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Foreign and Local Investment in East Africa

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 brief is based on a study that 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). The study was designed to explore whether foreign direct investment squeezes out locals, or conversely opens up opportunities for them. The study concludes the following:

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 long-term 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.

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

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