EAGER Policy Brief

NUMBER 48 / JANUARY 2001

Does it pay to court foreign investment?

The consensus of economic literature is that foreign direct investment (FDI) is a strong impetus to growth in trade, GDP and social welfare. What is less clear is whether domestic investment can take the lead? If so, it is cheaper and more politically popular to focus on stimulating it. With funding from the US Agency for International Development, a team of four African and American researchers undertook to explore that question through statistical analysis and case studies in Mauritius, Uganda and Kenya.

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. The team believed that low official savings rates are partially a mirage, reflecting lack of confidence in local financial institutions more than the actual savings behavior of residents. Weak financial sectors drive savings into overseas accounts and into non-financial local investments such as cattle.

Poor understanding of foreign/domestic investor dynamics 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 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.

USAID

Equity And Growth through Economic Research– an activity of USAID, Bureau for Africa, Office of Sustainable Development, Strategic Analysis Division

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The study of Foreign and Local Investment in East Africa, on which this policy brief is based, used Granger causality tests to examine the relationships between foreign and domestic investment on a 110-country global investment database, using both annual data and five-year averages for the period 1970 to 1996. The analysis showed that FDI is a strong stimulus to domestic investment in every region and time period. The isolated cases in which either foreign or public investment appeared to squeeze out local private investment appeared to be cases in which major sectors of the economy were divided up into exclusive monopolies. The monopolies did indeed squeeze out local private sectors. Monopoly businesses, however, generally failed to compete and most monopolies have been broken.

To the team's surprise, in developing countries there was no converse stimulation of foreign investment by spurts in domestic investment.

Three case studies of Mauritius, Uganda and Kenya, showed why it has been difficult for local investors to take the lead. Mauritius is interesting because it had sophisticated local investors with surplus capital who were actively trying to diversify their investments into manufacturing, agricultural exports and tourism. These were mainly Franco-Mauritian families, whose wealth derives from the sugar plantations that occupy nearly the entire arable lands of the island. They were motivated to invest in Mauritius because it is their home, and they looked for export potential to take advantage of the Export Processing Zone legislation passed in 1971. They knew international trade, and could readily develop commercial contacts in Europe. Yet it took the arrival in the early 1980s of textile manufacturers from Hong Kong and Taiwan and hotel/resort operators from South Africa to set off the boom. Why?

The key missing ingredient was that cornerstone of the modern global economy: knowledge. While knowledgeable about business in general, local investors lacked the breadth and depth of practical knowledge to operate textile factories and world-class tourist facilities on a competitive basis. When foreign investors became interested in significant numbers in the 1980s, locals invested in joint ventures with some. In other cases, they developed less direct linkages. As suppliers of inputs, jobbers, market consultants, hired managers, etc., they learned how to be competitive in those sectors. Soon they were competing successfully and buying out foreign interests.

In Uganda and Kenya, local investors have found opportunities in developing the same linkages with foreign-owned firms. They have succeeded more often in upstream and downstream clusters that complement foreign firms than in competing head on with them.

So the answer to whether it pays to court foreign investment is a clear yes. Foreign investment benefits both local investors and the national economy.

The expense of promoting foreign investment pays off best for governments that take a holistic approach to investment policy. Investment incentives will only pay off once countries overcome their ethnic particularism and ensure that the fundamentals that attract investors are in place, namely:

- 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,
- A proactive globalization policy, recognizing the importance of information technology, and
- Alertness to international opportunities and obstacles, as they appear.

These issues are of such broad scope that investment climate monitoring needs to be conducted at the top levels, both government and private. Investment promotion centers have little impact until such monitoring is established.

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

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