensuring consistency of economic policies, the political stability minimised investor uncertainties, fostering foreign investment. Although the KANU party persists in power during the multi-party era implying policy consistency (except for a few reversals), politically instigated insecurity threatens investor confidence in the country, discouraging existing and potential investment.

- **Availability of a cheap and trainable labour force**

Persistent massive unemployment continues to make the country's labour comparatively cheaper than such investor homelands as Europe and South East Asia (e.g. Hong Kong and Taiwan), despite the Minimum Wage Legislation and other Wage Guidelines.

Kenya enjoys a literacy rate of about 80%, most of its labour force have at least attended primary school. This attribute of the Kenyan labour was said to be attractive to investors due to the ease and flexibility with which workers can be trained in most production techniques.

- **Economic performance**

The country's good macroeconomic performance record in the 1960s and 1970s was reflected in the following indices:

- average GDP growth rate of about 6.5% per year,
- average GDP per capita growth rate of about 3% per year,
- minimal inflation rate (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. However, the macroeconomic instability the country experienced since the 1980s with negative GDP growth rates, rapid population growth, double-digit inflation rates, large current account imbalances and external indebtedness, have been a deterrent to foreign investment.

Large disparities in income distribution and growing poverty were also cited as deterrents to investment accruing both their implications on the effective market for the investors' products and on political stability. The country's poorest 40% of households receive less than 15% of total income while the top 10% receive about 35%. Kenya's Gini index of income distribution is 44.5.[22] Poverty was rampant in the country with about 47% of the country's population being absolutely poor. These dismal human development indicators meant limited domestic market for the manufactured products and potential for social unrest.

- **Infrastructure**

The Kenya government initially invested heavily in infrastructure, resulting in a relatively adequate and reliable road network and airport, and expanded and modernised the telecommunications, electricity, water and sewerage facilities. These were said to be positive factor to investor decisions. However, over the years, the country's infrastructure has become a negative factor in the investors' decisions. The Kenya's infrastructure is either in serious state of decay and or grossly inadequate owing to poor maintenance and allocation of insufficient funds for its expansion.

- **Institutions and Law and Order**

General law enforcement, thus physical security of people and property, and judicial support for commercial contracts has worsened over time according to investors surveyed. Key decisions removed the checks and balances from Kenya's political system. Parliamentary oversight of financial probity in the executive branch was breached immediately after independence. The controller and auditor general reported on this, but nothing was done. (Himbara 1994 and Leys 1970) Autonomy of judicial and regulatory

[22] World Bank, World Development Indicators, Table 2.8. A high Gini index indicates more inequality, and a lower one more equal income distribution. Indices typically range from about 30 to about 60. Kenya's index of 44.5 is close to the average for African countries in which income distribution has been measured.

agencies was undermined when Kenyatta lifted the traditional life tenure, and made the attorney general, controller, justices of the high court and other regulatory officials serve at the President's pleasure. The opposition agreed with this move, as a normal cultural prerogative of chiefs of state. Daniel arap Moi is quoted as having said, while he was still in the opposition, "… we know that the President is above the law. If we say that the President is above the law, why should we say that he should be denied these new powers which rightfully belong to him?"(Weekly Review Dec. 22, 1975)

The Ndegwa Commission in 1971 opened the way for a new form of obligatory joint venture by authorizing civil servants to be in private business simultaneously with their public service. Parliamentarians and members of the executive branch immediately created firms, or took shares in firms created by others. Firms with such connections customarily benefited from official decisions and policies.

Educational institutions have fared better than political and economic ones. Kenya's schools no longer produce the quality of graduate that they did at independence, but they provide nearly universal education (61 percent of elementary-school-aged children reach 5th grade), and the quality is superior to schools in other East African countries. Kenyans with technical educations are in demand by employers throughout the region.

- **Preferential market access**

Kenyan exports have preferential access to world markets through the ACD, Lomé Convention (to the European Union), Generalised System of Preferences (GSP) (to the USA, Japan, Canada, Switzerland, Norway, Sweden, Finland, Australia, Austria, and most European Union countries) and PTA/COMESA Agreements (to the regional markets in Eastern and Southern Africa). A few investors from countries, which either did not have such access or had exhausted quotas, relocated here to take advantage of the country's largely unexploited preferential market access.

- **Investment incentives and promotions**

Investment guarantees have recently become more enforceable, with the World Bank involved in facilitating export-led growth. Most investors cited several incentives that pulled them to invest in the country; from investment allowances and guarantees about repatriation of capital and profits, to non-expropriation of property. Lack of confidence in the judicial system is compensated by provisions settlement of investment disputes through Kenya's membership to the World Bank-affiliated Multilateral Investment Agency (MIGA) and International Centre for the Settlement of Investment Disputes (ICSID), and the packages of incentives for the MUB and EPZ schemes.

- **Investment Approval Process**

The country's initial investment approval process was a negative factor in investors' decisions. The process was cumbersome and costly, requiring acquisition of a multiplicity of licences. The delays implicit in the process often meant lost investment opportunities and high transaction costs for investors.

In 1992 the IPC Act was amended and the approval process was speeded up, with a provision that an investment approval decision be communicated within a maximum of 4 weeks. In case of approval, the IPC was also mandated to issue a certificate of General Authority, which enables investors to begin implementing their projects immediately with a grace period of 6 months within which to acquire necessary business operation licences. The one-stop processing of investments vested in the IPC was widely cited as a positive factor in investors' decisions to locate here. Many investors also cited the promotional efforts of such government agencies as IPC and EPZA as a factor in their investment decision. These institutions have organized investment promotion conference abroad including in the U.K., Germany and Hong Kong with others being planned for in South Korea and South Africa.

- **External Push Factors**

Push factors identified by foreign investors included exhaustion of foreign market quotas of their product (shirts) and high labour costs in their home countries.

8.1.2 Local Investors

Many of the factors that attracted foreign investors cited above were equally important to local investors. In addition, there are local conditions that could be regarded as having played a catalyst role to encourage local investment by Kenyans. Among these were the following:

- **Restrictions on Investment Abroad**

Initially, under the Exchange Control Act, Kenyans were prohibited from investing abroad, let alone holding a foreign bank account. Thus, Kenyan wishing to invest had no alternative but to do so locally. With recent liberalization of the country's foreign exchange controls, Kenyans are now able to invest both locally and abroad.

- **Financial Controls**

Prior to 1986, financial controls existed in the commercial banking sector, including interest rate and foreign borrower controls, which favoured local investors. The administratively set low interest rates made capital cheap while restrictions on foreign borrowers minimized competition to local investors for domestic credit. Furthermore, the interest controls favoured direct investment as opposed to financial investment. Liberalization of the country's financial sector after 1998 has, of course, eroded the financial advantages for local investors.

- **The Ndegwa Commission Report of 1971**

The Report aimed at the Kenyanization of the country's civil service through attraction of high quality manpower from the private sector. It endorsed Kenyan civil servants' participation in private enterprises, allowing them to invest and run businesses. This may have boosted local investment especially in the service industry, property and construction industry, and merchandise trade. However, the 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.

- **Preferential Treatment on Award of Government Tenders**

Local investors are privileged in the award of government tenders for the supply of commitment. A local firm within a 10% margin of the lowest foreigner bidder especially of local tenders generally gets awarded the tender.

- **Institutional Support**

Recognising the prevailing problem of lack of sources for long-term capital for local investment, the Kenya government established special long-term financing institutions such as ICDC, IDC, and DFCK to facilitate local investment. The institutions facilitated investments of both private sector and public sector based on parastatals.

8.2 Linkages between Foreign and Local Investment

The stratified sample of firms for the Kenyan case study was drawn from a database of the Registrar of Companies. The comprehensive database for about 1200 firms covers such information as a firm's identification, numbers, ISTC code, spatial location, incorporation date, total value of fixed assets, shares of local and foreign fixed assets, number of local and foreign employees, initial local and foreign investment, and domestic and export sales. Altogether a sample of eighty (80) firms was randomly drawn from the sampling strata (five size categories and three sectors) in the database. The sample was proportional by sector, but weighted to favor larger firms. The distribution of this sample of firms by sector and employment stratum is summarized in table 8.1, below.

The data in the table shows that the agribusiness firms dominate in the sample of firms, accounting for more than 75% of it, and with each of the remainder sectors accounting for less than 15% of it. The dominance of the agribusiness firms in the sample is consistent with the agrarian nature of the Kenyan economy. Another structural feature of the Kenyan economy revealed by the data in the table is the dominance of small and medium enterprises (SMEs), employing between 1 and 500 employees. These accounted for about 73% of the sample drawn.

Table 8.1: Sample of Kenyan Firms, by Sector and Employment Stratum

SECTOR	EMPLOYMENT CATEGORY						
	1-50	51-100	101-200	201-500	501-1000	1001-5123	TOTAL
Agribusiness	12	10	10	10	10	10	62
Chemical & Mining	2	1	2	2	2	0	9
Engineering & Construction	3	2	2	2	2	0	9
TOTAL	17	13	14	14	12	10	80

Source: Registrar of Companies database.

As the data in table 8.2 reveals, the ownership status of the majority of the firms in the sample could not be determined from the database as either purely local, purely foreign or jointly owned.

Table 8.2: Sample of Kenyan Firms by Sector and Ownership Stratum

SECTOR	OWNERSHIP STATUS				
	Local	Foreign	Joint	Unknown	Total
Agribusiness	19	1	6	36	62
Chemical & Mining	1	1	1	6	9
Engineering & Construction	2	1	2	4	9
TOTAL	22	3	9	46	80

Source: Ayako Computations.

A diverse range of both formal and informal linkages between foreign and local investment were identified. These are conveniently presented under the following sub-headings:

8.2.1 Ownership Linkages

Legal joint ventures create a direct linkage in a minority of cases. In these ventures, the foreign investors brought the following:

- technical manufacturing knowledge,
- factory management know-how,
- access to needed raw materials, and
- market contacts required to succeed.

The local investors, on the other hand, typically brought to the table the following:

- land (in the case of investments requiring large areas of agricultural land and beach front whose acquisition by foreigners requires presidential assent),
- capital,
- local policy logistical know-how, and
- local market experience.

Over the years joint ventures have increased, showing growing collaboration between local and foreign investors. While the IPC and EPZ encourage these, their formation is purely voluntary on both sides. Although, initially, local partners brought a small proportion of the needed capital to the table, some eventually became majority shareholders and even completely bought out the foreign investors. Reported buy-outs of foreign firms was not only limited to the joint ventures but also to firms which had started as wholly foreign firms. Also, in some cases, foreign investors had brought out purely foreign or joint ventures. There were a limited number of buyouts. Where they occurred they were attributed to several factors including high operational costs of foreign firms; quick on the job learning of technical manufacturing and management skills by Kenyans; capital availability through increased savings and increased access to FOREX-denominated loans due to liberalization of foreign exchange controls and support from local financial institutions.

8.2.2 Contractual Linkages

Sub-contracting was the main contractual linkage reported between the foreign and local firms. The sub-contracting by foreign firms was typically for support services such as transport, security, cleaning and food services. Despite potential benefits of sub-contracting component manufacture many of the foreign firms indicated a preference for importing components and/or producing them internally. The cited reasons for this preference focused primarily on the risks of sub-contracting relating to both quality and availability of the components. Many of the foreign firms doubted the ability of local firms to meet production specifications and to supply parts in a timely fashion.

8.2.3 Labour Training Linkages

Unlike Mauritius, there were minimal labour training linkages reported between local and foreign firms. The reported linkage was limited to the attachment of trainees of local firms to larger firms for on-the-job training on sub-contracts. Also, workers trained by the foreign firms who quit their jobs became available for employment in the local firms.

8.2.4 Market Linkages

Both formal and informal market linkages for the purchase of inputs and sale of products were reported between the foreign and local firms. The linkage seemed lopsided as most foreign firms imported the majority of their raw materials, limiting their local purchases to such minor commodities as stationary and packaging materials. Neither type of firms reported selling their product(s) through formal contractual arrangements with the other. There had been a major push in the 1970s to oblige manufacturing firms to engage local distributors, but that effort has lapsed.

8.2.5 Collaboration and Communication Linkages

While the foreign and local firms competed in terms of product price, quality and timely availability, they also reported various forms of both informal and formal collaboration. At the informal level, these firms collaborated through transfer of clients, consulting on technical matters, selling or promotion of another's product and through attachment of staff trainees.

At the formal level, the sets of firms collaborate and communicate through sub-contracting and membership to same business associations such as the Federation of Kenya Employers (FKE), Kenya National Chamber of Commerce and Industry (KNCCI), and Kenya Association of Manufacturers (KAM). These associations play a role, particularly for Kenyan African members, in protecting, supporting and assisting their members. Their goals are improving and safeguarding business, fostering collaboration and communication links among firms, providing legal advice and settling labour disputes. Kenyan Indian participation is far from universal.

8.2.6 Financial Linkages

Limited financial linkages were reported between the sets of firms; whose main financial linkages were with their banks. Some reported inter-firm financial linkages were based, indirectly, on provision of trade credit and pre-payments. The linkages were, however, reported to be on the decline due to scarcity and high cost of credit in the country. Interest rates on short-term commercial loans ranged between 27 and 40 percent during the period of the study in 1998.

Overall, linkages between the foreign and local firms were reported to be low. The Kenya government had currently no systematic project to foster linkage among firms generally. To enhance the linkages and promote industrial development, the Kenya government has three policy options which are (1) to allow markets to create the linkages; (2) use 'market friendly' incentives; and (3) force linkages through state intervention. The interventionist policy option (2) would entail provision of tax and other incentives to increase the absorptive capacity of the local firms through acquisition of management and skill training. This would not only make them attractive for sub-contracting by foreign firms but also encourage them to export. The interventionist policy option (3) would entail imposition of local content requirement of the products of foreign firms.

8.3 Problems and Opportunities Investors Face Today

8.3.1 Shared Problems and Opportunities

- **Excessively High Interest Rates**

The prevailing high interest rates in the commercial banking sector discourage existing and potential investors. Existing firms, unable to service their loans, have either contracted the scale of their operations or have been declared bankrupt. The situation has been attributed to government reliance on borrowing through treasury bills with a return averaging about 27%. With such high returns on the treasury bills, commercial lending rates were now as high as 40%, significantly reducing possible viable new investment opportunities. Local investors were worst hit with this high cost of credit. Many of the existing businesses which had borrowed when the rates were about half were now finding it extremely difficult to service their mortgages with several being threatened with bankruptcy. To reverse the situation the government must reduce its borrowing through the treasury bill medium and expand other sources of money including from tax revenue, levies and from donors. It should also reduce and have better control of its expenditure. A shift to reliance on taxes as a principal source of revenue would reduce the government's internal debt burden as it entails no repayment to taxpayers except by way of services.

- **Decaying and Inadequate Infrastructure**

The decay and inadequacy of infrastructure were cited as key problems facing investors in Kenya. The major problem areas in infrastructure were cited as roads, telecommunications and port services. Although the country's road network was once reasonably adequate, it is currently in a serious state of decay, implying high operation costs for businesses. Given the state of the infrastructure firms were incurring high transportation costs and were unable to receive raw materials or export their products in a timely manner, with attendant costs. The country's telecommunication services were said to be inadequate, expensive, and unreliable. Large unfilled orders existed, in some cases taking several years before being satisfied. Telecommunication tariffs were reportedly set to satisfy repayments of foreign loans for telecommunications development, and were generally higher than in developed countries, implying high business operational costs. Kenyan telecommunications tariffs declined during the period of the study, bringing them below those experienced in Tanzania and Uganda. The unreliability of the country's telecommunications network, attributed to old equipment and power disruptions, implies inability of the businesses to communicate with suppliers and customers. This was said to have caused the businesses huge losses in terms of cancelled orders.

Port services at Mombasa are inefficient and the port is heavily congested causing businesses long delays in clearance of necessary cargo (equipment, machinery and raw materials) to manufacturers. The congestion at the port of Mombasa was attributed to the poor state of the Mombasa-Nairobi road, inadequate supply of railway wagons for those manufacturers wishing to divert transportation of the cargo from road to rail and cumbersome verification of containerised cargo and corruption. Several consequences of the deteriorating port services to the manufacturers were cited. First, shipping lines experiencing a turn around duration of about one and half months were now imposing a surcharge ranging between US$ 70-140 per day until they are allowed to berth, implying increased freight costs for manufacturers. Second, non-timely delivery of imported raw materials had already disrupted the production plans of firms with some having even stopped production. This had led to shortage of products and reduced efficiency of firms to service confirmed orders. Furthermore, firms that had stopped production found it very difficult to sustain the increased overhead costs accruing from the non-competitiveness of their products. Finally, the refusal of some ships to berth at Mombasa and instead to offload at either the Tanga or Dar es Salaam port had increased the cost of sea freight and inland transportation for the firms.

Other infrastructural problems cited are related to energy and water supply. The problems with energy supply were identified as power surges, cuts, shortages and interruptions. These problems, attributed to several factors including old power generation and distribution equipment, overreliance on hydro power (vulnerable to vagaries of the weather) and corruption, had caused firms huge losses in terms of destroyed power sensitive equipment, wasted perishable raw materials, lost value of output, and unnecessary payments to staff. The firms had adjusted to the problem through installation of stand-by diesel generators, implying additional production costs to them. Considering that the power problems had become a permanent feature of the Kenyan economy, many firms suggested that they be given waiver of duties on inputs for the own power generation with those that produce a surplus feeding to the national grid.

Many firms cited water supply by the Local Authorities as both inadequate and unreliable, resulting from old equipment, unreliable power supply and vagaries of the weather. The water problems had resulted in large losses to firms in terms of lost value of output. The firms were coping with these water problems through sinking of own bore-holes without remission of rates from the local Authorities or waiver of duties on the needed inputs, implying increased production costs.

- **Poor Governance**

Poor governance reflected in spiralling corruption and politically instigated insecurity discourages both local and foreign investors in the country. The rampant corruption in the country was said to be principally manifest in the receiving and giving of bribes on services rendered by government departments and other authorities and tenders given to local and foreign suppliers and contractors. The corruption they felt had eroded the moral fabric of the society, retarded economic development, subverted the rule of law, and made price of manufactured goods non-competitive as the bribes were shifted to consumers. This denied firms and consumers the benefits of free and open competition. Many of the firms interviewed do not believe that the Kenya Government is serious about tackling corruption despite public acknowledgement of its existence and establishment of the Anti-Corruption Authority.

The business community private sector was making its contribution to curb corruption. The East African Association had a code on corruption to which all its members were signatory while the Kenya Association of Manufacturers (KAM) was in the process of evolving a similar code for its 600 members. However, success of the private sector initiatives to curb the vice was said to depend on the government providing an enabling environment. Such an environment could be brought about through:

- provision of a system for declaration of assets by senior officials and others holding position of authority;
- provision of systems for periodic or random monitoring of assets of the senior officials or others in authority;
- empowering the Anti-Corruption Authority with regard to declaration of assets and monitoring of assets owned by senior government officials;
- enhancing the independence, integrity, and de-politicization of the judicial system as a cornerstone of the rule of law, enabling them to carry out punishment of the culprits involved in corruption;
- removal of all opportunities upon which corruption thrives including monopolies, onerous taxes, regulations fees and licences which impede business activities; and
- enactment of a law through an Act of Parliament to empower the freezing, seizure and confiscation of illegally acquired wealth of officials in positions of authority, when it is proved that such officials are guilty of corruption.

Insecurity has grown in the country due to tribal polarizations since the 1992 multi-party general elections. Arms have filtered in from the civil strife-torn neighbouring countries and massive unemployment and poverty have threatened the country's relative political stability in the continent, increasing uncertainty of safety of investment in Kenya. The ongoing tribal clashes in some parts of the Rift Valley and Coast provinces and frequent raids on businesses by armed gangs, resulting in deaths, massive displacement of people and loss of property, had greatly damaged Kenya's past image as a secure investment and tourist destination. It was suggested that the on-going process of political reforms be hastened to usher in good governance and attendant political stability to foster the investment climate.

- **Ineffective in Implementation of Policies.**

While on paper the Kenyan government has committed to liberalization of the economy and its package of investment incentives is competitive with other countries, implementation was reported slow and in some cases even lacking. One example cited was with regard to the amendment of the Trade Licensing Act announced in the last Budget Speech.

Implementation of amendments to the Trade Licensing Act including automatic issuance of one business permit by Local Authorities upon payment of the required fees was expected to commence from January, 1998, but had yet to start. Most of these Authorities continue to issue a multiplicity of licences. The cumbersome and costly licensing procedures and poor performance by these Authorities continue to hamper investment in the country.

Many firms complained that they were paying too much for the licences and not getting value for money in terms of delivery of services since garbage remained uncollected, roads were in bad shape, water and sewerage services were inadequate and unreliable.

The inability of the government to enforce policy decisions aimed at easing operating conditions reflected lack of a follow-up mechanism to allow for implementations of policy proposals. It is critical that the government strengthen its implementation record of economic policies and incentives for investment.

- **High Taxation of Businesses**

Although the government had made substantial progress in reducing and rationalizing the country's tariff and VAT structures, recent reversals, re-imposition of some duties on raw materials and increase of VAT for revenue purposes, was said to be hurting businesses through increased production costs and, hence, reduced profitability. The government was accused of being narrowly focused on the revenue dimension to the detriment of its development and investment promotion role. Even where duties had not been reversed, producers felt they were too high. The high duties and VAT made it cheaper for consumers to purchase imported goods than locally manufactured ones,. This costs Kenya jobs, which it cannot afford to lose. They argued that a cut in duties and VAT would promote investment with implied long-term revenue increases that would offset short run losses of such revenue.

- **Costly Settlement of Trade Disputes, Inadequate Regulatory Framework**

Both the direct legal fees and indirect costs for the settlement of trade disputes were described as prohibitive. The indirect costs, accruing from considerable delays in the settlement of the disputes, was attributed to the politicisation of the Kenyan judicial system, with declining independence and integrity. It was suggested that the existing structure of legal fees be reviewed downwards and the efficiency of the judicial system enhanced to expedite the processes of justice.

The government's business regulatory framework providing for prohibition (banning) of production of products that don't meet standards especially by small entrepreneurs was said to be retrogressive and anti-competitive. It was suggested that the country's regulatory system be positive on how to promote compliance with the required standards though legal pressure, education and attachment of technical staff.

- **Bias of Incentives towards New Foreign Investment**

The incentives for investment for export under the MUB and EPZ schemes primarily targeted foreign investors. Under the liberalized foreign exchange policy, the incentives were said to be discriminatory against local investors for export. It was suggested that the government had yet to recognize the leadership role of the local investor in the country's goal of a NIC status by the year 2020 and, hence, the need develop a set of incentives targeting these. Furthermore the incentives were said to target new investment whereas many of the existing firms were operating at about 60% of their installed capacities.

Growing local investment through provision of specific packages of incentives and funds could be used as effective strategy for attracting all types of investment.

8.3.2 Opportunities

Despite the above-cited problems most of the firms interviewed reported increased volumes and profits over the past few years. Few of these firms planned to relocate from Kenya. Most them said that they were in Kenya for the long-term and had been accustomed to most of the cited problems, and were optimistic they would be resolved in time.

The most attractive new opportunities for investors during the study period seemed to be in financial markets especially in treasury bills. With these short-term instruments, the investors assume risk for only three months in the process earning super profits, which, with the liberalization of the foreign exchange controls are promptly repatriated. Some foreign investors, considering long term investment too risky due to the prevailing political environment, get attracted to short-term gains from treasury bills yield rates of about 27% that are higher than in their home countries. Hence, these investors can borrow cheap at home and invest in these instruments for a quick turnaround.

Liberalisation of the country's foreign exchange controls had increased opportunities for local investors in the MUB and EPZ schemes. Prior to this, the EPZ scheme favoured foreign investors with access to foreign currency required for operation in these schemes. Even the few local investors who had access to the required foreign currency to operate in the schemes, went through discouragingly cumbersome approval process to secure it. Now the playing field is considered more level.

Other emerging opportunities for investment in Kenya include manufacture of electronic components and agro-processing of such products as coffee and tea.

8.4 Policy Implications and Case Study Conclusions

The findings of the Kenya case study illustrate why investment promotion is not primarily a question of devising incentive packages and marketing them. It has adequate incentive packages, but its marketing efforts are met with polite coolness. The problems in Kenya are more fundamental than incentives, or even macroeconomic management and political stability. Kenya has held a steadier political path than Uganda, but recent trends have discouraged investors. Recovery will require action on all fronts currently rated as negative, namely:

- Ethnic polarization—which can be overcome through leadership and deliberate building of cross-ethnic linkages, both horizontal and vertical,
- Government spending priorities—away from corrupt rewards to insiders, and towards rebuilding infrastructure and public institutions, including education,
- Rule of law and order—clear and transparent regulations, uniformly enforced, and
- Civil service reform to enhance competence and client orientation—currently underway, but with ambivalent support from government.

Overcoming ethnic polarization will require leadership from all groups and all levels of society, not just central government. Business and professional associations could play an important role. They have to be clear, however, that they are part of the problem. It is not something that one group can blame on another.

Government has begun attending to infrastructure problems in recent years, under pressure from business and donors. It has not, however, succeeded in diminishing the detour of public resources to private gains. The result has been accelerated government spending rather than reoriented budgets. Progress in elimination of marketing boards and public corporations has been slow. The problems of poorly oriented government spending, corruption, regulatory burdens, tax evasion and civil service reform all revolve around the conflicts of interest engendered by allowing civil servants to engage in private business while in office. The time has come for a thorough revision of the Ndegwa Commission's results, and elimination of at least the major sources of conflict of interest.

The findings of the literature on social capital imply that Kenya needs to focus its attention primarily on rebuilding its institutions, both public and non-governmental. Sound institutions are the one factor capable of overcoming the ethnic fragmentation with which Kenya has been endowed by historical circumstances beyond anyone's control. Kenya still has reasonably sound financial and educational institutions, which provide strong basis for a turnaround. A new focus on institution building will require leadership from government to focus on government ethics, performance, and credibility. In the private sector, leadership to bridge ethnic gaps and create business-to-business linkages would lay the basis for a stronger private sector. This can be good business in the short term, and it is an essential component in a long-term turnaround capable of attracting significant foreign and domestic investment.

9. POLICY ANALYSIS

9.1 Foreign or Domestic: Which Takes the Lead?

The statistical analysis in this study established that foreign investment takes the lead in stimulating domestic investment, and, more generally, economic growth. Those who argue that it squeezes out domestic investment are wrong as far as the big picture is concerned. In countries, such as Mauritius, where foreign investment has been a strong stimulus to growth, domestic investors reported unanimously foreign investment was a good thing, as linkages with foreign investors allowed them to benefit as well. In fact, even in Uganda and Kenya, nearly all African business leaders interviewed favored foreign investment, and recognized that it offered them economic opportunities. The few policy-makers who still oppose foreign investment tend to be politicians, not business leaders, playing on nationalist or ethnic sentiments.

These findings contradicted the team's hypothesis that domestic investment might, at least occasionally take the lead in stimulating foreign investment. While it remains true that local business people are often aware of local opportunities and favorable changes in the policy framework before foreigners, they have not taken the lead in major investment spurts. Why is that the case? The traditional explanation is that there are low domestic savings rates, so capital is lacking for investment. This argument does not hold for Mauritius, where surplus investment capital was actively seeking investment diversification. It may not even hold for continental African countries. Savings is measured in the formal financial institutions. Where these are weak or unreliable, capital is stored in other ways, often in jewelry, livestock and real estate—not to mention overseas bank accounts.

Capital flows very quickly in the current global economy when new opportunities surface. A recent sharp increase in capital availability in Kenya in the late 1990s is a good example. Government began issuing treasury bonds at very attractive interest rates, sometimes exceeding a 40 percent annual yield. Under this stimulus, capital materialized in Kenya so fast that the Kenyan shilling began appreciating rapidly in value and government had to review its monetary management policy. Most of it was believed to be domestic Asian capital.

There are two points here: (1) that official savings statistics do not adequately reflect the capital available for investment, and (2) that savings and investment are no longer as directly linked in the modern economy as they were a few decades ago, because capital is so much more mobile. These arguments lead us to reject the hypothesis that lack of savings is the major obstacle to domestic investment taking the lead. Domestic investors, however, face another type of obstacle to innovation, one rooted in the characteristics and geography of the new global economy.

The new economy is information-based. Information constitutes a new kind of money, in a sense. Intellectual capital complements monetary capital and both are needed to be competitive. Information management is as important as money management. Knowledge workers are a key source of productivity and business expansion. Rapid, low-cost telecommunications, and particularly the Internet, allow businesses to exchange and organize much greater quantities of precise information more quickly than ever before. If they could resolve the payment and shipping problems, African business people could conduct rapid cost-effective equipment procurement via the Internet. They could also reach vast global markets for their products.

In this new economy, local investors throughout the world face major disadvantages. They are on the periphery, far from the centers of innovation and the concentrations of information. The information revolution has the ability to connect them more easily and cheaply than ever before to sources of information through cheaper, more reliable telecommunications and the Internet. But many have lived isolated for so long that they do not know how to build international contacts. Academics, NGOs and government offices in the case study countries are beginning to have Internet access, but only a few use the Internet regularly as a source of information. Email is growing in popularity because it reduces the costs and increases the precision of international communications. A few businesses were beginning to use the Internet in Mauritius when the fieldwork for this study was done (in 1997), but very few businesses in Kenya and Uganda even used computers. Among those who had computers email was more used than the Internet. Local telephone access charges were too high, creating an entry barrier that prevented most businesses from taking the on-line time needed to learn how to use the Internet.

In practical terms, this meant that domestic investors lacked critical knowledge needed to lead investment in new areas. Mauritian domestic investors, for example, had capital to invest in the l970s and 1980s and good contacts in European markets. They were experimenting with a wide variety of potential business opportunities. They lacked the knowledge necessary to establish textile factories, however, until Hong Kong and Taiwanese investors agreed to invest in Mauritius. Similarly, potential domestic investors in Kenya and Uganda lack information on all types of equipment, manufacturers, suppliers and markets needed to implement many types of new businesses.

While the new economy has been created by innovations in electronic communications that have the potential to close the information gap, the present tendency is just the opposite. The information gap is widening. For this reason, foreign direct investment has taken the lead and will continue to take the lead in the immediate future.

One of the most important policy shifts African countries can make to favor a broad range of foreign and domestic investment is towards reliable, cheap telecommunications and transportation networks. Most countries have treated national telecommunications companies as cash cows, and these have been among the last to privatize. Those countries which do open up to private operators in telecommunications often try to protect both their own and the telecom investors' revenue streams—at the expense of all other businesses and consumers. Many countries, including Uganda, still have high taxes on computers, on the grounds that they are a luxury. Kenya moved quickly into the information age when it boldly eliminated tariffs on computer imports, and decided to promote information technology in the early 1990s. Countries which maximize access to information technology will have a clear future advantage over those which continue to limit access and make it a major source of government revenue.

There are two main components to a sound transportation network, the basic infrastructure and the cost of operating vehicles. The first depends on government investment in building and maintaining infrastructure, and the second depends mainly on tariffs on vehicles and fuel.

The ramifications of the conclusion that foreign investment leads the trend extend to investment promotion. We hypothesized that if domestic investment could take the lead, it would be cheaper for governments to conduct promotional campaigns among domestic investors than foreign ones. We still believe that it is important to conduct promotional campaigns among domestic investors, but it is clear that a greater investment in promoting foreign investment is justified.

All African countries currently have programs intended to stimulate foreign investment. Most recognize that they also want to encourage local investment. But the analytical approach and resultant policy are compartmentalized piecemeal offerings, sadly out of sync with what the literature shows to be the strongest real determinants of investment, both foreign and local.

It is clear from the study that both foreign and domestic investors respond to a holistic investment climate, not just a series of tax incentives or a promotional invitation. The hypothesis that both sets of investors respond similarly was thus confirmed. On the other hand, we had hypothesized that, this being the case, dialog with local investors would be more detailed and ultimately cost effective than dialog with foreign investors, because they know the flaws in the system so well. Again the realities of the study changed our views. This approach would be unwise largely because of the nature of the dialog that emerges when a select group is consulted. The problem is that investors focus on their own interests, often quite narrowly defined. Given an opportunity for dialog with policy-makers, particularly one in which they are defined as a stakeholder group, they are likely to plead for protectionism and privilege, not the "greater common good." This observation applies to foreign as well as domestic investors. In practice, however, domestic investors have more opportunities to meet with policy-makers and argue for protectionist policies. Policy-makers are also more easily persuaded by domestic protectionist arguments, as they frequently combine political and economic rationales.

Our conclusion is that policy-makers need to recognize protectionist logic. They need to expect every economic policy to have a trade-off, every argument to have two sides. When they hear business people argue for a particular policy, they need to ask themselves, "If this group gains, who loses?" Going on to define the winners and losers, and to quantify the magnitude of the gains and losses, they can arrive at an economically appropriate decision. Policy-makers who are not trained in economics may need to employ economists who can identify and quantify gains and losses for each policy option, and present these concisely. In the course of the workshops for economists and policy-makers held over a five-year period by the USAID Equity and Growth through Economic Research Project (EAGER), one could observe this happening. Policy-makers who initially favored protective tariffs to keep a tannery or agricultural processing factory viable, discovered that they were thereby crippling entire livestock and agricultural sectors. By the end of the project, several had shifted to favoring what would benefit the larger number and the economy as a whole. The present study team concluded that as a complementary practice to cost-benefit analysis, policy-makers wanting to promote investment should conduct stakeholder dialogs, as often as possible, in open mixed sessions with both foreign and local investors present and addressing their common concerns. Promotional campaigns should address both groups of investors simultaneously.

This leaves the question of how to address legitimate concerns of local investors that they are both historically and presently disadvantaged in terms of access to business education, skills, technology, practical experience, global contacts and credit.

The most important lesson of the case studies is that forcing the process by reserving certain businesses for disadvantaged groups does not work. What does work is linkages between foreign and local investors. Local investors in all three countries found their best initial opportunities not in competing head to head with foreign investors in a particular industry, but in complementary aspects of the upstream and downstream chain of activities in that sector. By being good suppliers of goods and services and/or processors or marketers of the foreign investors' products, they could grow their own businesses. Some who started as jobbers, providing, for example cutting and assembly services for large textile firms, eventually learned the business well enough to operate full-service firms themselves.

How can governments push this process without forcing investors into uneconomic relationships? Voluntary programs generally work best for investors, especially if policy-makers can get investors to own the process—to see the legitimate social need and be pleased to be part of the solution. Where a national resource is at stake, as in mining industries, governments would be justified in setting a local sub-contracting and procurement threshold that investors must meet. Then they need to let investors decide how best to meet that benchmark in ways that are economically viable for them.

9.2 Old and New Determinants of Foreign Direct Investment

The determinants of FDI are changing not only in their importance in the global economy, but also in their structures and characteristics. That is why developing countries increasingly need to understand not only the motives of foreign investors but also their more complex strategies. The overseas investment strategies of MNCs in the new economy can be summarized in six main considerations:

- Access to resources,
- Secure mobility of people, goods, information and capital into, around and out-of the country,

- Sound institutions—stable government, security of life and property, rule of law, viable financial services, and modern education and health systems,
- Economic characteristics of the location,
- Host-country investment incentives, and
- International policy environment.

Countries compete for foreign direct investment based partly on natural resources and geographic advantages, but Mauritius has shown that countries can succeed based almost exclusively on policies and institutions. The four factors listed above all respond to good policies. History counts, however. Policy-makers in countries with a history of poor policies and institutional degradation will need to work longer and harder to achieve a sustained turnaround.

9.2.1 Access to Resources

Historically, the availability of natural resources has been the most important FDI determinant for countries lacking the capital, skills, know-how and infrastructure required for their extraction and sale to the rest of the world. The importance of this determinant per se has not decreased but the importance of the primary sector in world output has declined. In addition, large indigenous, often state-owned, enterprises have emerged in developing countries with the capital and skills to extract and trade natural resources. These changes mean that TNC participation in natural resource extraction is taking place more through non-equity arrangements and less through FDI, although the value of FDI in natural resources is far from declined.

9.2.2 Secure, Low Cost Mobility

Secure mobility of people is determined by a combination of passenger transportation networks and immigration and labour policies. Secure mobility of goods depends on freight and postal networks and customs law and practice. Secure mobility of information depends on telecommunications, courier and postal networks, plus the degree of protection afforded intellectual property and business confidentiality. For capital movements, monetary policies, capital markets and banking institutions are still fundamental.

In any of these policy areas, total freedom is not the goal—substantial freedom is. Countries have a legitimate need to set limits and to monitor movement in all of these areas. Total freedom of movement could create inappropriate risks. For example, countries bar persons with felony criminal records and terrorist or mob links. Immigration restrictions need to be more flexible and more responsive to economic change than has been the case in the past, however. Mauritius has found it necessary to allow continued immigration of contract textile workers from China and India, even though a substantial skilled worker base exists on the island itself. The rationale is that a sprinkling of faster, more reliable immigrant workers keeps the whole chain competitive. This kind of finely tuned immigration policy is rare. More often, as in Kenya and Uganda, countries seek to exclude competition from foreign workers as soon as there is evidence of any local capability. Another aspect of immigration and labour policy that surfaced in investor interviews is the problem of employment for family-members of investors and key staff. Given the global trend toward entry of women and youth into the salaried labour force, a modern investment incentives policy should include an assurance of work permits for family members. The impact on local unemployment is more likely to be positive than negative particularly where such employment can be outside the investor's firm, as family members in the work force also facilitate the transfer of skills and technologies from their home country.

While airports in all three case study countries are adequate, the ports, roads and railroads in East Africa have been allowed to disintegrate or have failed to keep up with growth to the point where they are a major disincentive to investors. Remedying this situation should be an immediate priority.

Mobility of goods has been restricted periodically in East Africa by border closings, arbitrary and corrupt customs practices. In the last decade border closings have rarely been a problem, and both countries are working to improve customs operations. But a culture of corruption takes time and concentrated effort to eradicate, and establishing credibility with business people takes even longer.

Remaining legal obstacles to movement include regulations making it difficult and costly for trucks to cross borders carrying merchandise. MNCs favor regional integration, but a more immediately attainable solution would be local leadership on this issue and a series of bilateral agreements to facilitate truck movements.

The East Africa Cooperation Agreement (EAC) was signed by Kenya, Uganda and Tanzania early in 2000. Those countries have also belonged for a couple of decades to the Common Market of Eastern and Southern Africa (COMESA). Member countries have generally not implemented the principles agreed to by COMESA, making it an awkward stalled effort.

In addition to physical and legal transportation problems, there is the question of cost. On transportion costs as an obstacle to business, Kenya and Uganda ranked worse than the African average in the investors' survey (13^{th} and 14^{th}/20 respectively), while Mauritius ranked 6^{th}/20. (World Economic Forum/HIID, 1998) This has to be understood in a context where Africa ranks worst of all continents. To be competitive in the new economy, all three countries will have to focus on reducing transportation costs.

Secure, low cost mobility of information has become the leading priority in the new economy. All three case study countries are beginning to pay attention to this area, but with sharply varying degrees of success. Mauritius ranks best in Africa in telecommunications infrastructure, and second best in telecom costs. Kenya and Uganda rank below the African average on both indices. (World Economic Forum/HIID, 1998) Internet service and intellectual property will be key indices for future investment.

A great policy success in all three countries has been liberalization of currency controls, previously a key restraint on free movement of capital. Mauritius removed controls in the 1980s and Kenya and Uganda moved to floating currencies in the mid-1990s. All three saw an immediate improvement in the investment climate. Monetary management has been less of a problem than policy makers had feared. Each country has experienced gradual currency devaluation, but none has experienced sharp drops or hyperinflation. Capital markets are seen as a major means of attracting increasingly rapidly mobile international capital. Mauritius and Kenya have established small fairly successful capital markets. Uganda is hesitating between developing its own and using the Kenyan market in the new EAC.

9.2.3 Institutions

The stark findings of recent analysis of variants research force policy-makers' attention to two areas that used to be only vaguely connected with investment promotion: ethnicity and institutions. (Easterly and Levine 1994; Alesina and Tabellini 1989; Alesina and Drazen 1991; Shleifer and Vishny 1993; Alesina and Rodrik 1994; Alesina and Spoalare 1995, Easterly and Levine 1996) (See above, chapter 2.3.) The ethnicity variable accounted for half of the growth differential between Asian and African countries from the 1960s to 1990. That variable is a factual measure of ethnic fragmentation, not a policy variable, so the policy implications can only be inferential at this point. A logical inference, and one supported by the positive Mauritian experience, is that policy-makers should focus every effort on minimizing ethnic differences. Ethnicity not an immutable attribute ascribed at birth, but a fluid combination of ascribed and acquired identity. Individuals are at the heart of a set of concentric ethnic circles, and can define themselves, and be defined by others, as belonging to very narrow or very wide ethnic categories, depending upon the context. Politicians and policies strongly influence that process, transforming diverse ethnicity into a celebrated source of national pride or a font of hatred and violence. Of the case studies, Uganda is suffering the longest lasting negative effects of ethnic polarization. Kenya's recent plunge into ethnic polarization was cited by a significant portion of potential investors who would not consider investing in Kenya at present.

The good news is that sound institutions can offset the negative influence of ethnic fragmentation. This provides a focus for policy-makers who resent the fact that a variable over which they feel they have no control should have such explanatory power. Sound institutions start with rule of law in general, and respect for private property in particular. Mauritius is highly ranked on both accounts. Kenya and Uganda have suffered from a tendency for rule to be personalized. This is reflected in Daniel Arap Moi's statement while he was still in the opposition that President Kenyatta was, of course, above the law. (See above, chapter 8.1.1) Law and order in Kenya and Uganda, as in much of the world, are maintained by the credibility of personal authority more than by respect for law. The situation is complicated in ex-colonial countries by the fact that written law was introduced by colonial authorities. This leaves it vulnerable to violation at all levels of society.

Similarly private property is not a traditional African concept. Property was held communally throughout Africa. Authority over it was not lodged in a single proprietor, but in superimposed hierarchy of rights. The right to expropriation was often exercised by chiefs. They took smaller liberties with their loyal clients' possessions, and totally dispossessed officials or subjects who defied their authority. This tradition came through in the early post-independence period. In Uganda, seizing Asian properties and driving the owners out of the country under Idi Amin followed this model, as did, in Kenya, post-independence campaigns to nationalize some colonial-era firms and lands and forcibly transfer Asian firms to African ownership. Under Museveni, investors report an end to government claims on commissions, kickbacks or other rents from private business. In Kenya, the practice is still an obstacle to investment.

Can and should African countries convert to legal systems enforcing private property? The philosophical transition has already been made in most cases, in that constitutions generally proclaim the right to private property. Implementing laws are much more ambiguous, with many types of overlapping rights and jurisdictions. This team is convinced that there is no other alternative for countries that wish to mobilize capital to develop a modern economy. We have studied traditional tenure systems and the social system with which they are integrated for several decades. To ease the social disruption caused by any transition in property rights, we think it best that strict respect for private property be enshrined and enforced first in corporate law, intellectual property law and urban land law. From there it is already extending to cash cropped farming areas, and will eventually extend to land in general. Countries which move this process along quickly will have an advantage over traditionalists.

Security of life and property are also major concerns for investors. Foreign investment requires high mobility of people, goods, information and capital. High crime rates affecting any one of those areas will deter investment. This has particularly been a problem for Kenya in the last two decades.

Viable financial institutions are the next most important aspect of sound institutions needed to attract investment. Foreign investors can and do use off-short banking services for many of their financial needs. Local investors suffer most from unsound financial sectors. Crony capitalism has plagued African credit schemes, to the point where few banks offer long-term credit at all. Kenya and Uganda's banks were considered among the least sound in Africa; Mauritius was near the top. (World Economic Forum/HIID, 1998: 196) If Kenya and Uganda are to compete effectively for investors, their banks must offer faster, lower cost and more reliable financial services of every type.

Education and health are likewise of critical importance. Literacy in English is increasingly important in the computer age. Literacy in Indian and Chinese languages is likely to be important as those densely populated emerging markets develop. Computer literacy and telecommunications technical skills are becoming more important. Employers are increasingly seeking countries where good technical schools complement liberal arts curricula.

The fine nuances of health systems such as the quality and cost of care have been overshadowed by a single factor in the last decade—the rising incidence of life-threatening communicable diseases. Malaria, HIV-AIDS, and drug-resistant tuberculosis are endemic in tropical Africa and now epidemic. Investors used to consider this a human resources problem affecting mainly local staff. Now many fear for themselves and their families as well. Even companies that can afford to provide the best care for their employees cannot ensure their good health.

In recent years Kenya and Uganda have relaxed restrictions on non-governmental organizations, which has produced a flourishing civil society. This too contributes to sound institutions. The evidence suggests that the more organizations of all types that citizens participate in, the healthier, more stable the society. Such organizations can create negative social capital, to the extent that they are particularistic and push for privilege or separatism rather than openness. The vast majority of such organizations, however, make a positive contribution, providing for dialog, the development of organizational skills and experience with cooperation and compromise in ever larger groups.

Institution building has been regarded as a long-term process. Yet with the global economy accelerating, and the gap between poor and rich widening, it has to move faster. Policy-makers need to focus on it, and to realize that without sound institutions they are at a competitive disadvantage.

9.2.4 Economic factors

Market size, costs of operation and the macroeconomic framework are the main economic factors on which investors focus. Market size leads major MNCs to focus on Asia, and particularly on China, which has begun to show sustained GDP growth. African countries could not rival China even if the continent were unified, which it decidedly is not. Investment promotion officials like to combine the populations and GDP of SADC or COMESA countries to claim large markets. Investors soon learn, however, that these regional organizations have not yet created an integrated market, that the borders are still very real obstacles to movement. This certainly means that serious regionalization has to take place. In the meantime, however, it implies that investment promotion campaigns should target medium and smaller investors, matching scale to scale.

Costs of operation make it difficult for all three case study countries to compete, so they need constant attention from policy-makers. Labour costs are low in Kenya and Uganda, but not as low as China, Viet Nam or Cambodia. In Mauritius they have already become medium by world standards. Costs of fuel, energy, telecommunications and transport also make it difficult for firms in all three countries to compete. Now that competitiveness study methodology has become widely known, professional associations should be monitoring and dialoguing continuously amongst themselves and with government on means to keep costs competitive.

A stable macroeconomic framework has been the goal of structural adjustment programs, which have left no African country untouched in the last fifteen years. Mauritius liberalized trade and currency restrictions in the early 1980s, voluntarily and well ahead of the pack. Kenya and Uganda followed suit in the 1990s. Uganda has been among the darlings of the international financial institutions because it got its policies right, and saw an economic response. Investors generally rank the government and economic policies highly. Uganda was among the first to qualify for debt relief on this basis under the international financial institutions Highly Indebted Poor Countries program. Government got control of deficit spending, floated the currency (which stabilized), liberalized trade, maintained control of inflation, restored confiscated properties and generally restored investor optimism. Actual successful investment has been disappointing, however, as high costs of operation have not been offset even by the most supportive government attitude. Getting macroeconomic policies right is still a necessity, but it is not enough.

9.2.5 Host-Country Incentives and Business Facilitation

How important are investment incentives? Can countries afford them? The short answer emerging from this study is that incentives are the fourth of the major considerations. If a country ranks well on the first four factors, very modest tax incentives can attract investment. The worse a country ranks on the first four factors, the higher the risk investors assign it, and the worse bargain it gets on taxes. Countries that try to compete by giving away everything have generally not taken care of the first four factors first, and are trying to buy investment interest in a rather unhealthy bargain.

Why have major incentives worked so well for Mauritius then? Mauritius had most of its first four factors in good shape, with the exception of transportation costs and government efficiency. Its major handicaps were lack of resources and tiny market size. It could only grow through export promotion, so it has agreed to a permanent and total tax exemption for export industries. And it has reserved its major resource, its beaches, for local ownership.

In comparison, Kenya and Uganda have moderate mineral resources, substantial tourism potential, hydropower potential and many other under-exploited assets. They need to offer substantial tax incentives now mainly because they have not maintained their infrastructure, nor created the sound institutions, nor lowered operating costs sufficiently to make their firms competitive.

In order to compete, host countries seeking FDI can no longer rely on creating an FDI-friendly policy framework, sitting back and watching it work. The global economy shifts so rapidly, new technology is introduced so often, that policy-makers need to formulate and reformulate strategies based on close observations of the motives and strategies of MNCs that they would like to attract.

As FDI policies become similar around the world, additional determinants are needed to attract investment. Business facilitation measures are measures designed to make MNCs more comfortable in doing business in a country. These measures include investment promotion, incentives, after-investment services, improvements in infrastructure and measures that reduce the administrative costs of doing business. Business facilitation tools are increasingly used by countries, in more sophisticated ways. For instance, single investors are targeted, and offered after- investment services. Although this measure might be costly, a successful investment could be a marketing tool in order to attract other similar investment.

9.2.6 International Policy Environment

By international policy environment, we mean both policies in the country from which FDI originates and more generally policies that might affect the decisions of MNCs to invest that do not originate in either the home or the host-country. While the extent to which countries wishing to attract FDI can actually influence such policies may be very limited, understanding them is critical.

For example, a primary reason for the rise in popularity of outsourcing by high-tech firms in the United States is the high cost of labor in the United States. While many countries around the world have a cost advantage vis a vis the United States, most U.S. firms chose to locate in East Asia, at least initially. Why did they choose East Asia? Apart from the direct cost advantages offered by these countries, Japanese firms were all outsourcing to countries in East Asia. And, at that time, Japan actually dominated the electronics industry.

Critics of MNCs have charged that MNCs move to less developed countries in search of more lenient environmental standards than those existing in their own countries. This may or may not be true. But, if it is, it has important implications for developing countries wishing to attract FDI. Finally, Mauritius is a prime example of the type of "push" factor we are talking about. Chinese investors would not have considered Mauritius had it not been for the need to circumvent the United States' Multi-Fibre agreement.

All of the above are examples of conditions that can lead an MNC to invest overseas. And, all of the above are examples of events over which developing countries will have little or no control. They can however make it a point to stay informed about events such as these and try to take advantage. At least for Kenya and Uganda, the steps required to even become a country that an MNC would consider investing in will take time. And, in the process, the local business community should benefit.

9.3 Country Competitiveness in the New Economy

As noted above, technology and innovation have become critical to competitiveness. Openness to trade, FDI and technology flows, combined with deregulation and privatization, have improved firms’ access to markets for goods and services and to immobile factors of production and have increased competitive pressures in previously protected home markets, forcing firms to seek new markets and resources overseas. At the same time, technological advances have enhanced the ability of firms to coordinate their expanded international production networks in their quest for increased competitiveness. More and more firms are therefore developing a portfolio of locational assets to complement their own competitive strengths when they engage in FDI, as witnessed by the growing number of firms that are becoming transnational.

To attract such competitiveness-enhancing FDI, it is no longer sufficient for host countries to possess a single locational determinant. MNCs undertaking such FDI take for granted the presence of state-of-the-art FDI frameworks that provide them with the freedom to operate internationally, that are complemented by the relevant bilateral and international agreements, and that are further enhanced by a range of business facilitation measures. When it comes to the economic determinants, firms that undertake competitiveness-enhancing FDI seek not only cost reduction and bigger market share, but also access to technology and innovative capacity. These resources, as distinct from natural resources, are people-made. They are “created assets”. Possessing such assets is critical for firms’ competitiveness in a globalizing economy. Consequently, countries that develop such assets become more attractive to TNCs. The rise in the importance of created assets is precisely the single most important shift among the economic determinants of FDI location in a liberalizing and globalizing world economy. In addition, the new configuration also includes agglomeration economies arising from the clustering of economic activity, infrastructure facilities, access to regional markets and, finally, competitive pricing of relevant resources and facilities.

One implication for host countries wishing to attract TNCs undertaking competitiveness-enhancing FDI is that created assets can be developed by host countries and influenced by governments. The challenge is precisely to develop a well-calibrated and preferably unique combination of determinants of FDI location, and to seek to match those determinants with the strategies pursued by competitiveness-enhancing TNCs. It must be remembered too that created assets also enhance the competitiveness of *national* firms. Thus, policies aimed at strengthening innovation systems and encouraging the diffusion of technology are central because they underpin the ability to create assets. Also important are other policies that encourage the strengthening of created assets and the development of clusters based on them as well as policies that stimulate partnering and networking among domestic and foreign firms and allow national firms to upgrade themselves in the interest of national growth and development

All in all, the different investment determinants are country-specific and depend on an individual country’s political as well as economic situation and on the progress it has made in the improvement of its investment climate, in the liberalization of its FDI policies and in its promotion activities. For instance, some countries will have to make every effort to create the basic conditions of a favorable investment climate, such as ensuring political and economic stability. These measures should be followed or accompanied by efforts to promote private-sector development, to ensure the proper functioning of markets and to engage in more prudent macroeconomic management.

Countries that have put these conditions in place will have to focus on the further improvement of the FDI climate, for example, on the simplifying of administrative and bureaucratic procedures, learning from best practices elsewhere.

Other countries that have FDI potential but receive low levels of FDI might also need to focus on promotion efforts and look at ways of attracting FDI to particular industries or projects. Those countries that have already established promotion agencies need to review the effectiveness of their work. Unexploited investment potential on the part of newly investing countries should be identified and targeted in promotional efforts. Countries that have all the core FDI framework and that are undertaking aggressive business facilitation measures should also use globalization as a tool. In other words, they should constantly innovate, use technological advances and offer MNCs the most efficient and cost-effective alternative by playing on the firms strategies and motives.

9.4 Will Investment Frameworks Become Standardized?

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There has been some progress in negotiating a multilateral framework on investment for particular sectors, such as telecommunications. The WTO had been moving toward more generalized standardization, or at least principles. If this happens, host countries' bargaining power on FDI policies will decrease. Making FDI policies standard could help some countries to accelerate their FDI liberalization policies, by creating consensus and reducing debate. Advocates argue that it will stabilize policies and enhance transparency, creating the reliability needed to encourage investment. On the other hand, it would reduce the bargaining power of countries who need to compensate for inadequacies in one area by offering incentives in another.

Components under discussion for a future Multilateral Framework for Investment include (Khor 1998):

- The right of entry and establishment of foreign companies to enter and establish themselves in some sectors of the host country,
- The right for full equity ownership,
- National Treatment,
- Removal of many regulations and conditions now imposed on foreign companies by host governments (e.g. Movement of personnel, performance requirements, allowing foreign firms to take part in privatization projects),
- Protection of foreign investors in regard to discrimination, intellectual property, expropriation, etc., and
- Establish a dispute settlement system to make the agreement legally binding and enforceable.

Generally, barriers would be removed to allow international companies to cross borders, set up projects and interact with local companies. Under this framework, MNCs would face minimal or no regulations in host countries as to conditions for the establishment, ownership, and operation of business.

10. SUMMARY OF CONCLUSIONS AND RECOMMENDATIONS

10.1 FDI has a strong stimulus effect on domestic investment, and on economic growth--but it is not a panacea.

10.2 A holistic approach to encouraging investment is needed. It has to take into account how each country compares on the five key factors:

- Access to resources;
- Secure mobility of people, goods, information and capital into, around and out-of the country;
- Sound institutions—stable government, security of life and property, rule of law, viable financial services, and modern education and health systems;
- Economic characteristics of the location; and
- Investment incentives and business facilitation; and
- the International policy environment.

10.3 Priorities and sequencing will be different for each country and sector, depending on how it measures up to the competition.

In Kenya and Uganda the priorities need to be institution building, infrastructure, security and cost reductions. Within those categories there are nuances: in the security area, Kenya needs to bring down on its high crime rate, while Uganda concentrates on making peace with rebels in the north and west. Each country will need to do its own institutional evaluation and reform plan. Similarly, business people and government will have to confer on which costs can most readily be reduced for the greater benefit of all. An important consideration in that process will be applying the truism emblazoned on matatas, but not yet respected in government services: "Time is money." In the accelerating world economy, delays have become an increasing costly aspect of transaction costs for everything from processing a shipment through customs to transferring money to getting a permit.

All three countries have mostly got their macroeconomic framework right now. Unfortunately that is not enough, as most of the rest of the world's countries have done likewise.

10.4 A multilateral investment framework will probably not help the three case study countries attract investment.

It tells policy-makers what investors want, but not how to get their country there ahead of the rest.

10.5 The factors above provide a framework for monitoring by each country.

Instead of relying on low level investment promotion units to market their countries, governments need to do regular self-evaluations, based on internal and external dialog and monitoring. Evaluations can be led by groups like the Presidential Forum in Uganda. Similar task forces can be created in each country. The leaders know the most dynamic, representative and knowledgeable groups. They should report at least quarterly to government on how the country ranks in each area. Each report should conclude with recommended policy priorities and adjustments to implementation where needed.

APPENDICES

Table A 4.1

DOES FDI STIMULATE DOMESTIC INVESTMENT?

(Investment as a Share of Gross Domestic Product - annual data 1970-1996)

Dependent Variable:	Total Domestic Investment		Private Domestic Investment		Public Domestic Investment	
Regressors:	LSDV	GMM	LSDV	GMM	LSDV	GMM
Foreign Direct Investment (-1)						
Africa	0.46	0.26	0.85	0.55	0.06	-0.13
	(1.81)	(3.21)	(2.63)	(0.87)	(0.77)	(0.69)
Asia	0.52	0.37	2.14	5.06	0.26	1.04
	(2.38)	(3.12)	(1.96)	(2.42)	(0.51)	(0.77)
Latin America	0.47	0.63	0.38	1.01	0.09	-0.07
	(1.97)	(3.51)	(1.14)	(1.69)	(0.68)	(0.58)
OECD	0.05	0.54	-0.07	-0.28	-0.03	0.11
	(0.36)	(8.89)	(0.41)	(0.56)	(0.47)	(0.99)
Domestic Investment (-1)						
Africa	-0.03	-0.04				
	(0.65)	(6.79)				
Asia	0.05	-0.05				
	(0.74)	(3.99)				
Latin America	-0.17	-0.07				
	(1.33)	(7.96)				
OECD	0.82	0.46				
	(19.92)	(11.28)				
Private Domestic Investment (-1)						
Africa			-0.27	-0.92	0.05	0.05
			(2.97)	(3.86)	(1.93)	(0.71)
Asia			0.09	-0.56	0.07	0.04
			(0.91)	(2.08)	(1.71)	(0.41)
Latin America			-0.06	-0.87	0.04	-0.19
			(0.58)	(1.22)	(1.17)	(0.66)
OECD			0.83	0.93	0.00	-0.01
			(18.19)	(4.04)	(0.01)	(0.09)
Public Domestic Investment (-1)						
Africa			-0.52	-0.52	-0.17	-0.16
			(1.14)	(1.14)	(0.95)	(0.67)
Asia			0.26	0.26	-0.03	0.21
			(0.36)	(0.36)	(0.16)	(0.77)
Latin America			-0.82	-0.82	0.09	-0.02
			(1.45)	(1.45)	(0.68)	(0.12)
OECD			0.41	0.41	0.68	0.38
			(1.19)	(1.19)	(6.43)	(4.91)
n	1704		677		677	
R^2	0.85		0.85		0.93	
Sargan Test		57.71				

Data Source: All data come from International Financial Statistics tapes. Data on foreign direct investment for Sub-Saharan Africa was updated using the United Nations Commission on Trade and Development Investment Directory Volume V, published in 1997. N

Table A 4.2

DOES FDI STIMULATE DOMESTIC INVESTMENT?

(Investment as a Share of Gross Domestic Product - five year averages)

Dependent Variable:	Total Domestic Investment		Private Domestic Investment		Public Domestic Investment	
Regressors:	LSDV	GMM	LSDV	GMM	LSDV	GMM
Foreign Direct Investment (-1)						
Africa	2.78	2.89	0.82	3.71	0.19	1.27
	(2.35)	(2.67)	(0.55)	(2.52)	(0.53)	(2.93)
Asia	-0.28	2.18	7.89	16.32	1.87	2.27
	(0.25)	(2.35)	(2.77)	(8.11)	(2.64)	(4.22)
Latin America	2.19	1.99	0.85	2.52	0.07	1.04
	(2.18)	(2.89)	(0.72)	(1.28)	(0.19)	(2.31)
OECD	-1.76	-4.21	0.25	-2.29	-0.26	-0.71
	(1.83)	(3.08)	(0.28)	(1.47)	(1.07)	(1.66)
Domestic Investment (-1)						
Africa	0.06	0.07				
	(0.24)	(0.56)				
Asia	-0.43	-0.23				
	(1.38)	(1.45)				
Latin America	-0.15	-0.11				
	(0.45)	(0.35)				
OECD	0.45	0.51				
	(1.78)	(2.69)				
Private Domestic Investment (-1)						
Africa			-0.39	-0.66	-0.09	-0.01
			(1.29)	(4.39)	(0.99)	(0.21)
Asia			-0.01	-1.19	0.12	-0.15
			(0.04)	(1.61)	(1.27)	(1.25)
Latin America			-0.41	0.17	0.12	0.09
			(0.88)	(0.58)	(1.02)	(1.45)
OECD			0.48	0.45	0.09	0.04
			(2.67)	(3.09)	(1.49)	(0.62)
Public Domestic Investment (-1)						
Africa			0.32	0.39	-0.42	-0.51
			(0.39)	(0.37)	(1.52)	(3.22)
Asia			-0.34	-0.61	-0.53	-0.44
			(0.49)	(0.26)	(2.01)	(1.23)
Latin America			-1.69	-0.66	-0.62	-0.82
			(2.21)	(0.72)	(1.79)	(4.86)
OECD			0.69	0.91	0.28	0.38
			(1.79)	(0.91)	(1.65)	(2.59)
n	283		146		146	
R^2	0.83		0.76		0.92	
Sargan Test				4.59		13.45

Data Source: All data come from International Financial Statistics tapes. Data on foreign direct investment for Sub-Saharan Africa was updated using the United Nations Commission on Trade and Development Investment Directory Volume V, published in 1997. N

Table A 4.3

DOES DOMESTIC INVESTMENT STIMULATE FDI?

(Investment as a Share of GDP - Annual Data 1970-1996)

Dependent Variable:	Foreign Direct Investment		Foreign Direct Investment	
Regressors:	LSDV	GMM	LSDV	GMM
Domestic Investment (-1)				
Africa	0.03	0.01		
	(1.43)	(12.75)		
Asia	0.04	0.01		
	(1.08)	(2.32)		
Latin America	0.01	0.01		
	(0.65)	(9.96)		
OECD	-0.03	-0.02		
	(1.79)	(8.81)		
Private Domestic Investment (-1)				
Africa			0.04	0.05
			(1.81)	(0.95)
Asia			0.04	0.07
			(0.21)	(1.31)
Latin America			0.01	0.46
			(0.39)	(2.16)
OECD			-0.003	-0.04
			(0.26)	(0.76)
Public Domestic Investment (-1)				
Africa			0.04	-0.17
			(0.61)	(1.42)
Asia			0.09	-0.44
			(1.47)	(1.96)
Latin America			-0.09	-0.26
			(0.99)	(2.04)
OECD			-0.08	0.14
			(1.46)	(1.46)
Foreign Direct Investment (-1)				
Africa	-0.24	-0.19	-0.27	-0.47
	(1.02)	(49.43)	(2.03)	(1.96)
Asia	0.06	-0.02	0.25	-0.46
	(0.44)	(0.09)	(1.22)	(0.79)
Latin America	-0.02	-0.27	-0.13	-0.35
	(0.07)	(19.73)	(0.66)	(0.96)
OECD	0.56	0.11	0.59	0.47
	(7.63)	(12.29)	(7.13)	(1.96)
n	1704		674	
R^2	0.47		0.73	
Sargan Test		76.29		5.19

Data Source: All data come from International Financial Statistics tapes. Data on foreign direct investment for Sub-Saharan Africa was updated using the United Nations Commission on Trade and Development Investment Directory Volume V, published in 1997. N

Table A 4.4

DOES DOMESTIC INVESTMENT STIMULATE FDI?

(Investment as a Share of GDP - five year averages)

Dependent Variable:	Foreign Direct Investment		Foreign Direct Investment	
Regressors:	LSDV	GMM	LSDV	GMM
Domestic Investment (-1)				
Africa	0.09	0.11		
	(1.83)	(1.99)		
Asia	0.12	0.14		
	(1.19)	(1.45)		
Latin America	0.06	0.09		
	(1.09)	(1.54)		
OECD	-0.12	-0.76		
	(2.48)	(1.97)		
Private Domestic Investment (-1)				
Africa			0.02	0.19
			(0.45)	(2.37)
Asia			0.13	0.24
			(2.43)	(2.11)
Latin America			0.04	0.26
			(0.70)	(3.15)
OECD			-0.07	-0.21
			(1.42)	(2.45)
Public Domestic Investment (-1)				
Africa			0.06	0.11
			(0.33)	(0.56)
Asia			0.25	-0.01
			(1.77)	(0.04)
Latin America			-0.04	-0.19
			(0.18)	(0.81)
OECD			-0.17	-0.12
			(1.42)	(0.65)
Foreign Direct Investment (-1)				
Africa	-0.67	-0.71	-0.53	-0.24
	(2.54)	(3.04)	(1.38)	(0.46)
Asia	-0.44	-0.42	0.51	-0.16
	(1.09)	(1.56)	(1.44)	(0.36)
Latin America	-0.77	-0.79	-0.24	-1.61
	(2.03)	(2.73)	(0.91)	(3.52)
OECD	0.39	0.41	0.41	0.93
	(2.09)	(3.28)	(1.59)	(2.76)
n	283		145	
R^2	0.77		0.77	
Sargan Test		13.79		13.71

Data Source: All data come from International Financial Statistics tapes. Data on foreign direct investment for Sub-Saharan Africa was updated using the United Nations Commission on Trade and Development Investment Directory Volume V, published in 1997. N

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