

## Foreign Investment and Economic Development: Evidence from Private Firms in East Africa

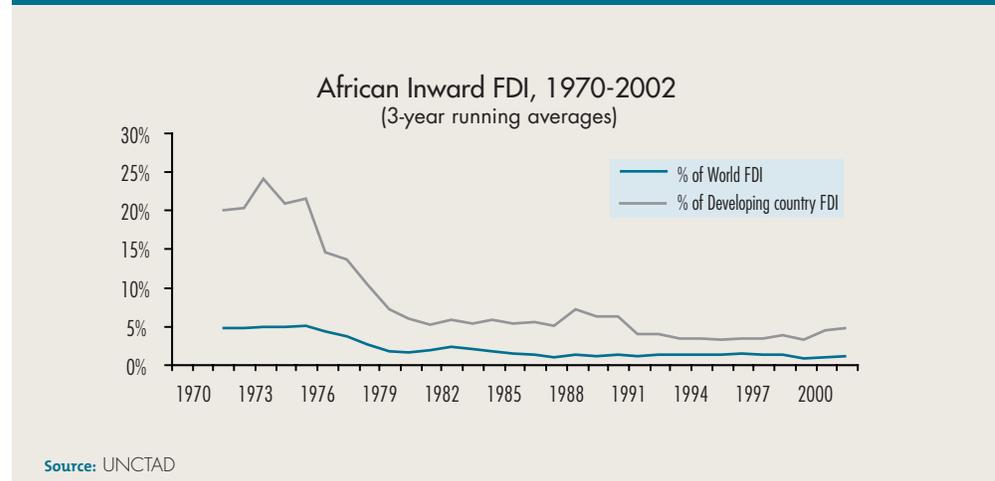
Todd Moss and Vijaya Ramachandran \*

**Summary:** Africa's share of global non-extractive FDI has been declining. Despite ongoing liberalization, part of this trend can be traced to lingering sentiments against foreign capital reinforced by local politics that help to create a difficult business environment. New results from firm surveys in Kenya, Tanzania, and Uganda suggest that many of the objections to foreign investment are exaggerated or false. Based on this three-country sample, foreign firms are more productive, bring management skills, invest more heavily in infrastructure and in the training and health of their workers, and are more connected to global markets. At the same time, they do not appear to succeed by grabbing market share and crowding out local industry. This data suggest that there are important positive effects from FDI for both the host economies and the workers in foreign-owned firms. African governments should therefore take positive steps to attract more FDI, including further liberalization and measures to directly ameliorate binding constraints. The donor community can contribute to these efforts by accelerating efforts to analyze and enhance investment climates. Resistance to reciprocal non-discrimination in international investment agreements may also need to be re-thought.

### Foreign Investment in Sub-Saharan Africa

Foreign direct investment (FDI) can play an important role in developing countries. At the macroeconomic level, it brings new capital for investment, contributing to the balance of payments, and potentially adding to future economic growth. Evidence suggests that FDI also can contribute to raising exports and integrating countries into global economic networks. At the microeconomic level there are a range of purported benefits from FDI, such as higher productivity through new investment in physical and human

**Figure 1. Africa's Share of FDI Has Fallen**



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capital, increased employment, enhanced management, transfer of technology, and spillover effects on local firms through supply and distribution chains, trading, and outsourcing. Partly out of recognition of these benefits, most low-income countries have undertaken reforms to attract more investment. Many African countries have liberalized the environment for FDI (e.g., allowing foreigners into previously reserved sectors) and created inducements (e.g., tax holidays, easing of import and customs controls, infrastructure investment, or labor law reform).

The response to Africa's investment policy changes has been mixed, and marked by three trends:

- Inflows have increased over time. Annual flows in the 1970s averaged less than \$1 billion per year, but rose to \$9.3 billion per year in the most recent three years (2000-02).
- Africa's relative share has fallen, as total world FDI has grown much faster (see Figure 1).
- Investment has been strongly concentrated. In the most recent 5-year period, just three countries (South Africa, Angola, and Nigeria) accounted for 55% of the total and the bottom 24 countries for less than 5%. Additionally, there has been a long-standing concentration in the extractive sectors, particularly petroleum.

## African Skepticism Toward Foreign Investment

Despite growing competition for FDI, the continent has a strong historical skepticism toward foreign capital. Although the colonial period ended more than a generation ago, it also has influenced

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Africa's ambivalence toward the global economy. European companies' role in imperial expansion and harsh treatment of laborers in the past helped to link in the public's mind international business

with exploitation. The ideology of the anti-colonial movements and economic nationalism were heavily biased against foreign capital. Symbolically, leaders sought a break with foreign actors that were identified with colonialism or external control. More practically, political elites did not want to be constrained by outsiders who might control key strategic sectors of the economy or their access to foreign exchange.

In addition, many of the claimed benefits of FDI are frequently challenged, both on ideological and empirical grounds, by local leaders and non-governmental organizations. A common critique is that foreign investors crowd out local firms that cannot compete because of size, financing, marketing power, or some other unfair advantage. There are also complaints that foreign firms exploit local labor and make no contribution to the wider economy, either through creating jobs, training workers, or in using local suppliers. Another grievance against foreign

investment is that, although the theory suggests capital inflows, in practice FDI can be a drain on foreign exchange. More broadly, there is concern that the interests of foreign firms diverge from social objectives or that their presence restricts the ability of governments to promote development.

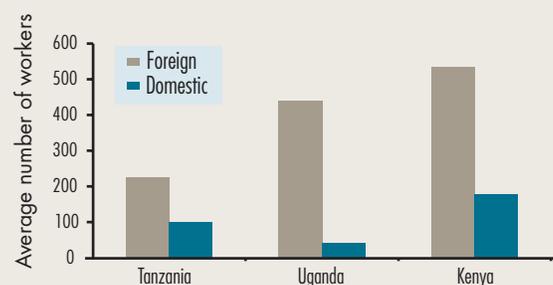
## Homegrown Barriers to FDI

As a direct result of these historical and political issues, governments have constructed a series of barriers to foreign entry. Early efforts were targeted at large European and small South Asian investors, but a more recent influx of capital from East Asia and South Africa has helped to sustain some of these issues.

- *Nationalization and regulation.* Unwinding Africa's widespread and extensive state intervention in the economy (including the creation of parastatals, heavy regulation, and nationalization or expropriation) is an ongoing process.
- *Localization.* Most African countries have at some point had a deliberate policy of Africanization, whereby the state intervenes to transfer ownership of firms from foreigners (or indigenous minorities) to locals. This policy continues in some forms today, especially in privatization with explicit preferences or discounts for domestic investors.
- *Direct legal barriers.* Countries often reserve sectors for nationals, restrict foreign ownership, or impose legal performance requirements (e.g., local employment, partnership or inputs) on foreign firms.
- *Indirect business climate barriers.* Perhaps most importantly, there are a range of indirect obstacles related to the business climate that acts as *de facto* barriers to FDI. Despite economic reform in Africa, the policy environment is still poor relative to other regions. Indirect barriers typically include bureaucratic and other informal impediments, such as ambiguous regulatory approval, delays in customs clearance, visas for expatriate workers, or weaknesses in the legal system.

Critically, it is also not always clear that the indirect barriers are unintentional, but rather could be used as deliberate impediments to foreign entry or operation. Political economists have frequently found that excess bureaucracy, erratic economic

**Figure 2. Foreign Firms Employ More Than Domestic Firms**



Source: Regional Program on Enterprise Development (RPED), World Bank.

policy, and other problems associated with weak business environments have strong political logic because they protect privileged participants and create opportunities for rents. At times, nationalist resistance to liberalization, including worries of foreign domination or the displacement of local firms, may instead have narrow rent-seeking roots, designed to benefit or protect certain favored people or groups.

### Foreign Investment in East Africa: New Results from Firm Surveys

Given this context, we turn to three country cases. Kenya, Tanzania, and Uganda are each undergoing policy reform and each has each seen a recent rise in FDI. Analysis of data from recent firm surveys by the World Bank<sup>1</sup> finds that foreign firms often operate in a very difficult business environment and that, despite these obstacles, they are more productive and invest more than domestic firms.

Evidence of the difficult business environment includes:

- Both foreign and domestic firms complain about macroeconomic instability, unreliable electricity, corruption, tax administration, and crime.
- A higher proportion of foreign firms complain about corruption in all three countries, suggesting that they bear a greater burden of non-official payments.
- Foreign firms spend significantly more time on inspections and meetings with officials.

At the same time, the data shows that foreign firms make a substantial contribution to local development. For example, they:

- Report a higher percentage of revenue for tax purposes;
- Employ substantially more workers (Figure 2);
- Report higher value added per worker (Figure 3);
- Invest more in infrastructure;
- Are nearly twice as likely to have a formal training program (Figure 4) and much more likely to provide health insurance or on-site medical care; and

- Export more of their output and are able to purchase imports, although they still they rely on domestic suppliers for nearly half their inputs.

In sum, many of the objections to foreign investment in Africa are exaggerated or false. Foreign firms in the three-country sample invest more in local infrastructure, are more likely to train their workers, and are larger and more capital-intensive than local enterprises. Econometric analysis of the data also shows that market power is not a direct factor driving greater profits for foreign firms and that FDI is not a drain on foreign exchange. Instead, the results indicate that foreign firms may be more profitable because they are more productive as well.

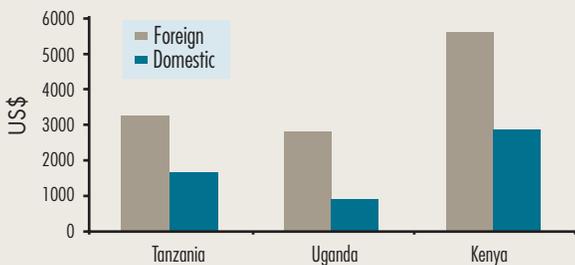
**Despite tough business climates, foreign firms in East Africa are more productive and invest more than domestic firms.**

### Policy Implications

The evidence from East African firms has several policy implications. Most obviously, the host governments should reconsider some of their skepticism toward foreign investment and move to lower barriers to entry and operations through further liberalization. Rather than imposing blanket limitations on foreign investment or insisting on joint ventures, developing country governments should be focused on attracting investment that generates jobs and builds human capital. For the donor community, this suggests that further analysis of firm competitiveness can be fruitful and that attention to investment climate issues

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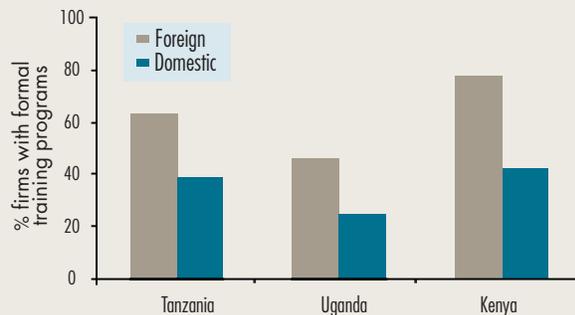
**Figure 3. Foreign Firms Report Higher Value Added per Worker\***



\*Value Added is measured as value of sales minus the cost of raw materials and cost of energy. This amount is then divided by the number of workers in the firm to get value added per worker.

Source: RPED

**Figure 4. Foreign Firms More Likely to Train Workers Than Domestic Firms**



Source: RPED

should accelerate. Donors should also continue to work with African governments to take steps to directly ameliorate some of the binding constraints on firm entry and expansion. Lastly, these findings also indicate that measures in multilateral trade or investment agreements to protect low-income countries, such as excluding them from reciprocal obligations on non-discrimination and national treatment, may be perversely anti-developmental. Rather than seeking special exclusions, both poor and rich countries should be working to find ways to increase capital flows to developing regions, including sub-Saharan Africa.

## Endnotes

<sup>1</sup> We use data collected by the World Bank's Regional Program on Enterprise Development (RPED) on 300-400 manufacturing firms in Kenya, Tanzania, and Uganda surveyed over 2002-03. For more information and methodology see [www.worldbank.org/rped](http://www.worldbank.org/rped).

## Related CGD Work

Foreign direct investment and capital flows are two of the Center's core areas of policy-based research. Our work on FDI and international capital flows concentrates on the challenges and opportunities that investment presents to global development and poverty reduction, including issues of barriers to market entry, and stimulating entrepreneurial activity. For related CGD materials on this issue, please refer to the following works, which are available online at [www.cgdev.org](http://www.cgdev.org).

Benn Eifert, Alan Gelb and Vijaya Ramachandran. "Business Environment and Comparative Advantage in Africa: Evidence from the Investment Climate Data." Working Paper 54. (Washington, DC: Center for Global Development, 2005).

Todd J. Moss, Vijaya Ramachandran and Manju Kedia Shah. "Is Africa's Skepticism of Foreign Capital Justified? Evidence from East African Firm Survey Data." Working Paper 41. (Washington, DC: Center for Global Development, 2004).

Theodore H. Moran, Edward M. Graham and Magnus Blomstrom, eds. [Does Foreign Direct Investment Promote Development?](#) (Washington, DC: Center for Global Development, 2005).

## Forthcoming CDG Work

Theodore H. Moran. [Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries.](#) (Washington, DC: Center for Global Development, 2006).



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# CGD Brief

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