Foreign Direct Investment
in Sub-Saharan Africa: Origins, Targets,
Impact and Potential

Edited by S. Ibi Ajayi

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List of Abbreviations

ACP	Africa, Caribbean and Pacific
AfDB	African Development Bank
AGC	Ashanti Goldfields Company
AGOA	African Growth and Opportunity Act
ALSCON	Aluminum Smelting Company
BEDIA	Botswana Export Development and Investment Authority
BEE	Black economic empowerment
BERI	Business Environment Risk Intelligence
BIDPA	Botswana Institute of Development Policy Analysis
BITs	Bilateral investment treaties
CAC	Corporate Affairs Commission
CEDA	Citizen Entrepreneurial Development Agency (Botswana)
CEEB	Central Eastern European and Baltic countries
CEPS	Customs, Excise and Preventive Services
CIS	Commonwealth of Independent States
CMC	Common Man's Charter
COMESA	Common Market of Eastern and Southern Africa
DTA	Double Taxation Agreement
EAC	East African Community
EBRD	European Bank for Reconstruction and Development
ECOWAS	Economic Community of West African States
EPZ	Export processing zone
EPZA	Export Processing Zone Authority
ERP	Economic Recovery Programme (Ghana)
FAP	Financial Assistance Policy (Botswana)
FDI	Foreign direct investment
FGN	Federal Government of Nigeria
FINSAP	Financial sector adjustment programme
FIAS	Foreign Investment Advisory Service (World Bank)
GEAR	Growth, employment and redistribution strategy
GFCF	Gross fixed capital formation
GFZB	Ghana Free Zones Board
GIPC	Ghana Investment Promotion Centre

GMM	Generalized method of moments
GSM	Global System for Mobile Communications
ICC	International Chamber of Commerce
ICSID	International Convention for Settlement of Investment Disputes between States and Nationals of Other States
ICT	Information and communication technology
IDCC	Industrial Development Coordinating Committee
IDZs	Industrial development zones
IMF	International Monetary Fund
IPPA	Investment promotion and protection agreement
ISO	International Standards Organization
ISSER	Institute of Statistical, Social and Economic Research (Ghana)
KIPPRA	Kenya Institute of Public Policy Research and Analysis
LDCs	Least developed countries
M&A	Cross-border merger and acquisition
MDGs	Millennium Development Goals
MFDP	Ministry of Finance and Development Planning (Botswana)
MIDP	Motor Industry Development Programme
MIGA	Multilateral Investment Guarantee Agency
MNC	Multinational corporation
NAFTA	North American Free Trade Agreement
NCP	National Council on Privatization
NEPA	National Electric Power Authority
NEPAD	New Partnership for Africa's Development
NIPC	Nigeria Investment Promotion Commission
NITEL	Nigerian Telecommunication Ltd.
NNPC	Nigerian National Petroleum Corporation
NOFP	Net open forward position
NTEs	Non-traditional exports
OECD	Organization for Economic Cooperation and Development
R&D	Research and development
REPA	Regional Economic Partnership Agreements
SACU	Southern African Customs Union
SADC	Southern African Development Community
SAP	Structural adjustment programme
SARB	South African Reserve Bank
SARS	South African Revenue Service
SDIs	Spatial development initiatives
SMMEs	Small, medium and microenterprises
SOE	State-owned enterprise
SSA	Sub-Saharan Africa
TI	Transparency International
TIPA	Trade and Investment Promotion Agency (Botswana)
TISA	Trade and Industry South Africa
UDC	Uganda Development Corporation
UIA	Uganda Investment Authority
UNCTAD	United Nations Conference on Trade and Development
WDI	World Development Indicators
WTO	World Trade Organization

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Acknowledgements

Chapter 1
Introduction: A General Overview

S. Ibi Ajayi

Averuge annual inflows of foreign direct investment (FDI) into Africa doubled in the 1980s compared with the 1970s. It also increased significantly in the 1990s and in the period 2000–2003. Comparisons with global flows and those of other regions may be more useful, however. In the mid 1970s, Africa's share of global FDI was about 6%, a level that fell to the current 2–3%. Among developing countries, Africa's share of FDI in 1976 was about 28%; it is now less than 9% (see UNCTAD, 2005). Also in comparison with all other developing regions, Africa has remained aid dependent, with FDI lagging behind official development assistance (ODA). Between 1970 and 2003, FDI accounted for just one-fifth of all capital flows to Africa.

It is well known that FDI is one of the most dynamic international resource flows to developing countries. FDI is particularly important because it is a package of tangible and intangible assets and because firms deploying them are important players in the global economy. There is considerable evidence that FDI can affect growth and development by complementing domestic investment and by facilitating trade and transfer of knowledge and technology (see Holger and Greenaway, 2004). The importance of FDI is envisioned in the New Partnership for Africa's Development (NEPAD), as it is perceived to be a key resource for the translation NEPAD's vision of growth and development into reality. This is because Africa, like many other developing regions of the world, needs a substantial inflow of external resources in order to fill the saving and foreign exchange gaps and leapfrog itself to sustainable growth levels in order to eliminate its current pervasive poverty (see Ajayi, 1999, 2000, 2003a/b).

The Issues

The literature on the FDI–growth relationship is vast for both developed and developing countries. The basis for most of the empirical work focuses on neoclassical and endogenous growth models. It is often claimed that FDI is an important source of capital, that it complements domestic investment, creates new jobs opportunities and is in most cases related to the enhancement of technology transfer, which of course boosts economic growth.

While the positive FDI–growth linkage is not unambiguously accepted, macroeconomic studies nevertheless support a positive role for FDI especially in particular environments. Existing literature identifies three main channels through which FDI can bring about economic

growth. The first is through the release it affords from the binding constraint on domestic savings. In this case, foreign direct investment augments domestic savings in the process of capital accumulation. Second, FDI is the main conduit through which technology transfer takes place. The transfer of technology and technological spillovers lead to an increase in factor productivity and efficiency in the utilization of resources, which leads to growth. Third, FDI leads to increases in exports as a result of increased capacity and competitiveness in domestic production. Empirical analysis of the positive relationship is often said to depend on another factor, called "absorptive capacity", which includes the level of human capital development, type of trade regimes and the degree of openness (Borensztein et al., 1995, 1998).

There are doubts about the catalyst role of FDI in the growth process in some quarters (see UNCTAD, 2005). It is true that FDI brings both costs and benefits, which must be properly evaluated at the point of decision making on the best policy approach to be adopted (Ikiara, 2003). The evaluation will inevitably be country-specific. It has been suggested that "policy makers in Africa should give more careful consideration to these trade-offs if they wish to maximize the benefits from FDI" (UNCTAD, 2005: 65). Thus, the domestic policy framework is crucially important in determining whether the net effects of FDI inflows are positive.

The belief that attracting FDI is the key to bridging the resource gap of low-income countries and avoiding further buildup of debt while directly tackling the causes of poverty has been strengthened by the experiences of a small number of fast-growing East Asian newly industrialized economies (NIEs), and recently China (UNCTAD, 2005). Since the Asian crisis, the call for an accelerated pace of opening up to FDI has intensified in the belief that this will bring not only more stable capital inflows but also greater technological know-how, higher-paying jobs, entrepreneurial and workplace skills, and new export opportunities (Prasad et al., 2003).

Given the importance attached to FDI, Africa must therefore learn how to attract greater volumes of this important potential resource. This is one of the underlying reasons for the Special Workshop convened by the International Monetary Fund (IMF) and the African Economic Research Consortium (AERC), on the *Determinants of Foreign Direct Investment in Africa.* There are many studies on the theoretical determinants and a large though inconclusive econometric literature on the determinants of FDI generally. Many studies have emphasized, among others, governance failures, problems of policy credibility, macroeconomic policy failures and poor liberalization policies as deterrents to FDI flows. African countries have in the last decade made considerable efforts to improve their investment climate. Many governments are liberalizing their FDI regimes because they associate FDI with positive effects for economic development and poverty reduction in their respective countries. The economic performance of the region improved in some cases from the mid 1990s as countries adopted structural adjustment programmes that hinged on pushing down inflation and government expenditures and establishing realistic exchange rates. The expected upsurge in FDI inflow as a result of these improvements is yet to occur.

Too often, potential investors shy away from Africa because of the negative perception of the continent. This conceals the complex diversity of economic performance and the existence of investment opportunities in individual countries. Indeed, some African countries have been able to attract FDI based on their macroeconomic policy framework and the conducive regimes put in place, while others have not. It is against this background that the IMF/AERC Special Workshop was undertaken.

The vast literature on FDI identifies a number of reasons for firms investing across national boundaries. It is difficult in reality in many countries to isolate the different motives, as one motive may overlap into another. The major motives often identified that have particular relevance to Africa are (Basu and Srinivasan, 2002):

- Natural-resource-seeking investment, which aims to exploit the natural resource endowments of countries. Companies extracting oil (in Nigeria), gold (in Ghana) and diamond (in Botswana) belong to this category.
- Market-seeking investment, which aims to access new markets that are attractive as a result of their size and/or growth.
- Efficiency-seeking investments, which aim to take advantage of special features in a certain area such as the costs of labour, the skills of the labour force, and the quality and efficiency of infrastructure.

The general objective of the work in this volume is therefore to identify the determinants of FDI in Africa, which of them have worked for which countries, and to specify what African countries need to do in order to integrate into the global financial markets. Using appropriate theoretical and analytical frameworks, the studies in the volume assess and analyse the various factors influencing the volume of FDI in African countries, breaking it down along the various components of FDI and analysing the various determinants. Specifically, the studies in this volume analyse the following issues, among others:

- The determination of FDI in general and specifically to Africa including emphasizing the determinants of different types of FDI.
- The institutional structures and others that are necessary for countries to be attractive to different types of FDI.
- The experience of developing countries (particularly in Asia and emerging economies) that have been successful in attracting FDI and the lessons Africa can learn from them.

The book is divided into two parts. Part I consists of two chapters comprising framework papers that deal with the analytics and a review of the subject matter and cross-country issues, while Part II consists of seven country case studies (Botswana, Cameroon, Ghana, Kenya, Nigeria, South Africa, Uganda) that attempt to provide necessary information at the country level. The aim of the framework papers is to provide a broad brush of the issues highlighting what we do know from the literature on the determinants of foreign direct investment in general and to specific African country in particular. Central to the objective of the country case studies is to identify areas of commonality in the various factors attracting FDI – and also areas that are peculiar to some countries – and to see whether replication is possible and what lessons can be learnt from one another.

At the country level the studies present the trends, magnitudes and composition of FDI, and the policies put in place to attract FDI, by analysing the following issues:

- The current situation in the country with respect to FDI, and the presence/absence of necessary institutions (as identified in the framework papers) for FDI inflows.
- The magnitude, composition and trends of FDI.
- An examination of the factors influencing the flows of FDI to the country, breaking them down along the different components of FDI.
- What the country needs to do in the near and medium term to become attractive to FDI, including appropriate institutional and other structures that need to be in place.

This study on the determinants foreign direct investment in Africa is important for several reasons. First, a number of countries in Africa that attract FDI have not been studied. It would be very useful to know why FDI flows to some countries and not to others. This study assumes added relevance given that FDI is seen as a catalyst element for Africa's new growth and development strategy. Second, it would be useful to know if different factors work differently

in different countries. Third, it is important to know if indeed policy matters very much in attracting FDI in the selected African countries.

The International Monetary Fund (IMF) and the African Economic Research Consortium (AERC) sponsored the studies in this volume jointly. The papers in the volume were presented at a workshop in Nairobi in December 2004 and at a second workshops in Accra, Ghana, in 2006.

The Framework Papers

The first of the two framework papers is Ibi Ajayi's "Determinants of Foreign Direct Investment in Africa: A Survey of Evidences" in Chapter 2. Ajayi analyses the various factors influencing the flow of foreign direct investment in Africa and provides evidence on the relative importance of these factors.

The broad objectives of the chapter are to analyse the trends of foreign direct investment into Africa and the major determinants of FDI in general, and to survey the empirical evidences on the major determinants of FDI in Africa.

Ajayi first puts the issue of FDI in the context of the development needs of African countries and the channels through which FDI is expected to affect growth. As to be expected there are country variations to the continent's average. The next phase of the discussion concerns the allocation of FDI into various sectors in Africa and emphasizes the importance of the primary sector and the importance of the service sector in recent times. The various determinants of FDI within a general theoretical framework are then analysed, identifying the major factors – in particular the pull and push elements – in FDI. The push factors are those that are external to the host countries such as the growth and financial markets in developed countries, while the pull factors are the domestic policies of the countries and include a wide array of important issues. The same discussion also deals with the particular factors affecting FDI, and how Africa is different from the rest of the world. The results of empirical analyses of the determinants of FDI in Africa are discussed, and explanations given for why Africa has lagged behind in receiving FDI relative to other regions of the world.

Chapter 3, the second framework paper, asks, "Why Does FDI Go Where it Goes? New Evidence from the Transition Economies". In this paper Nauro F. Campos and Yuko Kinoshita study the factors accounting for the geographical patterns of foreign direct investment inflows among 25 transition economies. The main finding is that the most important determinants of FDI locations are institutions and agglomeration economies. They also find that FDI is attracted by an abundance of natural resources and relatively low labour costs. Also of great importance in attracting FDI are such factors as respect for the rule of law and openness to trade. Moreover, external liberalization has a positive impact on FDI. Among the deterrents to FDI are poor quality of bureaucracy and increased transaction costs.

The Country Case Studies

In Chapter 4, H.K. Siphambe analyses the issues of FDI in Botswana. The main findings are that a lot of FDI has been attracted mainly into the mining and financial sectors. The mining sector accounted for more than 80% of FDI in 2000. A large part of this investment is for diamond mining by Debswana Diamond Company. Other mineral developments are copper/

nickel in Selibe-Phikwe and Tati. The Government of Botswana has been trying to put in place all necessary measures that would allow the country to have a comparative advantage in attracting FDI. These have been achieved through incentive schemes and necessary infrastructure such as industrial land and factory shells. Other identifiable factors that have put Botswana in advantageous position and in the process should bolster FDI include:

- A stable political environment; and stable macroeconomic policy.
- Competitive exchange rate relative to the South African rand.
- Low crime level.
- Good human capital development.
- Good labour relations.
- Botswana producers have access to South African markets because of Botswana's membership in SACU, and to the Zimbabwe market because of the 1956 trade agreement.

In terms of reality, however, Botswana has not gained much from FDI over the last decade. In 1980, for example, FDI was about 9% of GDP but the ratio steadily fell thereafter first to about 5% in 1985. By 1998, it was only about 2% and in 2000 it stood at 0.57%. The author adduces several reasons for this failure. The case of Botswana therefore illustrates that macroeconomic policies are necessary but not sufficient to attract FDI.

Chapter 5 contains Sunday Khan and Lydie Bamou's analysis of foreign direct investment flows to Cameroon. The chapter examines the evolution, sectoral distribution and sources of FDI into the country and identifies the factors that have been responsible for attracting FDI. While recent data indicate an increasing trend for FDI into Cameroon, the ratio of FDI/GDP shows that Cameroon still lags behind, as it is below the sub-Saharan average and actually lower than for all low-income countries.

The sectoral distribution of FDI is in favour of the tertiary sector as against the primary and secondary sectors. In the period of the 1990s until 2002, about 45% of all FDI went to the tertiary sector, while 34% went to the secondary sector. These two generally receive market-seeking FDI.

After reviewing some of the major determinants of foreign direct investment in the literature, the authors specify a model starting from a simple partial adjustment process used by some studies. In the regression analysis undertaken to find the major determinants of FDI, the level of infrastructure development appears to be the most significant and robust determinant of FDI in Cameroon. The market size, the openness of the economy to international trade, human capital development and the rate of economic growth are also important, but to a lesser extent than infrastructure. Other factors such as the exchange rate, level of political risk, rate of inflation and agglomeration effects (or herding behaviour) have no effects on FDI in Cameroon.

The authors identify a number of policies that Cameroon has to put in place in order to be competitive in attracting FDI. These include:

- Creating a more investment-friendly environment.
- Improving the availability of infrastructure.
- Investing in education.
- Opening up the country through trade.
- Providing necessary incentives.
- Adopting and enforcing a zero tolerance stance on corruption.

Yaw Asante, in Chapter 6, deals with the flow of FDI to Ghana. The chapter seeks to analyse the various types of FDI in Ghana and their relative magnitudes, the destination of FDI

among the sectors of the economy, and the economic, political and other factors that might influence the sectoral allocation. The history of FDI in Ghana dates back to the 1970s when the annual inflow was as high as US$68 million. Towards the end of the decade, with the ascendancy of the Rawlings government, Ghana experienced FDI outflows. Since the advent of the Economic Recovery Programme in 1983, four phases of FDI inflows are discernible:

- 1983–1988: Sluggish inflows averaging about US$4 million per annum.
- 1989–1992: Modest inflow averaging about US$18 million per annum, with the lowest and the highest being US$14.8 million in 1990 and US$22.5 million in 1992.
- 1993–1996: Significant inflows, reaching US$233 million in 1994 with the privatization of Ashanti Goldfields Company.
- 1997–2001: General oscillation.

The major types of FDI attracted into Ghana have included investments to exploit the mineral resources in the country, mainly gold; these are generally termed the non-market seeking type of FDI. The authors also discuss investments arising from active policies and free zones schemes, as well as investments in response to structural reforms including privatization under the types of FDI into Ghana.

The sources of FDI into Ghana are many, with Britain topping the list followed by India. Ghana has undertaken active policies to attract FDI, including fiscal incentives. The three main fiscal changes affecting the sector that were put in place during the ERP era were the reduction in minimum royalties from 6% to 3%; reduction in corporate tax from 55% to 35%; and tax exemption for imported plant and equipment. Other policies to attract FDI include tax holidays, accelerated depreciation allowances and arrangements for profit repatriation. Generous incentives also exist for free zone developers. From available evidence on sectoral allocation, the services sector tops the list in Ghana, followed by manufacturing and tourism.

Francis Mwega and Rose Ngugi, in Chapter 7, analyse the various factors that constrain improved net FDI inflows into Kenya and examine whether the country responds differently to the various determinants of FDI than other countries. Among the issues analysed are the magnitude of net FDI inflows, their composition and sectoral destination, as well as the economic, political and other factors that might influence them.

Asserting that there has been high volatility to FDI flows in Kenya, the authors conclude that FDI has not played an important role in the Kenyan economy despite the reforms that have been undertaken and the many incentives provided to foreign investors. In the period 1997–2001, FDI was about 0.6% of GDP, a ratio that was below the African average of 1.9%. Since the 1980s, the country has faced declining net inflows compared with neighbouring countries like Uganda and Tanzania. While Kenya accounted for about 87% of cumulative net FDI into East Africa in the early 1980s, by 2001 that share was down to 21%, compared with 40% and 36% for Uganda and Tanzania, respectively. The country has therefore lost its competitiveness in attracting FDI.

The chapter notes that the deterioration of Kenya's business environment in the 1980s and 1990s was a major deterrent to the flows of FDI. Thus, not only has FDI been volatile, it generally declined in the 1980s and 1990s. FDI in Kenya has mainly gone into agriculture, manufacturing and services. In 2001, Kenya had about 114 multinational corporation (MNC) affiliates, many of them in both the industrial and tertiary sectors with others attracted by the natural resources especially those in agro-industry and the cement industry. The FDI flows into these sectors originate in Western Europe and the United States. On the other hand, the foreign firms located at the export processing zones (EPZs) are mainly from Sri Lanka and India, even though US firms account for 10% and UK firms for 2% of investment in EPZs.

In Chapter 8, Olawale Ogunkola and Afeikhena Jerome appraise the structure, trends and magnitudes of FDI in Nigeria with a view to ascertaining policy-induced changes in the structure. Available data suggest that Nigeria was the second largest FDI recipient in Africa in 2002. Traditionally, the FDI has concentrated in the extractive industries, mainly oil, but there has been a diversification into the manufacturing sector in recent years. Overall, Nigeria has put in place a number of policies to attract FDI. There have been inconsistencies in the policies, however, and the vigour with which these policies have been pursued. For several years, the country stuck to rather hostile policies for private sector development in general and to FDI in particular. Essentially, Nigeria has made little progress in attracting FDI. This may sound paradoxical given that Nigeria is one of the biggest recipients of FDI in Africa. When related to the size of its economy, it becomes apparent that the volume of FDI received is rather small using standard parameters such as inflows as a percentage of gross capital formation or FDI stock as a percentage of GDP. Relative to other countries, Nigeria seems to perform poorly on all counts.

While the FDI regime in Nigeria is improving, serious deficiencies remain. Political and institutional uncertainty persists in Nigeria and the weakening of the rule of law has discouraged FDI and trade flows outside the oil sector. Legal and judicial systems are inadequate to support the needs of new investors into other sectors of the economy. Addressing problems related to corruption, inadequate infrastructure and inconsistent regulations remains the key element of the country's future prospects of attracting more efficiency-seeking FDI. There is need for a proactive policy towards FDI that involves the upgrading of national laws and incentives that are in conformity with international practices.

South Africa is one of the major destinations of foreign direct investment in Africa. Chapter 9, Oludele Akinboade, Franz Siebrits and Elizabeth Rousset's offering to our continent-wide analysis, discusses the trends in South African FDI by examining the levels of inflows, origin and sectoral distribution. South Africa accounts for a small part of the global FDI flow. It had a share of only 0.18% in 1991–1996, which rose to 0.82 in 2001 before declining to 0.12% in 2002. The bulk of foreign investments into South Africa has been market-seeking, as evidenced by the concentration in manufacturing, financial services, telecommunications, and food and beverages.

The attractiveness of South Africa as an investment destination is discussed alongside the regulatory and policy measures being implemented to attract FDI. South Africa dominates FDI inflows in the Southern Africa Development Community (SADC), receiving a substantial amount of new FDI inflows into the region and hosting the greatest number of foreign subsidiaries across a broad range of economic sectors. This trend notwithstanding, South Africa has attracted less FDI than its global share of GDP would suggest.

The chapter highlights the various policy measures that have been put in place to attract FDI in recent times. It cautions on the need to address social issues such as crime and the rising prevalence of HIV/AIDS, as these may affect the flow of FDI.

Chapter 10 is the Uganda country case study. Here Marios Obwona and Kenneth Egesa analyse the various types of FDI and the relative magnitudes of the components. The chapter examines the destination of FDI among the sectors of the economy and shows that a host of factors (economic, political and others) explain the attraction of FDI to Uganda in recent years. Privatization and the return of previously confiscated properties of expelled Asians have led to considerable FDI, which cuts across various sectors. In addition, a string of policies has been implemented in recent times to achieve macroeconomic stability. These together with the peace in a large part of the country have brought large inflows of FDI. No single factor affected the flows of FDI into Uganda, but various factors have had an effect at different times.

In terms of lessons from Uganda, the following are identified as important factors in attracting FDI:

- A predictable and consistent policy and macroeconomic environment;
- Successful implementation of privatization;
- Efforts at regional integration, which is important in attracting market-seeking investments;
- Aggressive investment promotion;
- Reforms undertaken among incentive schemes and related government agencies to fulfil the criteria for investment promotion; and
- Administrative simplicity, which has contributed significantly to FDI attraction.

The various positive steps made to attract FDI notwithstanding, there still remain liabilities especially in the areas of infrastructure, level of corruption and improvement of institutional support. Consequently, there is need to continue to enhance the business environment and improve the risk coverage schemes on both bilateral and multilateral basis.

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Part I

The Framework Papers

The Determinants of Foreign Direct Investment in Africa:
A Survey of the Evidence

S. Ibi Ajayi

Over the last three decades the economic performance of Africa can be described as mixed. The GDP growth rate of 3.2% achieved in 2002 translates into a low growth rate of 0.8% in per capita income compared with the rate of 1.9% in 2001 (UNECA, 2003a: 1). This rate of growth in per capita income is insufficient to reduce in a significant way the level of poverty, which remains the overarching goal of development policy in Africa. In 2003, Africa's population was estimated to have grown at the rate of 3.6%. Rapid economic growth is necessary but not sufficient for poverty reduction.[1]

Investment is a critical requirement for growth. Africa's savings rate is lower than other regions of the world and lower than the required investments for growth that can alleviate poverty. Indeed, for the entire continent, the savings and investment rates are still low and this constitutes a great restraint on development. Recent research by Sachs and Warner (1995) indicates that at least 1% of the 3.4% difference in growth rates between East Asia and Africa is explained by low investment. The Doha Development Agenda, the Monterrey Consensus, the New Partnership for Africa's Development (NEPAD), the 2002 Organization for Economic Cooperation and Development (OECD) Ministerial and the Johannesburg World Summit underscore the importance of foreign direct investment in the achievement of sustainable development in Africa. The first of the eight Millennium Development Goals calls for eradicating extreme poverty and hunger; in order to meet the first target of that goal – to reduce by half the proportion of Africans living in poverty by 2015 – Africa needs to fill an annual resource gap variously estimated to be of the magnitude of 10–15% of its GDP or an estimate of US$60–64 billion. NEPAD targets an annual investment of US$64 billion to achieve the growth rate of 7–8% per year to arrest the economic decline and poverty in the continent.[2]

The attainment of the 7–8% annual growth rate remains elusive for a number of African countries. In 2003, only Chad, Equatorial Guinea, Mozambique and Angola reached 7% growth rate, while growth in seven countries indeed contracted.[3]

Putting the Issues of FDI in context

In recent times, developing countries see the role of foreign direct investment (mostly referred to as FDI henceforth) as crucial to their development. FDI is regarded as an engine of growth as it provides much needed capital for investment, increases competition in the host country industries, and aids local firms to become more productive by adopting more efficient

technology or by investing in human and/or physical capital. Foreign direct investment contributes to growth in a substantial manner because it is more stable than other forms of capital flows. The benefits of FDI include serving as a source of capital, generating employment, facilitating access to foreign markets, and generating both technological and efficiency spillovers to local firms. It is expected that by providing access to foreign markets, transferring technology and generally building capacity in the host country firms, FDI will inevitably improve the integration of the host country into the global economy and foster growth. According to Gorg and Greenaway (2004: 189), FDI is seen as:

> a key driver of economic growth and development. Most governments consider attracting FDI as priority, particularly in developing and transition economies. It is given this emphasis not just because it boosts capital formation but also because it can enhance the quality of the capital stock.

As a result of the potential role of foreign direct investment in accelerating growth and economic transformation, many developing countries in general, and Africa in particular, seek such investments to accelerate their development efforts. Promoting and attracting FDI has therefore become a major component of development strategies for developing countries. In the case of Africa, the role of FDI as a source of capital has become increasingly important not only because of the belief that it can help to bridge the savings–investment gap but also because it can assist in the attainment of Millennium Development Goal targets. Given the region's low income and domestic savings level, its resource requirements and its limited ability to raise funds domestically, the bulk of its finance for the future will have to come from abroad, mostly in the form of FDI. See Ajayi (1999) for other forms of financing development in Africa.

Thus a number of African countries have put various measures in place – apart from improving their investment environment – that they hope will attract foreign direct investment to their economies. Some of these are incentives (sometimes called "sweeteners") to ensure that resources are directed to areas and sectors where they are badly needed to deal with the issues of employment generation and poverty elimination. Indeed, in some cases, there is the risk of "racing to the bottom" as countries compete for FDI. It is not crystal clear whether FDI is being attracted into industries and sectors that have the greatest multiplier effect in terms of promoting sustained growth and indirectly alleviating poverty. It is not often also realized that in order to fully benefit from spillover effects of FDI, there is a minimum threshold of absorptive capacity that a country must have. Right policies therefore do matter in order to benefit from this aspect of globalization[4]. For some analysts, the capacity of Africa to attract FDI is determined principally by its natural resources and the size of its local markets. Using Nigeria and Angola as examples, it has been found out that the two countries have been able to attract FDI because of their oil endowments, the unconducive nature of their political systems notwithstanding. In general, however, these two factors are inadequate to explain FDI flows. FDI flows reflect not only the policy and political environment in host countries, but other factors as will be shown later.

The broad objective of this chapter is to analyse the trends of foreign direct investment into Africa, analyse the major determinants of FDI in general and survey the empirical evidence on those determinants. The chapter first examines the FDI trends in Africa and then discusses the allocation of FDI into various sectors in Africa. It then delves into the determinants of FDI within a general theoretical framework identifying the major factors, in particular- the pull and push factors in FDI. In the same section we also deal with particular factors affecting FDI, and

how Africa is different from the rest of the world. The results of empirical analyses of the determinants of FDI in Africa are discussed. An explanation is given for why Africa has lagged behind in receiving FDI relative to other regions of the world, along with the results of survey findings on FDI and some conclusions and recommendations.

FDI Trends in Africa

T he last decade has witnessed significant increases in the flow of foreign direct investment to the developing countries of the world. The balance of evidence, however, supports at least one conclusion: the inflow has been uneven. Middle-income countries have benefited from this upsurge at the expense of lower-income countries (Akinkugbe, 2003). In spite of policy initiatives in a number of African countries and the significant improvements in the factors governing FDI – including but not limited to economic reform, democratization, privatization, enduring peace and stability – FDI inflows to Africa still lag behind those of other regions of the world. The expected surge of FDI inflow into the continent has not occurred. Many explanations have been given in the literature for Africa's small share in the global FDI flows. The myriad of explanations varies from bias against Africa because of its risks, inappropriate environment, political instability, and so on, to the adoption of inappropriate policies or indeed that Africa is simply different, so that the factors that attract FDI to other countries simply do not work for Africa.

The available evidences seem to point to the fact that Africa has been receiving the lowest share of global FDI over time. Africa's share of FDI to developing countries declined over time, from about 19% in the 1970s to 9% in the 1980s and thence to about 3% in the 1990s; it stood at 6.7% in 2002, a rate lower than those attained in the 1980s. The FDI inflows to Africa increased from an annual average of US$4.6 billion in 1991–1996 to US$18.8 billion in 2001. It fell to about US$11.0 billion in 2002, however, a decline of about 41%. See Appendix Table 2.A1. The fall in 2002 is in conformity with the declining trend in global FDI flows. From about 2.% of global FDI flows in 1997, Africa's share steadily declined to 1.69% in 2002.

There are a lot of variations in many African countries as shown in Appendix Table 2.A2. The FDI that goes into Africa is concentrated in a few countries, with the four traditionally biggest recipients pocketing a significant proportion: Egypt, Angola, Nigeria and South Africa. The inflows that South Africa has enjoyed in recent times have been attributed mainly to the privatization process, the return of companies that had relocated to neighbouring countries during the apartheid period and the interest of investors in the South African large domestic market.[5] Of the increase in FDI flows between 1995–1998 and 1987–1990, 33% went to four oil-producing countries: Angola, the Congo Republic, Equatorial Guinea and Nigeria.[6] FDI in the oil industry remained dominant in 2002, with Angola, Algeria, Chad, Nigeria and Tunisia accounting for more than half of the 2002 inflows (UNCTAD, 2003: 9). In 2002, Egypt, Angola, Nigeria and South Africa had a share of 61.9%. Given the importance of Tunisia in 2002, its inclusion brought these countries' share to 70.11%. Swings of FDI to these countries have a major impact on the flows of FDI to Africa as a whole.

Looking at FDI inward stock, it increased steadily over time from US$32.2 billion in 1980 to US$171.0 billion in 2002 (see Appendix Table 2.A3). In 1980, Africa had 4.6% share of global FDI inward stock. This share declined over time until it reached 2.4% in 2002. Similarly, Africa's share of FDI inward stock to developing countries declined from 10.46% in

1980 to 7.3% in 2002. This share is in contrast to that of the Latin America and the Caribbean region, which increased its share of FDI inward stock to developing countries from 16.39% in 1980 to 32.58% in 2002. Even though Asia's share fell from 72% in 1980 to about 60% in 2002, it nevertheless attracted to itself the greatest share.[7]

Shown in Appendix Table 2.A4 is the inward FDI stock as a percentage of the gross domestic product. In 1980, inward FDI stock was 8.2% of GDP. Ever since, the share steadily increased, reaching 30.6% in 2002. Other regions performed better than Africa. Latin America had a ratio of 6.5% in 1980, but this rose to about 45% in 2002. Asia and Pacific had a share of 17.9% in 1980, which increased to 33.3% in 2002. Masked in Africa's aggregate figures are wide country variations. In 2002, for example, Tunisia had inward FDI stock as percentage of GDP of 66.2%. This is in contrast to Angola (98%), Zambia (70%) and Gambia (74.9%). The situation is not too different when we look at the inward FDI as a ratio of fixed capital formation. (See Appendix Table 2.A5.) Africa inward FDI flow as a percent of gross fixed capital formation was 5.3% in 1980 but it rose to only 8.9% in 2002. This is in contrast to other regional groups: Latin America and the Caribbean had a ratio of 8.1% in 1980 but rose to 14.6% in 2002, Central Asia's ratio of 10.3% in 1980 rose to 37.1% in 2001.

An important way of comparing FDI performance in various countries is to utilize the FDI performance index. If a country's share in global FDI flows matches its relative share in global GDP, the country's (region's) FDI performance index would be one. A score greater than one implies a larger share of FDI relative to GDP, while a score of less than one indicates a smaller share of FDI relative to GDP. Appendix Table 2.A6 shows the inward FDI performance index by region for the periods 1988–1990, 1993–1995 and 1999–2001. As seen from the table, the developed countries received FDI that is commensurate to their share of global GDP in the period 1999–2001. The same is true of developing countries as a whole. Africa, however, received less FDI than its relative share in global GDP. For the same period (1991–2001), other regions that received more than their own share include Latin America and the Caribbean, South America, Central Asia and East and South Asia.

Sectoral Allocation of FDI in Africa

The structure of FDI worldwide has in general shifted towards services. In the early 1970s the sector accounted for only one-quarter of the world FDI stock; in 1990 this share was less than one-half and by 2002, it has risen to about 60% (UNCTAD, 2004: 15).

Africa continues to attract FDI into sectors where competitive advantages outweigh the continent's negative factors. These include minerals, timber, coffee, and oil (Mills and Oppenheimer, (2002). Contrary to common perception, the concentration of FDI in Africa is no longer restricted to mineral resources. Even in the oil exporting countries, services and manufacturing are becoming key sectors for FDI.[8] Recently, FDI has been diversifying into other sectors – in particular manufacturing and services. In 1992, 30% of FDI stock in Nigeria was in the primary sector, 50% in manufacturing and 20% in services. Similarly in 1995, 48% of FDI inflows into Egypt were in services, 47% in manufacturing and only 4% in the primary sector. Over time, Mauritius has also been able to attract FDI into the manufacturing sector, mainly in textiles and electronics. Morocco's FDI receipts have risen fivefold in the past decade, most of it in manufacturing and services.

In terms of the sources of FDI, Germany's FDI has increasingly been going into the manufacturing sector, while more than 60% of the British FDI stock is in manufacturing and services.

Also, the FDI from the United States of America has been in manufacturing, mainly in food and primary and fabricated metals (UNCTAD, 1999a). The share of US FDI stock in Africa that is in the primary sector dropped from 79% in 1986 to 53% in 1996 (Ikiara, 2003).

A survey of multinational corporations in 2000 indicated that the sectors with the greatest potential to attract FDI in Africa are tourism, natural resources industries and industries for which the domestic market is important. As has happened in many African countries in recent times, telecommunication is in this category. This has assumed great importance with the privatization of telephone companies in many countries and the emergence of the global system of communication (GSM) in many African countries.

Providing a Theoretical Framework for the Determinants of FDI: A Cursory Glimpse

A number of studies examine the determinants of capital flows to developing countries. These studies tend to look first at capital flows generally and then to focus specifically on foreign direct investment. In general, the studies divide the factors influencing capital flows into developing countries into push and pull factors. The push factors, which are external to developing countries, focus on growth and financial market conditions in industrial countries. Looking at these factors, Calvo et al. (1993) concluded for emerging markets that total flows are driven primarily by push factors, mainly growth and interest rates in industrial countries. Mody and Murshid (2001) found that developments within an individual developing country tend to raise capital to that country by increasing the share of total flows allocated to that country. These studies suggest that the push (external) factors determine the pool of funds available to LDC, while the pull factors determine their allocation among less developed countries (Collins, 2002).

The pull factors depend on a long list of domestic policies and characteristics of potential host countries. Among the various indicators are:
• Macroeconomic policy and performance (growth, the external balance, real exchange rate over-valuation and exchange rate regime, financial market development).
• Indicators of current and capital account openness.
• Tax levels and existence of incentives to encourage capital inflows.
• Measures of the quality of legal and other institutions (including corruption).
• Conflict measures.
• Political regime.
• Size of domestic markets and natural resource base.

In the literature on FDI there are four main motives for seeking to invest abroad. These are broadly described as resource seeking, market seeking, strategic asset seeking and efficiency seeking. In the case of resource seeking, investors locate abroad in order to secure cheaper supplies of raw materials or inputs that are not available at home. Such resources may be natural resources like oil and gas or low-cost input such as labour. The basic reason is to lower production costs and enhance competitiveness in both local and foreign markets. Most resource-seeking FDIs are usually export-oriented. Market-seeking FDI opens up new markets in the host country or neighbouring countries. The main motive is to bring about a reduction in the cost of supplying a market. Efficiency-seeking FDI attempts to produce in as few countries as possible, with each one having advantages in terms of location, endowment and government

incentives. Strategic-asset-seeking FDI, on the other hand, locates in a place in order to take advantages of what is available in terms of research and development and other benefits.

What Then Are the Major Determinants of FDI in General?

There is no unanimously accepted single factor determining the flow of investment. The literature is replete with information on the full range of factors that are likely to induce the flow of foreign direct investment anywhere. It is often claimed that those factors that are favourable to domestic investments are also likely to propel foreign direct investment. These are the various factors that propel the flow of FDI into a given geographical location, say a country or a region. In making decisions to invest abroad, firms are influenced by a wide constellation of economic, political, geographic, social and cultural issues.[9] It is important to note that while the list of factors is fairly long, not all determinants are equally important to every investor in every location at all times. It is also true that some determinants may be more important to a given investor at a given time than to another investor.

While it is difficult to determine the exact quantity and quality of FDI determinants that should be present in a location for it to attract a given level of inflows, it is nevertheless clear that a critical minimum of these determinants must be present before FDI inflows begin to occur (Ngowi, 2001). One would rationally expect that investors would choose a location in accordance with the profitability of that location. The profitability of investment is expected to be affected by specific factors, however, including country characteristics as well as the types of investment motives. As pointed out by Campos and Kinoshita (2003), market-seeking investors, for example, will be attracted to a country that has a large but fast growing market, while resource-seeking investors will search for a country with abundant natural resources.

The factors influencing the flow of FDI thus range from the size of markets to the quality of labour, infrastructure and institutions, to the availability of resources. These and others are discussed below.

- A number of studies emphasize the importance of the size of the market and growth in attracting FDI. Market size and growth have proved to be the most prominent determinants of FDI, particularly for those FDI flows that are market seeking. In countries with large markets, the stock of FDI is expected to be large since market size is a measure of market demand in the country. This is particularly true when the host country allows the exploitation of economies of scale for import-substituting investment.

- The costs as well as the skills of labour are identified as the major attractions for FDI. The cost of labour is important in location considerations, especially when investment is export oriented (see Wheeler and Mody, 1992; Mody and Srinivasan, 1998). Lower labour cost reduces the cost of production, all other factors remaining unchanged. Sometimes, the availability of cheap labour justifies the relocation of a part of the production process in foreign countries. Recent studies, however, have shown that with FDI moving towards technologically intensive activities, low cost unskilled labour is not in vogue. Rather, there is demand for qualified human capital (Pigato, 2001). Thus, the investing firm is also concerned about the quality of the labour force. It is generally believed that highly educated personnel are able to learn and adopt new technology faster, and the cost of retraining is also less. As a result of the need for high quality labour, investors are most likely to target countries where the government maintains a liberal policy on the employment

of expatriate staff. This is to enable investors to bring in foreigners to their operation in order to bridge the gap in the skill of local personnel wherever it exists.

- That the availability of good infrastructure as crucial for attracting FDI is well documented in the literature, regardless of the type of FDI. It is often stated that good infrastructure increases the productivity of investment and therefore stimulates FDI flows (Asiedu, 2002). A study by Wheeler and Mody (1992) found infrastructure to be very important and dominant for developing countries. In talking about infrastructure, it should be noted that this is not limited to roads alone, but includes telecommunications. Availability and efficiency of telephones, for example, is necessary to facilitate communication between the host and home countries. In addition to physical infrastructure, financial infrastructure is important for FDI inflow. A well-developed financial market is known from available evidence to enable a country to tap the full benefits of FDI. Alfaro et al. (2001), using cross-section data, find that poorly developed financial infrastructure can adversely affect an economy's ability to take advantage of the potential benefits of FDI. In a study by Bhinda, Griffth-Jones and Martin (1999), it was found that problems related to funds mobilization were on the priority list of the factors discouraging investors in Uganda, Tanzania and Zambia.

- Country risk is very important to FDI. Several studies have found FDI in developing countries to be affected negatively by economic and political uncertainty. There is abundant evidence to show the negative relationship between FDI and political and economic stability. In a study on foreign owned firms in Africa, Sachs and Sievers (1998) conclude that the greatest concern is political and macroeconomic stability, while Lehman (1999) and Jaspersen et al. (2000) find that countries that are less risky attract more FDI. Perception of risk in Africa is still very high and continues to hinder foreign direct investment.

- Openness of an economy is also known to foster the inflows of FDI. The more open an economy is, the more likely it is that it would follow appropriate trade and exchange rate regimes and the more it would attract FDI.

- The institutional environment is an important factor because it directly affects business operations. In this category is a wide array of factors that can promote or deter investment. The first of these is the existence of corruption and bribery. Corruption deters the inflow of FDI because it is an additional cost and because wherever it exists, it creates uncertainty, which inhibits the flow of FDI. The second is the level of bureaucracy involved in establishing a business in a country. Complex and time-consuming procedures deter investment. The third institutional factor is the existence of incentives in the form of fiscal and financial attractions. This last factor is only useful to the extent that other favourable factors are already in place. Fourth, there is also the institution of the judiciary, which is key to protecting property rights and law enforcement regulations. A frequent measure of this is the rule of law, which is a composite of three indicators (Campos and Kinoshita, 2003): sound political institutions and a strong court system; fairness of the judicial system; and the substance of the law itself. It is expected that countries with better legal infrastructure will be able to attract more FDI. Related here is the enforceability of contracts: The lack of enforceability in many African countries raises risk of capital loss and hinders FDI.

- The availability of natural resources is a critical factor in attracting FDI. This is particularly so in Africa where a large share of FDI has been in countries with abundant natural resources.

In some cases, the abundance of natural resources has been combined with a large domestic market. African countries that have been able to attract most FDI have been those with natural and mineral resources as well as large domestic markets. Traditionally about 60% of Africa's FDI is allocated to oil and natural resources (UNCTAD, 1999a/b). The Africa region possesses not only large reserves of oil, gold, diamonds and copper, but also more than half of the world's cobalt and manganese, one-third of bauxite, and more than 80% of chromium and platinum. A number of countries, including Angola, Nigeria, Côte d'Ivoire, Botswana and Namibia, have been host to FDI because of this advantage.

- Foreign investors may be attracted to countries with an existing concentration of other foreign investors. In this case, the investment decision by others is seen as a good signal of favourable conditions. The term "agglomeration economies" is often applied to this situation (Campos and Kinoshita, 2003). The clustering of investors leads to positive externalities. Three types of such externalities have been identified in the literature. The first is that technological spillovers can be shared among foreign investors. Second, they can draw on a shared pool of skilled labour and specialized input suppliers. Third, users and suppliers of inputs cluster near each other because of the greater demand for a good and the supply of inputs, which is provided by the large market.

- Return of investment is another major determinant of FDI flows. In general, FDI will go to countries that pay a higher return on capital. For developing countries, testing the rate of return on capital is difficult because most developing countries do not have a well-functioning capital market (Asiedu, 2002). What is often done is to use the inverse of real GDP per capita to measure the return on capital. The implication of this is that all things being equal, investments in countries with higher per capita income should yield lower return and therefore real GDP per capita should be inversely related to FDI (Asiedu, 2002). The empirical result of the relationship between real GDP per capita and FDI is mixed. In works by Edwards (1990) and Jaspersen et al. (2000), using the inverse of income per capita as proxy for the return on capital, they conclude that real GDP per capita and FDI/GDP are negatively related. Results of studies by Schneider and Frey (1985) and Tsai (1994) are different as they find a positive relationship between the two variables. This is based on the argument that a higher GDP per capita implies better prospects for FDI in the host country.

- Macroeconomic and other policies also play a role. Macroeconomic policy errors resulting in exchange rate misalignment and the lack of convertible currencies constrain FDI flows. In cases where policies are not sustainable, FDI flows are hindered.

A look at Africa reveals compelling evidence that FDI may have been attracted by one or more of the following four categories of considerations (Basu and Srinivasan, 2002):

- *Investment that is intensive in natural resources:* Given the abundance of natural resources in Africa, a large share – almost 40% – has been in the primary sector. For a number of countries, including Angola, Botswana, Namibia and Nigeria, the oil and mineral sectors have been targeted.

- *Investment driven by "specific" locational advantages:* During the apartheid era, a number of investors wishing to capture the large market in South Africa located in Lesotho and Swaziland. These countries therefore at that time benefited from inflows of FDI.

- *Investment driven by host country policies that actively target foreign investment:* A few countries have tailored their policies to target foreign direct investment by ensuring political and economic stability. Such policies provided specific tax incentives and created export-processing zones. These countries include Mauritius and Seychelles.

- *Investment in response to recent economic and structural reforms:* A few countries that were shunned by investors in the past are now the darlings of investors in response to the far-reaching economic and structural reforms. Uganda and Mozambique, whose economic reforms have been fairly successful, have attracted FDI inflows.

Empirical Evidence on the Determinants of FDI in Africa

Over time a number of studies have been carried out to examine/analyse the various determinants of FDI in Africa specifically. In one or two cases, Africa is shown to be different from the rest of the world in terms of the various factors affecting foreign direct investment. The implications of such finding are sweeping. It means in the first place that whatever fundamentals are present in the various economies, Africa is unlikely to attract FDI. According to Asiedu (2002), policies that have been successful in other regions may not be equally successful in Africa. The second is that economic policy does not matter for FDI.[10] The findings of various studies on the determinants of FDI in Africa have been contradictory in many cases.[11]

There is a dearth of empirical work that is solely concentrated on the determinants of FDI in African countries. In most of the studies that have been carried out, only a limited number of African countries are included. For example, Gustanaga et al. (1998) consider a total of 49 countries, only 6 of which are in sub-Saharan Africa (SSA), while Schneider and Frey (1985) consider 51 countries, of which 13 are in SSA. About half of the 51 countries in Edwards (1990) are in SSA. In their econometric analysis of the determinants of FDI using panel data, Elbadawi and Mwega (1997) argue that while market size is relatively unimportant in explaining FDI flows to Africa, economic growth is an important determinant. They find that a depreciation of the real effective exchange rate, an increase in a country's openness to trade and the expansionary effects of fiscal balance have positive impacts on FDI. It is also shown that an improvement in removing restrictions and providing good conditions for private initiative have important bearings on FDI inflows, while the number of political upheavals has a negative bearing. Terms of trade shocks and the level of schooling are found to have little impact on FDI into Africa. Incidents of war and African regional integration arrangements are found to have limited impacts on FDI flows.

Two recent studies also concentrate on Africa. The first, by Schoeman et al. (2000), which is limited to South Africa, analyses how government policy (mainly deficit and taxes) affects FDI. The second set of papers is by Asiedu (2002, 2004). Using cross-section data on 71 developing countries, Asiedu (2002) attempts to answer the following set of questions: What factors drive FDI to developing countries? Are these factors equally relevant for FDI to SSA? Why has SSA attracted so little FDI? Why has SSA been relatively unsuccessful in attracting FDI despite policy reform? Is Africa different? The analysis is focused on only three main variables – the return on investment, availability of infrastructure and openness to trade – and does not take into account natural resource availability, which is an important determinant of FDI to Africa. Asiedu concludes that:

- Countries in SSA have on average received less FDI than countries in other regions by virtue of their geographical location.
- Both higher return on investment and better infrastructure have positive impact on FDI to non-SSA countries, but no impact on FDI to SSA.
- Openness to trade promotes FDI to SSA and non-SSA countries. The marginal benefit from increased openness is less for SSA, suggesting that trade liberalization will generate more FDI to non-SSA countries than SSA countries.

Her results imply that Africa is different and that factors attracting FDI to other regions may not be equally applicable in Africa. This implies that the success stories in other places cannot in some cases be replicated in Africa. Three policy implications arise from the results of the empirical work.

- African countries need to liberalize their trade regime in order to enhance FDI flows. The full benefit of trade liberalization is only achievable if investors perceive the reform not only credible but irreversible.
- Policies that have worked in other countries cannot be blindly replicated in Africa, since these policies may have different impacts on Africa.
- Africa is overly perceived as risky. Consequently, countries in the region receive less FDI by virtue of their geographical location. To dispel the myth, there is need to disseminate information about the continent.

In another paper, Asiedu (2003) used panel data on 22 African countries for the period 1984–2000 to examine empirically the impact of several variables including natural resource endowment, macroeconomic instability, FDI regulatory framework, corruption, effectiveness of the legal system and political instability on FDI flows. The paper debunks the notion that FDI in Africa is solely driven by natural resource availability and concludes that natural resource endowment, large markets, good infrastructure and an efficient legal framework promote FDI, while macroeconomic instability, corruption, political instability and investment restrictions deter investment flows. These results imply that African governments can play major roles in promoting FDI to the region through appropriate policy framework. In the short and medium term, government can increase their FDI by streamlining their investment regulation framework, implementing policies that promote macroeconomic stability and improving infrastructure. In the long run, more FDI can be achieved by curbing corruption, developing a more efficient legal framework and reducing political instability (Asiedu, 2003).

Morisset (2000) focuses exclusively on Africa and controls for natural resource availability. He identified which African countries have been able to attract FDI by improving their business climate. Evidence from the countries shows that proactive policies and reoriented governments can generate FDI interest. He makes the point that by implementing policy reforms, African countries can also be successful in attracting FDI that is not based on natural resources or aimed at the local market, but rather on regional and global markets. Using panel data for 29 countries over the period 1990–1997 he finds that GDP growth rate and trade openness have been positively and significantly correlated with the investment climate in Africa. On the other hand, the illiteracy rate, the number of telephone lines per capita and the share of the urban population (a measure of agglomeration) are major determinants in the business climate for FDI in the region. Political and financial risk as measured by the International Country Risk Guide (ICRG) and the International Investors ratings did not appear significant in his regression.

One major deterrent to FDI flows cited in the literature is uncertainty. Uncertainty is also

a known factor plaguing Africa's development strategy. Empirical studies of the relationships between FDI and uncertainty in developing countries are very few. Two studies, by Ramasamy (1999) for Malaysia and Lehmann (1999) for developing countries, find a negative relationship between uncertainty and FDI in developing countries. Even fewer studies address the connection between uncertainty and FDI in Africa. While Bennell (1995) and Pigato (2000) highlighted the role of uncertainty, none of them formally addresses the impact of both economic and political uncertainty in African countries. Lemi et al. (2001) examines how uncertainty affects FDI flows to African economies by analysing FDI flows from the United States, US manufacturing FDI and US non-manufacturing FDI flow to sampled host countries in Africa. Using a generalized autoregressive heteroscedastic model, the study concludes:

- The impact of uncertainty on the flow of FDI from all sources is insignificant.
- For aggregate FDI from the United States, economic and political uncertainties are not major concerns.
- For US manufacturing FDI, only political instability and government policy commitment are important factors, whereas for US non-manufacturing FDI, economic uncertainties are the major impediments only when coupled with political instability and debt burden of host countries.
- Other economic factors such as labour, trade connections, size of the export sector, external debt and market size are also significant in affecting FDI flow to Africa.

Why Has Africa Lagged behind in Receiving FDI?

Empirical evidence does show clearly that the rate of return to investment in Africa is higher than that of other developing economies. Why then is Africa not attracting FDI commensurate to this economic fundamental? There are a couple of studies that attempt to answer this question. The first sets of explanations deal with the riskiness of investment in Africa, the perception of Africa as a continent riddled with disease, pestilence and high instability. The image of the continent as a location for FDI is thus not favourable (UNCTAD (1999a: 1):

> For many people in other parts of the world, the mention of Africa evokes images of civil unrest, war, poverty, diseases and mounting problems. Unfortunately, these images are not just fiction. They reflect the dire reality in some African countries – though certainly not in all.

The negative influence masks the complex diversity of economic performance of individual countries and the variety in the economic opportunities. In a recent work by Rogoff and Reinhart (2003), the role of price and currency instability is used as an explanation for the inability of Africa to attract FDI. In their concluding remarks, these authors claim that major events such as wars and civil unrest occur more frequently in Africa than other regions. These events, they claim, have adverse effects on the investment climate because they often bring along disastrous effects like high inflation and higher levels of other distortions such as capital controls that help parallel and illegal currency markets thrive and deter investments. Among the reasons for the low inflow of FDI to Africa is that the reform in Africa has on the average been mediocre relative to the other regions of the world (Asiedu, 2004).

Survey Findings on Africa

nformation on the determinants of FDI in Africa based on survey findings is summarized in Table 2.1. The first five major determinants are the growth of local market, profitability of investments, size of local markets, access to regional markets and trade policy (Ikiara, 2003: 24). This table is comprehensive and includes the various factors discussed earlier.

Table 2.1: Determinants of FDI in Africa, 2000–2003: Survey findings

Determinant	% viewing it as positive determinant	% viewing it as negative determinant*
Growth of local market	67	11
Profitability of Investment	62	27
Size of local market	62	28
Access to regional markets	60	12
Trade policy	58	14
Political and economic outlook	52	28
Tax regime	48	23
Regulatory & legal framework governing FDI	45	21
Access to skilled labour	41	20
State of physical infrastructure	41	25
Investment incentives	40	20
Access to natural resources	39	21
Administrative costs of doing business	39	28
Access to low-cost unskilled labour	32	24
Access to capital finance	31	28
Access to global markets	30	38
Level extortion and bribery	19	49

Note: *This column should be interpreted with care. In the case of profitability of investment, for example, 27% of the respondents felt that it was low and discouraged FDI.
Source: UNCTAD/ICC survey of TNCs (November 1999 – January 2000), reported in UNCTAD (2000). Reproduced from Ikiara (2003).

Table 2.2 presents the survey rankings of the top 20 African countries in 2000–2003 with respect to their attractiveness and progress in improvement of the attractiveness (Ikiara, 2003: 21). From the survey, South Africa, Egypt, Morocco and Nigeria are the four most attractive countries for FDI in Africa.

South Africa is ranked first in terms of both its attractiveness to FDI and its progress in improving attractiveness to FDI, even though the volume of FDI to it in 2000 and 2002 was less than that to Nigeria. Nigeria also had more FDI inflows than Egypt and Morocco in the years listed. The table further shows that Tanzania and Uganda have made tremendous improvements in their attractiveness, while Libya, Angola, Zimbabwe and Nigeria are likely to lose some of their attractiveness.

Table 2.2:   Attractiveness to FDI of the top 20 African countries in 2000–2003

Country / Ranking	Attractiveness to FDI	Progress in improving attractiveness
South Africa	1	1
Egypt	2	3
Morocco	3	2
Nigeria	4	7
Tunisia	5	4
Ghana	6	6
Libya	7	14
Côte d'Ivoire	8	5
Algeria	9	10
Kenya	10	11
Mozambique	11	9
Botswana	12	12
Angola	13	23
Zimbabwe	14	18
Tanzania	15	8
Mauritius	16	16
Namibia	17	15
Ethiopia	18	17
Uganda	19	13
Malawi	20	21

Source: UNCTAD/ICC survey of TNCs (November 1999 – January 2000), reported in UNCTAD (2000). Reproduced from Ikiara (2003).

Conclusion

Summarizing this discussion is difficult without repeating some of the major points made in various sections. At the risk of oversimplification, a number of highlights can be pointed out. In this chapter we have tried to underscore the importance of foreign direct investment to Africa and how Africa, in spite of various reforms, has attracted insignificant proportion of global FDI. Some of the explanations given include the perceived riskiness of investment in Africa, price and exchange rate instability, and the relatively mediocre nature of reform in Africa relative to other regions of the world. Some African countries have lost their relative position in attractiveness to FDI flows while others have improved theirs. In all cases it is shown that policies do matter.

As discussed in the chapter, FDI flows are influenced by both pull and push factors. The push factors are mainly growth and interest rates in the industrialized countries, while the pull factors consist mainly of host country characteristics and policies. It is important to note that while the list of factors is fairly long, not all determinants are equally important to every investor in every location at all times. Thus the various policies in various countries underscore the importance of country case studies as the factors propelling investment in one country need not be the same for other countries. It is this area of commonality and differences that are important to this study.

Notes

[1] About 48% of Africans live on less than one dollar a day as compared with 4% for Eastern and Central Europe. This hides a lot of country diversity, as the poverty rate varies across Africa: Burkina Faso 62%, Nigeria 70%, Zambia 64%, Mali 73% and Central African Republic 66% (Asiedu, 2003).

[2] In 2002, 5 countries in Africa achieved the needed growth rate of 7% to meet the Millennium Development Goals, 43 countries had rates of growth below 7%, while 5 countries registered negative growth rates. See UNECA (2003b), Economic Report on Africa.

[3] These are Zimbabwe, Ethiopia, Seychelles, Côte d'Ivoire, Guinea Bissau, Central African Republic and Burundi.

[4] For details of the various policy changes that are required see Ajayi (2000, 2003, 2005).

[5] For details see Morisset (2000).

[6] For details see Pigato (2000).

[7] Information computed from UNCTAD, *World Investment Report* (2003).

[8] For more details see "Fact sheet on foreign direct investment: Focus on the New Africa", at www.fdi.net. See also www.dipp.nicin/fdi_statistics.

[9] For details on the role of these factors see Assanie and Singleton (2002), available from http://www.asiapacificresearch.ca/caprn/FDI_and_Economic_Growth-CEA-May_2002.pdf

[10] From various studies, however, we find that policy does matter very much in attracting FDI to Africa. The roles of policy in affecting the levels and composition of FDI have been reviewed extensively by Balasubramayam and Salisu (2001) and Pain (2000). Further evidence can be found in Pigato (2000), Morisset (2000) and Asiedu (2003).

[11] For details on the effects of selected variables on FDI see Asiedu (2002).

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Appendix   Explanatory Tables

Table 2.A1: Foreign direct investment inflows by host region

	1991–96	1997	1998	1999	2000	2001	2002
Annual average							
World	254,325.88	481,910.95	686,028.27	1,079,082.75	1,392,957.44	823,824.79	651,188.50
Developed countries	154,641.17	269,654.19	472,265.10	824,642.29	1,120,527.84	589,378.95	460,334.39
Developing countries	91,502.20	193,223.66	191,283.93	229,295.22	246,056.56	209,431.16	162,145.07
Africa	4,606.45	10,666.71	8,928.01	12,231.49	8,489.36	18,768.69	10,997.72
Latin America and Caribbean	27,069.41	73,274.53	82,039.62	108,255.09	95,357.91	83,725.21	56,018.52
Asia	59,410.82	109,092.44	99,982.99	108,528.62	142,091.20	106,777.83	94,989.12
Pacific	415.55	189.99	333.31	280.01	118.09	159.43	139.70
Central and Eastern Europe	8,182.52	19,033.09	22,479.24	25,145.24	26,373.03	25,014.67	28,709.04
LDCs	1,712.88	3,400.53	4,573.35	5,974.02	3,427.31	5,628.53	5,231.79
Share of global FDI inflows (In per cent)							
World	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Developed countries	60.80	55.96	68.84	76.42	80.44	71.54	70.69
Developing countries	35.98	40.10	27.88	21.25	17.66	25.42	24.90
Africa	1.81	2.21	1.30	1.13	0.61	2.28	1.69
Latin America and Caribbean	10.64	15.20	11.96	10.03	6.85	10.16	8.60
Asia	23.36	22.64	14.57	10.06	10.20	12.96	14.59
Pacific	0.16	0.04	0.05	0.03	0.01	0.02	0.02
Central and Eastern Europe	3.22	3.95	3.28	2.33	1.89	3.04	4.41
LDCs	0.67	0.71	0.67	0.55	0.25	0.68	0.80
Share of developing countries (in per cent)							
Developing countries	100.00	100.00	100.00	100.00	100.00	100.00	100.00
Africa	5.03	5.52	4.67	5.33	3.45	8.96	6.78
Latin America and Caribbean	29.58	37.92	42.89	47.21	38.75	39.98	34.55
Asia	64.93	56.46	52.27	47.33	57.75	50.98	58.58
Pacific	0.45	0.10	0.17	0.12	0.05	0.08	0.09
Central and Eastern Europe	8.94	9.85	11.75	10.97	10.72	11.94	17.71
LDCs	1.87	1.76	2.39	2.61	1.39	2.69	3.23

Sources: Figures and data calculation from UNCTAD (2003).

Table 2.A2: FDI inflows, by region and economy, 1991–2002 ($ millions)

Region/Economy	1991-96 (annual avg.)	1997	1998	1999	2000	2001	2002
Africa	4,606	10,667	8,928	12,231	8,489	18,769	10,998
North Africa	1,615	2,716	2,882	3,569	3,125	5,474	3,546
Algeria	63	260	501	507	438	1,196	1,065
Egypt	714	887	1,076	1,065	1,235	510	647
Libyan Arab Jamahiriya	(12)	(82)	(150)	(118)	(142)	(101)	(96)
Morocco	406	1,188	417	1,365	423	2,808	428
Sudan	18	98	371	371	392	574	681
Tunisia	425	365	668	368	779	486	821
Other Africa	2,992	7,951	6,046	8,663	5,364	13,295	7,452
Angola	346	412	1,114	2,471	879	2,146	1,312
Benin	41	26	35	61	60	44	41
Botswana	(28)	100	90	37	54	26	37
Burkina Faso	9	13	10	13	23	9	8
Burundi	1	-	2	-	12	-	-
Cameroon	9	45	50	40	31	67	86
Cape Verde	10	12	9	53	34	9	14
Central African Rep.	(1)	-	-	3	1	5	4
Chad	20	44	21	27	115	-	901
Comoros	-	-	3	-	1	-	1
Congo	86	79	33	521	166	77	247
Congo, Dem. Rep. of	3	(44)	61	11	23	1	32
Côte d'Ivoire	158	450	416	381	235	44	223
Djibouti	2	2	3	4	3	3	4
Equatorial Guinea	66	53	291	252	108	945	323
Eritrea	37	41	149	83	28	1	21
Ethiopia	10	288	261	70	135	20	75
Gabon	(243)	(587)	(200)	(625)	(43)	169	123
Gambia	12	21	24	49	44	35	43
Ghana	105	82	56	267	115	89	50
Guinea	14	17	18	63	10	2	30
Guinea-Bissau	2	11	4	9	1	1	1
Kenya	13	40	42	42	127	50	50
Lesotho	21	32	27	33	31	28	24
Liberia	(28)	214	190	256	(431)	(20)	(65)
Madagascar	13	14	16	58	70	93	8
Malawi	(4)	(1)	(3)	46	(33)	(20)	
Mali	29	74	36	51	83	122	102
Mauritania	7	1		1	9	(6)	12
Mauritius	21	55	12	49	277	32	28
Mozambique	39	64	235	382	139	255	406
Namibia	112	84	77	111	153	275	181
Niger	16	25	9		9	23	8
Nigeria	1,264	1,539	1,051	1,005	930	1,104	1,281
Rwanda	3	3	7	2	8	4	3
Sao Tome & Principe	-	-	-	1	2	6	2
Senegal	20	176	71	136	63	32	93
Seychelles	24	54	55	60	56	59	63
Sierra Leone	1	10	(10)	6	5	3	5
Somalia	1	1		1			
South Africa	450	3,817	561	1,502	888	6,789	754

Continued

Table 2.A2, continued

Region/Economy	1991-96 (annual avg.)	1997	1998	1999	2000	2001	2002
Swaziland	62	(15)	152	100	39	78	107
Togo	11	23	42	70	42	63	75
Uganda	65	175	210	222	254	229	275
United Rep. of Tanzania	63	158	172	517	463	327	240
Zambia	108	207	198	163	122	72	197
Zimbabwe	50	135	444	59	23	4	26

Source: As in Table 2.A1.

Table 2.A3: Foreign direct investment inward stock (In millions of dollars)

	1980	1985	1990	1995	2000	2001	2002
World	699,415	977,755	1,954,203	3,001,996	6,146,656	6,606,698	7,122,350
Developed countries	391,946	570,901	1,399,880	2,041,408	3,988,075	4,277,195	4,594,850
Developing countries	307,469	406,805	551,481	920,400	2,029,412	2,173,769	2,339,788
Africa	32,162	33,844	50,775	77,400	144,503	157,823	171,032
Lat Am & Car	50,404	80,129	116,963	201,755	608,924	705,746	762,229
Asia	223,707	291,626	381,481	638,222	1,272,245	1,306,301	1,402,488
Pacific	1,196	1,207	2,263	3,022	3,740	3,899	4,039
Cen & East Eur	0	49	2,841	40,187	129,169	155,734	187,868
LDC	3,419	5,132	8,165	16,208	35,609	40,867	46,099
Share of global FDI inward stock (in per cent)							
World	100	100	100	100	100	100	100
Developed countries	56.04	58.39	71.63	68.00	64.88	64.74	64.51
Developing countries	43.96	41.61	28.22	30.66	33.02	32.90	32.85
Africa	4.60	3.46	2.60	2.58	2.35	2.39	2.40
Lat Am & Car	7.21	8.20	5.99	6.72	9.91	10.68	10.70
Asia	31.98	29.83	19.52	21.26	20.70	19.77	19.69
Pacific	0.17	0.12	0.12	0.10	0.06	0.06	0.06
Cen & East Eur	0.00	0.01	0.15	1.34	2.10	2.36	2.64
LDC	0.49	0.52	0.42	0.54	0.58	0.62	0.65
Share of FDI inward stock to developing countries (in per cent)							
Developing countries	100	100	100	100	100	100	100
Africa	10.46	8.32	9.21	8.41	7.12	7.26	7.31
Lat Am & Car	16.39	19.70	21.21	21.92	30.00	32.47	32.58
Asia	72.76	71.69	69.17	69.34	62.69	60.09	59.94
Pacific	0.39	0.30	0.41	0.33	0.18	0.18	0.17
Cen & East Eur	0.00	0.01	0.52	4.37	6.36	7.16	8.03
LDCs	1.11	1.26	1.48	1.76	1.75	1.88	1.97

Sources: As in Table 2.A1.

Table 2.A4: Inward FDI stocks as a percentage of gross domestic product, by region and economy (Selected years, by percentage)

Region/Economy	1980	1985	1990	1995	2000	2001	2002
Africa	8.2	9.9	10.8	15.6	25.9	28.5	30.6
North Africa	3.2	5.3	9.1	13.9	15.3	17.4	20.9
Algeria	3.1	2.2	2.2	3.5	6.4	8.5	10.5
Egypt	9.9	16.4	25.6	24.4	20.1	20.4	24.3
Libyan Arab Jamahiriya							
Morocco	1.0	3.4	3.5	9.2	20.3	28.0	26.9
Sudan	0.4	0.6	0.4	2.3	12.4	15.7	19.4
Tunisia	38.2	58.5	62.0	61.0	59.3	58.4	66.2
Other Africa	10.9	13.5	11.9	16.6	34.5	37.5	37.5
Angola	1.8	9.9	10.0	58.0	90.0	106.0	98.3
Benin	2.2	3.2	8.6	18.9	26.1	26.5	25.0
Botswana	61.8	79.5	34.8	23.0	37.2	28.5	38.6
Burkina Faso	1.0	1.7	1.4	3.4	6.7	6.3	5.9
Burundi	0.7	2.1	2.7	3.4	7.0	6.9	6.8
Cameroon	4.9	13.8	9.4	13.3	14.3	15.7	15.7
Cape Verde			1.1	7.7	31.1	31.1	30.4
Central African Rep.	6.2	8.9	6.4	7.1	10.0	10.4	9.9
Chad	14.6	21.6	16.6	25.7	47.4	38.6	78.4
Comoros	1.6	1.8	6.8	8.4	11.9	11.1	10.5
Congo	18.5	22.4	20.6	40.7	58.8	65.9	69.5
Congo, Dem. Rep of	4.9	8.6	5.8	9.6	14.3	11.6	11.8
Côte d'Ivoire	5.2	10.0	9.0	16.2	36.4	32.1	31.3
Djibouti	1.2	1.1	1.5	3.4	6.1	6.4	6.8
Equatorial Guinea		7.0	19.2	106.9	90.0	115.0	92.8
Eritrea					48.0	42.3	49.1
Ethiopia	2.7	1.7	1.8	2.9	14.8	15.4	17.3
Gabon	12.0	24.9	20.3	8.9			
Gambia	52.7	56.3	49.4	48.4	51.2	54.0	74.9
Ghana	5.2	6.0	5.4	12.7	29.4	29.3	26.4
Guinea	0.1	0.1	2.4	3.5	8.6	8.9	9.4
Guinea-Bissau	0.1	2.7	3.3	7.8	21.3	23.3	22.0
Kenya	5.3	7.8	7.8	8.1	9.5	9.2	9.3
Lesotho	1.2	8.5	5.3	35.9	58.3	64.5	75.3
Liberia	77.7	115.1	194.9	379.3	478.7	477.4	455.8
Madagascar	1.0	1.8	3.5	5.5	8.8	9.4	9.9
Malawi	9.2	13.3	10.5	11.4	11.2	9.3	8.4
Mali	0.7	2.5	1.6	6.6	18.5	20.3	21.9
Mauritania		5.7	5.6	8.6	11.3	10.2	11.3
Mauritius	2.3	4.0	6.4	6.5	15.6	15.9	15.6
Mozambique	0.4	0.4	1.7	8.7	29.1	37.4	44.8
Namibia	86.4	134.2	80.9	48.7	36.7	25.2	34.1
Niger	7.6	14.3	11.5	19.3	23.7	23.0	21.0
Nigeria	3.7	15.5	28.3	50.0	49.1	51.5	42.2
Rwanda	4.6	7.8	8.2	17.9	14.4	15.0	14.6
Sao Tome & Principe			0.7		8.1	19.0	20.2
Senegal	5.0	7.3	4.5	8.3	18.9	18.5	18.6
Seychelles	36.8	62.1	55.4	63.3	97.0	111.7	115.0
Sierra Leone	6.8	5.7			2.9	2.9	3.3
Somalia	5.6	1.1		0.2	0.2	0.2	0.2
South Africa	20.5	15.8	8.1	10.0	37.1	44.0	48.7
Swaziland	41.8	29.1	39.9	41.1	31.1	37.1	54.6
Togo	15.5	27.5	16.5	23.4	42.1	45.6	47.0

Continued

Table 2.A4, continued

Region/Economy	1980	1985	1990	1995	2000	2001	2002
Uganda	0.7	0.2	0.1	4.7	21.3	26.1	30.0
United Rep. of Tanzania	0.9	1.4	2.2	6.2	19.6	22.6	25.0
Zambia	9.1	20.0	30.8	44.5	72.6	66.5	70.0
Zimbabwe	2.8	3.3	1.4	4.8	15.5	11.8	5.8

Source: As in Table 2.A1.

Table 2.A5: Inward FDI flows as a percentage of gross fixed capital formation, by region and economy 1991–2002 (percentage)

Region/ Economy	1991–96 (Annual avg)	1997	1998	1999	2000	2001	2002
Africa	5.3	9.7	8.0	11.8	8.8	19.4	8.9
North Africa	4.3	5.9	5.8	7.1	6.0	11.5	7.1
Algeria	0.5	2.4	4.0	4.3	3.8	8.6	8.1
Egypt	8.3	5.2	5.5	5.2	5.9	3.4	4.6
Libyan Arab Jamahiriya	-0.2	-1.9	-4.2	-3.8	-3.2	-2.7	
Morocco	6.3	17.2	5.3	16.5	5.3	37.2	4.8
Sudan	0.9	6.8	22.6	25.6	23.8	27.7	
Tunisia	10.3	7.8	13.6	7.0	15.2	9.3	15.0
Other Africa	6.1	12.5	9.8	16.4	11.7	27.0	10.7
Angola	45.3	21.1	48.6	86.8	28.0	66.7	
Benin	14.5	6.8	8.5	13.9	13.8	9.6	
Botswana	-2.7	8.6	7.4	2.7	4.2	2.2	3.0
Burkina Faso	1.7	1.7	1.3	2.0	3.9	1.4	1.1
Burundi	0.5		3.7	0.3	21.8		
Cameroon	0.6	3.1	3.1	2.3	2.1	4.4	5.0
Cape Verde	7.0	10.4	8.2	43.3	31.1	8.6	
Central African Rep.	2.4	0.3	0.3	2.1	0.9	3.8	
Chad	14.6	23.3	8.8	10.5	39.9		
Comoros	1.3	0.1	10.0	1.3	5.9	0.1	
Congo	15.1	15.7	6.9	111.4	17.9	8.3	27.4
Congo, Dem. Rep. of	0.4	-8.7	13.5	1.2	1.8	0.1	
Côte d'Ivoire	14.2	27.4	21.6	20.9	20.3	4.3	19.8
Djibouti	7.5	5.1	4.4	8.9	4.7	5.2	
Equatorial Guinea	53.4	15.8	69.8	52.8	21.4	202.9	
Eritrea	19.9	15.3	46.2	26.1	11.8	0.3	
Ethiopia	1.1	27.5	23.4	6.7	14.9	1.8	5.8
Gabon	-20.9	-45.1	-14.0	-51.2	-3.3	12.8	7.4
Gambia	16.2	29.2	30.9	64.4	59.7	50.0	
Ghana	8.1	5.0	3.3	16.1	9.6	7.1	4.0
Guinea	2.6	2.6	2.8	8.7	1.5	0.2	
Guinea-Bissau	2.3	31.5	16.6	22.8	1.8	2.1	
Kenya	0.8	2.1	2.2	2.6	8.3	3.2	2.9
Lesotho	11.4	5.6	6.1	7.5	8.2	8.7	11.2
Liberia							
Madagascar	3.9	3.3	3.3	10.9	11.1	11.4	1.2
Malawi	-1.3	-0.4	-1.4	20.7	-14.3	-10.5	
Mali	4.8	12.5	6.9	10.1	18.5	17.6	16.1
Mauritania	4.1	0.5	0.1	0.5	3.3	-2.4	
Mauritius	2.1	5.0	1.3	4.2	25.9	3.2	2.7
Mozambique	8.4	10.5	27.4	30.0	10.8	23.0	24.0

Continued

Table 2.A5, continued

Region/ Economy	1991–96 (Annual avg)	1997	1998	1999	2000	2001	2002
Namibia	18.3	11.7	9.9	14.3	23.8	39.9	
Niger	7.3	11.1	3.5	0.1	4.5	9.7	
Nigeria	29.0	16.4	11.9	52.1	49.4	31.3	34.9
Rwanda	1.2	1.0	2.4	0.5	2.6	1.3	
Sao Tome & Principe	-0.5	0.6	2.7	4.2	11.0	24.8	
Senegal	3.4	22.3	7.5	15.1	7.3	3.6	9.2
Seychelles	19.4	31.7	26.3	26.4	31.3	28.9	
Sierra Leone	-0.2	22.6	-25.9	21.0	12.2	4.4	
Somalia							
South Africa	2.0	15.5	2.5	7.4	4.7	40.5	4.8
Swaziland	24.5	-3.5	34.6	20.5	10.4	34.0	
Togo	6.5	11.3	19.3	34.9	20.9	30.5	
Uganda	7.7	15.5	18.5	21.1	22.7	21.3	24.0
United Rep. of Tanzania	6.0	14.0	12.8	38.9	29.3	20.8	14.5
Zambia	21.6	14.1	41.3	32.5	21.2	10.1	25.8
Zimbabwe	3.0	8.0	44.0	7.2	2.6	0.5	7.5

Source: As in Table 2.A1.

Table 2.A6: Inward FDI performance index by region, selected years[a]

Region	1988–90	1993–95	1999–01
World	1.00	1.00	1.00
Developed countries	1.03	0.76	1.00
Western Europe	1.33	1.11	1.77
European Union	1.33	1.12	1.80
Other Western Europe	1.33	0.95	1.29
Northern America	1.13	0.77	0.78
Other developed countries	0.29	0.20	0.12
Developing countries	0.99	1.98	1.01
Africa	0.80	1.11	0.67
North Africa	0.85	1.05	0.47
Other Africa	0.76	1.15	0.82
Latin America and the Caribbean	0.90	1.62	1.41
South America	0.74	1.21	1.31
Other Latin America and the Caribbean	1.26	2.57	1.59
Asia	1.06	2.30	0.87
West Asia	0.27	0.36	0.11
Central Asia	-	2.93	1.63
South, East and South-East Asia	1.31	2.70	1.02
East and South East Asia	1.74	3.22	1.22
South Asia	0.11	0.41	0.16
The Pacific	4.49	4.22	0.58
Central and Eastern Europe	1.02[b]	1.31	0.99

Notes:
a. Three-year average.
b. 1992–94. As most of the countries in this region did not exist in their present form before 1992, the period for the index is adjusted.
Source: UNCTAD (2003).

Chapter 3
Why Does FDI Go Where it Goes?
New Evidence from the
Transition Economies

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One of the key components of the movement towards economic globalization is international capital flows, in which portfolio investment and foreign direct investment (FDI) figure prominently. FDI has received the attention of a vast literature that focuses on its determinants as well as on its consequences. Two important theories throw light on the locational determinants of FDI. Trade theory based on factor endowments argues that FDI is drawn to countries with lower wages and more abundant natural resources, while the new trade theory suggests that economies of scale are a driving force of FDI and that agglomeration effects often play a crucial role.[1]

The objective of this chapter is to investigate the importance of institutions and agglomeration vis-à-vis initial conditions and factor endowments as determinants of the choice of location by foreign investors in an almost natural laboratory setting: the transition from centrally planned to market economies in Central Europe and in the former Soviet Union. The former communist countries present an extremely valuable and so far little utilized object of research. The transition was initiated more or less simultaneously in nearly 30 countries that differ substantially in terms of inherited institutions, initial conditions, income levels and reform paths. This richness of variation allows comparative analysis in a unique situation akin to a natural experiment: a number of centrally planned economies set out to implement economic and political reforms, applying different strategies and experiencing dramatically different outcomes (in a large number of different dimensions, among them FDI).

The collapse of the socialist system in the late 1980s created a myriad of investment opportunities in the Central and Eastern European and former Soviet Union countries. These economies were industrialized and could count on a relatively cheap yet highly educated workforce. FDI is also perceived as a catalyst as it could bring not only less volatile capital flows but also the technology and managerial know-how necessary for restructuring firms.[2]

Despite early optimism about large FDI inflows into the region, these high expectations have not materialized so far. The share of FDI inflows into transition economies has been consistently smaller than those of other developing regions such as Asia and Latin America. Between 1990 and 1994, transition economies received 2.1% of the global FDI inflows, while Latin America received about 10% and Asia about 20% (UNCTAD, 2002). Between 1995 and 1999, transition economies received 3.2% of global FDI inflows, while Latin America received about 12% and Asia about 16% (UNCTAD, 2002). Although these flows accelerated in the second half of the 1990s, they were still disproportionately concentrated in a handful of Central Eastern European and Baltic countries (CEEB).[3] For instance, between 1990 and 1994, the CEEB received 95% of the total per capita FDI to transition countries while between 1995 and 1998 the CEEB share declined to still substantial 84%.

This chapter tries to contribute to two different branches of literature. The first is the one on the locational determinants of FDI. One of the most recent developments is the incorporation of institutional quality in modelling the location decision of foreign firms. Institutions underpin local business operating conditions but are different from "physical" supporting factors such as transport and communication infrastructures. The basic notion is that a lower level of corruption, a fair, predictable and expedient judiciary, and an efficient bureaucracy help to attract FDI. Albeit intuitive, data constraints have impeded extensive testing of these ideas and constrained existing studies to focus on one sole aspect of the issue, normally corruption. In this chapter, we examine a array of institutional features and try to assess their relative importance.

The chapter also tries to contribute to a second strand of literature, that on FDI in transition economies. Past studies have focused on the more advanced countries in transition, and more specifically have favoured the Central European countries to the detriment of those from the former Soviet Union. For example, Bevan and Estrin (2000) study the determinants of FDI inflows into 11 transition economies,[4] while Resmini (2000) uses a similar set of 10 countries. Here we use a set of 25 countries covering both the more and the less advanced countries in transition. Hence, our objective is to provide a fuller and more complete identification of the factors that affect the success and failure of (all) transition countries in attracting FDI. One exception is the study by Garibaldi et al. (2001), which covers a large number of transition countries yet uses different variables and different estimation methods to conclude that FDI can be well explained by macroeconomic fundamentals.

We use a unique panel data set covering 25 transition economies between 1990 and 1998,[5] and report that the main determinants of FDI inflows to these countries are institutions, natural resources, agglomeration economies and labour costs. We also investigate whether the set of determinants varies across the region. We find that for the Eastern European and Baltic countries, institutions, agglomeration economies and the extent of economic reforms are the main determinants, while for the CIS countries,[6] abundant natural resources and economic reforms are main drivers of FDI inflows.

The chapter is organized as follows. In the next section, we review the theoretical framework on the location determinants of FDI. We then discuss the variables to be tested as the determinants of FDI in our empirical setting, the estimation method and the data used. This is followed by the presentation of the econometric results, plus concluding insights and suggestions for future research.

Literature Review

What are the host country characteristics that attract FDI? The emerging consensus is that the answer crucially depends on the motives of foreign investors in undertaking those investment projects. Accordingly, three types of FDI are recognized.[7] The first is market-seeking FDI whose purpose is to serve local and regional markets. This type of FDI is also called horizontal FDI as it involves replication of production facilities in the host country.[8] Tariff-jumping or export-substituting FDI is a variant of market-seeking FDI. Because the reason for horizontal FDI is to better serve a local market by local production, market size and market growth of the host economy are the main drivers. The impediments to access local markets such as tariffs and transport costs also encourage this type of FDI.

Second, when firms invest abroad to acquire resources not available in the home country, FDI is said to be resource- or asset-seeking. Resources may be natural resources, raw materials or low-cost inputs such as labour. Especially in the manufacturing sector, when multinationals directly invest in order to export, factor cost considerations become important. In contrast to horizontal FDI, vertical or export-oriented FDI involves a relocation of parts of the production chain to the host country. Availability of low-cost labour is one prime driver for export-oriented FDI. Furthermore, FDI in resource sectors such as oil and natural gas is attracted to the countries with abundant natural endowments.[9]

Third, foreign investment is said to be efficiency-seeking when the firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope. Bevan and Estrin (2000) found the evidence that this is the case for the first wave of EU accession countries.[10] Prospective membership of the European Union conducive to the establishment of regional corporate networks seems to have attracted more of efficiency-seeking FDI after the initial announcement of the progress of EU accession.[11]

All these suggest that the countries that possess a large market, low-cost labour, abundant natural resources, and close proximity to major Western markets would attract large amounts of FDI inflows. FDI would thus go to countries with favourable initial conditions.

On the basis of a survey of Western manufacturing companies, Lankes and Venables (1996) find that the main purposes of FDI in transition economies before 1995 varied substantially across countries. They find that there had been a noticeable shift from the region's projects to serve local markets to those to serve export markets. Export-oriented FDI was then expected to increase as the market integration with the EU progresses. If so, we would expect cost factors to become more important.

Another important variable for explaining the geographical distribution of FDI is agglomeration economies. When agglomeration economies are present, new investors mimic past investment decisions made by other investors in choosing the location. By co-locating next to other firms, they benefit from positive spillovers from investors already in place. The usual sources for these positive externalities are knowledge spillovers, specialized labour and intermediate inputs.[12]

The empirical evidence on agglomeration economies is ample. The existing literature is concentrated on FDI in the US or US FDI aboard. A seminal work by Wheeler and Mody (1992) makes a strong case for agglomeration (and market size) in US investors' location decisions. Barrell and Pain (1999) find similar results on US investment in Europe. Head, Ries and Swenson (1995) find industry-level agglomeration economies play an important role in

the location choice of Japanese manufacturing FDI in the US. A recent work by Cheng and Kwan (2000) report a similar effect of agglomeration observed in China.

Factor-endowment based theory suggests that inherent differences in endowments and favourable initial conditions among countries explain the geographical pattern of inward FDI. The only way the host country can affect this pattern is to change economic fundamentals. On the other hand, a story of agglomeration economies suggests that once countries attract the first mass of investors, the process will be self-reinforcing without resorting to changes in policies. In this light, if there is any agglomeration effect, we expect that the past stock of FDI will be a good predictor of current FDI even after controlling for the classical factors of comparative advantages.

A growing body of literature that relates institutions and economic outcomes argues that good economic institutions are instrumental to economic growth via higher investment, higher educational attainment and lower mortality (Mauro, 1995; La Porta et al., 1998).[13] We believe that good institutions can also play a crucial mediating role in attracting FDI. Thus, the key question we ask is how important institutions and the agglomeration effect are relative to other factors in the host countries.[14]

In transition economies, it is well known that the recovery after the initial drop in output level of these countries varied greatly across countries (Campos and Coricelli, 2002). The economies that recovered fastest tend to be the CEEB despite different inflation rates, fiscal deficits, external debts and privatization strategies. Also, these countries had been relatively more open to trade even before the process of transition began. The favourable initial conditions drew a large bulk of investment at the time of disintegration of the Council for Mutual Economic Assistance in 1991 and it might have been further magnified by the agglomeration effect.

In summary, in order to understand the determinants of FDI in transition economies it is crucial to specify an empirical model that allows for a combination of traditional (e.g., market size and labour costs), newer (e.g., institutions) and transition specific determining factors (e.g., initial conditions).

Data and Estimation

The data used in this study are a panel of 25 transition countries (the CEE, the Baltics and the CIS) between 1990 and 1998. The number of observations in the complete panel is 225 (=25x9).[15] The definitions of the variables are found in Table 3.1. Our dependent variable is per capita FDI stock in constant million US dollars and is constructed from a series of FDI inflows reported in the World Bank's *World Development Indicators* (WDI).[16] Independent variables are drawn from various sources reported in Table 3.1.

The time-series aspect is important for our study for at least two reasons. First, the agglomeration or self-reinforcing effects of FDI can be addressed only if there is a time series of FDI. In the presence of agglomeration, newly made investment would be a increasing function of the past investment already in place. Second, during the time period covered in our data, transition economies went through comprehensive reforms. Cross-sectional data would not allow us to take into account changes of the reform variables.

The cross-sectional aspect of our study is also important. Transition from planned to market economy started in the early 1990s in these countries but foreign investors were cautious in the beginning. Due to difficulty of obtaining sufficiently long FDI data, the past studies on FDI in

transition were often limited to the more advanced countries in transition (e.g., the CEEB countries) that are also the major recipients of FDI in the region. In this study, we use the set of 25 transition economies. Adding CIS countries to the data, we are hoping to introduce more heterogeneity as well as incorporate different motives of investment, which may vary across sectors.[17]

Table 3.1: Definitions of variables

Variable	Definition
FDI stock per capita	Cumulative FDI stock per capita (constant US$ million) (Source: The World Bank *World Development Indicators*)
Lagged FDI	One-year lagged cumulative FDI stock per capita
Market size	Real per capita GDP using chain method (Source: *Penn World Table 6.1)*
Labour cost	Gross nominal wage (Source: UNECE *Economic Survey of Europe*)
Education	General secondary school enrolment (%) (Source: UNICEF)
Natural resources	Natural resource endowment: =0 if poor, =1 if moderate, and =2 if rich (Source: De Melo et al., 1997)
Distance Brussels	Distance from Brussels to the capital city (km)
Telephone lines	Number of telephone mainlines per 1,000 people
Inflation	Annual average of current inflation rate (%)
External liberalization	Cumulative external liberalization index
Rule of law	The variable "law and order" that assesses the strength and impartiality of the legal system and popular observance of the law (Source: *International Country Risk Guide,* PRS Group)
Bureaucracy	Quality of bureaucracy (Source: Campos, 2000)
Trade dependence	Trade dependence as a share of GDP in 1989 (Source: De Melo et al., 1997)
Restrictions on FDI	The index of FDI restrictions (Source: Garibaldi et al., 2001)

Regression Variables

Investors choose a location of investment according to the expected profitability associated with each location. Profitability of investment is in turn affected by various country specific factors as well as a type of investment motives. For example, market-seeking investors will be attracted to a country with large local market and fast growing market. Resource-seeking investors will look for a country with abundant natural resources. Efficiency-seeking investors will weigh more of geographical proximity to the home country to minimize transportation costs. Thus, the location of FDI is closely related to comparative advantages of the country, which in turns affects the expected profitability of investment.

Classical Sources of Comparative Advantage
The classical sources of comparative advantages are input prices, market size, growth of the market and the abundance of natural resources.

The primary purpose of market-seeking FDI is to serve the host country market. Market size is a measure of market demand in the country. We expect per capita FDI stock to be greater countries with larger domestic market. To proxy for market size, we follow the literature and use real per capita GDP using the chain method (*RGDPCH*).[18] The figures are drawn from *Penn World Table 6*.

If foreign investors are seeking low labour cost sites, availability of cheap labour is an important reason for FDI. To take advantage of low cost of the labour input, firms can justify relocating a part of their production process to foreign countries. We use the nominal wage rate (*WAGEN*) as a proxy for labour cost. We drew the data from the United Nations Economic Commission for Europe's (UNECE) *Economic Survey of Europe*. If vertical FDI is dominant, we expect a negative sign on the coefficient (e.g., countries with lower labour costs would attract more FDI.)

Potential foreign investors should be concerned not only with the cost of labour but also with the quality of labour. A more educated labour force can learn and adopt new technology faster and the cost of training local workers would less for investing firms. Our labour quality index is general secondary education enrolment rate (*EDU*) collected by UNICEF.

The CIS countries (e.g., Azerbaijan, Kazakhstan and Russia) receive much FDI in resource-based industries as they are rich in oil and natural gas. In the typology developed above, this is considered resource-seeking FDI. Natural resource rich countries may attract foreign investment in those industries while they may also divert investment from the manufacturing sector.[19] The variable we use is *NATRES,* which indicates if the host country is "poor" (=0), "moderate" (=1) or "rich" (=2) in natural resources.[20]

Proximity to the home country is an important factor in explaining the volume of trade flows between countries in a gravity model.[21] It is a stylized fact in the empirical literature that trade volumes between two countries are a function of both the income levels of the two countries (GDP) and the distance between them. In a gravity model, the smaller the distance between two countries, the more they are expected to trade. Distance is a proxy for transportation costs or (economic) barriers to trade. In horizontal FDI, in particular, transportation costs are treated as a fixed cost by investors.[22] The greater the distance, the more incentives there are for firms to relocate production facilities to the host country. The proximity may be also relevant for cost-motivated investments such as vertical FDI. Note, however, that the proximity in a gravity equation is measured as distance between source and host countries (i.e., distance between the headquarters and the foreign production sites). Yet the current data cannot identify the source country of FDI. Given this constraint, we measure the physical distance in kilometres from Brussels to the capital city of the host country (*DISB*). Distance from Brussels is a proxy for ease of access to the major Western markets owing to low communication, transportation and coordination costs.

A good infrastructure is a necessary condition for foreign investors to operate business locally, regardless of the type of FDI. We use the number of main telephone lines (*TELEPHON*) from *World Development Indicators* as our infrastructure variable. Availability of main telephone lines is necessary to facilitate communication between the home and host countries.[23]

Macroeconomic Policy and Reform Variables

Investment decisions in emerging markets are also influenced by economic and political risks. Successful implementation of economic reform by the host government indicates a stable macroeconomic performance, which implies low investment risk.

A record of price stability is a good indicator for macroeconomic stability and the progress in market reforms. For example, a history of low inflation and prudent fiscal balance signals to investors how committed and credible the government is. For this, we use the annual average inflation rate (*INFAV*). Most transition countries suffered from a monetary overhang and thus high inflation after freeing prices at the onset of transition. Those countries that embarked on stabilization programmes early also succeeded in bringing inflation under control rapidly. The lower the average inflation rate is in the host country, the more successful the stabilization programme was, and the higher GDP growth can be expected in the short run. Thus, we expect that the more foreign investment, other things equal, will be attracted to countries with lower inflation rates.

Another indicator of economic reform is the extent of external liberalization. We use the variable *CLIE* to reflect a removal of trade controls and quotas, moderation of tariff rates, and reduction of foreign exchange rate restrictions.[24] Trade liberalization and a removal or reduction in capital controls indicate the speed and level of reforms most relevant to foreign investment among all the available indexes of structural reforms.[25] Since trade flows are often a complement to FDI flows,[26] more FDI would be attracted to the countries with more liberalized trade regimes. On the other hand, if FDI is basically intended for tariff-jumping purposes, the more restrictive trade regime may induce more FDI.

Another important policy variable we use is the index of FDI restrictions (*RES*). Larger values indicate greater restrictions on FDI flows, which implies less FDI inflows. The index is constructed by Garibaldi et al. (2001) based on *IMF Annual Report on Exchange Arrangements and Restrictions*.[27]

Institutions

Host country institutions also influence investment decisions because they directly affect business operating conditions. The cost of investment consists of not only the economic costs of investment but also non-economic costs such as bribery and time lost in dealing with local authorities. To assess business operation conditions of the host country for investors, we use two institutional variables, "rule of law" (*RULELAW*) and "quality of bureaucracy" (*BUROQUAL*). The indicator for rule of law reflects the strength and impartiality of the legal system and popular observance of the law.[28] The higher score in the rule of law implies better legal institutions. We expect that countries with better legal infrastructure will be able to attract more FDI.

The variable on the quality of the bureaucracy[29] is constructed from two indicators: (a) the extent to which the national bureaucracy enjoys autonomy from political pressure in a stable manner and whether it has an effective mechanism for recruiting and training, and (b) the ease of regulations concerning licensing requirements and labour, environmental, consumer safety and worker health. High values for this variable imply lower costs for foreign investors because an uncorrupt government with modest regulations is less likely to ask for bribery and side payments.

Agglomeration Economies

Agglomeration economies emerge when there are benefits from co-locating near other economic units as a result of positive externalities. In the present study, foreign investors may be attracted to countries with existing concentrations of other foreign investors. Being less knowledgeable of local environments of the country, investors may consider the investment decisions by others as a good signal of favourable conditions and emulate the decision to reduce uncertainty.

The theoretical literature refers to three sources of positive externalities that lead to the spatial clustering of investors. First, technology spillovers can be shared among foreign investors across various industries. General and/or technical information about how to operate efficiently in the host country is usually obtained by direct experiences of investors. This knowledge can be passed onto other foreign firms by informal communication. To benefit from such knowledge spillovers, firms have to locate close to others. Second, industry-specific localization is observed when firms in the same industry draw on a shared pool of skilled labour and specialized input suppliers. Third, the theory of new economic geography emphasizes backward and forward linkages as a source of agglomeration.[30]

In order to be able to distinguish precisely between different types of agglomeration economies, we would need more disaggregated data (say at the industry level) as well as more on the identity of the investors. With the aggregate data we have available, we can lump them all together by using a single variable, the one-year lagged FDI stock,[31] which is the approach used in most of the literature (Cheng and Kwan, 2000). Note that the inclusion of the lagged dependent variable on the right-hand side makes the OLS estimator inconsistent (we address this issue below).

Initial Conditions

Prior to the start of transition, the countries in our sample varied greatly in the initial level of development, macroeconomic distortions, and integration into the trading system of the socialist countries. De Melo et al. (1997) argue that such initial conditions play an important role in determining economic performance among transition economies.[32]

Initial conditions reflect determinants that are unrelated to policies and invariant during the sample period. For example, these include initial income level, the degree of industrial distortions, urbanization, natural resource endowment, and trade dependence (trade dependence is trade shares in GDP measured in 1989). Among these variables, we report results for natural resource endowment (*NATRES*) and trade dependence (*TRADDEP*) in our regressions.[33]

Estimation method

To test for agglomeration effects, we relate current FDI stock to past FDI stock along with other explanatory variables. We follow the model proposed by Cheng and Kwan (2000) in which they formulate the role of past FDI values as a process of partial stock adjustment. We assume that it takes time for FDI to adjust to equilibrium or desired level. The adjustment process is postulated as follows:

$$\Delta Y_{it} = a(Y_{it}^* - Y_{it-1}) \tag{1}$$

where $\Delta Y_{it} = Y_{it} - Y_{it-1}$ and Y_{it}^* is an equilibrium level or a steady-state level of the FDI stock. By rearranging the above, we get:

$$Y_{it} = (1-a)Y_{it-1} + aY_{it}^* \tag{2}$$

where a must be less than 1 for stability. The steady-state level of the FDI stock is determined by X_{it}, a vector of economic, policy, and institutional variables discussed in the previous subsections. That is:

$$Y^{*}_{it} = \boldsymbol{b}X_{it} + v_{it} \tag{3}$$

where v_{it} is an error term that includes the country-specific as well as a time-specific effects. The regression model we will estimate is thus:

$$Y_{it} = \boldsymbol{d}Y_{it-1} + \boldsymbol{l}X_{it} + \boldsymbol{e}_{it}$$
$$\boldsymbol{e}_{it} = \boldsymbol{h}_{i} + \boldsymbol{g}_{t} + u_{it} \tag{4}$$

where $\boldsymbol{d} = 1 - \boldsymbol{a}$, $\boldsymbol{l} = \boldsymbol{ab}$, and $\boldsymbol{e}_{it} = \boldsymbol{a}v_{it}$. Also, $\boldsymbol{h}_{i}$ is the country specific attributes and $\boldsymbol{g}_{t}$ is a time-specific attribute (e.g., time dummies). If there is an agglomeration effect or a positive feedback effect, then $\boldsymbol{d}$ is expected to be positive.

Because the lagged Y_{it-1} and the time-invariant country-specific attribute $\boldsymbol{h}_{i}$ are correlated, the OLS estimate is inconsistent. In order to solve this problem, we take a first difference:

$$\Delta Y_{it} = \boldsymbol{d}\Delta Y_{it-1} + \boldsymbol{l}\Delta X_{it} + \Delta \boldsymbol{e}_{it} \tag{5}$$

However, ΔY_{it-1} and $\Delta \boldsymbol{e}_{it}$ are still correlated. To get consistent estimates, we employ the instrumental variables (IV) estimates, or the generalized method of moments (GMM) proposed by Arellano and Bond (1991). GMM has advantages over the standard IV estimates because as the length of the panel increases, so does the number of valid instruments. For Equation 5, valid instruments are lagged levels of dependent variables, Y_{it-s} where $s \geq 2$ and $t = 3, 4, ..., T$. If X_{it} is strictly exogenous, then ΔX_{it-s} (for all s) can be used as additional instruments to increase the efficiency of the estimates. The validity of instruments is checked by the Sargan test. The second-order correlation of the error term in the first-differenced equation is checked by Arellano–Bond statistics for autocorrelation, which is asymptotically distributed as $N(0,1)$.

For a number of observations that is small relative to that of parameter estimates, however, we should be concerned with small sample bias being introduced in the GMM estimation. Because the data set we employ may suffer from such a bias, we report a fixed-effects model and compare with those obtained from GMM where appropriate.

Results

In this section we discuss our econometric results. As noted, our objective is to provide a more comprehensive description of the rationale of foreign firms to invest in transition economies. To do so, we try to go beyond the traditional factors identified in the literature (e.g., labour and transportation costs) and incorporate both agglomeration effects and the role of institutions. We argue that the omission of such factors can bias existing results. Our dependent variable Y_{it} is per capita FDI stock[34] in constant million US\$ in year t. (See Appendix A for a summary of the statistics reported below, and Appendix B for the correlation matrix.)

Host Country Characteristics as FDI Determinants

Table 3.2 reports the regression results for all countries in our sample. The first column presents the fixed effects model[35] and the second and third columns show the GMM estimations. All regressions include year dummies to control for time variation due to changes in external economic environment common across countries.

Table 3.2: Determinants of FDI: Fixed effects model and GMM (Dependent variable = per capita FDI stock [t])

	FE	GMM	GMM
Lagged FDI stock	0.81 (0.05)***	0.75 (0.07)***	0.79 (0.06)***
Market size	0.01 (0.008)**	0.01 (0.01)	0.01 (0.008)
Labour cost	-0.13 (0.06)**	-0.17 (0.07)**	-0.13 (0.06)**
Education	1.75 (1.98)	3.04 (2.59)	1.85 (2.01)
Natural resources	13.49 (4.25)***	18.22 (5.59)***	14.61 (4.96)***
Distance Brussels	-0.001 (0.005)	-0.002 (0.006)	-0.002 (0.005)
Telephone lines	0.51 (0.39)	0.91 (0.53)*	0.57 (0.41)
Inflation	0.007 (0.007)	0.004 (0.009)	0.007 (0.007)
External liberalization	40.48 (20.37)*	41.57 (27.70)	41.71 (20.86)**
Rule of law	6.35 (3.74)*	5.34 (5.02)	7.27 (4.28)*
Quality of bureaucracy	28.62 (13.04)**	38.95 (16.50)**	27.64 (13.32)**
Trade dependence	1.12 (0.26)***	1.35 (0.34)***	1.18 (0.30)***
Restrictions on FDI	-8.45 (3.23)**	-12.13 (3.94)***	-8.86 (3.40)***
N	119	99	99
R square	0.93	...	...
Sargan test	...	0.001	0.906
SOC	...	0.83	0.93

Notes: ***, **, and * indicate 1%, 5% and 10% significance level, respectively. Figures in parentheses are standard errors. Time dummies are included in regressions.
Market size and labour cost are treated as predetermined variables in column 3.

In the past, models often excluded agglomeration effects as a determinant. In reality, it generally takes time for the stock of FDI to reach the optimal level. The introduction of agglomeration and partial adjustment mechanism lends itself to straightforward econometric implementation by the inclusion of a lagged dependent variable. (Cheng and Kwan, 2000)

In the presence of a lagged dependent variable on the right-hand side, OLS yields inconsistent estimates as the lagged dependent variable is endogenous. To address this issue, we also report the GMM results in Table 3.2.[36] In small samples such as ours, the GMM estimators may not be very efficient. Alongside the results from GMM, we also report the fixed-effects model for comparisons.

Table 3.2 reports the results for the pooled sample. In column I, we have the fixed effects model, the coefficient of the lagged FDI d is 0.81. The coefficient of partial adjustment a is thus 0.19. This means that net investment in one year is 19% of the difference between Y^* and Y. If the steady-state level of the FDI stock does not change, it will take about five years for the gap between the equilibrium and the current FDI stock to close. The partial adjustment coefficient is somewhat reduced in size in columns II and III in the GMM and ranges from 0.21 to 0.25. Since the lower a implies the slower speed of adjustment, we see large persistence in the pattern of FDI in these transition economies.

Two specification tests in the GMM show a mixed result in column II. The p-value of the Sargan test is 0.001 and we reject the null that the over-identifying restrictions are valid. However, second-order serial correlation is not detected according to the SOC test, which implies that the model is correctly specified in this respect.

One possibility is that some of our independent variables are not strictly exogenous. For example, the error term in the current period might affect future changes in real GDP and wage.[37] We experimented with different sets of the variables and cannot reject that market size

and labour cost are predetermined. Column III reports the results for the GMM estimates when market size and labour cost are treated as weakly exogenous. The Sargan test shows that we can no longer reject that instruments are valid in column III.

Comparing columns II and III, most coefficients are reasonably constant. One should note that by using more instrumental variables, we recover what we initially found in the fixed-effects model in column III, particularly the significance of external liberalization and rule of law.

The results also indicate that FDI into the region consists of the various types of FDI discussed before. For example, the coefficient of market size is 0.01 throughout different specifications: an increase in real GDP by 1% leads to 0.1 % increase in per capita FDI. That is, foreign investors are indeed attracted to a large domestic market (market-seeking FDI). Market size becomes insignificant, however, in the GMM, which implies that market-seeking motives may not be a robust finding in these countries.

The lower-cost sites also attract FDI as seen in a negative sign on labour cost. Lankes and Venables (1996) find for the first half of the 1990s that FDI in the region was mostly market seeking. They argue that as the region integrates into European production networks, we would observe more export-oriented FDI. Our finding is consistent with their prediction for the second half of the 1990s.

Another important explanatory variable among traditional variables is the abundance of natural resources. Since it is a qualitative variable, we cannot interpret its elasticity on FDI. But the finding on natural resources,[38] or resource-seeking FDI is robust. Resource rich countries are mostly among the CIS such as Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan and Russia. For these countries, the abundance of natural resources may be one of the most important drivers of FDI. We will discuss further in the next subsection.

The results on reform, policy and institutional variables are striking. Most of these variables turn out to be positive and significant.

There are two trade related variables used in our regressions. One is the reform variable, cumulative external liberalization index. The other is trade dependence, which measures trade openness. Not surprisingly, external liberalization contributes not only to an increase in trade volume but also to greater inflows of FDI.

Greater trade openness also contributes to more FDI inflows. In emerging economies that are newly opening up, insufficient information on local conditions increases uncertainty and risks of the investment. Via goods trade, potential foreign investors may become better informed about local conditions and more encouraged to invest in the country they know better. Our result is consistent with the notion that FDI flows often complements trade flows. Turning to institutional variables, there is a strong indication that the countries with good institutions managed to attract more inflows of FDI. A good legal system and its enforcement reflected in high scores of rule of law assures that investors' rights will be more likely to be protected and thus they will be able to collect profits from their investment projects.

The other institutional variable – the quality of bureaucracy – reflects the level of corruption and the ease of regulations. The positive and significant coefficient presents further evidence that poor public sector institutions, or poor quality of bureaucracy, is a detriment to economic growth as it leads to lower investment of a foreign source.

We also find that restrictions on FDI are negative and significant, which implies that capital controls for direct foreign investment such as approval requirements and restrictions on profit remittance abroad are a deterrence for inward FDI. In this sense, FDI policy that limits foreign capital inflow is quite effective.

On the other hand, variables such as the level of education and infrastructure are found to be insignificant, though they have the expected sign. A insignificant coefficient on education is different from Noorbakhsh et al. (2001) finding that high labour quality is an important determinant of FDI. Their argument is based on the fact that an increasing number of FDI projects are undertaken in more technologically sophisticated industries in developing countries, which requires higher levels of human capital. This might be true for a broader set of developing countries such as Asia in which FDI is received dominantly in the manufacturing sector. This tendency is not observed in the CEEB and CIS countries. Another possibility is lack of cross-country variance, as most of these economies show rather high levels of human capital.

A positive sign for the inflation rate is obviously surprising. It is widely accepted that disinflation in the initial stage is key factor to rapid transition and sustained growth. Countries that have relatively low average inflation rates are expected to attract more capital flows as macroeconomic risks are lower in these countries. This result may be due to potential endogeneity as it may be closely related to other policy factor: successful and swift disinflation generally occurs before the countries liberalize the external sector.

Overall, we find that FDI into transition countries is driven mainly by agglomeration, large market size, low labour cost and abundant natural resources. Moreover, countries with good institutions, greater trade openness and lower restrictions on FDI flows are likely to receive more FDI.

Is FDI into the CIS Countries Driven by Different Factors?

The motives of FDI vary greatly across the sectors in which firms operate. For example, for natural resource based industries, the primary reason for foreign investors to choose the location is abundance of natural resources. For footloose industries that are more export-oriented (e.g. footwear, garments, car parts assembly), low labour cost is one of the most important determinants.

Despite the obvious importance of studies of FDI determinants at the more disaggregate level, the evidence on sectoral differences is rather scarce in the existing literature. One of the few exceptions is the study by Shiells (2003), which reports for each of 15 CIS countries sectoral and source country composition of FDI inflows. Not surprisingly, FDI in the CIS countries was mostly in resource extraction or energy transportation infrastructure. FDI in the CEEB, on the other hand, is predominantly in the manufacturing sector (Resmini, 2000).

In our data set, comparable statistics on sectoral breakdown are not available for many countries. Yet we expect to find different determinants for different sectors in FDI. To introduce sectoral differences with this limitation of the existing data, we divide the sample into two groups, CEEB (that is, non-CIS) and CIS. If sectoral differences in the location determinants are sizeable, then we would also find different factors at work in driving FDI into the two groups of countries.

Table 3.3 shows GMM group-wise regressions. The Sargan and SOC tests show that the model is correctly specified.[39] The GMM estimators are asymptotically biased in a small sample. Alternatively, we present results with those from fixed-effects model in Table 3.4.

Comparing the non-CIS and CIS countries, we find that there are indeed differences between the two groups. First, the agglomeration effect is present for the non-CIS but no longer so for the CIS. Second, abundance of natural resources is one of the most important determinants for

the CIS while it is not for the non-CIS. Third, telephone lines are significant only for the CIS. Finally, trade dependence is more important for the CIS countries. On the other hand, the common factors between the two groups are external liberalization, rule of law, quality of bureaucracy and restrictions on FDI.

Table 3.3: Determinants of FDI: GMM dependent variable = per capita FDI stock (t)

	Non-CIS countries	CIS countries
Lagged FDI stock	0.54 (0.12)***	0.30 (0.21)
Market size	0.01 (0.01)	0.007 (0.01)
Labour cost	-0.11 (0.09)	0.26 (0.23)
Education	0.88 (3.55)	-5.01 (2.72)*
Natural resources	0.35 (16.50)	51.20 (10.46)***
Distance from Brussels	0.05 (0.02)**	-0.018 (0.008)**
Telephone lines	0.35 (0.96)	3.22 (1.06)***
Inflation	0.06 (0.05)	0.003 (0.003)
External liberalization	313.73 (131.64)**	142.35 (34.17)***
Rule of law	31.27 (14.06)**	26.82 (7.70)***
Quality of bureaucracy	56.38 (22.19)**	44.51 (20.14)**
Trade dependence	0.63 (0.61)	4.99 (1.19)***
Restrictions on FDI	-20.38 (7.49)***	-23.00 (7.74)***
N	67	32
Sargan test	0.1301	0.9994
SOC	0.56	0.75

Notes: ***, **, and * indicate 1%, 5% and 10% significance level, respectively. Figures in parentheses are standard errors. Time dummies are included in regressions.

Table 3.4: Determinants of FDI: Fixed effects model [Dependent variable = per capita FDI stock (t)]

	Non-CIS countries	CIS countries
Lagged FDI stock	0.64 (0.09)***	0.30 (0.18)
Market size	0.02 (0.01)	0.007 (0.009)
Labour cost	-0.08 (0.08)	0.26 (0.20)
Education	-0.02 (2.87)	-5.01 (2.40)*
Natural resources	-3.35 (14.22)	51.20 (9.20)***
Distance from Brussels	0.05 (0.02)**	-0.01 (0.007)**
Telephone lines	0.09 (0.82)	3.22 (0.93)***
Inflation	0.08 (0.05)	0.003 (0.003)
External liberalization	264.15 (121.16)**	142.35 (30.05)***
Rule of law	28.13 (12.24)**	26.82 (6.77)***
Quality of bureaucracy	48.19 (18.42)**	44.51 (17.72)**
Trade dependence	0.51 (0.52)	4.99 (1.05)***
Restrictions on FDI	-15.82 (6.49)**	-23.00 (6.81) ***
N	80	39
R square	0.74	0.68

Notes: ***, ** and * indicate 1%, 5% and 10% significance level, respectively. Figures in parentheses are standard errors. Time dummies are included in regressions.

What is also noteworthy is that economic fundamentals such as market size and labour cost lose their statistical significance in the presence of reform, policy and institution variables.[40] Particularly for the non-CIS, inward FDI is explained mainly by the agglomeration effect, the progress of external liberalization, good institutions and fewer restrictions on foreign capital. For the CIS, in addition to these factors, resource abundance and the availability of telephone lines are important. A positive sign on distance from Brussels indicates that the geographical proximity to the Western market also plays a role in attracting FDI.

The different determinants between the two groups may reflect sectoral differences as well as differences in the initial conditions of these countries. The greater importance of agglomeration in the non-CIS is consistent with the greater externalities associated with the manufacturing sector because possible positive externalities arising from specialized labour, as well as user and supplier linkages, are more relevant for the manufacturing than for the resource sector. In the resource-based sector, investors might have fewer incentives to agglomerate as the more investors in position, the less resources to extract.

Turning to the fixed-effects model in Table 3.4, the same results in both groups hold up as in Table 3.3. The sizes of coefficients are almost identical in the CIS in Tables 3.3 and 3.4, which implies that the gains from employing the GMM might be marginal in a small sample of the CIS.

The study conducted by the EBRD finds that energy resources in some of the CIS countries (Azerbaijan, Kazakhstan, Turkmenistan, Uzbekistan and Russia) have tended to generate larger resource rents, which reduces the likelihood of reform as incumbent elites appropriate more rents and impedes efficient resource allocation.[41] In contrast, here we find that resource wealth can also be a "blessing" as resource abundance is found to attract FDI inflows, which not only bring capital and employment but also increase productivity and efficiency of domestic industries via technology transfer[42] (Campos and Kinoshita, 2002).

Whether FDI inflows can provide necessary impetus for further reforms is another matter. Natural resources may be a pull factor strong enough to attract FDI initially. But, without sound institutions and trade openness, FDI inflows may not continue as energy reserves dwindle in a country. To extend the benefits of FDI, the CIS need to channel more FDI into other sectors such as manufacturing, which is more persistent over time in its pattern.

We consistently find that international trade plays an important role in attracting FDI. The significance of trade dependence shows that the more open the country is, the more FDI it receives. For those countries that are not very open, they can do so by engaging in trade reform, e.g., removal of trade controls and quotas, moderation of tariff rates, and reduction of foreign exchange restrictions. For example, import quotas give bureaucrats more discretion as to the allocation of licences, which may encourage more bribery and thus corruption. Structural reforms in trade should be encouraged not only for greater FDI but also for limiting the scope of corruption.

Improved governance reflected in the high score of quality of bureaucracy also helps increase FDI flows. Some might argue that energy oil companies are used to dealing with corrupt governments and that they may weigh quality of bureaucracy less. But even for the CIS, our results show that good governance encourages more FDI inflow. By the same token, a weak legal system including property rights violations is an impediment to foreign investment. This may be because a poor legal system implies greater state involvement in the economy.

In sum, the geographical distribution of FDI across transition economies is accounted for by agglomeration, the progress of external liberalization, trade openness, good governance

and sound legal systems In addition, for the CIS, the main driver of FDI is abundance of natural resources and availability of basic infrastructure such as the main telephone lines.

Although market size and labour cost are not statistically significant in group-wise regressions, one should not dismiss the importance of these economic fundamentals. In the current setup, we try to explain the spatial distribution of FDI among 25 transition economies, which is a subset of the global market. Within our samples, average labour cost is substantially lower than that in the Western market. Thus, we predict that lower labour cost is one of the reasons why firms invest in transition countries. Within 25 countries, the variance in labour cost is relatively small and this may be why labour cost loses its statistical significance. A large domestic market size might be important if FDI is aimed to serve a domestic consumer market. But in our sample its effect on overall FDI flows is rather limited.

Conclusions

In this chapter, we study the factors accounting for the geographical patterns of FDI inflows among 25 transition economies by utilizing panel data between 1990 and 1998. The location determinants are classified into three categories: the first is country-specific advantages such as low-cost labour, large domestic market, skilled labour force, adequate infrastructure and proximity to the Western European markets. The second are institutions, macroeconomic policy and other policies that facilitate business-operating conditions. The third is the persistent pattern of FDI driven by agglomeration economies. Using the fixed effects and GMM models, we relate per capita FDI stock as a function of these three broad categories of variables.

The main finding is that the most important determinants of FDI location are institutions and agglomeration economies that override the importance of other economic variables. We also find that the region's FDI is motivated by abundance of natural resources and labour cost. Poor quality of the bureaucracy is found to be a deterrent to foreign investors as they conceive it as a high transaction cost that directly affects the profitability of their investment projects. A similar argument is made with respect to the rule of law, which was also found to be an important determinant of FDI in transition economies. Furthermore, foreign investors prefer transition countries that are more open to trade and with fewer restrictions on FDI as the destinations of their investment. We also find that progress on economic reform (external liberalization) plays a large role.

Finally, FDI motives vary greatly between non-CIS and CIS countries. In the non-CIS countries, which receive FDI mostly in the manufacturing sector, institutions and agglomeration are chief considerations for investors. In the CIS countries, which receive FDI mostly in the resource sector, abundance of natural resources and infrastructure are crucial factors.

Notes

[1] See Wheeler and Mody (1992), Head, Ries and Swenson (1995), and Kinoshita and Mody (2001).

[2] See Estrin, Hughes and Todd (1997), Lankes and Venables (1996, and Prasad et al. (2003).

[3] In per capita terms, these are Hungary, Estonia, Czech Republic and Poland. In total FDI inflows, Russia, Kazakhstan and Azerbaijan are added to this list (EBRD Transition Report 2000: 74).

[4] The 11 transition countries analysed in Bevan and Estrin (2000) are Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia and Ukraine.

[5] The data set constructed for this paper is available upon request from the authors.

[6] CIS stands for the Commonwealth of Independent States, which consists of all former Soviet Union countries (excluding the Baltic States); these are Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan.

[7] See Dunning (1993).

[8] The mode of horizontal FDI is typically Greenfield investment.

[9] As reported in Esanov et al. (2001), most FDI in resource-rich countries of the CIS are of this type.

[10] The first wave countries they consider are the Czech Republic, Estonia, Hungary, Poland and Slovenia.

[11] World Investment Report (UNCTAD, 2002) suggests that with the accession of various CEEB countries envisaged in 2004, the integration of operations by EU transnational corporations will be accelerated and that more efficiency-seeking FDI will be directed to the accession countries.

[12] Marshall (1920) argues that industrial districts arise because of technology spillovers, the advantages of thick markets for specialized skills, and the backward and forward linkages. A new economic geography emphasizes the linkages effect: users and suppliers of intermediate inputs cluster near each other because the large market provides greater demand for a good and the supply of inputs. See Krugman (1991), for example.

[13] More recently, Johnson et al. (2000) show that differences in institutional quality of law and corporate governance can also explain the depth and severity of the Asian financial crisis.

[14] For example, Wei (2000a/b) finds that corruption in a host country deters inward FDI substantially.

[15] The data used for estimation are unbalanced because of missing observations in the key variables.

[16] We use the GDP deflator as this was the only relevant series available.

[17] The main sector for inward FDI in the CEEB countries is manufacturing, while it is the resource sector in the CIS countries (UNCTAD *World Investment Report,* 2002).

[18] The base year is 1996.

[19] Gylfason and Zoega (2001) find that abundant natural resources may crowd out physical capital and inhibit economic growth. See also Robinson, Torvik and Verdier (2002).

[20] This variable is constructed by De Melo et al. (1997). We also used more direct measures (e.g., proven oil and gas reserves), but the results were not significantly different.

[21] Mody, Razin and Sadka (2002) and Portes, Rey and Oh (2001) interpret the distance as a proxy for informational frictions.

[22] See Krugman (1991).

[23] One alternative for the infrastructure variable is the percentage of paved roads in the country. This variable can be misleading: for example, if there is one main road in the country and it is paved, then the value for this will be 100. Thus large values may not necessarily indicate better infrastructure.

[24] The index is constructed by De Melo et al. (1997).

[25] Cumulative internal liberalization index (*CLII*) and cumulative private sector condition index (*CLIP*) were also tested. Due to high multicollinearity, *CLII* and *CLIP* are dropped.

[26] Empirical studies find that manufacturing FDI flows complement trade flows. See Caves (1996) and Singh and Jun (1995).

[27] The index covers the categories on approval requirements, the extent to which profits can be remitted abroad, ease in liquidating assets and preferential treatment of direct investment. See Appendix in Garibaldi et al. (2001).

[28] It reflects the degree to which citizens are willing to accept the established institutions for making and implementing laws and adjudicating disputes.

[29] *BUROQUAL* is close to one of the three corruption measures used by Wei (2000a/b).

[30] See Krugman (1991).

[31] We tried to distinguish different types of agglomeration by including the interaction terms of agglomeration with the share of the industry and urbanization at the initial year, but none of them was significant.

[32] Campos and Kinoshita (2002) find that both initial income level and FDI are important determinants of growth for 25 transition economies.

[33] Other initial conditions were tested but none of them was statistically significant.

[34] One alternative is to use the ratio of FDI to GDP. In transition economies, GDP is quite volatile during the initial years of transition. Thus, we prefer to choose per capita FDI to FDI/GDP.

[35] The Hausman test rejects the random effects model.

[36] On GMM estimation, see Arellano and Bond (1991) and Ahn and Schmidt (1995, 1997).

[37] Cheng and Kwan (2000) test for strict exogeneity of the four variables, income, wage, education, and infrastructure and they find that the first two are endogenous, or weakly exogenous in explaining FDI in Chinese regions.

[38] All time-invariant variables (natural resources, distance from Brussels, trade dependence and restrictions on FDI) drop out after first-differencing, so we first transform them by multiplying by a time trend. The similar coefficients are obtained when we re-estimate them by using the individual means of Y and X over time. See Hsiao (1986) for further discussion.

[39] We also estimated the GMM when market size and labour cost are weakly exogenous. But the estimators are similar. Since a small sample bias may be severe when the instrument matrix gets larger, we report here the results from strictly exogenous instrumental variables.

[40] The insignificance of market size and labour cost may be associated with endogeneity of these variables. We also estimated the model by treating both variables as weakly endogenous but their statistical insignificance remained.

[41] See Esanov, Raiser and Buiter (2001).

[42] However, the benefits of technology transfer are more relevant to FDI in the manufacturing sector than in the primary sector.

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Appendix A   Summary Statistics

	Obs	Mean	Std. Dev.	Min	Max
FDI stock per capita	188	164	295	0	1771
Lagged FDI stock	163	131	250	0	1572
Market size	165	6955	3249	1012	15170
Labour cost	151	167	217	0.02	1247
Education	225	19	8	4.4	51
Natural resources	225	0.52	0.75	0	2
Distance Brussels	225	2222	1387	719	522
Telephone lines	219	162	88	0	374
Inflation	225	434	1304	-0.8	15606
External liberalization	225	2.74	2.45	0	9.5
Rule of law	171	4.47	0.75	3	6
Quality of bureaucracy	225	2.45	1.63	0.83	8.33
Trade dependence	211	19	12	0	41
Restrictions to FDI	223	1.66	0.94	-0.03	3.37

Appendix B   Correlation Matrix

	FDI	Lag FDI	Market size	Wages	HK	Nat res	Dist	Tele	Infl	Fiscal bal	CLIE	Rule of law	Buro qual	Trad dep
Lagged FDI	0.984													
Size of the market	0.556	0.529												
Wages	0.429	0.397	0.61											
Education	0.248	0.234	0.44	0.34										
Natural resources	-0.275	-0.261	-0.234	-0.231	-0.197									
Distance Brussels	-0.371	-0.34	-0.669	-0.436	-0.416	0.256								
Telephone lines	0.4313	0.4178	0.6293	0.4991	0.7676	-0.389	-0.516							
Inflation	-0.213	-0.187	-0.206	-0.225	-0.11	0.1264	0.209	-0.12						
Fiscal balance	0.2384	0.2034	0.3235	0.3228	0.2635	-0.046	-0.268	0.274	-0.51					
External liberalization	0.6526	0.6404	0.4114	0.6113	0.4828	-0.349	-0.399	0.536	-0.37	0.3084				
Rule of law	0.4614	0.4241	0.2808	0.3890	-0.157	-0.264	-0.187	0.1407	-0.058	0.1494	0.3002			
Quality of bureaucracy	0.5994	0.5724	0.5287	0.1723	0.1215	-0.364	-0.522	0.189	-0.25	0.2117	0.4558	0.564		
Trade dependence	-0.201	-0.204	-0.431	-0.438	0.102	-0.085	0.398	0.057	0.186	-0.024	-0.321	-0.335	-0.42	
Restrictions to FDI	-0.408	-0.373	-0.326	-0.194	-0.062	0.3691	0.113	-0.25	0.028	0.025	-0.215	-0.298	-0.36	0.201

Part II

The Country Case Studies

Foreign Direct Investment in Africa:
Botswana Case Study

H. K. Siphambe

Until the discovery of diamonds, Botswana was one of the poorest countries of the world. Three decades have seen Botswana graduate from a low-income to an upper middle-income country with an annual GNP per capita of about US$3,280 – up from less than US$100 per annum in 1966. A large part of this success story emanates from the discovery and profitable exploitation of diamonds.

Botswana has been open to foreign direct investment (FDI) since independence. It is through this path, particularly the FDI into diamonds, that has been the driving force of the economy, allowing the economy to change in structure from dominance by the agricultural sector at independence to dominance by mining in about ten years. Agriculture shrank from a 39% share in 1966 to about 2% share of total output in 2003. Mining, on the other hand, has increased from nonexistent in 1966, reaching a peak of 47% before starting to decline to about 35% in 2003.

Currently the main challenge is to diversify the economy away from diamonds. This challenge has been the main focus of government policy as shown in the various national development plans as well as budget speeches. Yet very little progress seems to have been made in this area, as mining continues to dominate in terms of both share of output and share of exports. The mining contribution to employment is very small, however, at about 5% share. The manufacturing sector, which was the focus of early economic policy, has remained at below 10% contribution to output and actually declined to as low as 4% in 2003.

The government sector's contribution to total output has been quite significant and increasing over time, from 13% in 1966 to about 16% in 2003. The growth of government has both positive and negative aspects in terms of the future of Botswana's economy. On the positive side, it may crowd in private investment, as some sectors like construction benefit from government expenditure growth. On the negative side, the growth of government may mean that it is crowding out private sector investment that includes FDI.

Why does Botswana need FDI? As Table 4.1 shows, the economy has been dominated by diamonds and needs to move away from dependence on it for a number of reasons. One basic reason is that diamond is an exhaustible resource whose direct contribution to employment is very small compared with the total employment. Diamonds have reached their highest peak in terms of their contribution to sustained higher growth. The economy needs other engines to be able to achieve the Millennium Development Goals growth of 7% per annum. Domestic private investment has not been providing an adequate alternative to mining, as shown by falling

contributions of sectors like manufacturing. FDI is therefore needed to fill in this gap. The Government of Botswana is also committed to private sector led growth and development, and yet the government share of GDP continues to grow over the years. This may reflect the lack of willing participants in the private sector and thus the need to encourage FDI so as to be able to reduce the role of government.

Table 4.1:   Structural changes of the economy: 1966–2003

Sector/Year	1966	1976	1986	1996	2003
Agriculture	39	24	4	4	2.4
Mining	0	12	47	33	35.9
Manufacturing	8	8	6	4.8	3.9
Construction	6	7	3	6.2	5.6
Trade and hotels	18	16	18	18	21.1
Government	13	14	13	15.4	16.4
Other	16	19	9	18.6	14.7
Total	100	100	100	100	100

Source: Harvey and Lewis (1990); Bank of Botswana (2004).

Botswana's General FDI Policy Framework

At independence, Botswana had hardly any locational advantages for FDI, given its small and poor population living in the rural areas. When most African countries chose the economic option of state control in the 1960s and 1970s, Botswana chose to liberalize its economy and adopted a pro-market economy. Government still had a very central position in terms of planning economic activities, but it was always understood that in time government would give way to a private sector driven economy and allow the market to take a central role. At the political level Botswana chose to have multi-party democracy, with elections held every five years since 1966. Even though no change of government has ever occurred, the elections have so far been regarded as free and fair.

In terms of FDI, the political stability has provided a positive environment for its attraction to Botswana. It is also well documented that Botswana has had very sound management of its diamond commodity boom, avoiding to a large extent the "Dutch disease" phenomenon, which had been a major problem for most countries that had commodity booms. Rather than nationalize, as was fashionable then, Botswana chose to go into partnership with foreign investors, DeBeers Mining Company. The agreement to exploit diamonds at Orapa signed in 1969 gave De Beers 85% of the shares while Botswana got only 15%. Fortunately the agreement had a clause stating, "should conditions change so that one party was severely disadvantaged, the two parties will meet to work out how to correct things" (Harvey and Lewis, 1990). When it became evident that the diamond mine was more profitable than initially envisaged, government invoked this clause to renegotiate its share in 1975. Under the new arrangement, government shares in diamond proceeds are derived in three ways. First, government receives equity shares of 15% of the mining proceeds. Second, government has purchased an additional 20% of the shares as part of the agreement for the state to reserve the right to purchase optional equity shares in diamonds. This option has not only allowed the country to increase its shares in diamonds, but

has also given the country an opportunity to have direct representation in the Board of Debswana Mining Company, a local subsidiary of De Beers Mining Company. This has the advantage of strengthening the country's bargaining position when negotiating with Debswana because it gives government negotiators firsthand information on how the country's diamond mines are run. Botswana is one of the few, if not the only, country among least developed countries (LDCs) to have this kind of representation in a strong multinational like De Beers (Kempton and Du Preez, 1997). Third, the country receives an additional 15% of the shares as royalty. Overall, Botswana's current equity shares in diamonds are 50%. The country also has 33% shares in copper/nickel, and 50% shares in soda ash (Gaolathe, 1997).

Banking, which was in most countries considered to be a commanding height, was left to the hands of foreign banks, Barclays Bank and Standard. These were later joined by other banks that are also largely foreign owned. The sector is still largely foreign owned, as shown in Table 4.2. Two of the banks, Stanbic and Bank of Baroda, are 100% foreign owned, while others have more than 70% foreign ownership.

Table 4.2: The major players in the banking sector according to the ownership structure, market share in deposits, 2001

Name of bank	Year of local incorporation	Domestically owned equity %	Foreign equity %	Market share in total deposit
Barclays	1975	25.1	74.86	37
Standard chartered	1975	25	75	28
FNNB	1991	30	70	20
Stanbic	1992	0	100	10
Investec	2000	25	75	3
Bank of Baroda	2001	0	100	2

Source: Gabaraane (2004).

Since the creation of its own currency, the pula, Botswana has maintained a more liberal foreign exchange control and completely liberalized in 1999. The revenue from diamond mining was also reasonably invested in human capital in terms of health, education and infrastructure, which created a foundation for long-term growth. Whatever could not be spent was reasonably saved as has been evident from the continuous reserves over years. The country currently has a foreign exchange reserve of US$5.68 billion, which provides for 22 months of imports of goods (MFDP, Budget Speech 2005). Botswana scores high in most international indexes on the investment climate, indicating best practice in good governance, sound fiscal policies, good labour relations, low crime rate and high-sustained growth rates. In 2000, for example, it was ranked third on the African competitive index after Tunisia and Mauritius (United Nations, 2002). Standard and Poor's (Moody's) credibility and credit worthiness rating of Botswana is A+, making it the best in Africa. The country was also ranked the most transparent country in the African continent by Transparency International (BEDIA, 2004).

At policy and strategic levels Botswana has always been very supportive of FDI, as reflected in various trade agreements and financial assistance policies/programmes. Given the small market, it was imperative that the country adopt an export led growth strategy, implying entering into trade agreements (Bank of Botswana, 2003). These agreements are World Trade Organization (WTO), Africa, Caribbean and Pacific (ACP), European Union (EU), African

Growth and Opportunity Act (AGOA), Southern African Customs Union (SACU), and Southern African Development Community (SADC).

All these trade agreements have the potential to attract FDI that seeks to locate in Botswana for the purpose of gaining access to international markets. That has been the case with AGOA and SACU particularly. SACU provides for free entry of goods manufactured in Botswana to markets of members; most important for FDI, is the entry into the South African market, which is quite large in the region. Under AGOA there is duty free and quota free entry for almost all manufactured products. This mostly applies to textile products and has had an effect of attracting more FDI to Botswana's textile industry. Since the fall of the Hyundai Motor plant, textiles have made up the second biggest proportion of the manufacturing sector after beef. The SADC free trade agreement is also supposed to benefit FDI through provision of free entry of goods to member countries. For Botswana's case, however, that is not likely to increase the benefits substantially since the country already has free access to the biggest market in the region, South Africa, through SACU.

Among the policies to attract FDI was the Financial Assistance Policy (FAP), which was replaced by the Citizen Entrepreneurial Development Agency (CEDA) in 2001. Taking the form of labour and capital subsidies, tax holidays, and training subsidies, FAP was for most of its life mainly centred on provision of subsidies and grants. Many of the firms that benefited from FAP were in textile and small-scale agriculture. FAP was discontinued in 2001 following recommendations from its fourth review. The review had identified many implementation difficulties, including abuse of FAP funds and non-sustainability of projects beyond the five-year assistance from FAP being the chief problems. It was common for firms to relocate as soon as the five-year subsidy period lapsed, and in fact some of the big textile industries set up under FAP have since closed business. One such firm is ALGO Industries, which employed over 500 workers. CEDA (the programme that replaced FAP) provides financing to citizen businesses in all sectors of the economy in the form of subsidized loans and risk sharing, as opposed to outright grants. CEDA has no support for FDI, however, since it only supports locals, except in cases where the company is jointly owned with a local.

Botswana also provides a conducive tax policy with low company taxes (25%) and tax holidays. Certain incentives like the Selibe-Phikwe Regional Development Programme (SPRDP) provided for reduction of company tax to 15% and an exemption from withholding tax on dividends from after tax profits (Bank of Botswana, 2003). This was provided to diversify the Phikwe regional economy from the copper mine, which is not doing well financially. The package was available to manufacturing firms in the Selibe-Phikwe area provided they employ over 400 workers and export 100% of their product. Many of the firms established under the SPRDP, most of which were in textiles, closed down following the end of FAP.

At the institutional level, FDI was until 1988 the responsibility of the Trade and Investment Promotion Agency (TIPA), established in 1984. TIPA's main responsibility was to provide information needed by potential investors in Botswana. In 1998 TIPA was replaced by the Botswana Export Development and Investment Authority (BEDIA), whose main objective is to promote FDI. BEDIA also offers a one-stop service staffed by all relevant departments. The idea is to allow a prospective company to get all the information about issues relating to its business location from one centralized source: Potential investors were in the past running between various ministries looking for vital information, which was not convenient. BEDIA has since 1998 attracted 20 companies with a total employment of 4,400 to locate in Botswana. Six more companies with a total investment of P52 million started operating in the 2004/05 financial year, and five more were expected to start operating in 2005/06, with projected

employment of 1,100 (MFDP, 2005). Some of these are from China, Zimbabwe, South Africa, Taiwan, Sri Lanka, Mauritius and elsewhere. BEDIA has a larger mandate for FDI than its predecessor, TIPA. One aspect of this greater mandate is assisting to identify activities that are regionally and internationally competitive.

In summary, Botswana has established a number of programmes and policies that have enhanced its ability to attract FDI. The Botswana government has been striving to put into place all the necessary elements that would allow the country to have a comparative advantage in attraction of FDI.

There are thus many advantages for location of FDI to Botswana in comparison with other countries in the region. Among these are the following:

- The country has a stable political environment, with democratic elections every five years, which have always been regarded as free and fair even though no change of government has occurred since independence.
- The country also has an exceptionally stable macroeconomic policy environment, backed by financial surpluses, which make a financial crisis virtually impossible.
- Exchange rate policy is directed at maintaining a competitive real exchange rate, in particular against the South African rand because of the importance of South Africa as an export destination for non-traditional exports. This policy has considerable credibility because of its longevity – it has been pursued ever since Botswana stopped using the rand in 1976 and developed its own exchange rate policy, as a result of exceptionally large foreign exchange reserves.
- Botswana has "good labour relations", especially in comparison with South Africa, which has strong and militant trade unions that played a major part in the struggle to end apartheid and therefore have considerable influence within the ANC government. Trade unions in Botswana are relatively weak, resulting in strikes being few.
- Crime levels in Botswana are relatively low, especially compared with those in South Africa.
- Producers in Botswana have access to the South African market because of Botswana's membership in SACU and to the Zimbabwe market because of the 1956 trade agreement.
- The Botswana government has invested in serviced industrial land and factory shells in order to reduce the capital required for new investments and to speed up the investment process. This policy has not always worked successfully, however, because of certain operational problems.
- The Botswana government has the financial resources to provide a relatively high level of education to all of the school-age population on a sustainable basis, which can act as an advantage to its attraction as an FDI destination. There is considerable evidence that higher level of education leads to greater opportunity for profitable investment in the export of both manufactured goods and services (Wood and Mayer, 1998).

Growth of FDI in Africa

Foreign direct investment worldwide has been declining since 2001, and had fallen to US$651 billion by 2002. Amongst the main factors driving the FDI down are weak economic growth and tumbling stock markets. For developing countries, the decline in FDI was about 23% (United Nations, 2003: 3). It is frequently pointed out that Africa has

received a very small part of the large increase in FDI flows to developing countries that has occurred in recent years. Global outflows of FDI increased at 26% a year from 1986 to 1990, and at 17% a year from 1991 to 1995. Most recently, FDI outflows increased from US$380 billion in 1996 to US$647 billion in 2002 (United Nations, 2003: 3).

Africa's share of these flows has been very small, varying between 1.2 and 2.2% from 1995 to 2002. It was estimated at 1.6% in 2002 from 2.2% in 2001 (United Nations, 2003). However, Africa's share of global GDP is also very small, at about 1.1%, so that by this measure Africa receives slightly more than its proportionate share of FDI. It should be noted, though, that a large part of foreign investment in Africa has been in the mining sector, which is attracted very simply by the discovery of economically viable mineral resources. It occurs in spite of, rather than because of, the general investment climate, which has been consistently poor in a large number of African countries.

Because GDP per head is so low in Africa, if FDI is measured by the amount received per head of the population, then Africa did not do well. Africa received only US$10.9 per head in 1998, compared with an average for developing countries of US$35.4, although Africa's receipts by this measure had increased by 77% since 1995. These statistics are summarized in Tables 4.3 and 4.4.

Table 4.3:   Africa's share of FDI inflows (millions of US dollars)

Year	Africa	World	Percentage
1991–1996	4,606	254,326	1.8
1997	10,667	481,911	2.2
1998	8,928	686,028	1.3
1999	12,231	1,079,083	1.1
2000	8,489	1,392,957	0.6
2001	18,769	823,825	2.2
2002	10,998	651,188	1.6

Source: United Nations, World Investment Report 2003.

Table 4.4:   Inflows of foreign direct investment (FDI), by different measures

	Share of FDI inflows 1998 (%)	FDI inflows per $1,000 of GDP 1997 (US$)	FDI inflows per capita 1998 (US$)
Africa	1.2	15.6	10.9
All developing countries	25.8	26.9	35.4
Developed counties	71.5	12.4	518.3
World	100	15.8	108.9

Source: United Nations (2003). *World Investment Report 2003.*

In general FDI has been unevenly distributed. The top ten recipients are China, Brazil, Mexico, Argentina, Poland, Chile, Malaysia, Venezuela, Russian Federation and Thailand. Most of these countries have advantages of market size, increased openness, improved policy and strong economic fundamentals (Akinkugbe, 2003). What is important to note is that FDI is attracted by the prospect of making profits, which depends on resources among other things.

The point is that good policies in themselves may not be adequate to attract FDI. It is for this reason that countries considered to be undemocratic compared with Botswana, for example Angola, have attracted more FDI than Botswana – they offered greater prospects for more profitable investment.

FDI Flow into Botswana

Despite the existence of a more conducive enabling environment in Botswana, FDI into Botswana has steadily decreased since 1997. From an annual average of US$29 million for the 1989–1994 period, FDI inflows reached US$100 million in 1997, but declined significantly to US$37 million in 1999 and 2002 (United Nations, 2003). As shown in Table 4.5, net inflow of FDI as a percentage of GDP declined from 9.8% in 1980 to a low of 0.5%. Table 4.6 shows that Botswana's share of FDI fell from 60% to less than 2% in 1996–2000. United Nations (2003) classifies Botswana as one of the countries with high FDI potential. This report also notes that Botswana performed below its potential for the period 1993–2000, in spite of having been a frontrunner in the periods 1988–1990. It is therefore evident that Botswana has lost its competitive advantage in FDI attraction. The critical question is why such a disappointing record when the basic elements of an enabling environment are in place.

Table 4.5: Trend of FDI into Botswana as a proportion of GDP, selected years

	1980	1985	1990	1995	1998	1999	2000
Foreign direct investment, net inflows (% of GDP)	9.87	4.5	2.5	1.43	1.9	0.72	0.57

Source: UNCTAD (2001); World Bank (2003).

Table 4.6: FDI in Botswana compared with SADC and LDCs, 1975–2000 (per cent)

Item	SADC			LDCs		
	1975	1990	2000	1975	1990	2000
GDP	0.6	2.7	3.3	0.5	2.4	2.4
FDI stocks	2	9	1.7	30	16	4
FDI flows (5 yrs)	60	32	1.5	15	12	1.5

Source: United Nations (2002), Investment Policy Review Botswana.

Sectoral Distribution of FDI in Botswana

Table 4.7 and Figure 4.1 summarize the sectoral distribution of foreign direct investment in Botswana. As the table shows, FDI is concentrated in the mining sector, which accounted for more than 80% share of FDI in 2001. A large part of this investment is for diamond mining by Debswana Diamond Company. The FDI to mining is attracted by the profitability of this sector. Other mineral developments are copper/nickel in Selibe-Phikwe and Tati. Government is a major shareholder in some of these mining activities. Between 1997 and 2001 mining FDI

grew by 211%; retail, wholesale and trade by 315%; finance by 220%; and transport by 210%. Manufacturing had a growth of only 11% over the period, while construction actually declined.

Table 4.7:   Foreign direct investment by sector: 1997–2001 (millions of pula)

Sector/Year	1997	1998	1999	2000	2001	Share 2001	Growth
Mining	2,705	4,903	5,524	7,792	8,412	80.6	211
Manufacturing	246	333	273	344	274	2.6	11
Finance	228	226	523	619	729	7.0	220
Retail and wholesale trade	157	392	670	773	651	6.2	315
Electricity gas & water	7	8	…	…	…		
Real estate and business services	65	112	144	161	115	1.1	77
Transport, storage and communication	31	47	43	105	96	0.9	210
Construction	31	30	8	16	23	0.2	-26
Hospitality	44	60	83	75	135	1.3	207
Total	3,514	6,111	7,268	9,885	10,435	100.0	197

Source: Bank of Botswana: Annual Report 2002.

Figure 4.1: Sectoral distribution of FDI, 2002
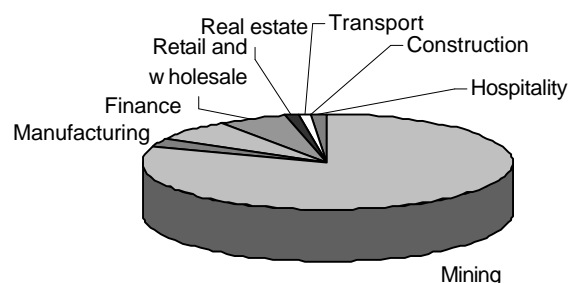
Source: Bank of Botswana (2002).

In terms of percentage shares, the second largest sector for FDI is services, accounting for 16.5% of the total stock of FDI. The largest industries within this sector are financial services at 7.1% and retail and wholesale trade at 6.2%. Retail and industry are mainly dominated by large chain stores attracted to the small but buoyant consumer market. Manufacturing, a sector earmarked by government for economic diversification from diamond, had a share of 2.6% of FDI in 2001. This is disappointing given that it is a sector that has benefited from the Financial Assistance Policy (FAP). A number of these projects were of temporary nature because FAP turned out to be too generous and thus encouraged firms to establish for the duration of the five-year subsidy and close down thereafter. Most of these were in the textile business, attracted to FAP and the lucrative market in South Africa and in the USA particularly under AGOA.

Box 4.1   Motor Company of Botswana

A geenfield plant costing US$60 million was built in Gaborone in 1997 to assemble Hyundai motor cars from completely knocked-down kits, for sale to South Africa. The foreign investors concerned already held the Hyundai franchise in a Botswana plant to produce these vehicles from semi-knocked-down components. They also controlled the South African distributor of the vehicles. The Motor Company of Botswana (Pty) Limited (MCB) was incorporated to own the venture. Its principals were a Zimbabwean businessman with interests in South Africa and a United Kingdom businessman. Hyundai was not the operator, but supplied kits for assembly under franchise.

MCB did not obtain Financial Assistance Policy (FAP) grants or the concessional corporate tax rate for manufacturing. It acquired a large industrial site from the government and a loan of about US$24 million from a parastatal, the Botswana Development Corporation (BDC). Two Dutch banks provided credit of another US$24 million.

In 2000, MCB failed, resulting in 600 job losses. It had produced only 7,000 units over two years, compared with a required break-even level of 15,000 per year. Loans were not repaid and BDC was burdened with interest arrears. It is probable that Hyundai, too, was left with large trade credits on the supply of kits. The affiliated Southern African distributor also collapsed and there have been persistent allegations of fraud against the principals. MCB has become a byword in Botswana for the "fly-by-night" foreign investor.

Source: UNCTAD (2002).

Most of these companies do not produce for the local market because the nature of the product is such that profit can be increased by pushing greater volume. Given that Botswana has a small market, it is not possible to sell a large enough volume to become profitable. Since the discontinuation of FAP and its replacement with CEDA, a number of textile firms have closed down because of financial problems and business mismanagement.

A major boost to FDI in manufacturing came from the establishment of a vehicle assembly plant from Hyundai Motor of the Republic of Korea and Haltec garment with major shareholders from Indonesia. Hyundai employed 600 workers and Haltec employed 1,000 workers. Both companies closed down in 2000, and all that employment was lost. (See Box 4.1.)

Origin of FDI to Botswana

Figure 4.2 and Table 4.8 summarize the share of FDI into Botswana by country of origin and some major foreign companies by country of origin. At the end of 2001 South Africa was the largest source of FDI with 62%. This reflects the proximity and close economic links between the two countries. The bulk of South African investments are in diamond mining. Other important areas where South Africa dominates are wholesale and trade, construction, property

development, and financial services. The second largest FDI flow comes from Luxembourg. This is attributable to investments by a De Beers subsidiary company domiciled in Luxembourg. UK has a substantial share of FDI, concentrated mainly in financial services. Three of the major banks, Barclays Bank, Standard Chartered Bank and Stanbic, are UK subsidiary companies. Information on shareholding proportions of these banking firms was shown in Table 4.1 above. The USA has negligible presence in Botswana in terms of FDI with a share of less than 1%. The "other" category includes the few known garment manufacturers from Asia (United Nations, 2002).

Figure 4.2: Share of FDI by country of origin, 2001
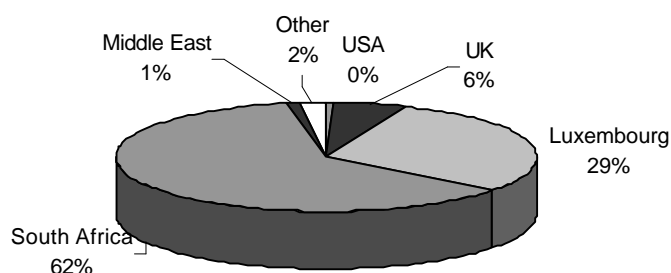
Source: Bank of Botswana (2003).

Table 4.8: Major FDI companies in Botswana

Company name	Home country	Industry	Assets (US$ million)	No. of employees
Debswana Diamond Company	South Africa	Mining	1,994	6,000
Barclays Bank	United Kingdom	Banking	435	850
First National Bank	South Africa	Banking	245	...
Standard Chartered Bank	United Kingdom	Banking	193	571
Botswana Insurance Holdings	South Africa	Insurance	...	400
Kentz	Malaysia	Construction	...	225
Stanbic Bank	United Kingdom	Banking	144	177
Blackwood Hodge	United Kingdom	Construction	...	53
Manica	United States	Transport	...	45

Source: UNCTAD (2002).

Table 4.9 provides profiles of 13 companies established through BEDIA's efforts, most of which were interviewed for this study. Seven of the companies were established in 2004, and their profiles were not readily available. Of the 13 companies established between 2000 and 2004, seven were in the textile industry, attracted mainly by the attractive USA market under AGOA and the South African market under SACU. Most of these companies manufacture for sale to the market outside Botswana because of the smallness of Botswana's market. Four of the 13 companies' shareholders originate from India.

Table 4.9:   New FDI projects in manufacturing: 2000–2004

Company	Place of origin	Products/ Services	# of workers	Year started	Markets served	Level of investment
B&M Garments	Mauritius	Garments	750	2000	EUUSA	P16 million
Rising Sun	China	Garments	600	2000	Supplying Edgars and other chain stores in South Africa	P6 million
Auto Ancilliaries	India	Automobile leaf springs	51	2001	South Africa, Namibia, Mozambique, Botswana	P2.5 million
Whinstone Enterprises	India	Blankets	3	2000	Malawi and local market	P1.2 million
Speck Systems	India	Mapping activities (IT sector)	3	2000	Botswana	P75, 000
Benrose Limited	South Africa	Garments	180	2001	South Africa	P2 million
DCDM	Mauritius	Consultancy and IT field	26	2001	Botswana	P2.5 million
Dinkie	Zimbabwe	Shoe steel caps	50	2001	USA, Canada, Malaysia	Not stated
Dinesh Textiles	Botswana	Men's and ladies' jeans	300	2001	South Africa, USA, Botswana	P4.5 million
WeldtechBotswana	India	Welding electrodes	13	2002	Botswana, South Africa	P1 million
Caratex 2	Taiwan/ Botswana	Jeans	450	2003	USA, South Africa	US$1 million
Bokomo	South Africa	Milling	70	2003	South Africa	P20 million
Vision International	Taiwan/ Botswana	Sportswear	600	2003	Botswana, South Africa, USA	US$2 million

Source: BEDIA (2004).

In summary, FDI in Botswana has been attracted by several factors. The largest FDI component, particularly that to the mining sector, is an investment to exploit profitable natural resources, especially diamonds. Since this is the hub of Botswana's survival, government has taken a keen interest in this sector and entered into a fifty-fifty partnership with De Beers. A

second kind of investment, especially in the finance sector, which is mainly dominated by banks, was attracted by the small but profitable domestic market. A third type of investment, that in manufacturing, was attracted by both government financial incentives (FAP) and export market advantages. This is particularly true for textile industries because of their access to USA markets through AGOA and the South African market through SACU. Earlier FDI in textiles was attracted by the generous financial incentives offered through FAP. A good number of fly-by-night investors started business in Botswana only to disappear with their equipment at the end of the FAP subsidy. None of the investment in Botswana has been attracted by structural adjustments and privatization because Botswana has never been subjected to structural adjustment. Privatization has also not taken off even though the policy has been approved by parliament.

Why Botswana's FDI May Have Been Falling

The previous sections showed that Botswana has lost attractiveness in terms of FDI. In order to illuminate this issue, a sample of the 13 firms that came to Botswana since 2000 were interviewed, and the results of the analysis of their responses to the major questions are summarized in simple table forms. Discussions were also held with Botswana Export Development and Investment Authority (BEDIA) authorities on the issues. Owing to time series data limitations, it was not possible to do meaningful econometric regression analyses of the determinants of FDI in Botswana.

Given that Botswana conforms to most of the established macroeconomic factors that have been established for other countries econometrically, we found very little sense in doing econometric work that would have shown obvious results. For the Botswana case therefore, it is the responses from these interviewed firms, discussions with BEDIA and data on some of the microeconomic issues that make up the Botswana story of being unattractive to FDI in the current period.

Major Attractions to Locating in Botswana

Table 4.10 summarizes the results of the surveyed companies, in terms of issues relating to what attracted them to locate in Botswana. As the table indicates, more firms were attracted to Botswana by political and economic stability and peace. The availability of foreign exchange and the liberal foreign exchange regime were also cited by about 27% of the firms. Almost equal percentages were responding to low tax rates and FAP at 15%. Fewer firms were attracted to the existing SA and EU markets at 12%.

Table 4.10. What attracted your company to locate in Botswana?

Answer	Frequency	Percentage
Foreign exchange	7	26.9
Political, economic and stability and peace	8	30.8
Low tax rate	4	15.4
Market in SA and EU	3	11.5
FAP	4	15.4
Total	26	100.0

Source: Survey data.

Major Constraints to Locating in Botswana

Companies were asked what they found to be the major constraints to locating in Botswana; their responses are summarized in Table 4.11. About 32% each thought it was the absence of financial incentives that is a problem and high interest rates and utility costs. Some lower number found the bureaucratic process in obtaining work permits quite a problem (13%), while 25% found the major problem being lack of skilled labour force and low productivity. When asked to provide solutions to the unattractiveness of Botswana as a location for FDI, 41% thought the country should provide export incentives. Following the review of FAP by the Botswana Institute of Development Policy Analysis (BIDPA), the scheme was abolished in 2001. When that was done an alternative scheme to support establishing firms was not formulated. Incentives alone may not offer the total solution to FDI, and yet it is acknowledged that support in the early years of establishment is absolutely important. It is for this reason that investors faced with a decision about location will opt for countries offering extra benefits if the macroeconomic environments are similar.

Table 4.11: Major constraints to locating in Botswana

Constraint	Frequency	Percentage
Lack of skilled manpower and low productivity	4	25.0
High interest rates and utility costs	5	31.3
No financial incentives since FAP	5	31.3
Long bureaucratic processes in work permit	2	12.5
Total	16	100.0

Source: Survey data.

Thirty-three per cent of the companies suggested that the country should speed up the issuance of work permits, which they argue currently follows a long bureaucratic process. These results were also reported by the World Bank (2003) Foreign Investment Advisory Service (FIAS) report. There are three ways foreigners can legally work in the private sector in Botswana:[1] normal work permits, exemptions granted by the Minster of Labour for designated companies and NGOs, and work permit waivers, which are granted pending consideration of a long-term work permit. Work permit waivers are granted for three months, but can be renewed for an indefinite period at District Labour Offices. While official statistics are available on the numbers of these three types of work permits that have been approved or granted, no accurate information exists on the actual numbers of employed and self-employed foreigners who are currently working in the country.

In April 2002, the Department of Labour issued a list of "scarce skills". Work permit applicants with these skills qualify for fast track procedures in which the requirement for evidence that no suitably qualified citizens are available is waived. According to the FIAS report, however, "even the fast track is not much faster than the regular procedure" (World Bank, 2003: 36).

Since mid 2003, the Botswana Export Development and Investment Agency (BEDIA) has had statutory powers to assess residence and work permit applications of foreign investors. Fewer than ten companies have been processed by BEDIA since then. These exemptions are valid for five years.

The FIAS Report concluded that obtaining work and residence permits is "among the most difficult investment procedures in Botswana. Overall, 44.4% of the 207 companies

responding to the survey complained about the procedures required in this area, making it one of the top two concerns of investors" (World Bank, 2003: 34). Nearly 60% of the foreign firms surveyed cited this as "a problem". Most complain that "the procedure is not transparent and it is difficult, if not impossible, to obtain information about the status of the application or the expected decision" (World Bank, 2003: 37).

The total backlog of work permit applications was 7,474 in late 2004.[2] The main bottleneck is for applicants to the Gaborone Regional Immigration Selection Board. Applications for the other three boards (Francistown, Lobatse and Selibwe Phikwe) take, on average, only six weeks to process compared with well over a year in Gaborone.[3] The Department of Labour has only 25 labour officers and is seriously short-staffed. The Department of Immigration has five times as many officers.

Temporary work permit waivers enable most foreign investors to circumvent unwieldy and bureaucratic work permit procedures. As the FIAS study correctly points out, "it is easy for a foreigner to live and work in Botswana for several years because it is so easy to obtain a temporary permit" (World Bank, 2003: 42).[4] The work permit issue may therefore be exaggerated, but in general Botswana does not have an excellent environment in terms of business, especially when it comes to procedure. A United Nations Economic Commission for Africa (UNECA) publication shows that starting a business in Botswana takes 11 procedures and 108 days, which is among the highest in Africa. In South Africa it takes 9 procedures and 38 days (UNECA, 2005: 20).

Table 4.12 summarizes responses from a sample of firms interviewed about what they thought could be done to make Botswana attractive for FDI. A bigger percentage of them (42%) indicated that the country should provide incentives, especially financial ones since there has been no scheme or programme to assist FDI following the discontinuation of FAP and its replacement by CEDA, which only assists locals. The second largest response, at 33%, is those who proposed that the government should speed up the work permit system, while 16% proposed that there should be reduction in utility costs.

Table 4.12: Major solutions to making locating in Botswana attractive

Solution	Frequency	Percentage
Reduce utility costs	2	16.7
Provide export incentives, e.g., FAP	5	41.7
Speed up issue of work permits	4	33.3
Centralize trading matters under one dept.	1	8.3
Total	12	100.0

Source: Survey data.

Another constraint cited by the firms interviewed – and one that was also identified by the World Bank (2003) FIAS study – relates to utility costs, costs of finance capital, cost of transportation, given that Botswana is land-locked, and costs of acquiring land.

The cost of finance in Botswana is considerably higher than its competing partners in the region, and as such prohibits investors from accessing funds from local institutions. Table 4.13 makes a comparison of the cost of finance between Botswana and other countries in the region. Currently the prime lending rate is 16.75% and normally banks charge some percentage points above the prime rate. This has been identified as one of the challenges that the country is facing as not all projects can be financed 100% through equity. When comparing the lending rate it is

evident that Mauritius, Lesotho and Botswana are the highest, although in reality only Botswana's and Lesotho's bank rates are high. Mauritius offers both financial and non-financial incentives that mitigate the cost of finance.

Table 4.13: Comparison of bank interest rates

	1999		2000		2001		2002		2003	
	BR	LR	BR	LR	BR	LR	BR	LR	BR	LR
Botswana	13.25	14.63	14.25	15.31	14.25	15.75	15.25	15.96	15.25	16.75
Lesotho	19.00	19.06	15.00	17.11	13.00	16.55	16.19	17.11	16.84	17.28
Namibia	11.50	18.48	11.25	15.28	9.25	14.53	12.75	13.84	11.50	15.68
RSA	12.00	18.00	12.00	14.50	9.50	13.77	13.50	15.75	12.00	16.50
Swaziland	12.00	17.42	11.00	14.00	9.50	13.25	13.50	15.25	12.00	16.00
Mauritius		21.63		20.77		21.10		21.00		21.00

*BR = Bank rate; LR = Lending rate.
Source: Unpublished BEDIA report.

Another factor making the business climate uncompetitive is the relatively high cost of utilities. Most of the industrialists who are already operational and those who visited the country to explore the investment opportunities cite this as a major challenge, and over 30% of the 13 firms interviewed said it was a big problem. Table 4.14 compares Botswana with Lesotho and Swaziland for costs of water, telephone and electricity. All are more expensive in Botswana than in the other two countries.

Land is also more expensive in Botswana than in Lesotho despite Botswana's larger land area. The one reason why land is more expensive in Botswana is that land is artificially made more expensive by making it scarce. The policy of servicing industrial and commercial land ahead of demand has been implemented on what should have been an adequate scale, but has been frustrated by government procedures. In recent years, large numbers of serviced industrial and commercial plots have remained undeveloped because they were allocated to people who held on to them in the hope of making a speculative profit. The regulations require plots to be developed within two years, but when this is not done the requirement is not enforced and the plots are not repossessed. Potential investors therefore face the frustrating experience of not being able to obtain highly visible vacant plots, while the Government's investment is wasted so long as plots remain unused.

Table 4.14: Utility and land costs

	Land	Water	Telecoms	Electricity
Botswana	P46.00/m2	P11.00 min charge	0.1657 thebe/unit	P 19.64 min charge
Lesotho	-	P2.00/kl	0.273 thebe/minute for >=100km distance	P5.15 fixed demand charge/kVa
Swaziland	P27.80/m2	P8.05 min charge	0.03 thebe/unit (local)	P7.71 min charge

Source: Unpublished BEDIA report.

Botswana is a landlocked country, meaning that manufactured goods have to be transported at high costs to the nearest port. Given Botswana's export-led strategy due to the small domestic market, this locational disadvantage is an important issue to take into consideration by any

foreign investor. Table 4.15 summarizes the cost of transport from Gaborone to Durban and compares the cost with transport costs from Johannesburg to Durban. The costs from Gaborone to Durban by both rail and road is more than twice that from Johannesburg.

Table 4.15: Transport costs by rail/road to Durban port

Service	From Gaborone		From Johannesburg	
	20ft light	40ft light	20ft light	40ft light
Cartage	P392	P590	*	*
Terminal handling charges	P426	P630	P426	P630
Carrier haulage charges	P113	P180	P113	P180
Wharfage	P500	P1,000	P500	P1,000
CTO production fee	P50	P50	P50	P50
Bill of lading fee	$10	$10	$10	$10
Rail (Road)	P2,883 (P5,360)	P5,770 (P7,772)	P933 (1,400)	P1,967 (2,333)

Source: Unpublished BEDIA report.

Interviewed firms also cited low labour productivity as a constraint to business investment. Labour productivity is a general problem for Botswana in both public and private sectors. Government has been responding to that concern by proposing to introduce a performance-based management system. Botswana National Productivity Centre was also created to deal with the productivity issue. Labour productivity has not improved significantly, however. It is partly due to this low productivity that procedures seem to be too long even though there are instances where it is indeed long because of the way government chooses to do things. Issuing of work permits is a case in point. One other issue exacerbating the problem of productivity is the shortage of skilled personnel. Although the Botswana government has invested heavily in education and training, the extraordinarily rapid growth of the economy has generated continuing skilled labour shortages. This situation is exacerbated by the impact of HIV/AIDS. The shortages have also been compounded by the difficulties and delays associated with obtaining work permits and residence permits for expatriate labour.

Apart from the issues discussed above, there are other explanations advanced for the country's lack of attractiveness compared with its competitors in the region. One of the reasons for Botswana's poor performance is that other countries in the region have opened up to FDI and have begun to receive increasing FDI, through privatization programmes and projects in natural resources or in their processing. Despite the fact that Botswana approved a privatization programme, even the first targeted industry for privatization, Air Botswana, has still not begun the process.

A second reason advanced for poor performance is that with the end of apartheid in 1994, South Africa became a competitor in attracting FDI into the region and a number of South African companies with investment in Botswana returned to their home country. South Africa has better infrastructure, a bigger market and generally a better investment climate than most countries in the region including Botswana. On the other hand, South Africa also has high crime rates and very strong labour unions that make the profitability of a new business less secure. Despite all these other negatives, South Africa is in general a more preferred investment destination than Botswana. Botswana has therefore lost some of its competitive advantage due to the entry of South Africa in the equation since 1994. There is also the fact that Botswana has

no shortage of local savings, which is sometimes used to finance expansion of production in major sectors. For example, a major expansion of Orapa in 2000 did not have a major impact on FDI because a large part of the expansion was financed locally and through other non-FDI means.

Conclusions and Policy Recommendations

Botswana's considerable FDI in the past was attracted into diamond mining and banking services; incentive schemes such as FAP drew some FDI into small-scale manufacturing and agriculture. Manufacturing was dominated by textiles. Botswana's FDI compared with SADC members has been declining since 1997, however.

Botswana's case supports the assertion that good macroeconomic policies are necessary for attracting FDI, but these are not sufficient. A number of reasons have been postulated for Botswana's loss of competitiveness. Among these are the entrance of South Africa into the race and the structural adjustment programmes of emerging countries like Angola and Mozambique. There are, as well, some microeconomic hindrances to FDI in Botswana that may also be responsible for the decline. These include the relatively high cost of utilities, the long bureaucracy in dealing with business issues, low productivity of labour, high cost of transport, the non-availability of assistance schemes coupled with relatively high cost of borrowing, and a shortage of skilled personnel and affordable business land.

Dealing with these factors is a main challenge for Botswana, especially in light of the need to diversify the economy away from diamond mining so as to create more employment. Attracting FDI is one big option available to the country to fill in the shortage of domestic investment. Reducing poverty to levels proposed in the Millennium Development Goals will require higher job creation from new investment than could be provided by local capital. There is therefore need to put in more concerted effort to dealing with these constraints to make the country more attractive to FDI. A fundamental part of the solution lies in improving general labour productivity in the country.

Notes

[1] Work permits are not required for non-citizens employed in the public sector.

[2] The breakdown by Regional Immigration Board at the end of 2004 was as follows: Francistown 152, Selibwe Phikwe 278, Lobatse 61, and Gaborone 6,983 (up to November only). A total of 400 Exemption Certificates was approved during 2004 (church applicants numbered 181 and applicants from other organizations 236).

[3] The Regional Immigration Boards meet weekly (except Lobatse, which meets fortnightly).

[4] Consultants are widely used by companies to renew waivers, which is quite costly (with fees of up to US$200 per employee).

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Chapter 5
An Analysis of Foreign Direct Investment Flows to Cameroon

Sunday A. Khan and Lydie T. Bamou

A number of empirical studies have identified investment as one of the major factors constraining economic performance on the African continent and capital formation is thus considered one of the essential components or requirements of GDP growth (Collier and Gunning, 1999; Khan and Reinhart, 1990). Ghura (1997: 27) says that in Cameroon the effect of investment on economic growth is "large, statistically significant, and robust". Cameroon's adoption of the structural adjustment plan in 1998 had as one of its principal objectives the promotion of investment, especially that of the private sector. Promoting investment has consequently been one of the cornerstones of government economic policy.

Like many other developing countries, Cameroon has relied on foreign savings to finance its development. The insufficiency of domestic savings has led to a huge savings gap, and consequently a foreign exchange gap. The latter arises when government expenditure plus private investment exceed government revenue and private savings and the internal imbalance spills over into an external imbalance of imports greater than exports. The financial sector in most developing economies is largely underdeveloped and often only gradually coming out of repression. Its capacity to mobilize domestic financial resources to close the gaps and develop the economy is quite inadequate. There has consequently been a need for foreign resource inflows, whether through official or private sources, to fill these gaps. Many studies have shown that resource flows are important for investment, and investment is described as the engine of economic growth.

Cameroon has received both official and private flows over the years. Official development assistance (ODA) has come from both bilateral and multilateral sources. Starting from independence, ODA increased steadily to get to a maximum of about 406 billion CFA francs in 1994. Most public investment in Cameroon has been carried out thanks to official flows. These include road construction, telecommunication infrastructure, railway, and most of the ago-industrial complexes built in the 1970s and 1980s. From 1994 to 2000, however, Cameroon's ODA declined by almost 34% from CFAF 406 billion to CFAF 271 billion.[1] A number of reasons explain this fall in aid flows: donor fatigue resulting from poor economic performance in donor countries, ineffectiveness of previous aid disbursements and the belief that this is linked to poor economic policy in recipient countries (Burnside and Dollar, 2000), increased competition from newly independent states in Eastern Europe, and the influence of international politics and diplomacy on aid allocation, among other reasons.

Compared with official capital flows, private capital flows and especially FDI to Cameroon have been low. Morisset (2000: 6) ranks Cameroon fifteenth among 29 sub-Saharan Africa countries in terms of net FDI flows between 1996 and 1997. Sub-Saharan Africa attracts less FDI than other parts of the world, but Cameroon's share is less than the average for sub-Saharan Africa. For example, in 1998 the FDI/GDP ratio[2] for sub-Saharan Africa was 1.30%, while that for Cameroon was only 0.57%. Earlier, in 1996, it was 1.4% and 0.38%, respectively. Cameroon is therefore not competitive in sub-Saharan Africa in the attraction of FDI. This is even worse when we consider FDI/GDP ratios for low income countries. These were 2.9% in 1998 and 3.2% in 1996. Despite being comparatively low, however, the trend for net FDI flows to Cameroon has been positive since the mid 1990s, after the big fall in the late 1980s and early 1990s. Figure 5.1 illustrates the net FDI in Cameroon, which peaked at US$305 million in 1985 before reaching an all-time low of negative US$128 million in 1990.

Figure 5.1:   Net FDI flows to Cameroon (US$ million)
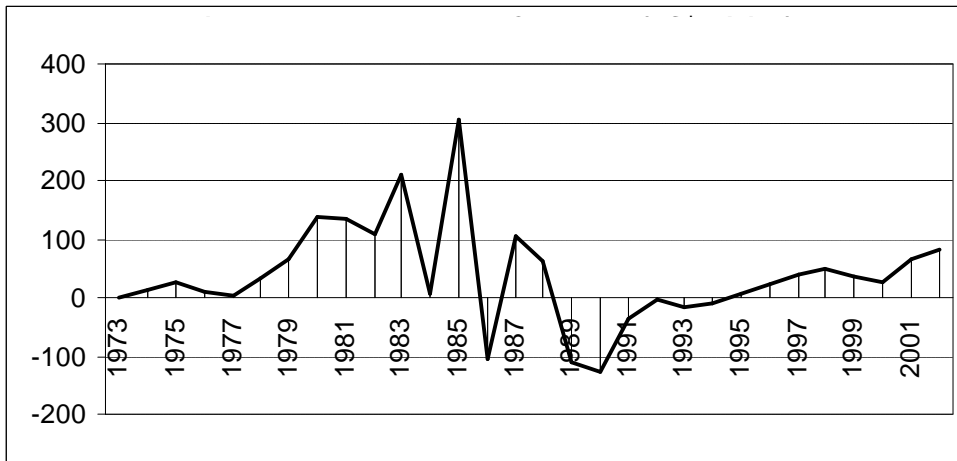
There is need for Cameroon to attract more FDI not only because aid is on the decline, but also more especially because of the numerous advantages[3] FDI has for the host economy. FDI allows the transfer of technology in the form of new types of fixed capital inputs, which cannot be achieved by financial investment or the trade in goods and services. It can also take the form of assistance to suppliers and customers. Recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country. The FDI incidence on the budget of developing countries is undeniable, as the profits generated by FDI have positive effects on the tax revenue of the host country. As an advantage over other forms of private capital flows (especially portfolio and short-term flows), FDI is thought to be "bolted down" and cannot leave at the first sign of trouble – it is more resilient. This stems from the fact that direct investors have a long-term view of the host economy, thus making them more resistant to the herd behaviour, and from the sheer difficulty of liquidating assets at short notice.

FDI is also considered to increase the competitiveness of firms operating in the host market, create spillover effects on the export sector of the beneficiary country and favour better integration into the world economy. Moreover, FDI is non-debt creating and both commercial

and exchange risk are passed on to the investor rather than borne by the host country. Earnings from private foreign investment are frequently reinvested and only a part is repatriated. In sum, FDI provides a package of financial capital, technology, managerial skills, information, and goods and services that can make an economy more competitive in the world marketplace, promoting growth and reducing poverty. Governments of developing countries are now giving new attention to the potential for private FDI in their economies. This is because many developing countries now desire to extend the private sector and to mitigate the external debt problem by attracting more private foreign investment.

With declining and more unpredictable aid flows, the benefits of FDI enumerated above, coupled with the incapability of the local financial system to mobilize enough local savings to cover the savings gap and finance economic development, increased FDI inflows remain a viable and sustainable alternative to developing the country. Our main objective in this chapter is therefore to examine the situation of FDI in Cameroon and identify those factors that can make Cameroon a more attractive destination for FDI. The study more specifically intends to: look at the sectoral pattern and origin of FDI in Cameroon; examine the institutional and regulatory framework put in place by government to guide the investment process, and more specifically FDI; identify the determinants of FDI flows to Cameroon; and suggest how government can make Cameroon more attractive to foreign investors.

The rest of the chapter is organized as follows. The next section presents some stylized facts on FDI in Cameroon, which is followed by an examination of the regulatory and institutional framework within which investment has taken place. The subsequent discussion reviews the literature on the locational determinants of FDI, and then specifies and empirically tests an FDI model for Cameroon. The conclusion offers proposals for attracting FDI to Cameroon.

Stylized Facts on FDI in Cameroon

I n this section, we examine the evolution of FDI to Cameroon, its sectoral distribution over time and the source of FDI inflows to Cameroon. The section ends with a review of how government investment policy has changed over the years.

The Evolution of FDI in Cameroon

A better appreciation of the evolution of FDI in Cameroon can be gained by dividing the recent economic history of Cameroon into four subperiods. The division is a function of significant economic events witnessed by the country and some major economic policy changes made by the government during this period. The following subperiods are identified and discussed below: the post-independence era (up to 1977); the oil-boom era (1978–1985), the era of economic crisis and failed reforms (1986–1993); and the post-devaluation era (1994–2002).

The first subperiod is the post-independence era (up to 1977), during which the economy was dominated by the agricultural sector. Agriculture was the principal source of economic growth, employment and foreign exchange earnings through the export of primary crops like cocoa, coffee and cotton. Real GDP grew at an annual average rate of 4.42% (between 1970 and 1977). The country had gained independence just about a decade earlier and most development projects (especially infrastructure) were still carried out by the government, but with the assistance of the former colonial power – France. FDI remained largely low, averaging US$10.1 million annually,

as there was some amount of resentment of foreigners (who were still essentially former colonialists). There was no explicit attempt to woo foreign investors. FDI during this period was concentrated mainly in the primary and secondary sectors of the economy.

The discovery and exploitation of crude oil marks the second subperiod: the oil boom era (1978–1985). The oil sector attracted a lot of FDI into the country. This subperiod recorded the highest net FDI flows to Cameroon over the study period, with most of it going into the oil industry. Net FDI averaged US$125.1 million annually. Real GDP growth rose rapidly at more than 8% per annum. The economy witnessed an important change, as oil replaced agriculture as the main source of foreign exchange. The contribution of the oil sector to government revenue moved from 9% in 1980 to 41% in 1985.

The third subperiod is that of the economic crisis and failed reforms (1986–1993). The main characteristic of this subperiod was the continuous fall in the prices of Cameroon's main export commodities; crude oil, cocoa and coffee. The international price of crude oil fell by two thirds between 1986 and 1988, while the prices of coffee and cocoa fell by one-half and one-third, respectively. Cameroon's terms of trade declined consequently by nearly 40% (Ghura, 1997). Real GDP growth turned negative and averaged almost -4% during this period. Economic activity shrank in most areas especially in construction and public works, but also in the production of cash crops. The real effective exchange rate is also reported to have appreciated during this period by some 40% (Ghura, 1997), owing especially to the appreciation of the French franc. The fiscal balance, which had been positive during the previous period, became negative and averaged more than 6% of GDP.

Cameroon was deep in crisis. Several attempts (including stabilization and structural adjustment programmes) to get the country out of the crisis failed. Cameroon was unable to successfully complete a single economic programme signed with the Bretton Woods institutions within this period. The first two stand-by agreements (1989 and 1992) negotiated with the IMF went off track. The third failed only three months after approval and was suspended. The economic reform programme supported by the structural adjustment loan (SAL) of the World Bank also encountered a lot of difficulties and disbursements were suspended. Only about two-thirds of the conditionalities under SAL[4] were started and fewer were actually implemented – and even those were behind schedule (IDA and IMF, 2000). The consequence of the failed reforms was that the macroeconomic framework, rather than improving as envisaged, deteriorated sharply. The Government of Cameroon showed its unwillingness to tackle the structural distortions impeding growth in the country, thus acquiring the reputation of reluctant reformer and this had serious effects on the credibility of its policies. The attitude of reneging on promises and the morose economic atmosphere did not favour FDI inflows – to the contrary, investment fled the country. For most of this subperiod, net FDI flows were negative. Average net FDI flows stood at a negative US$29.37 million annually as shown on Table 5.1. More private capital was going out of the country than was flowing in. This phenomenon of capital flight has been reported in several sub-Saharan African countries; Ajayi (2000) observes that among other effects, it reduces growth.

The last subperiod corresponds to the post-devaluation era (1994–2002). Given the magnitude of the macroeconomic imbalances, it became clear by the end of 1993 that internal adjustment alone was not sufficient to put the economy back on its rails. The adjustment had failed to restore external competitiveness, as nominal domestic prices showed considerable downward rigidity. Other countries in the Franc Zone were facing similar difficulties and to remedy the situation, the CFA franc, which had been pegged to the French franc in 1948, was reluctantly devalued by 50% in January 1994. Devaluation was seen as the last attempt to

bring the economy out of the crisis, as it was believed that the real exchange rate was highly over-valued. Following the devaluation, both bilateral and multilateral donors reacted by almost doubling the amount of net official flows. A new programme backed by the economic recovery credit (ERC) was signed with the World Bank in 1994. Structural Adjustment Credits II and III followed in 1996 and 1998, respectively. The IMF equally concluded a three-year programme – an enhanced structural adjustment facility (ESAF) with the Government of Cameroon in 1997. By end of 1999, all the performance criteria of the programme were met (in sharp contrast with the four previous stand-by agreements). Reforms were carried out in the following domains: civil service, financial sector, imports and tariffs, forest exploitation, privatization, regulatory framework, and others. Cameroon was gradually giving up the appellation of a reluctant reformer.

Table 5.1: The evolution of net FDI (annual averages) – millions of US$

Period	Net FDI flows	Real GDP growth
1970–1977	10.10[a]	4.42
1978–1986	125.09	8.30
1987–1993	-29.37	-3.99
1994–2002	35.45	3.50[b]
1970–2002	37.85[c]	3.44[d]

Notes: a. Average from 1973 to 1977.
         b. Average from 1994 to 2000.
         c. Average from 1973 to 2002.
         d. Average from 1970 to 2000.

Source: UNCTAD (WIR database), IMF (WEO database) and authors' calculation.

Export revenue increased by more than 100% from the previous subperiod. Real GDP growth turned round from an average decline of 3.99% during the previous subperiod to an average growth of 3.50% between 1994 and 2000. The regrouping in economic activity and the perceived commitment of the government to carry on with the reforms had a positive effect on investors. FDI inflows rose and at the same time outflows fell drastically. Average annual net FDI flows to Cameroon within this subperiod turned positive and stood at US$35.45 million. The upward trend continued, reaching more than US$83 million in 2002, but remained far below the level of more than US$200 million attained in the early 1980s during the oil boom.

The evolution of net FDI in Cameroon within these subperiods reveals the importance of resource exploitation and the level of economic activity. Of significance was the commitment of government in implementing agreed economic programmes, as this affects the credibility given government pronouncements by investors. The reforms in the domain of trade liberalization, the deregulation in the financial sector and other economic activities also appear to have had a positive impact on net FDI flows in Cameroon.

Sectoral Pattern of FDI in Cameroon

This part of the work relies on data taken from a sample comprising all registered enterprises in Cameroon between 1992/93 and 2001/02. The investment carried out by these firms each year and the share of foreign ownership in each firm is provided. For our purposes – analysing FDI – we took into consideration only firms with at least 10% foreign ownership. The firms were classified into the various sectors[5] of the economy – primary, secondary and tertiary –

which was all we could get in terms of data on the sectoral distribution of FDI in Cameroon. In this study, we consider FDI in the tertiary and secondary sectors of the economy as market seeking or horizontal, while FDI in the primary sector is considered as resource-seeking or vertical.

Figure 5.2 and Table 5.2 present the evolution of the distribution of FDI among the three sectors. In the early 1990s, the primary sector of the economy was still attracting substantial amounts of FDI. In 1992/93, almost 38% of all the FDI to Cameroon went to this sector. By 2001/02, this had declined to barely 4.78%. The primary sector was dominated by the extractive or mining industry, which alone received more than 83% of the sector's FDI within the period. Forestry took about 15%, and the rest (less than 2%) went to agriculture. The decline of FDI in forest exploitation can be attributed to the very strong legislative and fiscal pressure exerted on it towards the end of the 1990s for environmental concerns.

Agriculture was receiving virtually no FDI by 2002. The only visible flow of FDI into agriculture at the moment is in banana production with the presence of Delmonte (in partnership

Figure 5.2: Distribution of FDI across Cameroon's primary, secondary and tertiary sectors (in per cent)
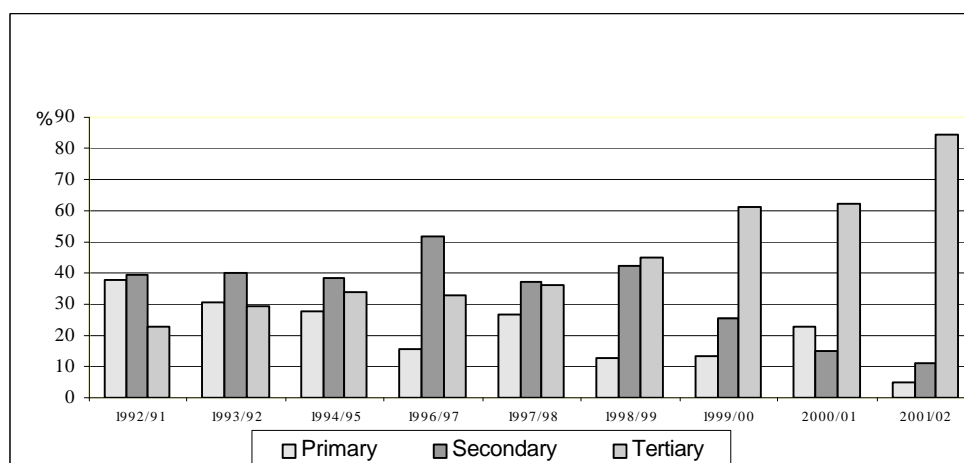
Table 5.2: Sectoral distribution of FDI in Cameroon (in per cent)

	92/93	93/94	94/95	96/97	97/98	98/99	99/00	00/01	½
Primary sector:	37.89	30.58	27.52	15.37	26.66	12.52	13.10	22.75	4.78
Forestry Industry	2.39	4.61	5.29	4.32	5.73	2.05	2.28	1.79	0.89
Extractive industry	35.42	25.69	21.74	10.54	20.72	10.08	10.38	20.61	3.77
Secondary sector:	39.28	40.16	38.52	51.93	37.42	42.43	25.66	15.12	10.86
Energy industry	19.15	13.43	11.52	15.76	13.69	4.75	4.04	1.62	2.59
Tertiary sector:	22.83	29.26	33.96	32.70	35.92	45.06	61.24	62.14	84.37
Transport industry	7.38	13.80	24.27	15.96	26.29	36.40	51.89	53.50	79.85

Source: Constructed by the authors using the Firm Investment Database from the National Institute of Statistics, Ministry of the Economy, Finance and Budget (2004).

with the Cameroon Development Corporation – CDC) and in palm oil production with a Malaysian firm. This is in contrast with the 1970s when FDI flows into agriculture were important especially in the production of cash crops like coffee and cocoa. Such a decline can be explained by fluctuating and falling prices of these commodities. On the whole, the share of FDI going to the primary sector has declined sharply within this period. No new oil wells have been discovered and Cameroon does not produce any other valuable minerals to attract FDI to the sector. FDI resulting from the Chad–Cameroon pipeline project is responsible for the surge in FDI in 2000/01. Our expectation is that the trend will continue, unless some minerals are discovered or forestry exploitation is increased significantly.

By 1992/93 the secondary sector of the economy was the highest attracter of FDI to Cameroon, with more than 40% of all FDI to Cameroon. This even rose to more than 50% in 1996/97, but started to decline sharply as from 1998/99 to stand at only 11% in 2001/02. The energy industry is the single most important puller of FDI in this sector. Within our period of analysis, about 29% of all FDI to the secondary sector went to energy production. FDI in energy became very important with the privatization of the electricity corporation (SONEL). The general trend shows a declining share of FDI going to the secondary sector of the economy.

The tertiary sector seems to be the main beneficiary of FDI flows to Cameroon in recent years. From only 22.8% of FDI in 1992/93, the sector was receiving more than 84% in 2001/ 02. Most of the FDI in this sector goes to the transport industry; within this study period the transport industry accounted for almost 76% of all investment in the tertiary sector. The surge in FDI in transport and telecommunication from 1999/00 can be attributed to the privatization of the National Railway Company, and the licensing of two operators in the mobile telephone market. These companies invested heavily to transform these sectors.

As a whole, the sectoral distribution of FDI in Cameroon in recent years is in favour of the tertiary sector. Within our period of analysis, this sector alone attracted more than 45% of all FDI inflows to Cameroon. Privatization and liberalization in the transport and telecommunications industries contributed enormously. The secondary sector received about 34% of all the FDI and the trend is downward. Market-seeking FDI thus constituted about 79% of all FDI inflows to Cameroon within this period. Cameroon's dominant and strategic position within the Central African Economic and Monetary Community (CEMAC) can to some extent explain the growth in resource-seeking FDI. Most of the foreign investors in Cameroon target the subregion, and not Cameroon alone. Within CEMAC, Cameroon produces more than 50% of the GDP and has about 50% of the population. It has the most developed industrial base and is very strategically located. The remaining 21% goes to the primary sector or for resource-seeking. The trend in resource-seeking FDI is downward and may continue on that path unless some mineral resources are discovered or forest exploitation increased. The prospect for FDI in agriculture is not bright because of the low and fluctuating prices of agricultural produce on the world market.

Appendix Table 5.A1 shows the distribution of FDI firms within the various sectors of the economy. The overall picture is that the number of firms with FDI is rising continuously. From 209 firms in 1992/93, the number rose to 350 in 2001/02 – an increase of 21% within nine years. Concerning the distribution of these firms within the various sectors, the general trend is not much different from the distribution of FDI flows discussed above. The tertiary sector had 51% of all the firms, while the secondary sector had 42%. This left just 7% of FDI firms in the primary sector.

Geographical Source of FDI to Cameroon

The essential part of FDI in Cameroon comes from OECD countries.[6] The historical relationship with France makes this country the main source of FDI to Cameroon. The stock of French FDI in Cameroon amounted to US$250.1 million in 1998, representing 21% of all FDI stock in Cameroon. The other main suppliers of FDI are the United States, Germany and the United Kingdom. Table 5.3 shows FDI stock from the main source countries for 1992 and 1998. Significant non-OECD foreign investment in Cameroon in the 1990s came from Malaysia. Their FDI stock stood at US$0.4 million in 1995, largely as a result of their acquisition of stakes in rubber production.

Table 5.3: FDI stock in Cameroon by country of origin, in US$ million (% of total FDI stock in parentheses)

Country	1992	1998
France	221.9 (21)	250.0 (21)
United States	263.1 (25)	178.0 (15)
United Kingdom	22.7 (2)	...
Germany	5.6 (0.5)	9.0 (0.8)
Total FDI	1059.0	1192.0

Source: UNCTAD WID Country Profiles: Cameroon.

As for the number and assets of FDI affiliates in Cameroon, ten US firms owned assets worth US$887 million, while seven German firms owned assets amounting to US$119.2 million in 1998. There was an average of nine US and six German firms in Cameroon in the 1990s. The German firms employed 2,000 workers, while the American firms employed 600. Unfortunately, we could not find comparable information on France from the UNCTAD source, despite the fact that she is the main source of FDI in Cameroon. In 2002, the biggest multinational affiliate in Cameroon in terms of sales was the American-owned Mobil Oil Cameroon with sales of US$195.5 million. This was closely followed by French-owned Société Camerounaise Equatoriale with sales amounting to US$160.7 million. Both firms operated in the mineral exploitation sector (petroleum sector). In relative terms, a greater proportion of American FDI was of the resource-seeking type than French FDI. The French are very much involved in the manufacturing sector in Cameroon.

The Regulatory and Institutional Framework for Investment in Cameroon

The regulatory and institutional framework in Cameroon has been provided largely by a series of investment codes adopted since independence. The investment code was a kind of investment policy paper for the government aimed at regulating and promoting investment in the country. Investment codes were promulgated into law in 1960, 1984 and 1990 and as an Investment Charter in 2002. In the rest of this section, we examine the incentives offered by these codes and their possible influence on FDI flows.

The 1960 Investment Code

The 1960 Investment Code was promulgated by Law No. 60-64 of 27 June 1960, and amended by Law No. 66-LF-5 of 10 June 1966. At the dawn of independence, Cameroon inherited a generally primary economy, based on the production and export of a certain number of cash crops (cocoa, coffee, cotton, tea, tobacco, palm nuts, timber, etc.). This period was marked by nationalist ideas and some suspicion toward private investors, who were essentially foreigners (former colonialists). There was no real objective to encourage foreign investment and since local private entrepreneurs could not take up the challenge, the state took on the task of investment. The setting up of many state-owned import-substitution companies therefore marks this period. Import tariffs were set very high to protect licensed companies and state enterprises and generous fiscal advantages were given to reinforce the protection.

The Investment Code provided incentives under several regimes: A, B, C, D, forestry, and small and medium-sized enterprises (SMEs). Almost all manufacturing enterprises benefited during creation from one or the other of the regimes provided in the code. In the first four regimes, enterprises were fully exempted from custom duties on the importation of machines and factors of production for the first ten years of operation. In addition, regimes B to D were provided supplementary fiscal privileges: tax exoneration on profits for a period of five years, deduction of depreciation allowances for the first five years from the income of the next three years. The regimes concerning SMEs and forestry enterprises were less generous. The only exoneration accorded the forestry sector was a maximum 5% reduction on import of equipment and other factors of production. The SME regime had a few other exonerations, but these were far fewer than the first four regimes.

The incentives provided favoured market-seeking foreign investment that could hide behind the tariff walls raised by the state. But the principal objective during this period was not to attract FDI, but to get Cameroonians more involved in the industrialization process following independence and the domination of colonially owned enterprises. This can explain the creation of many import-substitution enterprises by the state, in the absence of a strong local private entrepreneurial community. The effect of this protection was the reduction of imports, resulting in a more closed and self-supporting economy.

The 1984 Investment Code

It became evident that the 1960 Investment Code did not meet the main objectives envisaged as stated in the first, second, third and fourth five-year economic, social and cultural development plans of the country. Specifically, the rate of transformation of raw materials locally was still low, the industrial sector was not creating many jobs, the level of industrial integration remained very low, and regional development was still a long dream. Law No. 84-03 of 04 July 1984 instituting the investment code was an attempt to tackle some of these difficulties.

The main thrust of this code was the recognition of the importance of private investment and the opening up of the economy, to the achievement of the objectives of the Sixth Five-Year Economic, Social and Cultural Development Plan. The incentives were centred on important tariff exonerations for some imports and more fiscal inducements. The aim now was to encourage not only private domestic investment, but also foreign investment in productive activities. Much emphasis was given to the promotion of small and medium-sized enterprises. Unfortunately, the application of this code did not run for more than a year before the shock of

the economic crisis. The crisis pushed Cameroon into the adoption of a structural adjustment programme (SAP) under the auspices of the Bretton Woods institutions, which led to a further liberalization of economic activity and less discriminatory treatment of investors, whether foreign or local. The advent of the crisis could even be seen as a blessing in disguise. It should be pointed out, however, that most of the reforms agreed with the Bretton Woods institutions were implemented either behind schedule or not at all. As noted earlier, Cameroon was classified as a reluctant reformer.

The 1984 Investment Code was therefore never implemented. The priority of the government turned towards the stabilization of public finances and macroeconomic equilibrium. This was in line with the conditionalities of the structural adjustment programme, the confirmation accords signed with the IMF and the structural adjustment credit with the World Bank.

The 1990 Investment Code and Export Processing Zone Regime

It was in the context of the severe economic crisis that Ordinance No. 90/007 of 08 November 1990 promulgated the 1990 Investment Code into law. The main thrust of the 1990 Investment Code was the institution of three special regimes targeting separate types of investment. The first regime was for the creation of new enterprises and targeted specifically SMEs and strategic enterprises. The second was the free trade zone regime targeted exclusively at export-oriented enterprises. The third regime was for reinvestment, and aimed at existing enterprises. Of most relevance to this chapter is the free trade zone (FTZ) or an export processing zone (EPZ) in Cameroon. This was the regime that aimed specifically to attract FDI into the country. Our discussion thus focuses essentially on the creation, functioning and difficulties of the EPZ.

The principal goal of the EPZ regime was to attract new investment (especially FDI), and also to create jobs and promote exports. An organ[7] was set up to manage the EPZ with the main objective of streamlining administrative formalities and facilitating customs procedures. The status of an export-processing firm was to be accorded to firms using national raw materials, transforming on site and exporting at least 80% of their output. Another organ was created to serve as a one-stop investment office – the Investment Code Management Unit.[8]

A number of incentives were accorded to export processing firms by the EPZ regime:
* Firms are free from exchange rate and price controls.
* They have the possibility of selling a percentage of their output on the domestic market after the application of appropriate import taxes (but not more than 20% of output).
* All indirect and direct taxes were to be waived for the first ten years of operation. From then on, a 15% tax is levied on profits. Profits will be netted of 25% of the salaries paid to nationals and of 25% of investment expenses before tax is applied.
* Enterprises in the zone are exempt from import and export tariffs, but have to pay for services used in the process of importing or exporting.
* Enterprises are allowed to set their wage and do not have to pay dues to the National Social Security Fund if they provide parallel arrangements for their employees.
* Electricity and water are subsidized for export processing firms and telephone connection is facilitated and provided at a promotional rate for the first five years of operation.

The first permit for a firm to operate under the EPZ[9] regime was issued in 1992, two years after creation. Of the 44 firms admitted into the regime, only 20% were new firms; the others were firms already in existence before the new regime. They joined the EPZ regime simply to benefit from the generous incentives offered. The incentives therefore failed to attract new

investments as expected. Thus the results of the investment objective of the EPZ were far below expectations. Total investment in the zone was about 10% of all investment by the industrial sector (Nanfah, 2002: 53). In addition, 75% of the firms were involved in forest exploitation. This is a sector in which the value added before export is very small, compared with other sectors. Nanfah (2002: 69) estimates at more than CFAF 118 billion (between 1993/94 and 1999/00) the amount of revenue (export and import duties) lost by government as a result of the incentives accorded the EPZ. The EPZ experience in Cameroon has really been disappointing, especially in its attempt to attract FDI. The export processing regime was consequently repealed in 2002. Even now, all the timber firms have been excluded from the regime.

A number of reasons explain this dismal performance. First, the government failed to stick to the incentives accorded EPZ firms. For example, the tax for the timber sector increased to 4%, then to 17.5% by 2002, despite the government's promise of zero tax for the first ten years of operation. This could partly be attributed to commitments within the subregion. Indeed, in 1994 UDEAC member countries adopted a number of common fiscal and custom reforms, which led to the suppression of some fiscal and tariff exonerations provided by the 1990 code. The 1996/97 Finance Bill completely suppressed the remaining fiscal advantages accorded to enterprises. Such reneging actions raise questions about the credibility of government policy, which is then seen to be deleterious to investment, especially foreign investment. Second, the EPZ was launched during a period in which government credibility was already very low following several failed reform efforts with the Bretton Wood institutions. Third, administrative bottlenecks were not resolved. The one-stop investment shop (ONZI) meant to facilitate the installation of foreign investors never really worked because of lack of both material and human resources. The procedure for issuing business permits to investors was very lengthy and could take several months. Fourth, from the initial stages of the EPZ in Cameroon, the United States Agency for International Development (USAID) provided financial, logistical and developmental support. Following the passage in 1992 of a US law[10] restricting USAID assistance to EPZs, this support was lost and could not be replaced. Fifth, when the EPZ began Cameroon was in the midst of a period of high political instability and uncertainty. The early 1990s witnessed a lot of political upheavals as Cameroon was moving from a single party to a multi-party democracy. The period was characterized by street demonstrations, ghost town operations, strikes and many other events that greatly affected the economic life of the country. This was not a business-friendly atmosphere to attract foreign investment.

The 2002 Investment Charter

Law No. 2002/004 of 19 April 2002 instituted the Investment Charter in Cameroon. The charter conforms to the Investment Charter of the Subregion (CEMAC) adopted by the CEMAC Council of Ministers on 17 December 1999 in N'Djamena, Chad. It aims to resolve the global problem of the incentives for profitable investment and create favourable conditions for enterprises operating in Cameroon. It also intends to promote competitiveness in the domestic as well as external market. More specifically, the idea of the charter was to provide an appropriate institutional and regulatory framework to guarantee the security of investments, provide support to investors, and ensure fair and prompt settlement of investment-related as well as commercial and industrial disputes. It is worth noting here that the charter is not a substitute for the investment code. At the conceptual level, it covers and largely exceeds the scope of the investment codes and other codes instituted by the state (tax code, customs code, mining code, insurance code, labour code, etc.). In its application, the charter is expected to be subdivided into sectoral

codes (tourism, forestry, manufacturing industries, service industries and so on) and into economic zones.

This new instrument, designed in the context of globalization, plans to create, among others, an investment promotion board and a one-stop investment office. The one-stop investment office will process applications within a maximum of 15 days (the longest among the three regimes offered). Automatic approval is granted in the absence of objection at the end of the period. In terms of fiscal and custom incentives, equity between the various taxpayers is the watchword. The government commits to simplify and harmonize the procedures for assessing and collecting taxes. No specific rates for tax or custom incentives are offered, but the government promises to align with international norms. Custom duties will be moderate and the government will adhere to the policy defined by CEMAC and in conformity with the provisions of the World Trade Organization (WTO).

The use of the charter as an instrument to attract foreign investment can be seen from the listing of a number of rights and privileges to investors: freedom of enterprise, right of ownership, equality before the law, freedom to repatriate profits and capital, access to the foreign currency market, and equitable and transparent application of business, labour, social security, intellectual property and insurance laws. The charter also emphasizes the international investment-related treaties and conventions signed by the government in order to protect foreign investments. The involvement of the private sector and the civil society at certain levels in the investment approval process is viewed in the same manner.

Several of the special institutions and regulations referred to by the Charter are still awaited as well as that setting the composition and modalities of the National Competition Committee (CNC) instituted by Law No. 98/013 of 14 July 1998 regulating the national competition. For those reasons the 1990 Investment Code will remain in force until the entire drafting of the enabling legislation and regulations necessary to implement the more liberal Charter is put in place, in spite of its abrogation as clearly stipulated in Article 43 of the Charter.

As a conclusion, a number of reasons explain the poor performance of Cameroon in terms of FDI attraction despite the generous incentives offered by the regulatory and institutional framework especially from the 1984 Investment Code and the free trade zone regime:

*   The non-respect by the state for tax and tariff commitments, which created an atmosphere of suspicion and loss of confidence between the state and interested economic operators.
*   The limited autonomy and resources of the body set up to manage the export processing zone.
*   Sociopolitical instability within the Central African subregion and in Cameroon itself in the early 1990s.
*   Corruption, poor governance and administrative bottlenecks.
*   The silence observed by the government regarding the setting up of accompanying structures and the texts of application to the Investment Charter.

Determinants of FDI: A Review of the Literature

The literature on FDI determinants has adopted either the pull factor (demand-side) approach or the push factor (supply-side) approach, or a combination of both. The push-factor approach examines the key factors that could influence or motivate multinational corporations (MNCs) to want to expand their operations overseas. They try to explain why

national firms evolve into MNCs, and why they decide to locate production in another country rather than licensing or exporting (Singh and Jun, 1995). In this study we focus only on pull factors, which illustrate the relationship between host-country specific conditions and the inflow of FDI – that is, the factors that attract FDI when the decision to invest out of the home country is made by the MNC. A number of socioeconomic and political factors exist in the host country that determine available business opportunities and potential political risk and thus influence the decision of MNCs to locate in a specific country. Among these factors, those regularly cited in the FDI literature are: infrastructure, market size, level of human capital development, distance from major markets, labour cost, openness of the economy to international trade, exchange rate, fiscal and other non-tax incentives, political stability, the legal system, and monetary policies. Also important have been endowments in natural resources such as petroleum, diamond and huge forest reserves, among others (Pigato, 2001; Akinkugbe, 2003; Asiedu, 2002). The implication is that while push factors influence the overall size of FDI, pull factors determine which country receives what share of the FDI (Carlson and Hernandez, 2002).

The relative importance of the pull factors in attracting FDI depends on the type of FDI[11] in question. The literature generally identifies two main types of FDI,[12] market-seeking and resource-seeking FDI (Lim, 2001; Campos and Kinoshita, 2003). Market-seeking FDI is intended to serve the local market. It is also called horizontal FDI, as it involves the replication of production facilities in the host country. The motive might be to reduce the cost of supplying the market (such as tariffs and transport costs) or to become more competitive by responding promptly to local situations and preferences. Horizontal FDI is therefore expected to replace exports if the cost of market access through exports is higher than the net cost of setting up a plant and producing in a foreign country. Market-seeking FDI is driven essentially by market size and market growth of the host economy, as it aims to better serve the local market by local production. Impediments to accessing local markets, such as tariffs and transport costs, encourage this type of FDI.

Resource-seeking FDI, on the other hand, is motivated by factor cost differences. It goes for low-cost inputs such as natural resources, raw materials or labour. It is often called vertical, export-oriented or still raw material-seeking FDI since it involves slicing the vertical chain of production and relocating part of this chain in a low-cost location. Generally, vertical FDI will be stimulated when different parts of the production process have different input requirements and input prices vary across countries. According to Shatz and Venables (2000), international differences in factor and raw material prices and refinements in production technology will tend to encourage vertical FDI. This form of FDI is usually trade creating, since products at different stages of production are shipped between different locations, and especially back to the MNC's home market. It is important to note, however, that horizontal and vertical FDI are not mutually exclusive, although the distinction between them is useful (Shatz and Venables, 2000).

Among the many theories trying to explain FDI,[13] Dunning (1993) proposes a framework that synthesizes the explanations and suggests that three conditions are required to motivate a firm to undertake FDI. This has become known in the FDI literature as the OLI paradigm because it explains the activities of MNCs in terms of ownership (O), location (L) and internalization advantages (I). When selling its products abroad, a firm is at least initially disadvantaged relative to local producers. Thus, in order to compete effectively with indigenous firms, a foreign producer must possess some ownership advantages. They can take the form of a superior production technology or improved organizational and marketing systems, capacity to innovate, trademarks, reputation, or other assets. Ownership advantages assure a firm's

ability to enter the host country's market, but do not explain why the foreign presence should be established through production rather than exports. This issue is, in turn, addressed by location advantages that arise due to differences in factor quality, costs and endowments, international transport and communication costs, overcoming trade restrictions, and host government policies. The last advantage, internalization, explains why a foreign firm prefers to retain full control over the production process instead of licensing its intangible assets to local firms. This decision may be attributable to high transaction costs involved in regulating and enforcing licensing contracts.

The empirical literature on the determinants of FDI flows is large, but is characterized by a divergence of views concerning some determinants of FDI to developing countries. According to Chakrabarti (2001: 89), "the literature is not only extensive but controversial as well". Market size (as measured by GDP per capita) is the most widely accepted determinant of FDI flows. Almost all empirical studies on the determinants of FDI have included the host country market as one of the explanatory variables (Billington, 1999; Tsai, 1994; Campos and Kinoshita, 2003; Akinkugbe, 2003; others). This does not indeed mean that there is total unanimity on the positive effects of market size. Edwards (1990) and Jaspersen et al. (2000) find a negative relationship between FDI flows and market size. Other authors have opted for the use of absolute GDP, but this has been contested on the grounds that it is a poor indicator of market potential for the products of foreign investors, since it reflects the size of the population rather than income (Chakrabarti, 2001). The growth rate of GDP has equally been used in empirical studies to assess the impact of a rapidly growing economy on FDI flows. A rapidly growing economy provides relatively better opportunities for making profits than one that is growing slowly or not at all.

Another factor featuring in most studies on FDI determinants is openness of the economy to international trade. Given that most investment projects are directed towards the tradeable sector, a country's degree of openness to international trade should be a relevant factor in the MNC decision. On the other hand, some authors test the hypothesis that FDI that is basically intended for tariff-jumping purposes will be attracted by more restrictive trade regimes. The evidence on the effect of openness is consequently mixed. Akinkugbe (2003), Asiedu (2002), Campos and Kinoshita (2003), Edwards (1990), and others all report a significant positive effect of openness on FDI, but Wheeler and Mody (1992) find a negative effect on FDI in the electronic sector. Concerning trade barriers (tariffs), Lunn (1980) reports a positive relationship with FDI, while Culem (1988) finds the contrary. Asiedu (2002) recognizes the importance of capital account openness on FDI flows, although she does not assess it for lack of data.

The exchange rate is often cited as one of the determinants of FDI. There is an exchange rate risk involved in the repatriation of profits. Investors will prefer to invest in countries with strong currencies. The empirical results are equally mixed. Singh and Jun (1995) find a significant negative relationship between the real exchange rate and FDI for a group of developing countries, while Edwards (1990) finds a significant positive relationship. Other researchers prefer to use exchange rate uncertainty as an indication of macroeconomic uncertainty. Goldberg and Kolstad (1995) find exchange rate uncertainty to negatively affect the production level, but the relationship with FDI is unclear. Another indicator of a stable macroeconomic environment used in FDI studies is the record of price stability. A history of low inflation and prudent fiscal activity signals to investors how committed and credible the government is. Akinkugbe (2003) finds only a marginal negative effect of inflation on FDI. Schneider and Frey (1985) find both high balance of payment deficits and inflation to negatively affect FDI.

The influence of fiscal incentives (this might take the form of tax holidays, subsidies and others) is expected to be positive, but empirical studies have had mixed results. Wheeler and Mody (1992) find them not important, while UNCTC (1991) finds evidence that tax incentives have a positive influence on FDI. Billington (1999) observes that host country corporate tax has a negative effect in FDI.

The quality of institutions[14] is widely discussed in the FDI literature, but its empirical implementation is plagued by measurement problems. Institutions underpin the hospitality of the business environment. Several variables have been used to assess the impact of institutional quality on FDI flows. The level of sociopolitical instability, corruption, administrative bottlenecks, and inefficient and inequitable legal systems have been found to have a negative influence on FDI flows (Singh and Jun, 1995; Obwona, 1998; Campos and Kinoshita, 2003). An interesting paper in this domain is that of Lumenga-Neso and Morisset (2002), which looks at the administrative obstacles to FDI in developing countries. Twenty of the 32 countries in the sample are from Africa. They show that firms investing in developing countries face significant administrative costs. The high cost is attributable to acquisition and development of land, operational requirements for import-export, business registration, initial bank deposit, electricity, telephone and water connections, among others. All these factors increase the administrative cost of doing business and consequently deter foreign investment. They recommend that lowering corruption levels, improving the quality of governance, increasing financial openness and increasing public sector wages can reduce administrative cost. Such reforms should be incorporated into broader reforms such as trade, financial liberalization, anti-corruption measures and public sector reforms. The paper is important as it examines a domain (administration) that is usually characterized by a paucity of data. The scarcity of studies on administrative cost and FDI is explained more by the lack of data than by the conception that administrative issues are not important for FDI.

The empirical literature has also examined the effect of agglomeration factors on FDI. These include the level of infrastructure development and the existing stock of FDI. Both generally have a positive impact on FDI (Akinkugbe, 2003; Wheeler and Mody, 1992 ; Barry and Bradley, 1997; others). Asiedu (2002), however, finds that infrastructure development attracts FDI to other developing countries, but not to sub-Saharan Africa. A number of other variables have been included in FDI equations with varying results. Amongst them are human capital, government consumption, external debt and many others.

Chakrabarti (2001) attributes the wide divergence of views in the empirical literature to the wide difference in perspectives, methodologies, sample selection and analytical tools. He makes an attempt to resolve the divergences by using extreme bound analysis (EBA) to determine which coefficients of the explanatory variables of FDI are "robust" to small changes in the conditioning information set. His results indicate a strong support for the explanatory power of market size of the host country as a major, if not the most significant, determinant of FDI inflow. Other factors, such as openness to international trade, wages, net exports, growth rate, tax regime, tariffs and exchange rate turned out to be less robust, although not very fragile, as determinants of FDI inflow. According to these findings, while openness to trade, growth rate and tax regime are likely to be positively correlated, wages, net exports and exchange rate are more likely to be negatively correlated with FDI. Finally, another set of indicators such as inflation, budget deficit, domestic investment, external debt, government consumption, political stability, human capital, natural resources and infrastructure was found to be very fragile in their effect on FDI inflow and are highly sensitive to small alterations in the conditioning information set.

Determinants of FDI in Cameroon: An Empirical Investigation

An analysis of FDI determinants in Cameroon starts from a simple partial adjustment process as used by Singh and Jun (1995) for their study on FDI determinants in developing countries and also by Campos and Kinoshita (2003). The dearth of disaggregated FDI data for Cameroon precludes us from examining separately the determinants of market-seeking and non market-seeking FDI. The rationale for the inclusion of each of the host country factors and our data sources are dealt with in the next section, and the specifications for the model are given below.

Model Specification

FDI flows are likely to require time to adjust to the specific constraints faced by multinational companies. The FDI adjustment process is postulated as follows:

$$FDI_t - FDI_{t-1} = A(FDI^d_t - FDI_{t-1}) \tag{1}$$

where FDI^d_t is the level of desired FDI at time t.

The equation shows that change in actual FDI will respond only partially to the difference between desired FDI and past values of FDI. In any given period a desired level of FDI may not be completely realized (as actual FDI in the next period) because of physical and procedural constraints faced by MNCs. The parameter A captures the speed of adjustment to a desired FDI level. Further transformation of Equation 1 gives

$$FDI_t = AFDI^d_t + (1-A)FDI_{t-1} \tag{2}$$

The desired level of FDI is based on a number of host country factors denoted here as H, and a random error term α_t. The H factors are those that influence the decision of foreign investors to do business in Cameroon. The desired FDI is thus presented as follows:

$$FDI^d_t = \alpha_0 + \alpha_1 H_t + \varepsilon_t \tag{3}$$

When we substitute FDI^d_t from Equation 3 into 2, we obtain:

$$FDI_t = \beta_0 + \beta_1 H_t + \beta_2 FDI_{t-1} + \zeta_t \tag{4}$$

where $\beta_0 = A\alpha_0$, $\beta_1 = A\alpha_1$, $\beta_2 = (1-A)$, and $\zeta_t = A\varepsilon_t$

The host country (H) factors to be included as FDI determinants in Cameroon include: market size, growth of the economy, openness of the economy, the level of education, political risk, government size, infrastructure, exchange rate, wage rate, external debt and inflation.

Our basic FDI model will be constituted by three variables that have been found to regularly influence FDI in previous studies: market size, openness of the economy and infrastructure development. The specified FDI model with the variables to be tested is given as:

$$FDI_t = a_0 + a_1 gdp_t + a_3 OPEN_t + a_4 ER_t + a_2 GR_t + a_5 EDU_t + a_6 WAGE_t + a_7 INFR_t + a_8 INF_t$$
$$+ a_9 PR_t + a_{10} ED_t + a_{11} EPZ_t + a_{12} FDI_{t-1} + \zeta_t$$

where:

gdp = per capita GDP
OPEN = openness of the economy
ER = exchange rate
GR = growth rate of GDP
EDU = secondary education rate
WAGE = wage rate
INFR = infrastructure
INF = inflation
PR = political risk
ED = external debt
EPZ = export processing zone dummy, which takes 0 before the zone, and 1 after

Description of Variables and Data Sources

Most of the data for this study were obtained from International Monetary Fund (IMF) databases. Data on GDP, FDI flows, external debt, consumer price index, exchange rate and trade come from the IMF's World Economic Outlook (WEO) database. However, the data on the sectoral distribution of FDI in Cameroon come from the Department of Statistics and National Accounts in Cameroon. The exploitation of this database was explained above in the section on "Sectoral Pattern of FDI in Cameroon". The same source provided data on secondary school enrolment, electricity production and road networks. Documents used included *Cameroon in Figures* and *Statistical Annals of Cameroon*. These sources were complemented with data from the World Bank's World Development Indicators. Data on the indexes of political rights and civil liberties by Freedom House were obtained from their website.[15]

As noted, the host country factors used as variables in the model include: market size, growth of the economy, openness of the economy, the level of education, political risk, government size, infrastructure, exchange rate, wage rate, external debt and inflation. These are explained in turn, with the expectations of their performance when we run the model.

Market Size

Measured as GDP per capita, market size has so far been one of the most significant determinants of FDI flows. The market size hypothesis holds that a large market is necessary for the efficient use of resources and exploitation of economies of scale. The use of absolute GDP has been contested on the grounds that it is a poor indicator of market potential for the products of foreign investors, since it reflects the size of the population rather than their income or buying power (Chakrabarti, 2001). Conceptually, market size should be more important for market-seeking FDI than resource-seeking FDI. But the empirical literature is largely in favour of a positive and significant relation between market size and FDI. We are thus tempted to expect an equally positive relationship with the aggregate data we are using.

Openness

Given that most investment projects are directed towards the tradeable sector, a country's degree of openness to international trade should be a relevant factor in attracting FDI. However,

openness may have a different effect on the inflows of different kinds of FDI. On the one hand, as usually argued by the "protection jump" hypothesis, some market-oriented FDI is induced by high trade barriers. If this is the case, then openness would have a negative effect on the inflows of this kind of FDI. On the other hand, a higher degree of openness of an economy indicates not only more economic linkages and activities with the rest of the world, but also a more open and liberalized economic and trade regime. As a result, it is expected to attract more FDI inflows, particularly the inflows of resource-seeking or export-oriented FDI. In this study we are unable to say a priori the expected sign of the coefficient of openness because of the aggregate nature of FDI flows. Openness is measured as the ratio of exports plus imports to GDP.

Exchange Rate

A country with a weak currency will not attract foreign investors. An income stream (like repatriated profits) from such a country is associated with an exchange rate risk. Such income stream is capitalized at a higher rate by the market when it is owned by a weak currency firm. In order to take care of this possibility, the exchange rate *(XRATE)* is included in the FDI model for Cameroon. The nominal exchange rate of the US dollar against the CFA francs is used to measure the exchange rate risk. We expect a negative relationship between the exchange rate and FDI flows.

Growth of Real GDP

A rapidly growing economy provides relatively better opportunities for making profits than the one growing slowly or not growing at all. A high rate of economic growth is an indicator of development potential. Markets that are expected to grow faster will tend to attract higher levels of inward FDI. We therefore hypothesize a positive relationship between inward FDI and economic growth in Cameroon.

Lagged FDI

Foreign investors may view the investment decisions by others in a country as a good signal of favourable conditions and invest there too, to reduce uncertainty. That is, high levels of FDI in the past may signal to potential foreign investors the soundness and potential of an economy. The literature attributes this to a combination of agglomeration effects, information effects and a type of herding behaviour among foreign investors. Lagged FDI flows are therefore expected to attract more FDI.

Infrastructure

The infrastructure development of a region is also important, since it indicates how difficult and costly it may be to do business in the country. The more developed the road system in a country, for example, the easier the access to markets and the lower the transportation costs, and, thus, the greater the incentive to invest in that country. The multidimensional nature of infrastructure makes it difficult to measure, however. It comprises roads, telecommunications, railways and so on. It is difficult to capture the many aspects of infrastructure development, and the data available are limited. We choose to use in our models two measurements of infrastructure: ratio of paved roads and the production of electricity. We use the first principal component from these variables as a composite measurement of infrastructure. We expect a positive coefficient.

Human Capital

In their decision whether or not to invest (and how much to invest), foreign investors are also influenced by both the costs and the quality of the labour to be found in the host country. Countries where wages are higher, or where the labour force is less skilled, should find it more difficult to compete with other countries in attracting foreign investment. A more educated labour force can learn and adopt new technology faster, and the cost of training local workers would be less for investing firms. We measure the quality of labour using the share of the population enrolled in secondary education *(EDU)*. We could not find data on secondary enrolment ratio as traditionally used to measure labour quality in the literature. For lack of time series data on labour cost in Cameroon, we use the consumer price index as proxy for the wage rate. Our assumption is that the CPI reflects the cost of living, which should move with the wage rate. While labour quality is expected to positively influence FDI flows, labour cost is expected to have a negative effect.

Macroeconomic Stability

One indicator of a stable macroeconomic environment is a record of price stability. A history of low inflation and prudent fiscal activity signals to investors about the commitment and credibility of the government. We measure macro-stability as the change in the CPI, and expect a negative effect on FDI flows.

Political Stability

The importance of political stability in creating a climate of confidence for investors must not be underestimated. Whether perceived or real, political instability constitutes a serious deterrent to FDI as it creates uncertainties and increases risks and hence costs of doing business in the country. We use a combination of the two indexes of political freedom (political rights and civil liberties) as compiled by Freedom House to assess the effect of political risk on FDI. Freedom House combines these two indexes to classify countries into three categories: free, partially free and not free. Higher values for this index imply less political freedom. We add the two indexes to obtain a composite index of political risk in Cameroon. We expect that a higher political risk will deter foreign investors.

External Debt

Given Cameroon's huge external debt, investors perceive that future taxes may have to be increased so as to finance large external transfers to service the debt (problem of debt overhang). The size of the debt burden is expected to have a negative effect on FDI flows.

Export Processing Zone

The creation of the export processing zone in Cameroon in 1990 had as one of its principal objectives to attract foreign investment. We use a dummy variable to capture its influence on FDI flows into Cameroon. This variable will take the value one as from 1992 (the year the first investments were carried out), and zero elsewhere. We expect a positive link between the creation of the export processing zone and FDI in Cameroon, given the numerous incentives provided.

Regression Results

In order to avoid spurious regression that might result from running regressions with non-stationary variables, we study the time series characteristics of all the variables. A spurious regression will indicate a statistically significant relationship between variables in the model, when in fact this is just evidence of contemporaneous correlation. The Augmented Dickey–Fuller (ADF) test is used for this investigation. The results presented in Appendix Table 5.A2 show that most of our variables are non-stationary, but become stationary after a first difference. This implies that they have one unit root. Just one variable – inflation (derived as the annual percentage change in CPI) – is stationary in its level.

The fact that some of the variables are non-stationary implies that a regression with such variables may produce spurious results unless they are cointegrated. If two or more variables can be linked together to form an equilibrium relationship spanning the long run, then even though the variables themselves may contain stochastic trends they will nevertheless move closer over time and the difference between them will be stable. To test for cointegration, we run our regressions and apply the ADF test to the residuals. If the residuals are stationary, then we conclude for cointegration of the variables in the regression. The cointegration tests (ADF) are presented in Table 5.4 with the regression results.

Table 5.4: Determinants of FDI in Cameroon (OLS estimations)

Variables	Estimates and t-statistics (in parentheses)						
	1	2	3	4	5	6	7
Constant	-8.8249	-1.2498	10.9251	-15.9213	-5.0637	-14.1915	-16.2226
	(-0.3696)	(-0.0449)	(0.8584)	(-1.6094)	(-0.2058)	(-0.5357)	(-0.6312)
Per capita GDP	0.0627@	0.0532	0.1114@	0.0786@	0.0594	0.0601@	0.0841@
	(1.7945)	(1.4894)	(1.8972)	(1.8282)	(1.5723)	(1.7299)	(1.9540)
Openness	0.7730#	0.6673@	1.0223#	1.2335#	0.6624@	0.7606@	0.7749#
	(2.1129)	(1.8446)	(2.3532)	(2.6782)	(1.8257)	(2.0433)	(2.1037)
Infrastructure	19.5666*	20.2995*	19.9793*	18.2241*	20.5766*	17.3751#	16.0585#
	(3.6519)	(3.6362)	(3.6512)	(3.5984)	(3.6974)	(2.4519)	(2.3007)
GDP growth	...	0.3722@	...	...	...	...	...
		(1.8540)					
Political risk	...	...	-7.2228	...	...	...	...
			(-1.0945)				
Education	...	...	...	18.1028@	...	...	...
				(1.7922)			
Inflation	...	...	...	...	-0.4092	...	...
					(-0.7543)		
External debt	...	...	...	...	...	7.0925	...
						(0.5024)	
EPZ	...	...	...	...	...	...	10.3764
							(0.8142)
Lagged FDI	-0.0440	-0.0053	0.0001	-0.0234	-0.0127	-0.0009	-0.0302
	(-0.0221)	(-0.0260)	(0.0006)	(-0.1156)	(-0.0627)	(-0.0045)	(-0.1474)
Adj. R^2	0.6671	0.6576	0.6533	0.6559	0.6613	0.6568	0.6626
F-statistics	15.93*	12.14*	11.55*	11.29*	12.32*	12.10*	12.39*
	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)	(0.0000)
ADF	-3.6877*	-3.6754#	-3.7079*	-4.0202*	-3.6356#	-3.8010*	-3.6422#
	(-3.6852)	(-2.9705)	(-3.6959)	(-3.7076)	(-2.6348)	(-3.6852)	(-2.9705)

Notes: *, # and @ refer to significance at the 1, 5 and 10% levels. The numbers in parentheses below the parameter estimates are the t-statistics. For the ADF test, the critical values are in parentheses, while for the F-statistic, the p-values are in parentheses.

Column 1 of the table presents the results of our basic model. All the variables have the expected sign and are significant, apart from lagged FDI, which was meant to capture agglomeration or herding effects. These are variables that are generally significant in the FDI literature in developing countries. The significance of the basic variables is at varying levels, however. Market size (measured by per capita GDP) is only marginally significant at the 10% level, and it is not robust as it is insignificant in two of the seven estimations.[16] This marginal performance of market size can be explained by the aggregate nature of the FDI variable. While market size is important for market-seeking FDI, this is not the case for resource-seeking or vertical FDI. The output of resource-seeking foreign firms is exported back to the parent company and the local market is of little, if any, interest. A regression of market-seeking FDI on market size should produce significant and robust results for Cameroon.

The trade variable – openness – is significant for all the estimations. This implies that the more the economy of Cameroon is linked to the rest of the world through a liberalized trade and economic regime, the more FDI it will attract. The significance of this variable is not as strong as in some studies on developing countries, which can be attributed to the same reason as above, that is, the non-disaggregation of the FDI variable. The "protection jump" hypothesis holds that high trade barriers induce some market-oriented FDI. The openness of the economy should be a significant and robust determinant of vertical or export-oriented FDI.

The level of infrastructure development appears to be the most significant and robust determinant of FDI inflows to Cameroon. We measure infrastructure here as the first principal component of the ratio of paved roads and electricity production. A better road network and availability of sufficient electricity supply will facilitate and reduce the cost of doing business in Cameroon, and thus attract FDI inflows. Since the privatization of the electricity company (SONEL), however, consumption has exceeded production and for the past two years they have resorted to rationing. Unfortunately, we do not have the most recent data to assess its impact on FDI inflows. The growth of real GDP is also a significant determinant of FDI in Cameroon. Economic growth in Cameroon will thus attract foreign investment, which will reinforce the growth potentials of the economy. The quality of human capital as measured by the ratio of the population enrolled in secondary education is a significant factor in attracting FDI in Cameroon. This underscores the importance of an educated labour force in attracting foreign investors. Increasing the quality of human capital will attract foreign investors to Cameroon. Low-cost, low-skill labour will fail to attract high value-added industries (Noorbakhsh et al., 2001).

A number of other FDI determinants regularly used in the literature do not seem to have any significant effect on FDI in Cameroon. The political risk index has the expected negative sign, but is not significant. As measured by the two indexes of Freedom House, political rights and civil liberties have no effect on FDI inflows into Cameroon. These two indexes might be weak or narrow indicators of country or political risk. They measure only particular features of broader characteristics. Scores are based on subjective assessment. The insignificance might simply be due to the inability of the indexes to capture the political climate, rather than to the disregard of political risk by foreign investors. The inflation rate is also not significant, but has the expected negative sign. The debt burden fails even to have the expected negative sign. Other variables tried unsuccessfully, but not reported include the exchange rate, the wage rate (proxied by the CPI) and government consumption.

The dummy variable used to assess the influence of the export-processing zone on FDI has the right sign but is not significant. This ties in with our earlier conclusion that most of the firms benefiting from the export-processing regime were already in existence before the creation

of the zone. They merely moved from the existing investment regulations to the export-processing regime to reap the numerous privileges offered by the government. Little investment, and especially foreign investment, was actually created by the export-processing zone.

Generally, the FDI model performed satisfactorily, especially as all but one of our coefficients have the expected sign. The coefficient of lagged FDI is wrongly signed in four of our estimations. In terms of coefficient significance, however, some of our expectations were not met. The adjusted coefficients of determination show that the variables included succeeded in explaining at least 65% (adjusted R-squared) of the variation in FDI. The F-statistics for the overall significance of the regressions are all significant at the 1% level. The ADF test is equally significant in all the estimations, showing that the variables used in the regression are cointegrated despite being largely non-stationary.

Conclusion

This chapter has attempted to examine the evolution of FDI in Cameroon and identify the factors that have attracted FDI to Cameroon. The most recent data show an increasing trend for FDI in Cameroon, but Cameroon's FDI/GDP ratio still lags behind the sub-Saharan Africa average, and is even much lower than the average for all low-income countries. Cameroon has therefore not been very competitive in attracting FDI. An examination of the trend of net FDI flows to Cameroon shows a gradual increase in FDI during the post-independence period, followed by a surge in FDI during the oil boom, especially in the oil sector, but also in the other sectors of the economy. The severe economic crisis that plagued the country between 1986 and 1993 saw a drastic fall in FDI (net FDI was negative throughout this period). This resulted from a decline in the level of economic activity, failed reform attempts and political uncertainty. After the CFAF devaluation in 1994 and the successful implementation of some economic reforms, FDI was again on the rise. This has continued ever since, but still remains lower than the sub-Saharan African average.

Regarding the sectoral distribution of FDI, we have been able to obtain data only for nine years (1992/93–2001/02). The evolution has been in favour of the tertiary sector as against the secondary and primary sectors. Within this period, more than 45% of all FDI went to the tertiary sector and 34% to the secondary sector. These two sectors, which receive generally market-seeking FDI, get about 79% of all FDI to Cameroon. The primary sector has continuously attracted very little FDI, and the situation is worsening. The same sectoral trend is noticeable in terms of the number of FDI firms in the various sectors. An average of 15.75% of all the firms were either completely foreign owned or had foreign participation (at least 10%) within this period in Cameroon. The dominance of the service sector is confirmed as an average of about 51% of the foreign firms were in this sector during the period of analysis. The recent wave of privatization in the country can explain the flow of FDI to the service sector. A good number of the huge firms privatized were in the service sector, especially in transport and telecommunications. Most of the FDI is therefore not of the greenfield type, but most of the privatized firms have carried a lot of investments to modernize and increase their productive capacities. The historical ties with France make this country the main supplier of FDI to Cameroon; the United States of America is second.

The regulatory and institutional framework for investment in Cameroon from independence to 2002 has been provided by the Investment Code. Three Investment Codes and an Investment

Charter have been promulgated into law, each successive one trying to address the regulatory and institutional constraints facing investment and providing incentives to investors. Incentives offered have been in the form of tax holidays and custom duty exemptions, especially on imported capital equipment. The regulatory framework for investment in Cameroon has never been explicitly targeted at foreign investors. Rules are set for all types of investors.

The export processing zone experience has been a failure, not only in terms of attracting FDI, but also in terms of export promotion and employment despite the generous incentives provided. The effectiveness of the incentives was compromised by lengthy and restrictive bureaucratic procedures, limited powers of the body established to develop and operate the zone, and the government's reneging on promises. The EPZ scheme attracted very little investment, but the government bore a heavy fiscal cost.

Unlike the Investment Codes, the Investment Charter provides a regulatory and institutional framework that guarantees the security of investment, provides support to investors, and ensures fair and prompt settlement of investment-related, commercial and industrial conflicts. It does not list specific tax reductions or tariff exemptions as was the case with the Investment Codes, but it does aim to create an investment-friendly environment. Unfortunately, more than two years after its promulgation, its accompanying structures and texts of application have not been made known to the investor community, and its execution is still being awaited.

The regression analysis shows that the level of infrastructure development (increased electricity production and ratio of paved roads) appears as the most significant and robust determinant of FDI in Cameroon. The market size (GDP per capita), the openness of the economy to international trade, human capital development and the rate of economic growth are also important but to a lesser extent. The exchange rate, the level of political risk, the rate of inflation, the debt burden and the creation of an export-processing zone do not seem to have any influence on FDI in Cameroon. Agglomeration effects or herding behaviour are not equally important.

Our econometric analysis has relied on aggregate FDI data. A more disaggregated analysis of FDI into its various forms or sectors of destination would certainly have shed more light on FDI determinants in Cameroon. We do not have the most recent data on our variables to enable us to assess the impact of recent changes in the investment climate on FDI. Notwithstanding these shortcomings, a number of policy suggestions aimed at making Cameroon a more attractive FDI destination have come out of this study.

There is need for Cameroon to be competitive in attracting FDI. The first thing to do is to create a more investment-friendly environment. Improving the availability of infrastructure, opening up the country through trade, investing in education and promoting economic growth should be an important step in this direction. Incentives through tax holidays and custom exonerations do not seem to be a priority, but any promises of incentives made should be fully fulfilled. Reneging poses a serious problem about the credibility of future government policy commitments. Most FDI flows seem to be going to the tertiary sector. There is need for the government to encourage this, but not completely neglecting the other sectors. The creation of sectoral or even industry-specific codes should be helpful, as each sector or industry has its specific characteristics.

The texts of application of the Investment Charter should be published as soon as possible, since it provides the regulatory and institutional framework for investment in Cameroon, now and in the future. They should aim specifically at reducing the administrative bottlenecks that have plagued Cameroon for so many years, rather than emphasizing fiscal and custom incentives, as has been the case with the Investment Codes in the past. More autonomy should be granted to all institutions involved in the investment promotion process. As an example, the investment

promotion agency envisaged by the Investment Charter should be a quasi-governmental organization. That is, it should be funded by government but include those in the private sector and civil society and have autonomy in decision making. Its role should not be limited to investment facilitation, but should extend to research and promotion. The Investment Charter is a good document. The main issue is to ensure that it is fully implemented. In this respect, lessons should be learned from the failure of the free trade zone.

Cameroon is strategically well located among the CEMAC countries and has the most developed industrial base within the subregion. She stands to benefit most in terms of FDI inflows by encouraging economic integration in the subregion. Her bilingual nature is also an advantage that cannot be neglected.

Notes

[1] Data on ODA comes from OECD (DAC database).

[2] FDI/GDP ratios are taken from the World Bank's World Development Indicators 2001 CD-ROM.

[3] These arguments do not suggest that there are no demerits to FDI. Some scholars argue that FDI leads to the domination of the domestic economy by foreigners, neglects local capabilities, creates distortions in the domestic labour market by paying high wages, damages the environment, creates inequality between regions, crowds out domestic investment and lowers the productivity of domestic firms in the same industry – the so called "market stealing" effect through which foreign firms acquire market share at the expense of domestic firms. But the overall FDI picture is positive.

[4] Some of the structural adjustment loan conditionalities were aimed at promoting the investment climate: measures designed to eliminate constraints on economic opportunities, foster increased competition, and reduce inefficiency in the domestic market. The role of the state limited to providing an enabling environment for the private sector.

[5] According to the classification of the Department of Statistics of the Ministry of Finance, the primary sector is composed of the first six branches of the economy. The secondary takes from branch 7 to 24, while the tertiary consist of branches 25 to 30.

[6] Data on FDI stock and inflows for Cameroon are available online at http://stats.unctad.org/fdi/eng/tableViewer/wdsview/print.asp, while data on FDI source countries are obtained from UNCTAD WID Country Profiles: Cameroon.

[7] This organ was referred to in French as Office National des Zones Franches Industrielles – ONZI.

[8] This was the Cellule de Gestion du Code des Investissement (CGCI) in French. It has not become operational till today.

[9] It is important to note that none of the firms actually set up shop in the geographical area designated as the EPZ near the Douala seaport. They operated in what was referred to as export processing points (out of the EPZ), but fell under the same regime created for the EPZ. This created an additional problem of assuring that not more than 20% of the output was sold in the local market. Widespread corruption made the task even more difficult.

[10] The US law was enacted in response to campaigns by American labour groups who accused government institutions of using taxpayer money to "export American jobs abroad" and helping foreign competition push US workers out of their jobs (Madani, 1999).

[11] Some factors are likely to affect all types of FDI, but the different strategic objectives implicit in horizontal and vertical FDI, suggest that certain factors may affect one type of FDI more than the other.

[12] Campos and Kinoshita (2003: 6) add a third type of FDI known as efficiency-seeking FDI. This occurs when a firm can gain from the common governance of geographically dispersed activities in the presence of economies of scale and scope.

[13] Chunlai (1997) provides a summary of some of these FDI theories.

[14] Researchers regularly use measures of the hospitality (or riskiness) of the business environment designed by institutions like Freedom House, Transparency International, Business Environment Risk Intelligence (BERI), Heritage Foundation, World Economic Forum and others. Such measures are a combination of several factors believed to be related to business risk.

[15] These indexes can be obtained online from http://www.freedomhouse.org/ratings/allscore04.xls.

[16] A number of studies have even found market size to be negatively related to FDI: Edwards (1990) and Jaspersen et al. (2000).

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Appendix

Table 5.A1: Sectoral distribution of firms operating with FDI (1992/93–2001/02)

	Total number of registered firms	Firms with FDI[a] (per cent in parentheses)	Firms with FDI in each sector (per cent)		
			Primary	Secondary	Tertiary
92/93	1,519	209 (13.76)	6.22	33.49	60.29
93/94	1,509	190 (12.59)	6.84	34.21	58.95
94/95	1,480	199 (13.45)	7.54	33.67	58.79
96/97	1,470	236 (16.05)	7.63	35.59	56.78
97/98	1,439	237 (16.47)	7.17	60.76	32.07
98/99	1,776	264 (14.86)	6.44	58.33	35.23
99/00	1,746	284 (16.27)	6.34	60.21	33.45
00/01	1,866	286 (17.24)	6.99	35.31	57.69
01/02	1,659	350 (21.10)	5.71	30.29	64.00

[a] These are firms with at least 10% foreign ownership.
Source: Constructed using data from MINFIB/DSCN (2004).

Table 5.A2: Unit root test results using the ADF test

Variables	ADF statistics	Critical value	Order of integration	Level of significance (per cent)
FDI	-5.2737	-3.6852	1	1
GDP per capita	-2.6847	-2.6242	1	10
Openness	-4.1050	-3.6852	1	1
Growth rate	-6.1394	-3.6661	1	1
Political risk	-4.9743	-3.7076	1	1
Exchange rate	-3.7466	-3.6852	1	1
Inflation	-2.9652	-2.6242	0	10
Wage rate	-3.4997	-2.9627	1	5
Secondary enrolment	-2.7571	-2.6318	1	10
Infrastructure	-2.7666	-2.6265	1	10
External debt	-4.9765	-3.6852	1	1

Foreign Direct Investment Flows To Ghana

Yaw Asante

Since 1994, the government of Ghana has been making strenuous efforts – through institutional and legal frameworks, forums, and promotional campaigns – to encourage foreign direct investment (FDI) inflows to Ghana. The importance of FDI in eradicating poverty is echoed in the New Partnership for Africa's Development (NEPAD) declaration, which stipulates that in order for the continent to achieve the Millennium Development Goals (MDGs), Africa needs to fill an annual resource gap of US$64 billion, about 12% of GDP. Since income levels and domestic savings in the region are low, the bulk of the resources needed will have to come from abroad: from official sources (finance from multilateral organizations such as the World Bank); foreign indirect investment (which includes portfolio investments, bond finance and bank lending); or FDI.

The first of these, official assistance to the region, has been declining. For example, net official development assistance to sub-Saharan Africa (SSA) fell from US$17 billion in 1990 to US$10 billion in 2001, a decrease of about 41% (World Bank, 2003). In addition, foreign indirect investment is unavailable to most African countries, since most of the countries in the region cannot raise funds from international capital markets. As a consequence, the bulk of the external resources needed for poverty alleviation has to come from FDI. There has been little analysis of FDI flows to SSA in general, however, and to Ghana in particular.

The study thus seeks to analyse the following:
- The various types of FDI in Ghana and the relative magnitudes of the components.
- The destination of FDI among the sectors of the economy.
- The economic, political and other factors that might influence this sectoral allocation.

The economic attractiveness of a country for FDI depends primarily on the country's advantages as a location for investors of various types. There are, for example, market-seeking and non market-seeking FDI flows. Market-seeking investors look for large and growing markets and income of the host country. Non market-seeking FDI mainly entails producing in the host country and selling the product output outside the country. This is made up of resource-seeking ones, which look for ample natural resources, and efficiency-seeking types, which look for a competitive and efficient base for export production.

More general factors affect all prospective host economies: political stability, a sound macroeconomic framework, welcoming attitudes to foreign investors, adequate skills, low business transaction costs, good infrastructure and the like. Given these factors, it is still useful

to use promotional policies to attract FDI, particularly as competition for FDI mounts and investors become choosier. How much promotion is needed depends on the kind of FDI and the basic attractions of a host economy. A large and dynamic economy needs to promote itself less than a small and less dynamic one. If the economic base is weak or unstable, no amount of persuasion will attract large and sustained FDI inflows. A small and poor African country, like Ghana, is unlikely to attract the market-seeking type of FDI.

Determinants of FDI in Developing Countries

There is a large literature on the determinants of FDI flows across countries. The overall conclusion of this literature is that FDI will be attracted to those countries that provide a sufficiently high rate of return. These are countries that exhibit substantial macroeconomic and political stability, and therefore have favourable growth prospects. In addition, countries that attract FDI are likely to possess good infrastructure and legal systems (including the enforceability of contracts); a skilled labour force; and a liberalized foreign sector. Important as well is the availability of a large domestic market and natural endowments. Determinants of FDI, therefore, include the openness of the host country; political risk, measured for example by a country's credit rating; financial depth; government size, as represented by the ratio of government's consumption to GDP, for example; and the economic growth as a measure of the attractiveness of the host country's market. A study by Tsikata, Asante and Gyasi (2000) showed that the following factors were significant determinants of FDI to Ghana over the period of the study (1970–1997): trade regime, democratic governance, investment climate, economic uncertainty and raw material availability (because the mining sector is ore-dependent). Yet, recent literature also suggests that the responsiveness of FDI to the traditional variables, such as the rate of return on investment, infrastructure and openness, may be lower for SSA than for non-SSA countries.

The relative influence of the various determinants of FDI will also vary with the type of FDI. One or several of the following major categories of FDI have been attracted to sub-Saharan Africa (SSA):

- Investments to exploit natural resources.
- Investments that are attracted by other "specific" locational advantages.
- Investments resulting from the host country's active investment policies to attract FDI.
- Investments that respond to economic and structural reforms, including privatization.

Trends in FDI Flows to Ghana

Since the 1970s, Ghana has had a long, though modest, history of FDI. In the 1970s, FDI was mainly in import-substitution manufacturing. In 1970, annual inflows were as high as US$68 million but declined to US$11.5 million in 1972. (Refer to Figure 6.1 for the trends in FDI flows.) The decline in 1972 was probably due to the negative economic growth rate of 2.1% in 1972 from a positive growth rate of 5.6% in 1971.

FDI increased from then to US$71 million in 1975 only to sink to -US$18.3 million in 1976 (a decline of 125.8%). This decline followed the world FDI downturn of 21% (UNCTAD, 2003). An important feature of FDI is the three-way nexus of economic growth, investment and political stability that has emerged since 1972.

Figure 6.1:   FDI inflows to Ghana
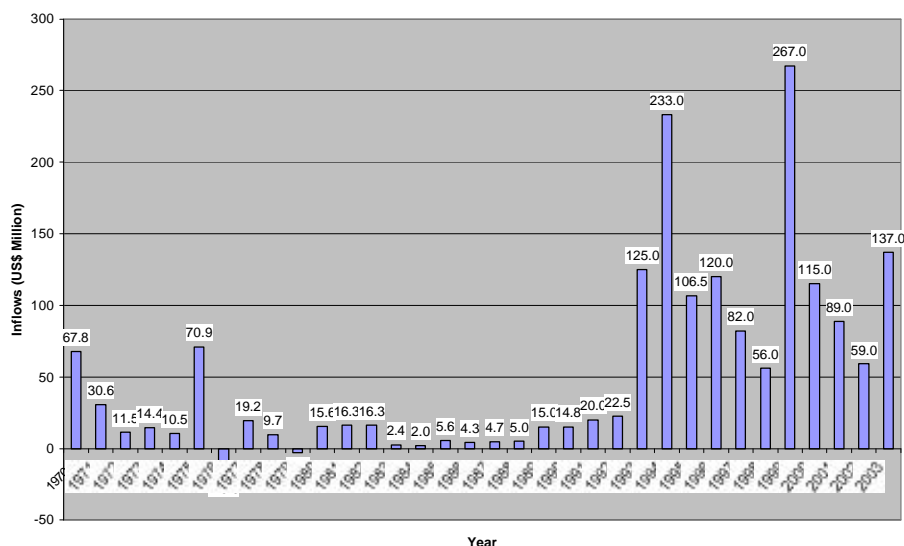
Source: *International Financial Statistics Yearbook* (various issues).

In 1979, when Rawlings first seized power and adopted a radical and anti-business stance, economic growth fell to -3.2% and there was an FDI outflow of US$2.8 million. Since the advent of the Economic Recovery Programme (ERP) in 1983, four phases of FDI flows can be distinguished:

- *1983–1988* was a period of sluggish inflows, averaging US$4 million per annum, the highest and lowest inflows being US$5.6 million in 1985 and US$2 million in 1984, respectively.

- *1989–1992* recorded moderate inflows averaging US$18 million per annum, the highest and lowest being US$22.5 million in 1992 and US$14.8 million in 1990, respectively.

- *1993–1996* was a period of significant (remaining in three digits) inflows, which reached US$233 million in 1994 (with the privatization of Ashanti Goldfields Company – AGC), but slid to US$106.5 million in 1995 before coming back to US$120 million in 1996.

- *1997–2003* saw flows oscillating, decreasing from US$82 million in 1997 to US$56 million in 1998 (the lowest over the 1993–2003 period), then peaking at US$267 million in 1999 before falling to US$115 million the following year. FDI dropped further to US$89 million and US$50 million, respectively, in 2001 and 2002 owing to the effect of the September 2001 attack on the United States (and the consequent global FDI drop of 41% in 2001 and 21% in 2002; UNCTAD, 2003). In 2003, the FDI recovery to US$137 million was due to a massive boost in FDI with the merger of Ashanti Goldfields and Anglogold and the beginning of a US$400 million gold mine investment by the US firm, Newmont (ISSER, 2004).

Comparison with Other African Countries

Table 6.1 compares FDI inflows into Ghana with selected African countries. Between 1991 and 1996, Ghana's average FDI inflows ranked fourth below those of Nigeria, Côte d'Ivoire and Zambia. In 1997, the ranking as well as the absolute value declined to ninth and US$82 million, respectively. Both indicators declined further in 1998 to tenth and US$56 million, respectively. In 1999 when Ghana's FDI inflow was at its peak since the 1970s, Ghana's ranking improved to third; in 2002 it was ranked eighth.

Table 6.1:   FDI into selected African countries (US$ million)

Country	1991–96 average	1997	1998	1999	2000	2001	2002
Botswana	-28	100	90	37	54	26	37
Burkina Faso	9	13	10	13	23	9	8
Cameroon	9	45	50	40	31	67	86
DRC	3	-44	61	11	23	1	32
Côte d'Ivoire	158	450	416	381	235	44	223
Ethiopia	10	288	261	70	135	20	75
Gambia	12	21	24	49	44	35	43
Ghana	105	82	56	267	115	89	50
Kenya	13	40	42	42	127	50	50
Mali	29	74	36	51	83	122	102
Nigeria	1,264	1,539	1,051	1,005	930	1,104	1,281
Senegal	20	176	71	136	63	32	93
Togo	11	23	42	70	42	63	75
Uganda	65	175	210	222	254	229	275
Zambia	108	207	198	163	122	72	197
Zimbabwe	50	135	444	59	23	4	26

Source: World Investment Report 2003 (UNCTAD, 2003).

Table 6.2 shows the rankings for the top 20 African countries for FDI inflows. With an average annual inflow of US$105 million between 1991 and 1996, Ghana was ranked among the top ten African countries in attracting FDI. That top ranking was short-lived, however. Between 1997 and 2002, Ghana slipped to twentieth position. The table reveals that even though Ghana's average inflows increased marginally from US$105 million to US$110 million, this was largely due to the peak value of US$267 million recorded in 1999.

All the countries that were ranked above Ghana between 1991 and 1996 were also ranked above her between 1997 and 2002. Out of the ten countries that were ranked below Ghana between 1991 and 1996, seven moved ahead between 1997 and 2002. Congo, Equatorial Guinea, Uganda, Algeria, Tanzania, Zimbabwe and Mozambique were all ranked lower than Ghana between 1991 and 1996 butall were ranked higher between 1997 and 2002. As the World Bank (2001: 6) observed, "While Ghana is perceived as an attractive FDI location by transnational firms – ranking sixth among African countries in the 1999/2000 UNCTAD survey – it has not realized commensurate inflows in comparison with the region or other developing countries". This is an indication of the competitiveness of the FDI environment and Ghana's loss of attractiveness as an FDI destination in favour of other African countries.

Table 6.2:   Top 20 African countries for FDI inflows (US$ million)

Country	Annual average (1991–1996)	Rank	Annual average (1997–2002)	Rank
Nigeria	1,264	1	1,152	3
Egypt	714	2	903	5
South Africa	450	3	2385	1
Tunisia	425	4	581	7
Morocco	406	5	1,107	4
Angola	346	6	1,389	2
Côte d'Ivoire	158	7	292	11
Namibia	112	8	147	17
Zambia	108	9	160	16
Ghana	105	10	110	20
Congo	86	11	187	14
Equatorial Guinea	66	12	329	9
Uganda	65	13	228	13
Algeria	63	14	661	4
Tanzania	63	15	313	10
Swaziland	62	16	77	23
Zimbabwe	50	17	115	19
Benin	41	18	45	31
Mozambique	39	19	247	12
Eritrea	37	20	54	28

Source: World Investment Report 2003 (UNCTAD, 2003).

Thus, Ghana must aspire to be competitive on the global market if it is aimed at being the "Gateway to the West African subregion". Macroeconomic policies are extremely important for international competitiveness, but getting prices "right" is not the whole story. It takes a supportive microeconomic environment to create sufficient conditions for success. For example, poorly designed regulations, taxes and sector policies, as well as time-consuming bureaucratic procedures, can raise the transaction costs of doing business and deter both local and foreign investors. While much has been achieved in the area of macroeconomic and trade policy reforms, serious questions remain as to whether a supportive microeconomic environment is yet in place to achieve the competitiveness required to attract investors to Ghana.

Types of FDI into Ghana

Ghana, being a small developing African country, has attracted the non-market seeking type of FDI. The major categories of FDI attracted into Ghana have been lured by natural resources and active promotional campaigns, plus structural reforms and privatizations.

Investments to Exploit Natural Resources
The mining sector, mainly gold, has become almost synonymous with FDI in Ghana, but it had gradually deteriorated prior to the Economic Recovery Programme (ERP). The several reasons identified for this include shortages of foreign exchange to maintain and rehabilitate the mines; lack of capital investments for exploration and development; poor management and lack of mining skills; infrastructure deterioration, particularly shortage of rail capacity for manganese

and bauxite; mining company financial problems due to the over-valued currency and spiralling inflation; a declining grade of gold ore; and smuggling of gold and diamonds (Tsikata et al., 2000). FDI could therefore have played a major role in arresting several of the problems identified, especially the dual problems of foreign exchange strangulation and shortage of the requisite mining expertise. For example, in the gold mining industry, long distances had to be travelled underground to reach work sites due to lack of investment in existing and new shafts.

But it was the fiscal policy regime that imposed the severest strain on the development of investment flow to the sector, in particular the gold mining subsector. Three main fiscal changes affecting the sector were implemented during the ERP era: reduction in minimum royalties from 6% to 3%; reduction in corporate tax from 55% to 35% ; and tax exemption for imported plant and equipment. The privatization of AGC by the government was also presumably aimed at sending signals that it was prepared to encourage the participation of the private (including foreign) sector. There is no doubt that policies and funding under the ERP have enabled a strong upturn in the mining sector. Data from the Minerals Commission, however, just describe the financing structure of the mining sector, and do not indicate what component is FDI. Since 2000, there has been an upward trend in the financing structure and part of this is undoubtedly from FDIall (Table 6.3).

Table 6.3:   Financing structure of the mining sector, excluding prospecting companies (US$ million)

Year	Equity	Senior debt	Shareholder debt	Total
1990	18.5	159.1	90.9	268.5
1991	9.9	18.3	59.0	87.2
1992	153.0	155.0	113.3	421.3
1993	1.1	5.7	0.0	6.8
1994	3.0	0.0	7.1	10.1
1995	7.3	2.4	14.2	23.9
1996	11.0	0.0	68.7	79.7
1997	19.9	60.8	137.5	218.2
1998	27.6	131.8	13.4	172.8
1999	35.3	41.2	77.3	153.8
2000	7.8	15.1	6.3	29.2
2001	28.5	50.1	30.0	108.6
2002	40.5	45.0	25.0	110.5
2003	20.6	60.2	75.0	155.8

Note: Senior debt is debt ranked ahead of other debt. It has priority if debt has to be redeemed in case of liquidation.
Source: Minerals Commission.

According to the state of the Ghanaian economy in 2003 (ISSER, 2004), mining companies have expressed concerns about problems that have an adverse effect on their operations. These include bureaucratic delays in dealings with the Bank of Ghana as well as a number of tax issues. Besides the volatility of world market prices for gold and other major minerals, the emergence of countries such as Zimbabwe, Mali and Tanzania as competitor countries has contributed to the loss of attractiveness of Ghana as a destination for mining investment. Licences issued to companies prospecting for new minerals dwindled from 62 in 1997 to 5 in 2001. The year 2003, however, witnessed a massive boost in expected inflows with the opening of a gold mine by Newmont and the promise of about US$450 million in investment over a long period.

With the exception of Newmont, no new mine has been commissioned since 1996 and work is well under way to revise legislation to improve incentives for new investment in the sector. FDI in 2003 increased to US$137 million from a low of US$59 million in 2002.

Investments Resulting from Ghana's Active Policies to attract FDI

A number of measures have been taken to improve the investment climate. These include investment incentives spelled out in a range of investment codes. The first was the Pioneer and Companies Act of 1959. This was followed by the Capital Investment Act of 1963 (Act 172), which sought to encourage foreign investment. The 1973 Investment Decree (NRCD 141) and Investment Policy Decree NRCD 329 of 1975, unlike the 1963 Act, was to encourage both local and foreign investors. The 1981 Investment Code (Act 437) sought to centralize investment promotion functions at the Capital Investment Board and consolidate all investment legislation. The 1985 Investment Code (PNDCL 116) established the Ghana Investment Centre as the Central Investment Promotion Agency.

All these investment codes attempted to provide a favourable investment climate by offering incentives to boost private investment. The incentives generally provided included tax holidays, accelerated depreciation allowances, exemption for import duties on machinery and equipment, investment allowances, and arrangements for profit repatriation. The need for constant review of the codes reflects the lack of the expected response to the various codes. Inflows remained sluggish, averaging US$4 million per annum between 1983 and 1988 (Figure 6.1).

Other measures taken in recent years to improve the investment climate include gradual removal of administrative and other bottlenecks and review of the tax structure as it relates to private investment, e.g., reduction of corporate tax to 45% maximum (1991) from 55% previously, for some enterprises. Retention accounts (and foreign accounts) were established for individual companies for retention of a portion of revenues earned from exports to finance imports of essential spare parts and raw materials or machinery, while credit expansion in 1987 and 1988 aimed to ensure adequate financial support for the priority sectors of the economy. Finally, a major step was the liberalization of the financial system.

On 29 April 1988, Ghana ratified the convention establishing the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. MIGA intends to encourage equity investment and other forms of foreign direct investment (FDI) in developing countries by reducing non-commercial risk. In effect, the MIGA Convention seeks to provide an insurance cover for foreign investors who participate in eligible investments in the productive sectors of the economy of developing countries. Despite the assurance of Ghana's investment guarantee under the Investment Code and the MIGA Convention, some countries still insist on bilateral investment promotion and protection agreements (IPPAs) with Ghana. Thus, the government has entered into bilateral IPPAs with a number a number of countries to further enhance the protection and security of the investment regime. (see Ghana Investments Centre, 1991). Ghana has also expanded the scope for FDI by reducing the number of industries closed to foreign investors.

The Ghana Investments Promotion Centre (GIPC) was set up under the GIPC Act of 1994 with the main objective of encouraging and promoting investment. The Act revised and consolidated the 1985 Investment Code to place more emphasis on private sector investments as an important element of accelerated economic growth. According to the Act, the existing code was oriented towards regulation and did not encourage the investment centre to engage in promotional activities. Also, the attitude of government has changed over time with a more favourable climate now than in the early 1980s. As part of the measures taken to make credit more readily available to the private sector, Ghana began a process of liberalizing its financial

system. Specifically, a financial sector adjustment programme (FINSAP), was initiated and a number of institutional and policy reforms were carried out that culminated in the liberalization of the financial sector by the beginning of 1989. The response was a moderate inflow between 1989 and 1992 and a significant inflow between 1993 and 1996 – with the inflow reaching US$233 million in 1994 when the GIPC was set up and the Government put Ashanti Goldfields (AGC) on the market (partial sale of AGC to the South African mining company, Lonmin).

The Free Zones Scheme and FDI Flows

In September 1995, Parliament promulgated the Free Zones Act to accelerate the exploitation of the country's general export potential. The Ghana Free Zones Board (GFZB) was accordingly established to assist and monitor the activities of export processing zones (EPZs) to be set up in the country. EPZs provide buildings and services for manufacturing, i.e., transformation of imported raw and intermediate materials into finished product, usually for export but sometimes partly for domestic sale subject to the normal duty. The EPZ is thus a specialized industrial estate located physically and/or administratively outside the customs barrier, oriented to export production. Its facilities serve as a showcase to attract investors, and as a convenience for their getting established, and are usually associated with other incentives.

A key objective of the Act was the attraction of FDI. To this end, an extensive package of incentives was offered, including the following:

*   Exemption of free zone developers from income or profit tax for 10 years;
*   Income tax after ten-year tax holiday, not to exceed a maximum of 8%;
*   Exemption from withholding taxes on dividends emanating from free zone investments;
*   Freedom for a foreign investor to hold a 100% share in any free zone enterprise; and
*   Various guarantees in respect of repatriation of profits and against unreasonable nationalization of assets.

Since 1995, as shown in Table 6.4, non-traditional exports (NTEs) have increased from US$159.7 million in 1995 to US$417.5 million in 2001. This could be partly attributable to establishment of the EPZs. Given the importance of increasing market size and providing scale to attract FDI to Africa, efforts at regional integration continue to be important. The New Partnership for Africa's Development (NEPAD) could be important in this direction. Since the new government assumed power in 2001, Ghana has set up a Ministry for Regional Integration and NEPAD.

Table 6.4:   Performance of non-traditional exports (US$ million)

Year	1994	1995	1996	1997	1998	1999	2000	2001
Amount	119.3	159.7	276.2	329.1	401.7	404.4	400.7	417.5

Source: Ghana Export Promotion Council data.

Ghana's Gateway Programme

In 1998, The Government of Ghana launched the Gateway Programme with the objective of promoting Ghana as the trade and investment centre of West Africa. The strategy emphasizes export processing zones and foreign investment as the main instruments for export development in the medium term. The objective is to reorient the frontline institutions – Customs, Excise and Preventive Services (CEPS), Ghana Ports and Harbours Authority, and the Ghana Civil

Aviation Authority – to play a more facilitating role to promote private sector businesses. In this way the programme seeks to attract investors to set up financial, banking, telecommunication and transport services in the country and thus transform Ghana into a regional economic hub.

The first phase of the programme is focusing on developing three export free zone enclaves by private operators with the Government providing off-site infrastructure. One intention is to improve frontline public services related to trade and investment by raising customs and immigration services, the ports and airport authorities, and the Environmental Protection Agency to ISO 9000 and International Chamber of Commerce (ICC) standards. The programme is also shifting towards targeted investment promotion by GIPC and the Free Zones Board and divesting from and expanding port and airport infrastructure to accommodate growing traffic in goods and passengers. The second phase will upgrade the other promotional agencies – Ghana Exports Promotion Centre (GEPC) and the Ghana Tourist Board – with a focus on the export of services.

Investments in Response to Structural Reforms, including Privatization

Ghana embarked on an Economic Recovery Programme in April 1983 to arrest the deterioration that had plagued the economy. The previous decade had been characterized by a plethora of instruments that restricted trade and adversely affected economic growth. These included the use of import licences and other non-tariff barriers to control imports and achieve balance of payments and import-substitution objectives. The launching of the ERP (which was predicated on an export-led strategy) changed the macroeconomic and incentive frameworks within which industry had to operate. There has been a substantial improvement in the trade regime with the reduction in the anti-export bias. The exchange rate policies pursued since 1984 have ensured substantial depreciation of the real exchange rate. The import control system has been completely liberalized and significant tariff cuts have been implemented. Since 1988 the export promotion programme has been made more attractive. FDI response was marginal, averaging US$4 million between 1983 and 1988.

Privatization in Ghana arose because of the poor financial performance and low productivity that characterized many of the state-owned enterprises (SOEs), culminating in huge financial losses to the state. The total operating deficit of the public enterprises in 1982 amounted to 3% of GDP, which was not much less than total government spending on education, health, social security and welfare in that year (Tangri, 1991: 254). Public enterprises had also become a significant drain on the government budget. Support for them ranged from 10% of government expenditure in 1982 to 8% in 1986. Between 1985 and 1989, the annual outflow from government to 14 core SOEs averaged 2% of GDP. The programme was started in 1988 after an intensive study conducted by the government revealed a disturbing array of problems plaguing the public sector, including the following:
- Constraints attributable to inadequacies, inconsistencies and lack of clarity of government policies on the SOE sector.
- Excessive political interference in the day-to-day operations of the enterprises.
- Inadequate capitalization and working capital.
- Lack of adequate incentives to stimulate higher performance and productivity.
- Lack of entrepreneurship direction and momentum

The divestiture programme got under way in terms of results in 1990/91. By 31 December 1997, the government had authorized 201 divestments of companies or divisions of companies. The breakdown, on a yearly basis, highlighting the mode of divestiture, is shown in Table 6.5.

Table 6.5: Approved enterprises for divestiture

Mode	To 1991	1992	1993	1994	1995	1996	1997	Total
Outright sale	16	4	3	30	19	18	15	105
Sale of shares	11	5	2	2	6	1	2	29
Joint venture	6	3	1	4	0	4	1	19
Lease	3	1	0	1	0	0	1	6
Liquidation	24	2	5	5	6	0	0	42
Total	60	15	11	42	31	23	19	201

Source: Divestiture Implementation Committee (1997).

FDI seemed to have responded positively to the privatization, as inflows increased from US$5 million in 1988 to US$15 million in 1989 and were moderate compared with the initial period of the ERP. Privatization of Ashanti Goldfields Company (AGC) also took place in April 1994; the Government of Ghana sold 18.8 million of its 44 million shares for about US$350 million. In January 1996, the government sold an additional 5.1 million shares for about US$112 million. In the same year (1996) Telecom Malaysia bought 30% of the shares of the then state-owned Ghana Telecom. Ghana has also been implementing reforms of the telecommunications subsector since 1996 aimed at expanding access to telephone facilities. Even though Ghana Telecom remains the main player in the telecommunications subsector, it commenced some form of privatization in 1997. Between 1997 and 2001, Ghana Telecom succeeded in increasing the number of fixed telephone lines from 100,932 to 199,934 (an annual average increase of about 19%). In addition to Ghana Telecom, there are two other fixed network operators, Western Telesystems Limited (Westel) and Capital Telecom.

Liberalization of the telecommunications subsector and increased competition has resulted in greater access to communications services since 1997. FDI responded positively to these privatizations by increasing to US$233 million in 1994 and US$120 million in 1996 (Figure 6.1).

From 1994 to 1998, agro-processed non-traditional exports (NTEs) grew by 26% per annum. To a large extent, this reflected the rapid takeoff of canned tuna exports, following a successful joint venture with Heinz (World Bank, 2001). In 1999, canned tuna alone contributed one-fifth of total NTEs (refer to Table 6.6). Between 1995 and 2000, tuna exports accounted for an average of over 90% of the exports of prepared foods and beverages. The cocoa butter subsector also gained new impetus following the privatization in 1993 of two state-owned factories to a German firm. As a result of investments by the privatized firm, processing capacity increased by 55,000 tons of cocoa beans, adding to the 25,000-ton capacity of another (state-owned) firm.

Table 6.6: FDI in selected non-traditional export categories in 1999 (US$ million)

Product	Amount
Canned tuna	61.20
Cocoa products	40.63
Other manufactures	14.53
Processed agricultural products	5.15
Agricultural products including fish	7.20
Wood products	4.34
Total for all NTEs	138.80

Source: World Bank (2001, Table 9).

Even though NTEs constitute a small percentage of total exports the investments following these privatizations are partly responsible for the large values of FDI between 1993 and 1996. Key export-oriented projects that have taken off since the mid 1990s include Pioneer Food Cannery (a Heinz joint venture canning tuna with US$31 million investment), West African Mills (US$57 million in cocoa processing) and Carson Products (US$10 million). These investments accounted for the high level of FDI in 1999. According to the World Bank (2001: 14), "FDI has played a major role in the recent growth of NTEs. Exports by foreign firms accounted for 75% of the increase in earnings recorded over the 1993–1999 period and approximately 34% of the value of NTEs in 1999".

Investment Patterns in Response to AGOA

From its inception in October 2000 to the end of 2002 the track record of the African Growth and Opportunity Act (AGOA) showed that the most widely distributed sector to benefit directly has been the textile-clothing pipeline. More countries have benefited from apparel exports under AGOA than any other sector whose output qualifies for preferential access to the US market under this act. Many of the investments are by Asian multinational corporations in Kenya, Lesotho and Mauritius. In just two years AGOA helped stimulate FDI of US$12.8 million in Kenya and US$78 million in Mauritius (World Investment Report, 2003). AGOA has not been a major driving force in attracting FDI to Ghana. Exporters acknowledge that Ghana has a low nominal wage rate, but the question arises as to whether unit labour costs in the textile and garments sector are internationally competitive. This concern revolves around the comparative wage–productivity ratio in labour-intensive industries like textiles and garments (World Bank, 2001).

Registration of Projects at GIPC

The Investment Code requires registration of FDIs with the Ghana Investment Promotion Centre[1] (GIPC) mainly to verify the minimum investments required by law. Table 6.7 shows the registration of projects with foreign interests between 1995 and 2003. The total number of registered projects increased from 149 (estimated at US$182.3 million) in 1995 to a peak of 234 projects (estimated at US$631.6 million) in 1997. Thereafter, the number of projects fluctuated but with declining trend to 138 projects valued at US$65 million in 2002. Between 1995 and 2003, an average number of 177 projects were registered per annum, with the services sector recording the highest average of 50 projects, followed by manufacturing with 47 projects and tourism with 20 (Table 6.7).

The high FDI in services (both in value and number of projects) is in line with global trends. The global FDI increase in services partly reflects the ascendancy of services in economies more generally: by 2001, this sector accounted, on average, for 72% of GDP in developed countries, 52% in developing countries, and 57% in Central and Eastern Europe countries (UNCTAD, 2004). In Ghana, the share of services in GDP increased from 28% in 1996 to 30% in 2003 and it has been the fastest growing sector over the past decade. In addition, countries have liberalized their services FDI regimes, which has made larger inflows possible, especially in countries previously closed to foreign entry. Firms have reacted by expanding their service production abroad.

Table 6.7: Number of projects registered by GIPC

	Manuf.	Services	Tourism	Agric.	Build-ing & const.	Export trade	General trade	Liaison office	Total
1995	45	37	11	11	12	21	3	9	149
	(30.2)	(24.8)	(7.4)	(7.4)	(8.1)	(14.1)	(2.0)	(6.0)	
1996	58	45	15	17	20	18	8	11	192
	(30.2)	(23.4)	(8.9)	(8.9)	(10.4)	(9.4)	(4.2)	(5.7)	
1997	67	57	31	15	17	14	17	16	234
	(28.6)	(24.4)	(13.3)	(6.4)	(7.3)	(6.0)	(7.3)	(6.8)	
1998	39	49	27	20	17	7	20	11	190
	(20.5)	(25.8)	(14.2)	(10.5)	(9.0)	(3.7)	(10.5)	(5.8)	
1999	44	59	29	14	14	9	18	11	198
	(22.2)	(29.8)	(14.7)	(7.1)	(7.1)	(4.6)	(9.1)	(5.6)	
2000	44	64	15	8	11	9	14	0	165
	(26.7)	(38.8)	(9.1)	(4.9)	(6.7)	(5.5)	(8.5)	(0.0)	
2001*	45	59	19	15	10	8	15	0	171
	(26.3)	(34.5)	(11.1)	(8.8)	(5.9)	(4.7)	(8.8)	(0.0)	
2002*	42	37	17	14	9	2	17	0	138
	(30.4)	(26.8)	(12.3)	(10.1)	(6.5)	(1.5)	(12.3)	(0.0)	
2003*	42)	39	19	12	10	6	24	0	152
	(27.6	(25.7)	(12.5)	(7.9)	(6.6)	(4.0)	(15.8)	(0.0)	
Ave.	47	50	20	14	13	10	15	16	177
	(27.0)	(28.2)	(11.4)	(8.0)	(7.5)	(5.9)	(8.7)	(6.0)	

Notes: Figures in parentheses are percentages of total number for the year.
      * Provisional.
Source: Ghana Investment Promotion Centre and author's calculations.

In Ghana, the liberalization of the services sector contributed to the number and value of projects in the services subsector. In the case of manufacturing, FDI into processed NTEs, especially tuna and cocoa products, was partly responsible for the number and value of projects. In the case of tourism, it is government policy to develop Ghana into an internationally competitive tourist destination. In this direction, a series of courses and workshops was designed to improve the operations of the hospitality industry throughout the country. Thus, the tourism industry continues to witness tremendous development as government exploits its potential through the 15-year master plan for tourism development that was initiated in 1996. The master plan seeks to alert the private sector as well as government agencies dealing with infrastructure necessary for the tourism subsector, and to identify the opportunities and programme developments that are necessary for the subsector. The Ghana Tourist Board also continues to carry out promotional activities designed to make Ghana a pristine destination. The Board's promotional activities have included the monitoring and evaluation of selected tourism plans in the country, the organization of festivals and celebrations.

The analysis of the registered projects for 2001, 2002 and 2003 shows an encouraging trend: a gradual but sure recovery after the effects of the events of 11 September 2001. In 2001, a total of 171 projects valued at US$97.30 million was recorded, while in 2002 (the year in which the full effect of the 11 September 2001 event was manifest) 138 projects valued at US$65.13 million was recorded. In terms of the estimated value of registered projects in 2003, services topped with US$69.2 million with manufacturing having an estimated value of only US$21.9 million and tourism US$4 million. Tables 6.7 and 6.8 show that the effect of 11

September 2001 fell more heavily on the services, tourism and export trade sectors. Both the number and value of registered projects fell in 2002 (when the full impact of 11 September was felt). The number of services projects registered declined from 59 in 2001 to 37 in 2002; that of tourism declined from 19 to 17; and export trade declined from 8 to 2. In terms of estimated value of projects, services declined from US$49.8 million in 2001 to US$7.9 million in 2002; that of tourism from US$5.3 million to US$3.7 million; and export trade from US$4.7 million to US$0.1 million. The severe impact on these sectors is partly due to the reversible nature of the activities, compared with the irreversibility associated with activities like manufacturing, agriculture, and building and construction (which were not so adversely affected).

Table 6.8:   Registered projects at GIPC (US$ million)

Year	Manuf.	Services	Tourism	Agric.	Building & const.	Export trade	General trade	Total
1995	76.1	65.2	2.5	19.9	14.1	2.3	2.3	182.3
1996	54.8	146.5	1.5	5.5	38.7	1.2	5.9	254.2
1997	100.5	435.4	4.0	60.0	9.2	1.3	21.2	631.6
1998	29.1	44.5	7.4	40.3	16.6	2.0	29.3	169.3
1999	19.2	130.5	6.7	41.6	24.4	0.7	10.8	233.8
2000	38.9	63.3	3.1	8.6	7.6	3.0	7.6	132.1
2001*	9.6	49.8	5.3	6.0	5.2	4.7	16.8	97.3
2002*	16.2	7.9	3.7	20.8	9.1	0.1	7.4	65.1
2003*	21.9	69.2	4.0	8.4	1.9	1.2	11.7	118.4
Average	*40.7*	*112.5*	*4.2*	*23.5*	*14.1*	*1.8*	*12.6*	*209.4*

Notes: * Provisional
Source: Ghana Investment Promotion Centre and author's calculations.

The number of registered projects by the top 20 countries is illustrated in Figure 6.2. The figure shows the sources of FDI into Ghana to be varied, with Britain topping with a total of 160 projects, followed by India with 147 projects. In spite of the high level of trade intensity

Figure 6.2: Registered projects by country (September 1994–December 2003
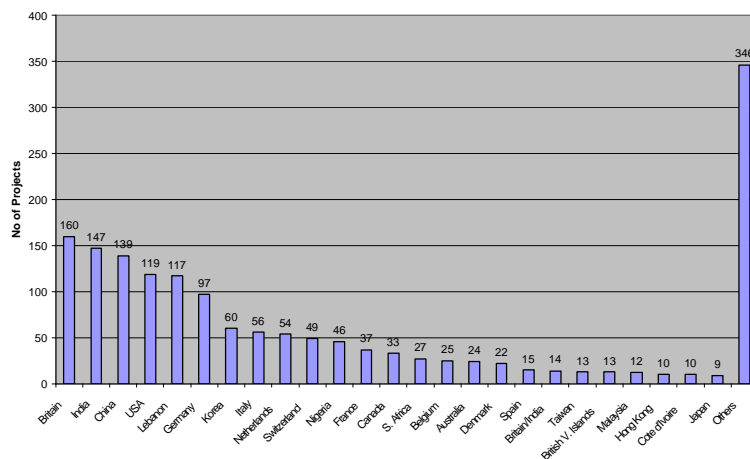
Source: Ghana Investment Promotion Centre.

that exists between Ghana and Japan, this rich Asian country ranks twenty-fifth as a source of FDI to Ghana, far below less endowed countries such as Nigeria, Côte d'Ivoire and British Virgin Islands.

In terms of the sectoral distribution of investment projects originating from these countries, it is worth noting that most of the developed countries of the North (e.g., Britain, USA and Germany) are biased in favour of the services sector, whereas developing countries like India, Lebanon and China tend to invest in the industrial sector (Table 6.9).

Table 6.9: Registered projects classified by country and economic activity: September 1994 – December 2003

	Country	Total	Agric	Bld/ cons	Exp. trade	General trade	Liaison	Manuf	Service	Tourism
1	Britain	160	2	12	9	9	18	34	64	12
2	India	147	18	6	13	18	15	54	11	12
3	China	139	5	10	3	15	5	44	26	31
4	USA	119	13	7	4	1	6	20	49	19
5	Lebanon	117	1	13	6	17	1	44	18	17
6	Germany	97	10	8	4	1	5	24	36	9
7	Korea	60	12	3	1	3	3	16	14	8
8	Italy	56	1	13	4	2	1	27	3	5
9	Netherlands	54	9	2	7	2	2	6	17	9
10	Switzerland	49	6	5	4	3	4	10	14	3
11	Nigeria	46	2	1	3	5	5	9	20	1
12	France	37	4		1	2	1	11	10	8
13	Canada	33	3	4	1	4		6	13	2
14	South Africa	27		2		4	4	1	16	
15	Belgium	25	6	2	4	4		1	7	1
16	Australia	24	1		1		2	7	10	3
17	Denmark	22	2	1	1	1	4	5	8	
18	Spain	15	2	3	1	2		4	2	1
19	Britain/India	14	1	1		4	1	7		
20	Taiwan	13	1		1	1		7	2	1
21	British Virgin Islands	13	1				2	1	8	1
22	Malaysia	12					3	1	8	
23	Hong Kong	10				2	5	2		1
24	Côte d'Ivoire	10		1	1		1	4	2	1
25	Japan	9	1				6		1	1
	Others	346	27	27	29	36	15	84	90	38
	Total	1654	128	121	98	136	109	429	449	184

Source: Ghana Investment Promotion Centre.

Table 6.10 summarizes the ownership structure of projects and investments. The table shows that the number of projects with foreign/Ghanaian joint ventureship declined from 648 (70.5%) between September 1994 and December 1999 to 291 (63.1%) between January 2001 and December 2003. Similarly, the value of investments with foreign/Ghanaian joint ventureship declined from US$1.073 billion (72.75%) between September 1994 and December 1999 to US$183 million (65.2%) from January 2001 to December 2003. This implies an increase in foreign investors who are going solo both in terms of the number of projects and in the value of projects.

Table 6.10: Ownership structure of projects and investments

	Jan 2001–Dec 2003		2003		2002	
	100% F	F/GJV	100% F	F/GJV	100% F	F/GJV
No. of projects	170 (36.9%)	291 (63.1%)	64 (42.1%)	88 (57.9%)	54 (39.1%)	84 (60.9%)
Total investment (US$ million)	97.84 (34.8%)	182.97 (65.2%)	36.26 (30.6%)	82.12 (69.4%)	24.38 (37.4%)	40.75 (62.6%)
	2001		2000		Sep 1994–Dec 1999	
	100% F	F/GJV	100% F	F/GJV	100% F	F/GJV
No. of projects	52 (30.4%)	119 (69.6%)	51 (30.91%)	114 (69.09%)	271 (29.5%)	648 (70.5%)
Total investment (US$ million)	37.20 (38.2%)	60.10 (61.8%)	52.71 (39.92%)	79.35 (60.08%)	403.16 (27.3%)	1,073 (72.75)

F = Foreign, F/GJV = Foreign/Ghanaian joint venture.
Source: Ghana Investment Promotion Centre.

Table 6.11 indicates that between January 2001 and December 2003, total registered investment amounted to US$280.82 million, with an FDI component of US236.30 (constituting 84.1%); the remaining US$44.52 million (15.9%) was from domestic investors. The value of FDI inflow was US$58.93 million in 2002 but picked up to US$88.06 million in 2003.

Table 6.11: Financing plan and ownership of projects (US$ million)

	Jan 2001–Dec 2003	%	2003	%	2002	%	2001	%	2000	%
Equity										
Local	34.02	12.1	24.31	20.5	3.04	4.7	6.67	6.9	7.75	5.87
Foreign	108.62	38.7	56.55	47.8	19.49	29.9	32.58	33.5	38.77	29.35
Total	142.64	50.8	80.86	68.3	22.53	34.6	39.25	40.3	46.52	35.2
Loan										
Local	10.50	3.7	6.01	5.1	3.17	4.9	1.32	1.4	9.40	7.12
Foreign	127.69	45.5	31.51	26.6	39.44	60.5	56.73	58.3	76.14	57.66
Total loan	138.19	49.2	37.52	31.7	42.61	65.4	58.05	59.7	85.54	64.80
Total	280.82	100.0	118.38	100.0	65.14	100.0	97.30	100.0	132.06	100.0
FDI inflow										
Foreign equity	108.62	46.0	56.55	47.8	19.49	29.9	32.58	33.5	38.77	29.35
Foreign loan	127.69	54.0	31.51	26.6	39.44	60.5	56.73	58.3	76.14	57.66
Total	236.30	84.1	88.06	74.4	58.93	90.5	89.32	91.8	114.91	87.0
Local participation in investment										
Local equity	34.02	12.1	24.31	20.5	3.04	4.7	6.67	6.9	7.75	5.87
Local loan	10.50	3.7	6.01	5.1	3.17	4.9	1.32	1.4	9.40	7.12
Total	44.52	15.9	30.32	25.6	6.21	9.5	7.99	8.2	17.15	13.0

Source: Ghana Investment Promotion Centre.

Summary

Ghana, as a small developing African country, has attracted the non-market seeking type of FDI. The major FDI categories of FDI that have been attracted into Ghana have included investments to exploit the mineral resources in the country, mainly gold. Three main fiscal changes affecting the sector were implemented during the ERP era: reduction in minimum royalties from 6% to 3%; reduction in corporate tax from 55% to 35%; and tax exemption for imported plant and equipment. The privatization of AGC by the government was also presumably aimed at sending signals that it was prepared to encourage the participation of the private (including foreign) sector.

Ghana has also undertaken active policies to attract FDI. These have included various incentives provided under the investment codes. All these investment codes have attempted to provide a favourable investment climate by offering incentives to boost private investment. The incentives generally provided included tax holidays, accelerated depreciation allowances, exemption for import duties on machinery and equipment, investment allowances, and arrangements for profit repatriation.

On 29 April 1988, Ghana ratified the convention establishing the Multilateral Investment Guarantee Agency (MIGA) of the World Bank. The Ghana Investment Promotion Centre (GIPC) was also set up under GIPC Act of 1994 with the main objective of encouraging and promoting investment. The objective of the Act was to revise the 1985 Investment Code to place more emphasis on private sector investments as an important segment for accelerated economic growth and to consolidate amendments to the code. As part of the measures taken to make credit more readily available to the private sector, Ghana began a process of liberalizing its financial system. Specifically, a financial sector adjustment programme (FINSAP) was initiated and a number of institutional and policy reforms were carried out, which culminated in the liberalization of the financial sector by the beginning of 1989.

In September 1995, Parliament promulgated the Free Zones Act to accelerate the exploitation of the country's general export potential. The Ghana Free Zones Board (GFZB) was accordingly established to assist and monitor the activities of the export processing zones (EPZs) to be set up in the country. A key objective of the Act was to attract FDI. To this end, an extensive package of incentives was offered.

Given the importance of increasing market size and providing scale to attract FDI to Africa, efforts at regional integration continue to be important. NEPAD could be important in this direction. Since the new government assumed power in 2001, Ghana has set up a ministry for Regional Integration and NEPAD.

In 1998, The Government of Ghana launched the Gateway Programme with the objective of promoting Ghana as the trade and investment centre of West Africa. The strategy emphasizes export processing zones and foreign investment as the main instruments for export development in the medium term. The objective is to reorient the frontline institutions – Customs, Excise and Preventive Services (CEPS), Ghana Ports and Harbours Authority, and the Ghana Civil Aviation Authority to play a more facilitating role to promote private sector businesses.

Ghana embarked on an Economic Recovery Programme in April 1983 to arrest the deterioration that had plagued the economy. The country started a privatization programme in 1988 after an intensive study conducted by the government revealed a disturbing array of problems plaguing the public sector. FDI seemed to have responded positively to these reforms as inflows increased from US$5 million in 1988 to US$15 million in 1989 and inflows were moderate compared with the initial period of the ERP. Privatization of Ashanti Goldfields

Company (AGC) also took place in April 1994 with the government of Ghana selling some of its shares for about US$350 million. In January 1996, the government sold additional shares for about US$112 million. In the same year (1996) Telecom Malaysia bought 30% of the shares of the then state-owned Ghana Telecom. FDI responded positively to these privatizations by increasing to US$233 million in 1994 and US$120 million in 1996. FDI also responded positively to privatization in the NTEs sector, especially in canned tuna, cocoa products and other manufactures in 1999.

AGOA has not been a major driving force in attracting FDI to Ghana. Exporters acknowledge that Ghana has a low nominal wage rate, but the question remains whether unit labour costs in the textile and garments sector are internationally competitive. This concern revolves around the comparative wage-productivity ratio in labour-intensive industries like textiles and garments.

The sources of FDI into Ghana are varied with Britain topping with a total of 160 projects, followed by India with 147 projects. In spite of the high level of trade intensity that appears to exist between Ghana and Japan, this rich Asian country ranks twenty-fifth as a source of FDI to Ghana, far below less endowed countries such as Nigeria and British Virgin Islands.

Between 1995 and 2003, an average number of 177 projects was registered per annum, with the services sector recording the highest average of 50 projects, followed by manufacturing with 47 and tourism with 20. In terms of the estimated value of registered projects, services topped with an average of US$112.5 followed by manufacturing having an estimated value of only US$40.7 million and agriculture with an average of US$ 23.5 million. The study shows that the effects of 11 September 2001 fell more heavily on the services, tourism and export trade sectors.

Notes

[1] GIPC investment data excludes investments in the mining sector.

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Foreign Direct Investment in Kenya

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This chapter investigates the factors that constrain improved net inflows of foreign direct investment (FDI) into Kenya and whether the country responds differently from other countries to the determinants of FDI. Among the issues analysed are the magnitudes of net FDI inflows, their composition and sectoral destination, as well as the economic, political and other factors that might influence them. We also base our analysis on the other FDI categorizations that exist in the literature. There are, for example, market seeking and non-market seeking FDI flows. Market-seeking FDI serves the local market and is, therefore, propelled by high domestic demand and income in the host country. Hence, small and poor African countries are unlikely to attract this type of FDI. Non-market seeking FDI mainly entails producing in the host country and selling the output outside the country, such as FDI in car assembly plants and in the extraction of natural resources.

The Importance of FDI

FDI is important to a country for various reasons. It brings investable financial resources, provides new technologies and may enhance the efficiency of existing technologies. FDI may facilitate access to export markets, thereby playing an important role in strengthening the export capabilities of the domestic economy. It may also enhance skills and management techniques, and provide cleaner technologies and modern environment management systems. These positive externalities may justify the favourable treatment of foreign investors versus domestic investors (Hoekman and Saggi, 1999).

FDI increases the rate of technological progress in the host country through a contagion effect from the more advanced technology and management practices used by the foreign firms (Findlay, 1978). This is through either copying the technology used by the foreign firms or accessing the latest technology. Such technology transfers may take place as a result of demonstration effects. Local firms may adopt technologies introduced by foreign firms through imitation or reverse engineering; as a result of labour turnover whereby workers trained by foreign firms transfer technological knowledge to local firms or they start their own firms; and through demand linkages whereby foreign firms provide services or inputs to local firms.

FDI also has potential to enhance growth of domestic firms through complementarity in production and productivity spillovers (Borensztein et al., 1998). Phillips et al. (2001) found

that FDI stimulates domestic investment, with a 1% increase in the FDI/GDP ratio followed by as much as a 0.80% increase in future domestic investment/GDP ratio in Africa. They conclude that FDI provides positive externalities and spillovers that make private domestic investment more profitable. In a survey, they found that nearly all interviewed business leaders in Kenya favoured foreign investment and recognized that it offered them economic opportunities.

On the other hand, FDI may induce a reduction in domestic savings and investment rates by stifling competition through exclusive production agreements with the host government. A dominance of FDI may adversely influence the development of indigenous entrepreneurship. Owing to liberal tax concessions, excessive investment allowances, disguised public subsidies and tariff protections often provided to foreign companies by the host governments, FDI contribution to public revenue via corporate taxes may be less than optimal. Indeed, the theory of immiserizing growth may well apply. In a distorted market, FDI can produce negative value-added at world prices accompanied by repatriation of profits and dividends.

It is generally believed, however, that FDI provides positive net benefits to the host country. As a consequence, many countries provide a range of incentives to entice FDI. Incentives typically include tax and duty concessions and guarantees against nationalization. Materials and equipment imports, for example, are often exempt from import duties. Other tax concessions include tax holidays, accelerated depreciation and exemption of investment income from the company income tax. The export processing zones in Kenya, for example, offer all investors a ten-year tax holiday, easy repatriation of profits and little regulation with regard to environment protection and labour standards.[1]

Little research has been done on the extent to which these investment incentives are effective in attracting foreign firms, their cost in terms of forgone tax revenues and the losses incurred from competition among countries to attract favoured firms. Such a review of the incentive systems is important because of the poor responsiveness of foreign investment in many African countries. The available evidence regarding the efficacy of financial and fiscal incentives in attracting FDI is ambiguous, not least because countries find themselves in competitive bidding to their general detriment if "excessive" incentives are provided, with little impact on the total supply of investment resources, justifying the case for cooperation among these countries (Hoekman and Saggi, 1999). On the other hand, such competition may serve as a signalling device, indicating the countries where FDI is most valued and has the highest social return.

Empirical studies generally find financial and fiscal incentives unimportant once other fundamental determinants of FDI are taken into account, undermining the case for providing them, making them pure transfers to multinational firms (Hoekman and Saggi, 1999). According to Collier and Gunning (1999), while current tax rates in Africa are not particularly high, their imposition is often arbitrary. There are also so many temporary tax exemptions for new investors that the tax burden for long-standing investors is necessarily fairly high, thereby discouraging long-term investment.

FDI has not played an important role in the Kenyan economy despite the reforms that have been undertaken and the many incentives provided to foreign investors. Over 1997–2001, FDI was about 0.6% of GDP, well below the African average of 1.9%. Since the 1980s, the country has faced a declining net inflow of FDI compared with neighbouring countries such as Uganda and Tanzania. In the early 1980s, for example, Kenya accounted for 87% of the cumulative net FDI in East Africa. By 2001, this was down to 21%, compared with 40% and 36% for Uganda and Tanzania, respectively. The country has therefore lost its competitiveness in attracting FDI to the two neighbours in the East African Community. There has been much concern among policy makers in Kenya over the decline of FDI, which they

attribute to low investor confidence, resulting from insecurity, corruption, poor infrastructure, high utility costs, high real interest rates and limited legal recourse (Kenya, 2003).

In the rest of this chapter we first look at the trends, types and destinations of FDI in Kenya, and then move to a review of Kenya's business environment, which influences the volume and composition of investment, with FDI flows a small but important component of gross capital formation in the country. Next is a discussion of the determinants of net FDI inflows in Kenya in a global context, which investigates to what extent net FDI inflows to Kenya are influenced by global fundamentals or whether there is a significant Kenyan dummy.

Foreign Direct Investment in Kenya: Trends, Types and Destination

FDI flows to Kenya have not only been highly volatile, they generally declined in the 1980s and 1990s despite the economic reforms that took place and the progress made in improving the business environment. The investment wave of the 1980s dwindled in the 1990s as the institutions that had protected both the economy and the body politic from arbitrary interventions were eroded (Phillips et al., 2001).

Magnitudes of FDI

As seen in Appendix Table 7.A1, net FDI inflows declined in absolute terms from an average US$30.67 million in the 1980s to US$17.7 million in the 1990s. The gross (net) FDI/GDP ratio declined from an average of 0.57% (0.42%) in the 1980s to 0.20% (0.198%) in 1990s. The data also show that the share of net FDI in gross fixed capital formation (GFCF) declined from 2.02% in the 1980s to 1.13% in the 1990s. FDI is therefore minuscule when compared with domestic investment (which is generally true across regions, both underdeveloped and developed). The data also show that there was a big jump of FDI flows into the country in 2000, reflecting new investments by mobile phone companies (involving mergers and acquisitions of US$3 million) and accelerated offshore borrowing by private companies to finance electricity generation activities, which became necessary because of the drought that prevailed that year. The net FDI/GDP ratio increased to 1.06% and the FDI/GFCF to 7.76% in 2000, before declining to more normal levels in 2001 (0.05% and 0.36%, respectively). Table 7.A1 shows the stock of net FDI inflows increased from US$368 million (or 5.1% of GDP) in 1980 to US$764 million (or 7.4% of GDP) in 2000.

Appendix Table 7.A2 summarizes the flows of FDI in Kenya relative to the countries in the region and the rest of the world in the 1990s. There was a general increase in the net FDI flows to SSA in the second half of the 1990s. The share of net FDI inflows to SSA relative to developing countries doubled from 2% in 1990–1995 to 4% in 1996–2001. The share of net FDI inflow to countries in the East African Community (Kenya, Uganda and Tanzania) relative to SSA remained fairly constant, however, at 7% in the two periods, with Kenya losing mainly to Uganda. Kenya's share of net FDI in EAC declined from 28% in 1990–1995 to only 4% in 1996–2001, while that of Uganda increased from 8% to 54%; Tanzania's share declined from 64% to 46% over the period.

Types and Sectoral Allocation of FDI

FDI is defined to include equity capital, reinvested earnings and intra-company loans. Table 7.A3 in the Appendix shows FDI flows by these types of investment in Kenya since the mid-1970s. From the table, it is evident that FDI inflows are largely equity and reinvested earnings. Intra-company loans flowing into Kenya are low, depicting the limited level of offshore financing in the country. Reinvested earnings of course depend on the performance of the economy and the profitability of multinational corporations (MNCs). The data therefore show a clear increase in reinvested earnings in 1975–1980 and 1985–1990, periods of fairly rapid economic growth fuelled by "coffee booms" as well as economic reforms in the latter period. There also seems to be a negative correlation between equity and reinvested earnings, with the country relying on new inflows during periods of poor economic performance and reinvested earnings during periods of good economic performance.

Data are not available on the sectoral allocation of the FDI flows to Kenya. The country does not have significant mineral resources, so that much of the FDI has gone to agriculture, manufacturing and services. Historically, 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 and the Indian Ocean. The Second World War brought a stimulus to industrial investment, to manufacture substitutes for imports disrupted by the war.

According to UNCTAD (2002), Kenya had about 114 MNC affiliates located in the economy in 2001. Table 7.A4 in the Appendix lists the 63 largest MNCs in the country, 27 in the industrial sector, 26 in the tertiary sector, and 10 in finance and insurance. The table shows many of the big multinational firms are in the industrial and tertiary sectors (the latter composed mainly of trade, transport and telecommunications). Most of these MNCs are from developed countries with a majority from Western Europe and the US. And many of these big firms are somehow the horizontal type, which means that market size and growth would be a major determinant of their activities in the country. They could also be in Kenya to capture the East African market. There are some that are attracted by the natural resources, especially those in agro-industry and the cement industry. They own plantations and process the products for both domestic and foreign markets. A number of them are listed on the Nairobi Stock Exchange in an attempt to diffuse ownership but they control the majority of shares.

The other category is those firms located in the export processing zones (EPZs). These are cost-saving and export-oriented firms (Table 7.A5). About 74% of the firms in the EPZs are foreign-owned; 11% are Kenyan-owned and 15% are joint ventures (in 2002). Of the total firms, 57% are in the garment industry and they make 56% of the total investments. Most of the foreign firms are from Sri Lanka and India. There are only a few firms from developed countries. The investment level of US firms, for example, is 10% of the total, while UK-based firms account for 2% of the investment in the EPZs. Only one US firm is in garment manufacturing; the rest of the developed country firms are outside the garment industry. The concentration in the garment industry is due to the opportunities offered under the African Growth and Opportunity Act (AGOA), especially with a readily available market with fewer restrictions provided by the United States. Most firms in the garment industry are footloose and can relocate rapidly; they are attracted by the low labour costs, although recently there have been concerns about low wages and the way workers are treated by the EPZ firms. The labour conflicts may create an atmosphere that is not conducive for attracting more firms.

There are differences in characteristics of FDI going to Uganda and Tanzania and that coming to Kenya. While the majority of the firms in Kenya are generally from industrialized countries, Uganda and Tanzania have attracted firms from developing countries as well, including Kenya. In Uganda in 1999, for example, 24% of the FDI came from the African region, of which 42% came from Kenya, forming 10% of the total FDI. For Tanzania, 30% of FDI came from Africa, of which 13% was from Kenya, forming 4% of the total FDI. In fact, two of the largest affiliates in Tanzania and four out of the top 29 MNCs were from Kenya, three from South Africa and one from Ghana. For Uganda, of the top 32 firms, seven had affiliates in Kenya and two in South Africa.

The Business Environment in Kenya since the 1970s

To put the FDI flows in and out of Kenya in perspective, we briefly examine in this section the dynamics of the business environment that have influenced the level and composition of flows over time.

The 1970s and 1980s

In the 1970s, when the country received relatively large capital inflows, various factors were in favour of attracting the FDI. Although the period suffered from macroeconomic instability, the market size was favourable, with a high GDP growth rate and a large regional market that included the East African Community (EAC). Similarly, the adopted industrial strategy favoured the net FDI inflows especially the market-oriented type. As discussed above, however, the 1980s saw a sharp decline in FDI. This was a period when the country started implementing structural adjustment programmes. There was a lot of uncertainty arising from policy reversals and the shift away from import substitution to an export-oriented industrialization strategy.

The 1980s were characterized by deterioration in the GDP growth rate and, following the collapse of the EAC in 1977, a reduced regional market. The period also saw increased uncertainty arising from policy changes and reversals. There were significant changes in the political system, especially with the introduction of a de jure single-party system, which reduced the level of democracy in the country.

With ineffective management of the economy, the debt ratio rose and the balance of payments deteriorated. The level of foreign reserves in terms of imports went down, openness deteriorated and domestic savings declined. The gap between the domestic investment and savings also widened.[2]

The 1990s and Beyond

The 1990s were characterized by the implementation of a comprehensive reform programme. Economic performance was weak, however, and any improvements in macroeconomic parameters were offset by rising costs of doing business, ethnic clashes and persistent corruption. The period also experienced a strained relationship between the government and the donors, which adversely affected investor confidence. With the reform process, the economy shifted towards a market system especially with the liberalization of interest rates and exchange rate and removal of price controls. The period also saw removal of import controls and relaxation

of capital controls, making the economy more open. A free exchange regime in the 1990s facilitated repatriation of dividends by foreign investors. This, together with the removal of barriers to foreign commercial private borrowing, has provided a more enabling environment for foreign investors. Furthermore, the government put up various incentives to attract investment. The establishment of EPZs, for example, allowed unrestricted foreign ownership and employment of expatriates as well as control over foreign exchange earnings in addition to extensive tax advantages. In addition, the process of drafting a new investment code, which would streamline investment laws and procedures to give investors assurances and guarantees against risks as well as the provision of a variety of incentives, is under way (in early 2005).

The Macroeconomic Environment

Appendix Table 7.A6 provides macroeconomic indicators for Kenya in the 1990s when FDI flows into the country declined substantially. The table shows generally that economic performance was weak. There was no sustained growth in GDP and the overall investment rate was falling. Macroeconomic instability characterized the period; the monetary authority was unable to sustain low inflation and the current account deficit widened with deteriorating terms of trade. On average, inflation rates increased from about 12% in the 1980s to 17% in the 1990s.

Lending rates rose during the period, increasing the cost of capital and therefore the cost of doing business. It was not possible to attract investments with such high lending rates even at the domestic level. A 2003 study by the World Bank and the Kenya Institute of Public Policy Research and Analysis (KIPPRA) found that the cost of capital is a major constraint to doing business (Blattman et al., 2004). The domestic saving rate went down from an average of 16% in 1980s to 14% in 1990s. Similarly, the level of domestic investment declined from about 27% in 1980s to 19% in the 1990s.

The fiscal deficit showed some improvement but this was happening in the context of worsening terms of trade and instability in the financial sector. Although interest rates went down in the second half of the period and the shilling depreciated, there was a loss in official reserves, which weakened the cushioning from external shocks. The weak economic performance was attributed to among other things the failure to sustain prudent macroeconomic policies, the slow pace in structural reforms and governance issues. This type of macroeconomic status was not conducive to attract either market-driven or cost-saving FDI.

The Political Environment

Although the reform process included efforts to establish a democratic government, there was a lot needed to strengthen the democratic system, especially through the review of the constitution. The demand for constitutional reform caused a lot of political tension and uncertainty to the investors. Appendix Table 7.A7 shows that although there was government stability (indicated by an increase in the government stability index), many of the socioeconomic and political indexes deteriorated (1990–2002). In the absence of significant public sector reforms, and with reduced political pressure on policy formulation systems, policy instability was still an issue the investors had to contend with. Similarly, with the government's laxity in dealing with governance issues, corruption was a major cost to the business community. The period also saw tribal clashes accompany the multi-party elections in 1992 and 1997, adversely affecting the distributional systems and demand patterns of goods and services. The table shows a general deterioration in the quality of institutions in the 1990s, reflected in a worsening of corruption, law and order and bureaucratic quality indexes.

The Government–Donor Relationship

In the 1990s, the economy was going through a comprehensive reform programme that targeted both macroeconomic stability and structural adjustment. The government failed to demonstrate adequate commitment to the reforms and to adhere to the set conditions for disbursement of funds. These failures contributed to a very shaky relationship between the government and the donors, which undermined the perceived goodwill to foreign investors and the ability of the government to carry on with reforms to remove policy obstacles, including the government bureaucracy in the civil service. For example, the demand for political reform in the early 1990s saw the donors suspend balance of payment support until the government fulfilled certain political conditions. There were delays in disbursement especially when the government failed to adhere to the agreed schedule and this made it difficult to achieve the set targets in good time. The dynamism in the conditionalities saw governance issues put as a condition by the IMF for disbursing funds to support the 1996–1998 reform programme. There was minimal effort by the government to comply and this led to the suspension of funds in 1997.

A look at the flow of FDI shows that the period after 1997 was characterized by huge outflows as compared with the early 1990s (Table 7.A2). Similarly, the period saw economic growth continue a downward trend together with the investment rate, which created uncertainty on investment returns. By the late 1990s, the unfinished reform agenda included the constitutional review to strengthen democracy, privatization, governance and civil service reforms.

Policy Incentives

With the reform process, the economy saw liberalization of interest rates and the exchange rate, removal of import controls, and relaxation of capital controls. Interest rates were liberalized in 1991, a floating exchange rate regime was established in 1993 and capital controls were relaxed in 1995. Trade liberalization policies were implemented in 1993, while in 1994 price decontrols were finalized. Low tariffs enable importation of inputs essential for production process, which should then attract the low-cost FDI. For the horizontal FDI, however, openness may mean low costs of exporting and therefore the ability to supply the market from home country or any other location.

In an effort to promote investment and exports, various initiatives were introduced in the 1990s including the establishment of the EPZs in 1990. Presently the country has five export processing zones, of which two are government-owned (Mombasa and Athi River); the other three are owned by the private sector (Nairobi, De La Rue at Ruaraka and Nakuru). The zones are licensed to carry out various activities including manufacturing, commercial and export-oriented services. The licensing requirement is that over 80% of activities must be export oriented.

The zones offer considerable incentives such as ten-year tax holiday followed by a 25% tax rate for the next ten years, exemption from import duties, value added tax and stamp duty, and no restriction on management or technical agreements. Special incentives are given to MNCs that invest in lesser-developed areas. There are no restrictions on foreign investment, or on foreign ownership. Repatriation of profits is unrestricted.

Table 7.A8 shows a gradual increase in the number of enterprises operating in EPZs. Although there is a rise in the amount spent accessing the local market for inputs, a large share of the raw materials is imported. The imports are cheaper because the firms are exempted from duty. However, delays due to transport and clearing procedures can inflate the cost of such raw materials. The argument is that the local market does not have the needed quality of raw materials

and intermediate inputs. The latter may reflect the disparity in technology or the failure to have spillovers or the high cost of production in the local market. Although employment seems to be rising, we find that on average EPZ firms are employing less (490) than half the average employment levels of the other MNCs (1,438), based on 2002 data (UNCTAD, 2003).

The other incentive is putting together the Investment Code, which entails establishment of an Investment Authority in charge of investment policy and the development of an investment roadmap by 2005. There is also commitment to reduce the number of non-zero tariff bands to three, the top tariff rate to 25%, and the duties on raw materials and capital goods by 2004 in the context of EAC. The Investment Authority will also build capacity to address trade disputes and dumping claims and harmonize investment incentives. The government is set to review licensing agreements, provide market information to Kenyan manufacturers, and support the private sector in identifying new markets, improving quality of Kenyan goods, reducing non-commercial risks, organizing export trade fairs, and exploiting AGOA as a measure to increase trade and investment performance.

The Cost of Doing Business

A friendly investment climate lowers the cost of doing business. Such costs include those imposed by the entry and exit requirements, labour regulations, access to credit, and government bureaucracy. There is a growing consensus that the level and productivity of private investment reflect the quality of regulations of business and the institutions enforcing them. On business entry, legal incorporation makes a business venture less risky and increases its longevity and likelihood of success. Table 7.A9 compares the cost of doing business in Kenya with that of other African countries. It shows that although it takes longer to register a business in Kenya, it costs less. Kenya requires multiple licences before an investor can set up a business. Some of these, like land and title transfers as well as registration, take from six months to eight years. Special authority is needed for oil and mineral prospecting. On labour regulation, there is more flexibility in both hiring and firing of workers. Effective labour market regulation can have a significant impact on labour market performance. Rigid labour market regulations are associated with unemployment and informality. On enforcement of contracts, the recent legal and regulatory reforms have revamped commercial courts. The results show that the duration of time required for starting a business is still very high but the process is less costly. Exiting the business activity also takes time. The bankruptcy process is lengthy compared with other markets, although not as costly. These characteristics seem not to be very inhibitive to attracting FDI.

In the World Bank/KIPPRA study (Blattman et al., 2004), infrastructure is rated very high as a major obstacle to doing business. The rating for telecommunication shows about 26% of the firms indicating it is a major obstacle, while 21% declare it as a moderate obstacle. Over 47% of the respondents rate electricity as either a major or very severe obstacle, but only about 26% rate transportation the same. Access to land is not a major problem for the firms, as 53% of the responses listed it as no obstacle. Tax rates and tax administration get a higher rating as business obstacles, with 41% and 27% of the respondents viewing them as major obstacles, respectively. Customs regulation, labour regulation and business/operating licences are not major obstacles to business in Kenya. The skills/education of workers gets a moderate rating given that most of the labour force in manufacturing is unskilled. Access to finance is not a major problem for the firms. The obstacle to them is the cost of finance, rated by 40.4% of the respondents as a very severe obstacle. Policy uncertainty and macroeconomic instability are also judged as major problems, scoring 30% and 28%, respectively. Corruption is ranked by 49% of the respondents as very severe obstacle, while 27% of the respondents rank it as a

major obstacle. This shows that corruption is the main factor that has led to low investment by these firms. Crime, theft and disorder also rank high, with 35% considering it a very severe obstacle and 34% regarding it as a major obstacle. Anti-competitive/informal practices also seem to be a problem to many firms; 38.3% rank it as a very severe obstacle and 25.3% rank it as a major obstacle.

A major area of concern by the donors is governance. Presently, the government has recognized the role of good governance in attracting investment and in determining the effectiveness of government institutions and revenue generation capacity. The government has moved towards addressing this problem by establishing a Ministry of Justice and Constitutional Affairs and a new department, under the President's Office, in charge of Governance and Ethics. The Kenya Anti-Corruption Commission was created by the passage of the Anti-Corruption and Economic Crimes Act in May 2003 to investigate corruption and economic crimes. The same year saw the passing of the Public Officers Ethics Act, which provides for a code of conduct for all public officers.

The judicial Code of Conduct and Ethics, which set up a door for an inquiry into corruption in the judiciary, was also approved and published by the Judicial Service Commission in May 2003. The report of the inquiry was released in October 2003; most of the magistrates and a number of judges of the High Court and the Court of Appeal were accused of corruption. These steps are likely to bring confidence to the investors who have been incurring exorbitant costs due to corruption, either in the process of establishing their businesses or in the process of their operations. With renewed confidence, private sector investment could be expected to spur up.

Is Kenya Different?

In this section, we analyse the determinants of net FDI inflows in a cross-country context. The objective is to ascertain whether Kenya's performance has been significantly different from that of the included countries.[3] We do this by testing whether the Kenya dummy is significantly different from zero in the empirical model.

The Empirical Model

There is a large literature on the determinants of FDI flows across countries. The overall conclusion is that FDI will be attracted to those countries that provide a sufficiently high rate of return. These are generally countries that exhibit substantial macroeconomic and political stability, and therefore have favourable growth prospects. In addition, countries that attract FDI are likely to possess good infrastructure and legal system (including enforceability of contracts); a skilled labour force; and a liberalized foreign sector. Important as well is the availability of a large domestic market and natural endowments. Determinants of FDI, therefore, include the openness of the host country; political risk, measured for example by a country's credit rating; financial depth; government size, as represented by the ratio of government's consumption to GDP, for example; and economic growth as a measure of the attractiveness of the host country's market. Recent literature also suggests that the responsiveness of FDI to the traditional variables, such as the rate of return on investment, infrastructure and openness, may be lower for SSA than for non-SSA countries (Asiedu, 2002).

It is then clear from the literature that investors respond to a holistic investment climate, not just a series of tax incentives or a promotional invitation. In our empirical analysis of factors likely to influence FDI, we consider five broad categories (Elbadawi and Mwega, 1998). First is basic fundamentals that correspond to a large extent to those factors considered under the neoclassical framework. These include the profitability of FDI as affected by projected returns in the country (usually proxied by the rate of economic growth, *DYN*) vis-à-vis projected returns elsewhere. More recently, the list of fundamentals has been extended to include human capital, proxied, for example, by the average total years of schooling in the population of age 15 or over in the initial year of the period (*TY15*); as well as spillover effects, proxied by trading partners' growth rates (*DYNT*), which affect the productivity of fixed capital and therefore returns. These variables are expected to have a positive impact on FDI.

Second are macroeconomic policy variables that in essence affect the variability of prices and interest rates and therefore the expected net returns on investment (Schneider and Fry, 1985; Rogoff and Reinhart, 2002). Macroeconomic policy credibility in the context of this chapter is perceived through the real effective exchange rate (*REER*) and the size of the fiscal deficit relative to GDP (*DFY*). A depreciation of the real exchange rate can be expected to encourage FDI inflows and to discourage outflows by enhancing the competitiveness of the economy. Baer (2001), however, observes that capital inflows are often associated with an appreciation of the real exchange rate that damages the tradeable sector.

Another important policy variable relates to ease of transfers across borders as affected by exchange controls and openness to trade (*TRAY*). There is also a widespread perception that open economies encourage more confidence and hence FDI (Jun and Singh, 1996).

Third is public investment GDP ratio (*IPUB*), a proxy for the quality of infrastructure, which to the extent that it raises capacity crowds in FDI. The quality of infrastructure has implications for the cost of doing business. For example, Loungani et al. (2002) find that higher telephone densities in host and source countries enhance FDI flows. Brainard (1997) in a study covering developed and developing countries found a positive relationship between transport costs and FDI. State involvement in commercial activities and budgetary financing of these activities may crowd out FDI, however. The interest therefore is to determine its net effect.

Fourth is the impact of the external shocks captured by external terms of trade shocks (*TTS*). In addition, the impact of external debt is accounted for through three channels: current debt to GDP (*DEBTY*), which is expected to be positively associated with FDI since contraction of current debt could help relax budget constraints and hence leverage FDI; debt overhang (proxied by squared *DEBTY*), which reflects past debt accumulation and is expected to be negatively associated with FDI; and the debt service ratio (DSX), which captures the liquidity and solvency constraints imposed by the debt burden.

Fifth are risks associated with the socio-political environment as well as the quality of institutions. Political risks encompass perceptions of civil unrest, instability of government and violation of civil liberties. Nordal (2001) observes that political risk may constitute a large part of the total risk investors face when investing in emerging markets. Rogoff and Reinhart (2002) argue that an obvious and powerful deterrent to FDI is political instability, with wars being an extreme form of instability. Political risk in developing countries is found to be significantly negative by Lecraw (1991) and Schollhammer and Nigh (1984). Busse (2003), looking at the relationship between democracy and FDI, shows that on average, investments by multinationals are significantly higher in democratic countries. The political instability index (PIN) is proxied by the average number of revolutions, strikes and assassinations in a country.

Apart from political instability, foreign investors are concerned about the quality of institutions in relation to safeguards for their property rights and the bureaucratic red tape of undertaking investment. Blomstrom and Kokko (2003) note that potential investors consider the rule of law, strong and clearly defined property rights, extent of corruption, the regulatory framework and local bureaucracy in making their investment decisions. Further, Balasubramanyam (2001) points out that the efficiency of a legal system is important in ensuring that there is not only proper enforcement of contracts but also maintenance of law and order. A well-functioning legal system also provides protection of intellectual property rights, which are a source of competitive edge for most foreign investors. Removing restrictions and providing a good business operating environment will positively affect FDI flows. Good administration of justice, respect for property rights, freedom from political intrusion in private business, low corruption, transparency and minimal red tape will promote FDI. The quality of institutions (*ICRGE*) is measured by the average indexes of corruption in government, quality of bureaucracy, and law and order.

The following is therefore the basic econometric model, which was estimated using half-decade panel data for 43 countries over 1960–1997:

> *FDIGDP = F(DYN, DYNT, TY15, REER, DFY, TRAY, IPUB, TTS,*
> *DEBTY, DEBTY2, PIN, ICRGE, DKENYA)*

where: *FDIGDP* = net FDI inflows to GDP ratio; *DYN* = real income growth (+); *DYNT* = trading partner growth rate, given by the average growth rate of real GDP per capita among trading, weighted by shares in total trade (+); *TY15* = average total years of schooling in the population of age 15 or over in the initial year of the period (+); *REER* = real effective exchange rate (+); *DFY* = fiscal deficit GDP ratio (+); *TRAY* = degree of openness as measured by the trade ratio (+); *IPUB* = public investment GDP ratio (+); *TTS* = terms of trade shock, given by initial share of exports to GDP, multiplied by the average percentage difference between the terms of trade in each year of the half decade and the terms of trade in the initial year of the half decade (-); *DEBTY* = the external debt GDP ratio (+); *DSX* is the debt service ratio (-); *PIN* = political instability index measured by the average of revolutions, strikes and assassinations (-); *ICRGE* = quality of institutions, proxied by the average indexes of corruption in government, quality of bureaucracy, and law and order (+); and *DKENYA* = Kenya dummy (+/-).

Half-decade data were utilized in order to control for short-run idiosyncratic effects on FDI. A country may have "lumpy" inflows for a short period because of newly discovered resources, for example, or mergers and acquisitions involving foreign investors or large privatizations. For at least those countries that receive large flows, there are likely to be significant feedback effects from the FDI ratio to economic growth, *REER*, and the budget deficit ratio. The latter were therefore replaced by instrumental variables. The instruments used were the contemporaneous values of the exogenous variables in the model.

The Econometric Results

Table 7.A10 in the Appendix gives the pooled econometric results. Most of the results conform to prior expectations. While the coefficient of the economic growth rate (*DYN*) is insignificant, that of the trading partners' economic growth (*DYNT*) is significantly and positively correlated with the FDI ratio at least at the 10% level. The average total years of schooling (*TY15*) has an insignificant effect on the FDI ratio.

The macroeconomic variables – real effective exchange rate (*REER*), the fiscal deficit ratio (*DFY*) and the trade ratio (*TRAY*) as well as the government investment ratio (*IPUB*) – all have an insignificant effect on the FDI ratio.

Terms of trade shocks (*TTS*) have a negative coefficient and become highly significant (at the 5% level) when non-significant variables are removed from the equation. The external debt income ratio (*DEBTY*) has a significant positive coefficient (at the 10% level), while its squared counterpart (*DEBTY*[2]) has a negative significant effect (at the 20% level), implying that the current debt stock stimulates foreign direct investment but at a decreasing rate.[4] The debt service ratio has the expected negative (but non-significant) coefficient.

Political instability (*PIN*) does not seem to significantly constrain the FDI ratio, and has a perverse positive coefficient, which is weakly significant at the 20% level (perhaps because political instability may be correlated with dependence on mineral resources). This is a rather surprising result given the importance of political risks in the context of irreversible investment theory. What seems to matter is the quality of institutions (*ICRGE*), which has one of the most robust positive effects on the FDI ratio. Removing restrictions and providing good business operating conditions encourages foreign direct investment.

The FDI/GDP ratio does not increase significantly in the late 1980s and the 1990s compared with the earlier period. The Kenyan dummy is consistently insignificant, suggesting that Kenya is on the regression line. Hence its FDI ratio is mainly determined by the global fundamentals – in this case, the trading partners' growth rate, terms of trade shocks, the external debt ratio and the quality of institutions.[5] With the first two variables exogenous, the result suggests that FDI promotion in Kenya is more fundamental than incentives, or even macroeconomic management and political stability. Recovery will require actions such as reducing corruption (for example, changing government away from corrupt awards to insiders), rebuilding institutions, and enhancing the rule of law and order, with clear and transparent regulations uniformly enforced (Phillips et al., 2001). Enhancing foreign aid flows (which increase *DEBTY*) and reducing the external debt overhang through debt forgiveness would also have a positive effect on FDI.

There is also no doubt that improved market access (captured by the trading partners' growth rate) may also induce foreign investment. Kenya has, for example, significantly benefited from AGOA and is among the top four largest exporters of textiles and clothing from sub-Saharan Africa (alongside Mauritius, South Africa and Lesotho). The European Union (EU) is also a very important market for Kenya. The Lomé IV Convention provided a guarantee of generally tariff-free access to EU market of African exports, although there have been concerns that access is less favourable for commodities in which African countries have a competitive advantage but that compete more directly with EU products, e.g., temperate products and fish products; and that trade policy instruments, e.g., health standards and anti-dumping measures, might be used against them were they to attempt to diversify the range of commodities they produce for export to EU. Such beliefs, by causing uncertainty with respect to market access, have deterred investment.

In February 2000, the EU and African, Caribbean and Pacific (ACP) countries (of which 48 out of 71 are African) reached an agreement on a 20-year trade treaty to replace the expired Lomé IV Convention. The new accord includes the phasing out of preferential EU tariffs on ACP exports by 2008 to be replaced by WTO-compliant Regional Economic Partnership Agreements (REPAs). These REPAs are also intended to assist economic integration by requiring the lowering of integration barriers among ACP countries. To compensate for the possible loss

of markets for ACP products in EU, the new agreement promises faster and more flexible assistance from EU to ACP countries, which includes development assistance of US$15 billion over seven years and duty-free access of "substantially all" exports into EU by the 39 "least developed" ACP members by 2005. The EU also agreed to a fundamental overhaul of its compensation mechanisms for shortfalls in export prices.

Collier and Gunning (1997a/b) have argued that introducing reciprocity into trade relations between Africa and Europe (through REPAs) could have a beneficial impact on Africa's exports and investment. Such agreements would not only secure market access but would help lock in trade policies against reversals, hence promoting investment and exports. They propose that as part of a partnership agreement, the EU agrees not to use anti-dumping measures against ACP countries (like the current EU agreement with Iceland). The favourable market access that African countries would enjoy in European markets (plus perhaps freedom from anti-dumping actions, etc.) would be conditional on their removing, permanently, tariffs on imports from Europe. This introduces a significant cost of reversing their trade liberalization, making the latter more credible as prospective investors would take it to be permanent. Hence such an ACP/EU arrangement would build on and complement regional initiatives.

Conclusions

FDI has not played an important role in the Kenyan economy despite the reforms that have been undertaken and the many incentives provided to foreign investors. FDI flows to Kenya have not only been highly volatile, they generally declined in the 1980s and 1990s. The investment wave of the 1980s dwindled in the 1990s as the institutions that had protected both the economy and the body politic from arbitrary interventions were eroded. The share of net FDI in gross capital formation, for example, declined from 2.02% in the 1980s to 1.13% in the 1990s. FDI inflows are largely equity and reinvested earnings, with limited intra-company loans flowing into Kenya.

FDI has mainly gone to agriculture, manufacturing and services. According to UNCTAD (2002), Kenya had about 114 foreign TNC affiliates located in the country in 2001, many of them in the industrial and tertiary sectors, with others attracted by the natural resources especially those in agro-industry and cement industry.

The business environment deteriorated in the 1980s and 1990s, undermining FDI. While the liberalization of the economy in the 1990s brought some improvements in the macroeconomic environment, this was offset by rising costs, ethnic infighting and persistent corruption. Economic performance was weak, political risks were generally high, and the relationship between the government and the donors was poor.

Our econometric model finds that the Kenya dummy is insignificant, suggesting that Kenya is on the regression line. Hence its FDI ratio is mainly determined by the fundamentals as captured by the trading partners' growth rate, terms of trade shocks, external debt ratio and quality of institutions, with obvious policy implications for attracting more FDI into the country.

Conceptually, government policy on FDI needs to counter two sets of market failures that may lead to a divergence between private and social interests. This justifies a case for government intervention with measures to promote FDI generally or specific types of FDI (UNCTAD, 1999). The first is coordination and information failures in the investment process, which can lead a country to attract insufficient FDI or the wrong types of FDI. Second, FDI may have

negative effects on development or it may lead to positive but static benefits that are not sustainable over time.

While private and social interests may, of course, diverge for any investment, some divergence may be specific to FDI, hence providing an economic basis for intervening with FDI. FDI may differ from local investment because multinational firms pursue regional or global competitiveness strategies, or because foreign investors are less committed to host economies and are relatively mobile. In addition, countries consider that foreign ownership has to be controlled on non-economic grounds, for example to keep cultural or strategic activities in national hands.

In practice, policy towards FDI has differed across countries depending on the nature of the economy and the government. While some (e.g., Malaysia, Singapore and Thailand) have made a deliberate policy to rely substantially on FDI; others (e.g., Korea and Taiwan) decided to develop local enterprises and autonomous innovative capability, relying on multinational firms mainly as sources of technology. There is therefore no ideal policy with respect to FDI for all countries and at all times. Any good strategy must be context specific, reflecting a country's level of economic development, the resource base, the specific technological context, the competitive setting and the government's capability to implement policies. Developing countries should therefore take into account information and coordination failures in the international investment process, as well as the static nature of advantages by multinational firms where domestic capabilities are low and do not improve over time, and where multinational firms fail to invest sufficiently in raising the relevant capabilities. These countries should also count infant industry considerations in the development of local enterprises, which can be jeopardized when inward FDI crowds out those enterprises. Moreover, weak bargaining and regulatory capabilities can result in unequal distribution of benefits or abuse of market power by multinational firms. FDI may crowd out domestic investment in the product market by adversely affecting learning and growth by local firms in competing activities, and in financial and other factor markets by reducing the availability of finance or other factors, or raising costs for local firms.

In summary, therefore (UNCTAD, 1999: 34):

> There is no ideal universal strategy on FDI. Any strategy has to suit the particular conditions of a country at any particular time, and evolve as the country's needs and competitive position in the world change. Increasingly, it also has to take into account the fact that international investment agreements set parameters for domestic policy making. Governments of developing countries need to ensure, therefore, that such agreements do leave them policy space they require to pursue development policies.

Notes

[1] For a detailed description of FDI incentives in Kenya, see the Investment Promotion Centre website, www.ipckenya.org.

[2] On domestic private investment (presumed to be correlated with FDI), Matin and Wasow (1993) postulate that reduced availability of credit and foreign exchange to the private sector (in the years following the coffee boom of 1976/77) and falling public infrastructure reduced private investment in the 1980s relative to the 1970s. Simulations showed that the private investment rate would have been 23% higher in the

1980s if these variables had remained at their 1978 level. On the other hand, the failure to implement adjustment policies following the collapse of the coffee boom and the EAC in 1977 undermined private investment. Though Kenya experienced greater macroeconomic stability than other SSA countries, her fiscal performance, both during and after the 1970s, left a lot to be desired. The failure to control current expenditure adversely affected public investment on infrastructure.

[3] The selection of the countries was driven by availability of data and included (by region): Cameroon, Democratic Republic of Congo, The Gambia, Ghana, Guinea-Bissau, Kenya, Malawi, Senegal, Sierra Leone, South Africa, Togo, Uganda, Zambia and Zimbabwe in sub-Saharan Africa; China, Republic of Korea, Malaysia, Philippines and Thailand in East Asia and the Pacific; Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru and Venezuela among Latin American countries; Egypt, Arab Rep., Iran, Islamic Rep., and Tunisia in the Middle East and North Africa; and Turkey, Bangladesh, India, Pakistan and Sri Lanka in South Asia.

[4] The results suggest that the optimal debt level beyond which the FDI ratio declines is 280–325%. Only a few countries in the sample have external debt levels in this range in the study period (Congo DR, Nicaragua and Zambia).

[5] According to the UNCTAD's Inward Performance Index, Kenya ranks number 33 out of the 43 countries in the sample, with an average index of 0.35 over 1988–1990 and 1998–2000. This means it receives only about a third of its global share of FDI relative to its global share of GDP, with the index declining from 0.5 in 1988–1990 to 0.2 in 1998–2000. Under the Potential Index, which takes into account a range of other fundamentals besides the economy's size, the country does better, ranking 16 out of the 43 countries in the sample, with the index declining from 0.127 in 1988–1990 to 0.168 in 1998–2000. In this sample, therefore, Kenya is a "low-potential economy" under UNCTAD's classification.

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Appendix   Supplementary Tables

Table 7.A1: Evolution of FDI in Kenya, 1970-2001

Year	Net inflows (BOP, current US$ million)	Gross Inflows (% of GDP)	Net inflows (% of GDP)	Net inflows (% of gross capital formation)	Net FDI stock, US$ million
1970	13.8	..	0.86	3.53	
1971	7.4	..	0.42	1.74	
1972	6.3	..	0.30	1.34	
1973	17.3	..	0.69	2.67	
1974	23.4	..	0.79	3.06	
1975	17.2	0.84	0.53	2.91	
1976	46.4	1.46	1.34	6.60	
1977	56.5	1.32	1.26	5.31	
1978	34.4	1.02	0.65	2.18	
1979	84.0	1.46	1.35	6.13	
1980	79.0	1.10	1.09	4.44	368
1981	14.1	0.29	0.21	0.90	
1982	13.0	0.35	0.20	1.11	
1983	23.7	0.64	0.40	2.17	
1984	10.8	0.28	0.17	1.01	
1985	28.8	0.56	0.47	2.12	416
1986	32.7	0.52	0.45	2.51	
1987	39.4	0.88	0.49	2.38	
1988	0.4	0.53	0.00	0.02	
1989	62.2	0.76	0.75	3.62	
1990	57.1	0.67	0.67	3.40	569
1991	18.8	0.23	0.23	1.17	
1992	6.4	0.08	0.08	0.58	
1993	1.6	0.03	0.03	0.18	
1994	3.7	0.05	0.05	0.32	
1995	32.5	0.36	0.36	2.05	614
1996	12.7	0.14	0.14	0.82	
1997	19.7	0.21	0.19	1.21	
1998	11.4	0.10	0.10	0.65	
1999	13.8	0.13	0.13	0.90	
2000	110.9	1.06	1.06	7.76	764
2001	5.3		0.05	0.36	737

Source: World Bank, *World Development Indicators*, 2003; UNCTAD, *World Investment Report*, 2002.

Table 7.A2: FDI flows in a comparative setting

	1990–1995	1996	1997	1998	1999	2000	2001
Inflows, US$ million							
World	224,945	384,960	481,911	686,028	1,079,083	1,392,957	823,825
Developing countries	72,702	149,759	193,224	191,284	229,295	246,057	209,431
SSA	2,777	4,356	8,137	6,233	7,925	11,912	5,719
EAC	103	283	373	424	447	574	503
Kenya	20	13	40	42	42	127	50
Uganda	44	121	175	210	222	254	229
Tanzania	39	149	158	172	183	193	224
Outflows, US$ million							
World	255,010	395,728	476,934	683,211	1,096,554	1,200,783	711,445
Developing countries	32,030	61,137	76,662	49,837	72,786	99,052	47,382
SSA	1,939	1,360	3,351	1,694	2,356	1,253	(2,741)
EAC	42	36	20	34	22	12	72
Kenya	3	25	5	14	30	40	77
Uganda	39	11	15	20	-8	-28	-5
Tanzania	0	0	0	0	0	0	0
Net inflows, US$ million							
World	(30,065)	(10,768)	4,977	2,817	(17,471)	192,174	112,380
Developing countries	40,672	88,622	116,562	141,447	156,509	147,005	162,049
SSA	838	2,996	4,786	4,539	5,569	10,659	8,460
EAC	61	247	353	390	425	562	431
Kenya	17	(12)	35	28	12	87	(27)
Uganda	5	110	160	190	230	282	234
Tanzania	39	149	158	172	183	193	224
Net inflow ratios, %							
SSA/ Developing countries	2	3	4	3	4	7	5
EAC/SSA	7	8	7	9	8	5	5
Kenya/EAC	28	(5)	10	7	3	15	(6)
Uganda/EAC	8	45	45	49	54	50	54
Tanzania/EAC	64	60	45	44	43	34	52

Source: UNCTAD (2003).

Table 7.A3: Foreign direct investment flows, by type of investment, 1975–2002 (millions of US dollars)

Year	Inward investment				Outward investment			
	Equity	Reinvested earnings	Intra-company loans	Total	Equity	Reinvested earnings	Intra-company	Total
1975	2.7	18.8	-4.4	17.2	...	0.5	0.8	1.4
1976	1.0	42.8	2.6	46.4	...	1.7	2.6	4.3
1977	4.8	41.1	10.6	56.6	...	2.4	0.2	2.7
1978	0.3	41.4	-7.3	34.4	-1.3	3.9	-0.3	2.3
1979	4.8	68.2	11.0	84.0	...	6.4	-0.5	5.9
1980	15.4	51.5	12.1	79.0	...	1.1	...	1.1
1981	13.6	0.6	...	14.2	...	5.9	...	5.9
1982	12.5	0.5	...	13.0	...	9.6	...	9.6
1983	23.4	0.4	...	23.7	...	14.5	...	14.5
1984	7.0	3.8	...	10.8	...	6.9	...	6.9
1985	10.7	18.1	...	28.9	...	5.4	...	5.4
1986	17.8	14.9	...	32.7	...	4.9	...	4.9
1987	5.7	32.9	.0.8	39.4	...	17.0	.13.7	30.8
1988	0.8	20.9	-21.2	0.4	..	...	2.2	2.2
1989	8.6	23.8	29.9	62.2	0.8	...	0.6	1.4
1990	12.0	45.1	.	57.1	...	...	...	...
1991	2.8	16.0	..	18.8	...	...	...	...
1992	4.8	1.6	...	6.4	...	...	...	...
1993	...	1.6	...	1.6	...	...	...	...
1994	...	3.7	...	3.7	...	...	...	...
1995	28.2	4.3	...	32.5	...	...	...	...
1996	8.4	4.3	...	12.8	...	...	-0.5	-0.5
1997	19.7	...	...	19.7	...	...	2.2	2.2
1998	11.4	...	...	11.4	...	...	...	...
1999	13.8	...	...	13.8	...	...	...	...
2000	83.3	...	27.6	110.9	...	...	...	...
2001	0.8	...	4.5	5.3	...	...	...	...
2002	...	...	...	...	...	...	...	...

Source: International Monetary Fund, August 2003 Balance of Payments CD ROM.

Table 7.A4: Top MNCs in the host economy, 2002 (millions of dollars and numbers)

Company	Home economy	Industry
A) Industrial		
British American Tobacco (Kenya)	UK	Tobacco
East African Industries	UK	Pharmaceuticals
Unilever Kenya	UK	Food
Brooke Bond Kenya	UK	Agriculture
East African Portland Cement Company	France	Non-metallic minerals
Carnaud Metalbox	USA	Metals
The Standard	UK	Printing and publishing
George Williamson Kenya	UK	Agriculture
Rhone Poulenc Kenya	France	Pharmaceuticals
Cadbury Kenya	Netherlands	Food
Nestle Foods Kenya	Switzerland	Food
Elida Ponds Kenya	UK	Pharmaceuticals
Teita Estate	Greece	Textiles
Kapchorua Tea Company	UK	Agriculture
Henkel Polymer Co.	Germany	Chemicals
Bata (K) Ltd.	Canada	Shoes
Bayer AG	Germany	Pharmaceuticals
British Oxygen	UK	Industrial gases
Cementia	Switzerland	Cement
Ciba Geigy	Switzerland	Pharmaceuticals
CMB packaging	France	Metal packaging
Coca Cola	USA	Beverages
Colgate-Palmolive	USA	Hygiene products
CPC	USA	Corn products
Glaxo Smithkline	UK	Pharmaceuticals
Sterling Winthrop	USA	Pharmaceuticals
Sumitomo	Japan	Construction
B) Tertiary		
Basf East Africa	Germany	Trade
Total Kenya	France	Petroleum
Express Kenya	Switzerland	Transport and storage
Amiran Kenya	UK	Trade
Tibbett and Britten Kenya	UK	Transport and storage
Cetco	Germany	Trade
Hoescht East Africa	Germany	Industrial chemicals
Kodak (Kenya)	USA	Photo
The Crown Cork Company (EA)	USA	Other business services
Blackwood Hodge (Kenya)	UK	Trade
Colas (East Africa)	France	Other business services
Express Mombasa	Switzerland	Transport and storage
Securicor (Kenya)	UK	Security services
Interfreight (Kenya)	Switzerland	Transport and storage
Jos Hansen and Soehne (East Africa)	Germany	Trade
British Petroleum	UK	Petroleum products
Caltex Oil	USA	Refinery products
ESSO	USA	petroleum
General Motors	USA	Vehicle assembly
Hilton International	UK	Hotels
Intercontinental Hotel	Japan	Hotel

Continued

Table 7.A4, continued

Company	Home economy	Industry
Mitsubishi	Japan	Motor vehicles
Orient Paper Mills	India	Paper products
Safari Park Hotel	South Korea	Hotel
Shell	UK	Petroleum
Total	France	Petroleum
C Finance and Insurance		
Barclays Bank of Kenya Ltd.	UK	Finance
Stanbic Bank Kenya Ltd.	South Africa	Finance
Middle East Bank Kenya Ltd.	Belgium	Finance
Dubai Bank Kenya Limited	UAE	Finance
UAP Provincial Assurance Society	UK	Insurance
Standard Chartered Bank (Kenya)	UK	Finance
American Life Insurance Company (Kenya)	USA	Insurance
Phoenix of East Africa Assurance Co.	United Rep.	Insurance
Independent Adjusters Kenya	Netherlands	Insurance
Insurance Holdings (Africa)	USA	Finance

Note: The table is adapted from *UNCTAD WID Country Profile: Kenya* (2003.)

Table 7.A5: Firms operating in EPZs, 2002

Company	Ownership	Activity	Date of operation
Birch Investments	Hong-Kong	Garments	Mar 93
Indigo Garments	India	Garments	Sep 99
Jar Kenya	USA	Garments	Jul 97
Kenap		Garments	Sep 99
Tri star	Kenya	Garments	Sep 94
Upan Wasana	Sri Lanka	Garments	Sep 01
Kapric Apparels	Hong Kong	Garments	Jan 01
Kentex Apparels	India	Garments	Jan 01
California Link EPZ (K) Ltd.	Sri Lanka	Garments	Mar 01
Union Apparels	Sri Lanka	Garments	Jul 01
MRC Nairobi	Sri Lanka	Garments	Oct 01
Sino Link	China	Garments	Aug 01
Sahara Stitch	Kenya	Garments	Dec 01
Sin Lane K	Taiwan	Garments	Dec 01
Protex K	Taiwan	Garments	Nov 01
Mirage Fashion Wear	India	Garments	Mar 02
Kenya Knit Garments	Taiwan	Garments	Mar 02
Wild Life Works	USA	Garments	Mar 02
Global Apparels (K)	India	Garments	Mar 02
Rolex Garments	India	Garments	Mar 02
Baraka Apparels	Kenya	Garments	Mar 02
Forum International		Garments	2002
Mega Garments Industries	Sri Lanka	Garments	Aug 02
Blue Bird Garments	Kenya	Garments	Nov 02

Continued

Table 7.A5, continued

Company	Ownership	Activity	Date of operation
Altex	Kenya	Garments	Oct 02
Rising Sun	Sri Lanka	Garments	Oct 02
Ashton Apparels	India	Garments	Aug 01
Orange Styles	India	Garments	Dec 02
Senior Best Garments	Taiwan	Garments	Nov 02
Ancheneyar	Sri Lanka	Garments	Dec 02
Lihua Garments	China	Garments	Dec 02
Premium Machinery Distribution	India	Sewing machines	
TJM Apparel Solutions	India	Sewing machines	Nov 02
Rupa Cotton Mills	Kenya	Cotton yarn	Oct 01
De La Rue Currency and Security Printing EPZ Ltd.	UK	Security printing	Mar 93
E.A. Molasses	Kenya	Storage/Lubrication	Jan 93
Golden Light	China	Torch bulbs	Oct 99
Indu Farm	Netherlands	Fruits & vegetables	Oct 00
Insight Digital Graphics EPZ	UK	Digital printing	Feb 00
Ivee Aqua.	India	Pharmaceuticals	Sep 95
Logistic Container Centre	Denmark	Container repair	Dec 97
Nodor Kenya.	UK	Dart boards	Sep 99
Norbrook Africa	UK	Pharmaceuticals	Apr 96
Oil Tanking	South Africa	Bitumen	Jan 93
Pwani	Kenya	Edible oil	Jul 00
Rayven EPZ Ltd.	UK/Kenya	Electronics	Oct 92
Rosavie	Belgium	Preserves	Mar 98
Muthama Gemstones	Kenya	Gemstones	Jan 01
Film Studios	Kenya	Film hiring	Jan 01
Plastic Compounders	UK	PVC compound	Jul 01
Cybel Agric	Kenya	Veterinary	Oct 01
Newcal Technologies	Kenya	Computer/ T	Oct 98
Transfleet	Pakistan	Godowns	Jan 95
Match Point	USA	Buying office	Oct 02

Source: EPZA (Export Processing Zone Authority), 2002.

Table 7.A6: Macroeconomic indicators

	GDP growth rate %	Invest-ment rate %	Dom. savings rate %	Over-all BOP rate	Current account balance	Tariffs, %	TOT	Budget deficit	Share private sector credit	Lending rate %	Exchange rate Ksh per US$	Infla-tion %
1990	4.21	24.3	14.4	(93)	(527)	12.5	103	-4.3	52.1	18.75	24.084	17.8
1991	2.08	21.3	19.0	(44)	(213)	10.7	113	-5.0	53.4	19	28.074	20.1
1992	0.48	16.9	13.7	(257)	(180)	15.2	118	-1.3	59.4	21.07	36.216	27.3
1993	0.24	17.6	23.8	412	71	12.0	128	-4.5	63.7	29.99	68.163	46.0
1994	3.03	19.3	19.6	62	98	16.0	116	-5.8	54.3	36.24	44.839	28.8
1995	4.82	21.8	11.3	(142)	(400)	16.1	103	-1.3	59.4	28.8	55.939	1.6
1996	4.64	20.4	13.2	387	(74)	12.1	120	1.2	62.3	33.79	55.021	8.9
1997	2.36	18.5	7.9	15.5	(377)	10.6	98	-2.2	64.1	30.25	62.678	11.4
1998	1.77	17.3	9.3	82.6	(363)	12.5	97	-0.8	59.1	29.49	61.906	6.7
1999	1.42	16.1	10.2	(34)	(90)	12.8	115	-0.7	59.7	22.38	72.931	5.7
2000	-0.2	15.4	5.7	(6.8)	(204)	12.8	102	0.9	61.2	22.34	78.036	10.0
2001	1.20	14.5	5.5	(47.5)	(318)	10.8	-	-0.2	56.9	19.67	78.600	5.7

Source: IFS; WDI.

Table 7.A7: Socioeconomic and political indexes

	Govern-ment stabi-lity	Invest-ment pro-file	Socio-eco-nomic condi-tions	Inter-nal con-flict	Exter-nal con-flict	Cor-rup-tion	Mili-tary in pol-itics	Reli-gion in pol-itics	Law and order	Ethnic ten-sion	Demo-cratic account-ability	Bur-eau-racy qua-lity
1990	4.500	6.500	6.333	6.250	7.000	3.000	3.000	5.000	3.000	1.000	3.000	3.000
1991	4.000	5.417	5.583	6.000	7.000	3.000	3.000	5.000	3.000	1.000	2.667	3.000
1992	4.250	6.417	6.000	6.500	10.000	3.000	5.000	4.000	3.000	1.667	2.917	3.000
1993	5.000	5.500	5.500	9.500	10.667	3.000	5.000	4.667	3.000	3.583	3.667	3.000
1994	5.583	5.000	5.417	10.250	12.000	3.000	5.000	5.000	3.500	3.917	4.000	3.000
1995	5.500	5.000	6.000	10.667	12.000	3.000	5.000	5.000	4.000	4.000	4.583	3.000
1996	6.333	5.000	5.667	11.000	12.000	3.000	5.000	4.750	4.000	4.000	4.167	3.000
1997	8.417	6.167	4.000	9.167	12.000	2.667	4.500	4.000	4.000	4.000	3.167	2.583
1998	9.917	7.000	4.000	5.417	11.917	2.000	3.000	3.750	2.167	3.167	2.917	2.000
1999	9.583	6.583	4.000	7.000	9.250	2.000	3.000	3.000	2.000	2.250	3.000	2.000
2000	9.000	6.333	3.500	7.500	7.583	2.000	3.000	3.000	2.000	2.000	3.000	2.000
2001	9.583	8.500	2.125	9.167	9.500	2.000	3.000	2.708	2.000	2.000	3.000	2.000
2002	8.417	9.000	1.500	8.333	9.500	2.167	3.000	1.500	1.583	1.708	3.000	2.000

Table 7.A8: Selected key EPZ indicators: 1997–2001

	1997	1998	1999	2000	2001	2002
Gazetted zones (Number)	15	16	16	19	23	31
Enterprises operating (Number)	17	18	22	24	39	54
Employment (Kenyans)	2,824	3,645	5,077	6,487	13,444	26,447
Private investment (Ksh million)	4,657	5,747	5,941	6,107	8,950	12,728
Output (Ksh million)	1,767	2,439	3,814	4,392	6,499	11,040
Exports (Ksh million)	1,263	1,805	3,020	3,635	5,962	9,741
Domestic sales (Ksh million)	503	649	706	755	538	932
Imports (Ksh million)	1,258	2,056	2,126	2,349	3,990	7,043
Domestic expenditure (Ksh million)	402	511	955	1,187	2,235	3,651

Source: EPZA Annual Report, 2001 and 2002.

Table 7.A9: Cost of doing business

	Country	Kenya	Tanzania	Uganda	South Africa	Botswana	Angola
Starting a business	No. of procedures	12	13	17	9	11	14
	Duration (days)	47	35	36	38	108	146
	US$ cost	223.41	513.69	306.36	357.98	417.94	6621
Enforcing contract details	No. of procedures	25	14	16	26	22	47
	Duration (days)	255	127	99	207	56	941
	Cost (% GNI per capita)	49.50	3.80	10.00	16.70		15.7
	Procedural complexity index	44	62	40	56	52	69
Getting credit	Public credit registry index	0	0	0	0	0	60
	Private bureau coverage (borrowers per 1000 capita)	309	0	0	469	382	0
	Creditor rights index	4	2	2	3	3	3
	Private credit (% GDP)	25.69	4.66	5.45	72.17	15.61	2.88
	Five bank concen-tration ratio (%)	57.00	72.60	76.30	74.90	97	0
	Interest rate spread(%)	12.94	15.47	11.83	5.08	5.13	34.4
Closing a business	Actual time (years)	4.6	3.0	2.0	2.0	2.2	
	Actual cost (% of estate)	18	8	38	18	18	
	Absolute priority preserved	100	33	33	100	100	33
	Efficient outcome achieved	0	1	1	0	1	0
	Goals-of-insolvency index	47	65	55	53	77	8
	Court-powers Index	33	67	67	67	33	6.7
Labour market	Flexibility hiring index	33	57	33	42	33	71
	Condition of employ-ment index	53	77	44	36	55	89
	Flexibility firing index	16	49	50	30	17	74
	Employment law index	34	61	42	36	35	78

Source: World Bank, *Doing Business* (various issues).

Table 7.A10: The FDI model estimates (dependent variable: FDIGDP)

	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
CONST	1.402**	1.671	-1.189***	-2.246	1.162***	-2.365
DYN	0.041	0.666	0.062*	1.422		
DYNT	0.371**	1.694	0.406***	2.091	0.339***	2.056
TY15	0.028	0.372				
REER	0.00008	0.070				
DFY	0.057*	1.628	-0.037	-1.268		
TRAY	0.002	0.316				
IPUB	0.028	0.744				
TTS	0.038	1.005	-0.066***	-2.029	0.061***	-1.987
DEBTY	0.011**	1.682	0.012***	2.328	0.008**	1.903
DEBTY^2	0.000017*	1.387	-0.000019**	-1.730	0.000014*	-1.431
DSX	0.007	0.437				
PIN	0.410*	1.629	0.331*	1.454	0.304*	1.407
ICRGE	0.385***	2.487	0.386***	2.792	0.418****	3.259
1985-89	0.057	0.115	-0.275	-0.630	0.111	-0.282
1990s	0.261	0.613	-0.408	-1.045	0.176	-0.530
DKENYA	0.445	0.654	-0.470	-0.697	0.547	-0.822
R^2		0.292		0.256		0.191
Adj. R^2	0.164		0.173		0.127	
S.E. of regression		1.114		1.117		1.109
F stat		2.279		3.074		2.991
Pr(F stat)	0.008		0.001		0.003	
D W stat	2.136		1.915		1.772	
Obs.	105		110		124	

Note: Significance: ****1% level, ***5%, **10%, *20%.

Chapter 8

Foreign Direct Investment in Nigeria: Magnitude, Direction and Prospects

E. Olawale Ogunkola and Afeikhena Jerome

The potential contribution of foreign direct investment (FDI) to economic development and integration into the world economy is now widely recognized. It assumed prime importance in the wake of declining concessional aid, which has created a preference for long-term and more stable financial inflows. The lessons from the experience with the Asian financial crises also pushed FDI into position as a sustainable and more credible alternative. In addition to providing capital inflows, FDI can also potentially boosts the growth of a country by "crowding in" other investments with an overall increase in total investment, as well as hopefully creating positive "spillover effects" from the transfer of technology, knowledge and skills to domestic firms. It can also stimulate economic growth by spurring competition, innovation and improvements to a country's export performance. The indirect impacts of FDI on the domestic economy are the main reason for the intense political focus on FDI in most countries, which has led to unprecedented levels of public subsidies, diplomatic efforts and promotional activities to attract investors (Mabey and McNally, 1998).

FDI does have some potential negative impacts, the most potent being anti-competitive and restrictive business practices by foreign affiliates, tax avoidance, and abusive transfer pricing. Volatile investment flows and related payments may be deleterious to balance of payments, while some FDI is seen as transferring polluting activities and technologies. Moreover, there is often fear that FDI may have excessive influence on economic affairs, with possible negative effects on industrial development and national security. The intensity of concerns about these types of impact is diminishing, however. FDI has grown dramatically and is now the largest and most stable source of private capital for developing countries and economies in transition, accounting for nearly 50% of all those flows in 2002. The increasing role of FDI in host countries has been accompanied by a change of attitude, from critical wariness toward multinational corporations to sometimes uncritical enthusiasm about their role in the development process. The domestic policy framework is crucial in determining whether the net effects of FDI are positive (UNCTAD, 1999). Thus, instituting (designing and implementing) a policy mix that maximizes the potential benefits and minimizes the potential negative effects is very important. Empirical evidence suggests that some countries have been more successful in this respect than others (UNCTAD, 1999). FDI, when handled properly, can make a positive contribution to development.

Only a few countries in Africa have been successful in attracting significant FDI flows, however. Indeed, Africa as a whole, and sub-Saharan Africa (SSA) in particular, has been on

the sidelines of the FDI boom. For most of the time since 1970, FDI inflows into Africa have increased only modestly, from an annual average of almost US$1.9 billion in 1983–1987 to US$3.1 billion in 1988–1992 and US$4.6 billion in 1991–1997.

African countries have made considerable efforts over the past decade to improve their investment climate. Renewed confidence in the positive benefits of FDI has led many countries that were restricting FDI from the 1960s to 1980s to be more open towards FDI in the 1990s and beyond. Governments are liberalizing FDI regimes as they associate FDI with positive effects for economic development and poverty reduction in their countries (Lall, 2000; Borensztein et al., 1998). More importantly, the economic performance of the region has substantially improved since the mid 1990s with the adoption of economic reform (structural adjustment) programmes that hinged on pushing down exchange rates, inflation and government spending. But the expected surge of FDI into Africa as a whole has not occurred and foreign investment is still significantly less than foreign aid. It remains concentrated in only a few countries and the number of foreign enterprises involved in SSA fell, owing to the testing business environment and problems such as poor infrastructure, corruption and foreign exchange shortages.

Too often, potential investors discount the African continent as a location for investment because a negative image of the region as a whole conceals the complex diversity of economic performance and the existence of investment opportunities in individual countries (UNCTAD, 1999). While the problems many African countries face are widely known and dominate the perceptions of the continent as a whole, there are a number of positive aspects that although highly relevant for foreign investors, are little known. Most African countries have substantially improved their FDI framework, and a number of them have already attracted significant amounts of FDI, in absolute or relative terms, or both, from an increasing number of home countries, including developing countries. In addition, FDI in Africa is no longer concentrated in the traditional natural resources sector, but has moved into manufacturing and services industries in considerable amounts during recent years. The increasing divergent trends in different countries makes "one-size-fit-all" policy recommendations more inappropriate than ever. The need to examine the trend in individual African countries rather than as a homogenous entity has become evident. This is the challenge of this chapter. The chapter appraises the structure, trend and magnitudes of FDI in Nigeria with a view to ascertaining policy-induced changes in the structure.

The chapter makes some distinct contribution to the literature. Nigeria remains under-researched on the subject of FDI, and this study provides a consistent analysis and detailed appraisal of FDI in Nigeria, albeit qualitative. The main findings of the study can be summarized as follows: paradoxically, while Nigeria has traditionally been one of the biggest recipients of FDI inflows in Africa, the country has failed to unleash its FDI potential largely for self-inflicted reasons. The country has made little progress in attracting FDI despite its immense human and natural resources. For a long time, like many African countries, Nigeria stuck to rather hostile policies for private sector development in general, and FDI in particular. Nigeria only cautiously and recently, in the mid 1980s, embarked on a reform path – but this was characterized by frequent interruption by political shocks and policy reversals. The FDI environment in Nigeria has improved, at least relative the situation in the pre 1980s, although it is still less accommodating – sometimes hostile – and inadequate to attract high quality, efficiency-seeking FDI. Addressing problems related to corruption, inadequate infrastructure and inconsistent regulations remains the key element for the country's future prospects of attracting more efficiency-seeking FDI.

A Socioeconomic Look at Nigeria

With a GDP of US$43.4 billion and a population of 132.8 million in 2002, Nigeria is the fourth largest economy in Africa and has an internal market that has no rival within the continent. The country is richly endowed with abundant human and natural resources: Vast arable land has complementing conditions that support agricultural activities. With an estimated 124 trillion cubic feet (tcf) of proven natural gas reserves – the tenth largest in the world – Nigeria is poised to become a major exporter of natural gas and is already ranked as the seventh major oil producer in the world. She has numerous solid mineral deposits including coal, bitumen, gypsum and others that have barely been harnessed. These range from precious stones to various industrial minerals for a wide range of industries such as construction, pharmaceuticals, food processing and other forms of manufacturing.

Economic growth has been poor, averaging just 1.6% through the 1980s and 2.4% in the 1990s. Years of economic mismanagement and corruption restricted economic growth, leaving Nigeria's GDP per capita under US$300 and placing the nation amongst the 20 poorest countries in the world. Oil provides 95% of foreign exchange earnings, 20% of GDP and 65% of budgetary revenues. Former military rulers failed to diversify the economy beyond oil. As a result, economic performance closely mirrors international oil prices.

Nigeria is highly indebted. Her relations with donors are periodically strained, chiefly over the government's persistent refusal to clear the external debt stock, which stood at US$28.4 billion at end-December 2001 and is largely the result of borrowing heavily in the 1970s on the back of high oil prices by successive military leaders. The distribution of the debt stock showed that the Paris Club accounted for 77.9%, multilateral holdings were 9.9% and the London Club of creditors was owed 7.2%. The balance of 4.6% was owed to promissory note holders and the non-Paris Club bilateral creditors held 0.4% (AfDB/OECD, 2003).

Nigeria is undergoing substantial economic reform under the new civilian administration. High oil prices in late 1999 boosted revenue and growth, resulting in a budgetary windfall and bringing public finances to a relatively stable position. Increased public spending has strengthened inflationary pressures, however, with inflation rising to 18% in March 2002.

The fragile democracy is threatened by recurrent political tension and heightened communal, religious and ethnic violence in the quest for access to economic resources and political power. Nigeria continues to rank low on most development indexes. Table 8.1 presents the country's major indicators.

Conceptual Framework for This Study

Ever intensifying foreign trade relations and international financial relations over the past decades have made national economies even more integrated. An important aspect of international economic integration is the larger role of foreign direct investment (FDI) in different economies. FDI has grown at rates far greater than those of international trade or output since the late 1980s, especially among the industrialized countries. Estimates by UNCTAD (2002) put the total stock of FDI capital at 17.5% of global GDP in 2000, more than double the size in 1990 (8.3%). A direct consequence of the greater presence of foreign-owned firms is the internationalization of production. Currently, companies that are under control of foreign investors account for about 11% of global production.

Table 8.1:   Nigeria: Key indicators

General Socioeconomic indicators				2002
Population, mid 2002 (millions)				132.8
GNI per capita (Atlas method, US$), 2002				290
GNI (Atlas method, US$ billion), 2002				38.7
Average annual growth (1996–02)				
Population (%)				2.5
Labour force (%)				2.6
Poverty (% of population below national poverty line)				—
Urban population (% of total population)				46
Life expectancy at birth (year)				45
Gross primary enrolment (% of school-age population)				82
Macroeconomic indicators	*1982*	*1992*	*2001*	*2002*
GDP (US$ billions)	49.7	32.7	42.5	43.4
Gross domestic investment/GDP	—	21.8	20.1	23.3
Exports of goods and services /GDP	16.3	42.2	44.4	37.7
Gross domestic savings/GDP	14.0	23.5	24.5	17.4
Gross national savings/GDP	11.4	16.9	22.9	14.8
Total debt/GDP	24.1	88.7	73.2	69.4
Average annual growth	*1982–92*	*1992–02*	*2001*	*2002*
GDP per capita	4.2	2.3	2.9	-0.9
GDP	1.2	-0.4	0.6	-3.1
Structure of the economy	*1982*	*1992*	*2001*	*2002*
Private consumption	69.9	58.1	45.5	55.4
General government consumption	16.1	18.4	30.0	27.2
Prices and government finance	1982	1992	2001	2002
Consumer prices	7.7	44.6	18.9	12.9
Implicit GDP deflator	2.6	83.6	7.8	11.6
Trade	*1982*	*1992*	*2001*	*2002*
Total exports (f.o.b.)	12.154	11.886	17.949	14.912
Total imports (c.i.f.)	17.730	9.842	13.619	14.752
External debt and resource flows	*1982*	*1992*	*2001*	*2002*
Total debt outstanding and disbursed	11.972	29.019	31.119	30.116

Source: Adapted from Nigeria at a Glance, The World Bank Group.
http://www.worldbank.org/data/countrydata/aag/nga_aag.pdf (accessed 24 March 2004).

There are several definitions of FDI in the literature. It refers to investments in businesses of another country, which may take the form of either "greenfield" investment (also called "mortar and brick" investment) or merger and acquisition, which entails the acquisition of existing assets rather than new investment. Rutherford (1995) contrasts FDI with portfolio investment, which is the acquisition of securities. Foreign direct investments are financial transactions aimed at acquiring a lasting interest in a company in another country. A lasting interest means that the direct investor has a long-term relationship with and significant influence on the management and policies of the foreign company. Direct investment commonly takes place when a company in one country obtains all or much of the share capital of a company in another country, often via merger and acquisition. In statistics, ownership of at least 10% of the

ordinary shares or voting stock is the criterion for the existence of a direct investment relationship. Ownership of less than 10% is recorded as a portfolio investment. FDI comprises not only mergers, takeovers/acquisitions and new investments, but also reinvested earnings and loans and similar capital transfers between parent companies and affiliates.

Countries typically act both as host to FDI projects in their own country and as participants in investment projects in other countries. A country's inward FDI position is made up of the hosted FDI projects, while the outward FDI position consists of the FDI projects owned abroad. Both larger inward and outward FDI positions may make the domestic economy more sensitive to economic disturbances abroad in the short run.

The literature on FDI identifies at the least four different motives for firms to invest across national borders (UNCTAD, 1998). These are:

- *Market-seeking investment* seeks access to new markets that are attractive because of their size, growth or a combination of both.
- *Efficiency-seeking investments* aim at taking advantage of cost-efficient production conditions at a certain location. Important factors that are taken into consideration are the cost and productivity levels of the local workforce, the cost and quality of infrastructure services (transport, telecommunications), and the administrative costs of doing business. This motive is predominant in sectors where products are produced mainly for regional and global markets and competition is mostly based on price (such as in textiles and garments, electronic or electrical equipment, etc.) and not on quality differentiation.
- *Natural-resource seeking investment* seeks to exploit endowments of natural resources. Naturally, the production and extraction of the resource is bound to the precise location, but given that most resources can be found in a relatively large number of locations, companies usually choose locations on the basis of differences in production costs.
- *Strategic-asset seeking investment* is oriented towards man-made assets, as embodied in a highly-qualified and specialized workforce, brand names and images, shares in particular markets, etc. Increasingly, such FDI takes the form of cross-border mergers and acquisitions, whereby a foreign firm takes over the entire or part of a domestic company that is in possession of such assets.

In reality, these motives are seldom isolated from one another. In most cases, FDI is motivated by a combination of two or more of these factors.

The contribution of FDI to economic growth has been debated quite extensively in the literature. Two main channels by which FDI affects economic growth are the traditional and the technological explanations. The "traditional" argument is that an inflow of FDI improves economic growth by increasing the capital stock, whereas recent literature points to the role of FDI as a channel of international technology transfer. There is growing evidence that FDI enhances technological change through technological diffusion. Moreover, FDI not only contributes to imports of more efficient foreign technologies, it also generates technological spillovers for local firms (Lensink and Morrissey, 2001). The knowledge spillovers may take place via imitation, competition, linkages and/or training (Sjoholm, 1999).

Theoretically, the view that FDI is positively correlated to growth is bolstered by developments in growth theory that highlights the importance of improvements in technology, efficiency and productivity in stimulating growth (Lim, 2001). Nevertheless, the empirical evidence that FDI generates positive spillovers for local firms is mixed. Some studies find positive spillover effects (Blomstrom et al., 2000; Sjohlomn, 1999), others find no effects and some even conclude that there are negative effects (Aitken and Harrison, 1999). On balance,

the literature agrees that the positive effects of FDI tend to outweigh the negative effects (Lim, 2001; Klein et. al., 2001).

A recurrent theme appears to be the need for the host country to have attained a certain threshold of development. The contribution of FDI to growth is strongly dependent on the circumstances in recipient countries. Certain host country conditions are necessary to ensure the spillover effects. In particular, human capital (an educated labour force) is necessary for new technology and management skills to be absorbed. In a very influential paper, Borensztein et al. (1998) suggest that the effectiveness of FDI depends on the stock of human capital in the host country. Only in countries where human capital is above a certain threshold does FDI positively contribute to growth. Balasubramanyam et al. (1996) also found the effect on growth to be stronger in countries with a policy of export promotion than in countries that pursue a policy of import substitution. Alfaro et al. (2001) conclude that below a threshold level of financial market development in the host country, FDI will not exert beneficial effects on growth. These studies tend to echo an earlier finding of Blomström and Kokko (1994) that the positive impact of FDI on economic growth is confined to higher-income developing countries. Developing countries must have reached a minimum level of economic development before they can capture the growth-enhancing effects of FDI.

The determinants of foreign direct investment inflows continue to engage academics' and policy makers' attention. The absence of a generally accepted theoretical framework has led researchers to rely on empirical evidence for explaining the emergence of FDI. Alhough there has been considerable theoretical work on foreign direct investment (see, e.g., Hymer, 1960; Caves, 1982; Buckley and Casson, 1976), there is no agreed model providing the basis for empirical work. The theoretical literature is choked with an array of hypotheses drawing heavily on theories of imperfect competition and market failure to explain the FDI phenomenon. These hypotheses find their roots in Hymer's (1960) seminal work, refined and publicized by Kindleberger (1969), but they emerged in a more consistent manner from Dunning's "eclectic approach". Dunning's (1974, 1980) OLI paradigm (ownership, location, internalization) has provided a taxonomic framework for most estimating equations. Dunning proposes that FDI can be explained by three categories of factors: ownership advantages (O) for firms to operate overseas, such as intangible assets; locational advantages to investment in the host rather than the donor country (L); and the benefits of internalizing the use of the assets (I).

The extensive literature, based generally on three approaches – aggregate econometric analysis, survey appraisal of foreign investors' opinion and econometric study at the industry level – has failed to arrive at a consensus. This can be partly attributed to the lack of reliable data, particularly at the sectoral level, and to the fact that most empirical work has analysed FDI determinants by pooling of countries that may be structurally diverse. The literature indicates that the key locational factors determining FDI are host country market size, input costs – notably of natural resources and labour and the riskiness of investment, both in terms of the economic and the political environment (see e.g. Singh and Jun, 1995; Culem, 1988). Studies of FDI in emerging markets have put particular emphasis on economic and political risk indicators (see Lucas, 1993; Jun and Singh, 1996). This comprises three main elements: macroeconomic stability, e.g. growth, inflation, exchange rate risk; institutional stability such as policies towards FDI, tax regimes, the transparency of legal regulations and the scale of corruption; and political stability, ranging from indicators of political freedom to measures of surveillance and revolutions.

In recent years, a flurry of studies has emerged, seeking explanations for why sub-Saharan Africa has been relatively unsuccessful in attracting FDI (Bhattacharaya et al., 1996; Collier

and Gunning, 1999; Collier and Patillo, 2000; Morisset, 2000; Jenkins and Thomas, 2002; Asiedu, 2002, 2004). In spite of methodological differences, the broad conclusions are largely the same. The macroeconomic policy environment is an important determinant of investment; and trade restrictions, inadequate transport and telecommunications links, low productivity, and corruption make Africa unattractive to potential investors. Asiedu (2002), for example, used a cross country regression model comprising 71 developing countries, half of which are in Africa. She found that FDI is uniformly low in Africa and a country in Africa will receive less FDI by virtue of its geographical location. She observed that policies that have been successful in other regions may not be equally successful in Africa. A higher return on investment and better infrastructure have a positive impact on FDI to non-SSA countries, but have no significant impact on FDI to SSA. Openness to trade promotes FDI to SSA and non-SSA countries, but the marginal benefit from increased openness is less for SSA. In a complementary study, Asiedu (2004) contends that although SSA has reformed its institutions, improved its infrastructure and liberalized its FDI regulatory framework, the degree of reform was mediocre compared with the reform implemented in other developing countries. As a consequence, relative to other regions, SSA has become less attractive for FDI. Jenkins and Thomas (2002) also recognize that Africa is significantly different; they ascribe the lower geographical spread to an African perspective that instability is endemic.

Trends in Foreign Direct Investment in Africa

At first sight, the debate over the potential effects of FDI in most African countries seems largely polemic, as the amount of investment during the past 20–30 years is so small – at least in relative terms. Starting from similar levels in the mid 1970s, annual FDI flows into sub-Saharan Africa stagnated for a long time at around US$5 billion, while the amounts received by Latin America as well as Asia, and in particular East Asia, expanded impressively from the 1980s onwards. Africa's share of FDI to developing countries has declined over time, from about 19% in the 1970s, to 9% in the 1980s and to about 3% in the 1990s (Asiedu, 2004). During the 1990s, Africa attracted about 2 % of global FDI flows. In 2002, FDI inflows fell below 1% of total global flows. This is in spite of the policy reforms implemented by countries in the region.

Since the late 1980s, African countries have embarked on wide-ranging reform programmes, including political and macroeconomic stabilization, trade and investment liberalization, privatization, and reduction of bureaucratic barriers to doing business, among others. By 1988, more than 20 countries in sub-Saharan Africa had revised or introduced new foreign investment laws (Bennell, 1990). By 1997, some 26 of the least developed countries (LDCs) in Africa covered by the UNCTAD survey had a liberal or relatively liberal regime for the repatriation of dividends and capital (UNCTAD, 1999). Also, there appears a renewed interest in regional integration and liberalization initiatives that seek to harmonize FDI policy frameworks.

According to *World Investment Report 2003*, FDI dropped globally from US$1.4 trillion in 2000 to US$840 billion in 2001 and US$651 billion in 2002. FDI inflows to Africa declined in 2002 by 41%, although in 30 of the region's 53 countries inflows actually increased. This downturn – from US$19 billion in 2001 to US$11 billion in 2002 – occurred at a time of worldwide slumps in FDI flows and largely reflected two cross-border mergers and acquisitions in South Africa and Morocco in 2001, of a magnitude not repeated in the region in 2002.

More than half of the countries marginally expanded their FDI inflows, while inflows for the others either remained the same or declined as shown in Appendix A. Top FDI recipients in

2002 were Angola, Algeria, Nigeria, Chad and Tunisia, which together accounted for half of all inflows as shown in Table 8.2 and Figure 8.1. Some traditional best performers, such as Morocco and South Africa, were displaced in 2002 by newcomers such as Angola and Chad that were relatively unknown as hosts to FDI flows into the region.

Table 8.2: Foreign direct investment in Africa: Inward flows in US$ million (top 10 by 2002 ranking)

Country	2001	2002
Angola	2,148	1,312
Nigeria	1,104	1,281
Algeria	1,196	1,065
Chad	-	901
Tunisia	486	821
South Africa	6,789	754
Sudan	574	681
Egypt	510	647
Morocco	2,808	428
Mozambique	255	406

Source: UNCTAD (2003).

Chad was the star African performer in attracting FDI in 2002. The country, which had received no FDI at all in 2001, registered inflows of over US$900 million. Much of this investment is related to the proven oil reserves in the Doba basins of Lake Chad. Chad thus became the fourth largest recipient in Africa and the second largest among LDCs after Angola.

Outward FDI from Africa in 2002 recovered from its negative performance in 2001, but remains small and dominated by six countries: Ghana, Kenya, Liberia, Morocco, Nigeria and South Africa. The top ten performers in 2002 are presented in Figure 8.2 and Table 8.3. South Africa is still the largest source of investment outflows and it is home to all three of the African firms on UNCTAD's top 50 developing country MNC list. South African MNCs have traditionally invested abroad in the mining sector, but their recent focus has been on telecommunications. MTN and Vodacom SA both made inroads into the telecommunications

Figure 8.1: Foreign direct investment in Africa: Inward flows in US$ million (top 10 by 2002 ranking)
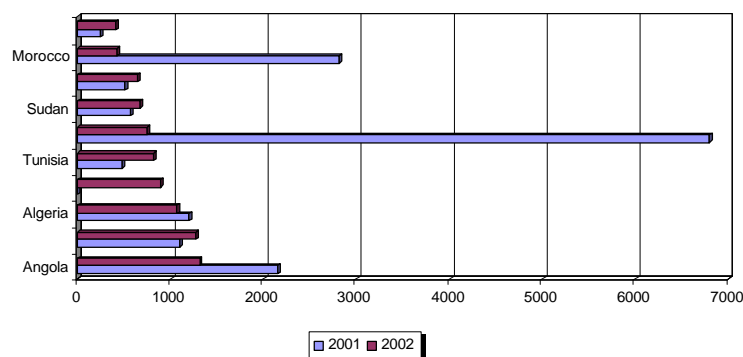
industries of many African countries. South African Breweries recently bought a 64% stake in Miller Brewing Co. of the United States, becoming SABMiller. SABMiller then went on to acquire Bira Peroni (Italy) and Harbin Brewery (China) in 2003.

Table 8.3:   Foreign direct investment in Africa: Outward flows in US$ million (top 10 by 2002 ranking)

Country	2001	2002
Libyan Arab Jamahiriya	84	110
Nigeria	94	101
Algeria	9	100
Kenya	50	76
Ghana	53	61
Senegal	-7	39
Morocco	97	29
Egypt	12	28
Swaziland	9	27
Mali	17	19

Source: UNCTAD (2003).

Figure 8.2:   Foreign direct investment in Africa: Outward flows in US$ million (top 10 by 2002 ranking)
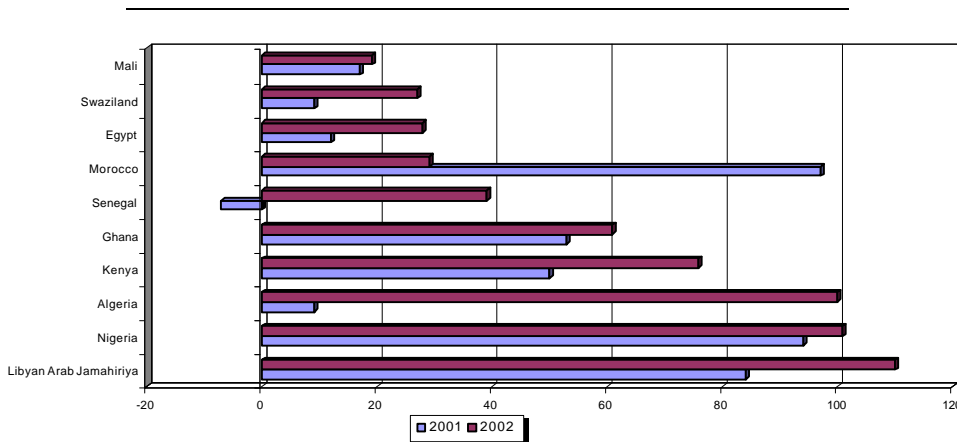
FDI in Nigeria

As indicated in Table 8.3, Nigeria was the second largest FDI recipient in Africa in 2002. Table 8.4 presents FDI indicators for Nigeria from 1985 to 2001. FDI inflows increased from US$486 million in 1985 to US$1.1 billion in 1995 and peaked at US$1.939 billion in 1997. Since then, they have been hovering at around US$1 billion. Net outflows have been very insignificant except in 1990 when they were US$1.824 billion. Inflows as a percentage of GDP ranges between 16 in 1985 and 57 in 1998.

Cross-border merger and acquisitions (M&A) activity has been particularly insignificant in Nigeria, reflecting the dominance of greenfield investment. Table 8.5 presents comparable

M&A figures for Angola and South Africa, the other two top FDI recipients in Africa. While figures for Angola are virtually nonexistent or insignificant, Nigeria performed poorly compared with South Africa in both M&A sales and purchases.

Table 8.4: FDI indicators for Nigeria (1985–2002)

Indicator	1985	1990	1995	1996	1997	1998	1999	2000	2001	2002
FDI inflows (US$ million)	486	588	1,079	1,593	1,539	1,051	1,005	930	1,104	1,281
FDI outflows (US$ million)	-15	1,824	104	42	58	107	92	85	94	101
Inflows as % of GFCF	8	15	21	20	16	12	52	49	31	35
Outflows as % of GFCF	-0	47	2	1	1	1	5	52	3	3
FDI Inward stock (US$ million)	4,417	8,072	14,065	15,658	17,198	18,249	19,254	20,184	21,289	22,570
FDI outward stock (US$ million)	***	2,586	3,975	4,017	4,075	4,182	4,273	4,3582	4,452	4,553
Inward stock as %of GDP	16	28	50	44	47	57	55	42	42	42
Outward stock as % of GDP	***	9	14	11	11	13	12	9	9	9

Source: UNCTAD Database www.unctad.org/statistics (accessed 20 April 2004).

Table 8.5: Comparable cross-border merger and acquisitions figures for Nigeria, 1995–2002 (US$ million)

	1995	1996	1997	1998	1999	2000	2001	2002
Nigeria								
Sales	-	-	-	12	18	15	1	-
Purchases	2	-	-	-	-	-	6	-
Memorandums								
Angola								
Sales	-	-	-	-	-	-	19	-
Purchases	-	-	-	-	-	-	-	-
South Africa								
Sales	640	1,106	2,664	1,932	1,902	1,171	11,916	2,933
Purchases	593	1,522	2,766	2,514	5,715	6,393	2,594	1,947
Africa								
Sales	840	1,805	4,346	2,607	3,117	3,199	15,524	4,684
Purchases	13,372	29,646	35,210	21,717	63,406	48,496	55,719	22,858
World								
Sales	186,593	227,023	304,848	531,648	766,044	1,143,816	593,960	369,789
Purchases	186,593	227,023	304,848	531,648	766,044	1,143,816	593,960	369,789

Source: UNCTAD, World Investment Report, 2003; www.unctad.org/statistics

The success of Nigeria's drive for foreign investment remains in doubt with a reported downward slide of global interest in the nation's economy. The trend is summarized in Table 8.6, which presents UNCTAD's country ranking of inward FDI Performance Index and Inward FDI Potential Index. These indexes rank countries according to their potential for attracting

FDI. On the basis of the indexes, Nigeria is currently ranked 83 after South Africa and Benin, which are ranked 81 and 82, respectively.

Table 8.6: Country rankings and values of the UNCTAD inward FDI performance index and inward FDI potential index, 1988–1990, 1993–1995 and 1999–2001

Inward FDI performance index				Inward FDI performance index				
		Value					Score 0 – 1	
Rank[a]	Economy	1988-90	1993-95	1999-01	Rank[a]	Economy	1988-90	1993-95	1999-01
78	Peru	0.137	4.295	0.726	84	India	0.120	0.163	0.160
79	United States	1.121	0.725	0.719	85	Ukraine	..	0.201	0.159
80	Colombia	1.112	1.439	0.700	86	Turkey	0.135	0.187	0.159
81	South Africa	-0.042	0.383	0.696	87	Gambia	0.135	0.160	0.158
82	Benin	2.593	0.402	0.669	88	Yemen	0.060	0.178	0.156
83	Nigeria	3.925	5.879	0.639	89	Nigeria	0.128	0.160	0.151
84	Uzbekistan	..	0.429	0.634	90	Syrian AR	0.117	0.188	0.151
85	Myanmar	0.708	1.771	0.630	91	Romania	..	0.170	0.149
86	Cote d'Ivoire	0.398	1.959	0.627	92	Indonesia	0.177	0.207	0.148
87	Belarus	..	0.182	0.532	93	Morocco	0.121	0.167	0.148
88	Ukraine	..	0.567	0.524	94	Colombia	0.141	0.173	0.147

[a] Ranked by the index for 1999–2001.
Note: The inward FDI Performance Index is the ratio of a country's share in global FDI flows to its share in global GDP. The Inward FDI Potential Index is an unweighted average of the scores of eight normalized economic and social variables.
.. Data not available
Source: UNCTAD, *World Investment Report*, 2003; www.unctad.org/statistics

Sectoral Analysis

Traditionally, FDI into Nigeria has been concentrated in the extractive industries, but in recent years there has been a diversification into the manufacturing sector. Although data on sectoral allocation are inconsistent, at the beginning of the 1990s the primary sector accounted for only a little over 30% of the total FDI stock in Nigeria, while manufacturing attracted almost 50% and services close to 20%. This section appraises the origins of FDI inflows to Nigeria, the sectoral composition in order to establish the "enclave" nature of the inflows, a disaggregated analysis of inflows to the manufacturing sector and FDI outflow from the country using statistics generated from the Central Bank of Nigeria. To put the figures in perspective, the net flows of FDI into Nigeria are presented in Table 8.7.

A cursory examination of Table 8.7 reveals that outflows were generally smaller than inflows, thereby resulting in positive net flows. A few exceptions to this observed trend were recorded. Net flows with respect to the UK were negative for three years (1974, 1979 and 1988) suggesting a 9% probability of a negative net flow with respect to the UK. For the USA, the probability was about 50%. The corresponding figure for Western Europe was about 13%. However, overall negative net flows were recorded in 1989 and 1990 mainly because of the significant outflows to the US in 1989 and substantial outflows to the USA and the Western Europe in 1990. For some other years, negative net flows recorded by the USA were more than compensated for by the positive net flows recorded mainly by UK and Western Europe.

Table 8.7:   Net flows of FDI in Nigeria, 1970–2001, million naira

	United Kingdom	United States of America	Western Europe	Others	Total
1970	47.4	26.4	29.6	18.2	121.6
1971	147.6	107.4	36.2	28.4	319.6
1972	177.7	-50.7	106.0	15.3	248.3
1973	91.2	21.3	48.2	31.9	192.6
1974	-28.1	-7.9	44.6	39.7	48.3
1975	24.7	235.2	130.3	85.2	475.4
1976	84.5	-159.0	62.9	57.9	46.3
1977	130.8	-89.0	85.9	69.9	197.6
1978	122.5	55.2	108.6	45.5	331.8
1979	-91.7	223.4	128.4	29.8	289.9
1980	318.2	0.4	131.2	17.2	467.0
1981	7.4	-128.1	242.8	15.2	137.3
1982	564.6	733.0	207.6	1,19.7	1,624.9
1983	615.0	-200.6	116.6	25.7	556.7
1984	500.6	-6.1	-25.1	65.4	534.8
1985	484.8	-94.7	-58.0	-2.4	329.7
1986	1,479.7	511.3	227.8	280.8	2499.6
1989	434.2	-183.0	224.5	204.3	680.0
1990	-783.2	,536.3	459.4	133.1	1345.6
1991	1,529.6	-2,092.0	-72.2	195.2	-439.4
1992	573.5	-433.5	-930.9	326.6	-464.3
1993	419.5	-1,035.9	1,330.2	1,094.2	1,808.0
1994	560.4	6,836.9	747.4	124.5	8,269.2
1995	3,633.3	6,041.8	22,558.2	761.1	32,994.4
1996	1,136.7	1,387.6	-267.4	1,650.3	3,907.2
1997	3,216.1	5,043.5	38,285.0	2,132.5	48,677.0
1998	1,194.8	-288.2	1,249.4	575.0	2,731.0
1999	232.6	3,768.7	1,437.6	292.0	5,730.9
2000	14,146.4	-868.4	2,147.0	8,653.8	24,078.8
2001	1,235.6	-1,489.5	1,261.0	771.9	1,779.1
2002	1,75.8	1,885.6	907.7	406.9	3,347.0
Average	2,673.7	-490.0	738.9	451.0	3,675.7

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Five-year averages for the inflows and out-flows presented in tables 8.8 and 8.9 reveal an upward trend in inflows from about ₦451.7 million in the first half of the 1970s to about ₦10.7 billion in 2000 and 2001, down from a peak of about ₦22 billion in 1995–1999. Outflow also recorded an upward trend, increasing from about ₦265.6 million in early 1970s to about ₦7.3 billion in 2000–2001.

There have been marked changes in the sources of FDI inflow into Nigeria, especially since 1999. While the UK contributed about a third of the FDI on average for the entire period under review (i.e., 1970–2001), its share declined to 27.7% between 1990 and 2001 (tables 8.10 and 8.11). Two episodes are discernible in the case of the USA. First is the period between 1970 and 1984 when its average contribution hovered between 22 and 25%. It recorded a jump to about 37% in 1985–1989, peaking at 47% between 1990 and 1994 and declining in

the latter half of the 1990s before closing at about 46% of the total FDI inflows to Nigeria. Thus, while the UK and USA jointly accounted for about 60% of the FDI inflows into Nigeria, it is noteworthy that the USA has taken over from UK as the largest source of FDI into the country.

Table 8.8:   Cumulative inflow of FDI in Nigeria, 1970–2000, million naira

Period	United Kingdom	United States of America	Western Europe	Others	Total
1970-1974	184.7	113.7	113.2	40.1	451.7
1975-1979	233.1	154.0	202.6	83.1	672.9
1980-1984	608.3	317.9	298.6	99.9	1,324.7
1985-1989	1,593.2	1,686.2	767.4	250.7	4,297.5
1990-1994	1,598.1	6,044.1	6,783.4	731.1	15,156.8
1995-1999	5,555.7	3,027.5	9,830.7	3,215.3	21,629.2
2000-2001	1,435.6	7,194.4	1,140.0	925.4	10,695.3
1970-2001	1,616.8	2,222.1	2,883.1	748.5	7,470.5

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Table 8.9:   Cumulative outflow of FDI in Nigeria, 1970–2001, million naira

Period	United Kingdom	United States of America	Western Europe	Others	Total
1970–1974	97.5	94.4	60.2	13.4	265.6
1975–1979	179.0	100.9	99.4	25.5	404.7
1980–1984	207.1	238.1	164.0	51.3	660.6
1985–1989	964.2	1,750.6	611.1	88.5	3,414.4
1990–1994	333.5	3,484.7	2,095.9	431.3	6,345.5
1995–1999	1,550.4	1,794.2	954.7	730.3	5,029.7
2000--2001	10.2	6,512.1	315.6	495.5	7,333.3
1970–2001	5,21.2	1,573.1	642.4	240.4	2,977.2

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Table 8.10: Cumulative inflow of FDI in Nigeria, 1970–2000, percentage

Period	United Kingdom	United States of America	Western Europe	Others	Total
1970-1974	40.8	24.9	25.4	8.9	100.0
1975-1979	34.9	21.9	30.6	12.5	100.0
1980-1984	43.7	21.8	27.6	6.9	100.0
1985-1989	39.3	36.6	18.0	6.1	100.0
1990-1994	12.7	46.7	31.6	9.0	100.0
1995-1999	28.5	19.4	34.7	17.4	100.0
2000-2001	27.7	45.7	13.0	13.5	100.0
1970-2001 (average)	33.0	29.6	27.0	10.3	100.0

Source: Based on figures from CBN's Statistical Bulletin (various issues).

The structure of outflow is significantly different from the observed trend in the inflows. While the UK was the most favoured destination of outflow of FDI in Nigeria between 1970 and 1979, the USA has taken over that position since 1990 and accounts for 39–72% of the outflows. In summary, about 43% of FDI outflows from Nigeria between 1970 and 2001 was to the USA, 26% to UK and 23% to Western Europe. The outflows to "others" remained around 8%.

Available data on net capital flows distinguished the UK, the USA and Eastern Europe from "others". The major components include: unremitted profit net change in foreign share capital, net trade and suppliers credit, net other foreign liabilities, and net liabilities to head office. Apart from the mid 1980s and early 1990s when unremitted profit recorded negative figures, it was a consistent and widely used component of net capital flows.

Table 8.11: Cumulative inflow of FDI to Nigeria, 1970–2000, percentage

Period	United Kingdom	United States of America	Western	Others Europe	Total
1970–1974	36.1	34.9	23.7	5.3	100.0
1975–1979	46.1	22.7	24.7	6.4	100.0
1980–1984	28.7	38.6	25.9	6.8	100.0
1985–1989	25.2	50.4	21.0	3.3	100.0
1990–1994	5.2	55.6	28.9	10.3	100.0
1995–1999	24.9	43.6	18.6	12.9	100.0
2000–2001	0.2	71.6	5.8	22.4	100.0
1970–2001 (average)	26.0	42.9	22.7	8.4	100.0

Source: Based on figures from CBN's Statistical Bulletin (various issues).

On average unremitted profit formed about 44% of net FDI flows to the country during the period under review. Table 8.12 reveals that trade and suppliers credit were also significant components of net FDI in the country at least prior to the 1990s. Other foreign liabilities and liabilities to head office are the least common components of net FDI flows (except for 1985–1989 period for other foreign liabilities and 1990–1994 for liabilities to head office). Also sparingly contributing to the net FDI flows to the country is net changes in foreign share capital (perhaps except for 1975–1979)

Table 8.12: Components of FDI in Nigeria, 1970–2001, percentage

	Unremitted profit	Changes in foreign share capital (net)	Trade and suppliers credit (net)	Other foreign liabilities (net)	Liabilities to head office (net)	
1970–1974	59.6	-7.7	69.4	-53.8	32.5	100.0
1975–1979	123.0	38.8	65.1	-84.0	-42.9	100.0
1980–1984	52.8	14.3	57.8	-22.1	-2.8	100.0
1985–1989	-14.1	-10.8	37.6	80.2	7.2	100.0
1990–1994	-30.0	-9.1	-220.2	1.9	357.4	100.0
1995–1999	60.0	19.1	5.1	0.0	15.8	100.0
2000–2001	74.0	1.4	211.4	-5.8	-181.0	100.0
1970–2001	43.9	7.0	15.5	-12.5	46.0	100.0

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Sectoral Composition of Cumulative FDI in Nigeria

As expected, mining and quarrying is the most attractive sector for the stock of FDI in Nigeria. As can be seen in Table 8.13, however, the sector attraction has been diminishing; its share declined from about 51% in 1970–1974 to about 14% in 1980–1984 before increasing gradually to about 44% in 1995–1999. The stock of FDI in the manufacturing sector compared favourably with the mining and quarrying sector as it averaged about 32% for 1970–2001. The sector only recorded below this average in the 1970–1974, 1995–1999 and 2000–2001 periods.

Table 8.13: Sectoral composition of FDI in Nigeria, 1970–2001, percentage

	Mining & quarrying	Manufac- turing	Agricul- ture	Transport & communi- cations	Building & construc- tion	Trading & business services	Miscella- neous services
1970–1974	51.2	25.1	0.9	1.0	2.2	16.9	2.7
1975–1979	30.8	32.4	2.5	1.4	6.4	20.4	6.1
1980–1984	14.1	38.3	2.6	1.4	7.9	29.2	6.5
1985–1989	19.3	35.3	1.4	1.1	5.1	32.6	5.2
1990–1994	22.9	43.7	2.3	1.7	5.7	8.3	15.4
1995–1999	43.5	23.6	0.9	0.4	1.8	4.5	25.3
2000–2001	30.7	18.9	0.6	0.4	2.0	25.8	21.5
1970–2001	30.3	32.2	1.7	1.1	4.7	19.1	10.9

Source: Based on figures from CBN's Statistical Bulletin (various issues).

The stock of FDI that resided with trading and business services increased gradually from about 17% in 1970–1974 to about 33% in 1985–1989 before declining to 8% in 1990–1994 and further to about 5% in 1995–1999. It is not clear if the 2000–2001 figure, 25.8%, marked the beginning of a sustainable recovery.

Agriculture, transport and communications, and building and construction remained least attractive to host FDI in Nigeria. Jointly, they accounted for about 7.5% of the stock of FDI in Nigeria. The share of miscellaneous services presents two episodes: Prior to 1990, the share of the sector in the stock of FDI averaged 5%. Since the 1990s the average has jumped to about 20%. Thus, the average for the entire period was about 11%.

In general, paid-up capital and reserves, and other liabilities for the entire period contributed, respectively, 53% and 47% of stock of FDI. The period 1990–1994 was an exception for the almost 50-50 chance when paid-up capital and reserves contributed about 71% with other liabilities accounting for only 29%.

Sectoral analyses of the composition of the stock of FDI revealed that relative to other sectors, manufacturing, mining and quarrying, and trading and business services relied on paid-up capital and reserves. The relative decline in the use of paid-up and reserves by the mining and quarrying sector is depicted in Table 8.14 with its share declining gradually and consistently from about 27% of paid-up capital and reserves in 1970–1974 to about 2% in 2000–2001. A structural shift was noted in the trading and business services and miscellaneous services sectors. Between 1970 and 1989, the share of trading and business services, which was around 25%, declined to about 15% on average between 1990 and 2001. Similarly, the relative share of paid-up capital by miscellaneous services, which used to be around 7% prior to 1990, jumped to an average of 30% after 1990.

Agriculture, transport and communications, and building and construction jointly accounted for about 7% of the paid-up capital and reserves component of the stock of FDI in the country in recent years. The shares of agriculture, and transport and communications declined from about 1.6% and 1.5%, respectively, in the early 1970s to about 0.5% and 0.4% in 2000–2001. The high relative shares of other liabilities in mining and quarrying, manufacturing, and trading and business services confirmed these sectors as the most attractive.

Table 8.14: Paid-up capital as a component of FDI, 1970–2001, percentage

	Mining & quarrying	Manufac- turing	Agricul- ture	Transport & commu- nications	Building & construc- tion	Trading & business services	Miscella- neous services
1970–1974	27.0	39.8	1.6	1.5	3.2	22.4	4.5
1975–1979	12.3	44.6	4.1	1.2	3.5	25.9	8.4
1980–1984	11.4	52.0	4.6	1.0	4.7	26.7	9.2
1985–1989	8.6	46.2	2.4	1.1	3.4	31.0	7.3
1990–1994	3.9	46.3	2.2	1.4	2.6	17.7	25.9
1995–1999	2.1	47.8	0.6	0.5	3.2	11.0	35.0
2000–2001	1.9	45.2	0.5	0.4	5.2	15.6	31.6
1970–2001	10.3	46.0	2.5	1.1	3.5	22.0	16.1

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Composition of FDI in Manufacturing and Processing Industries in Nigeria, 1970–2001

Table 8.15 shows that textiles, food products, other chemical products, beverages, and other non-metal products accounted for about 50% of FDI stock in the manufacturing and processing industries in Nigeria over the period under review.

Table 8.15: Cumulative FDI in manufacturing and processing sector by type of industry, percentage

	1970– 1974	1975– 1979	1980– 1984	1985– 1989	1990– 1994	1995– 1999	2000– 2001	1970– 2001	Cumu- lative
Textiles	18.2	24.3	19.1	15.9	19.7	10.6	12.0	17.6	17.6
Food products	10.5	9.5	8.7	9.9	13.3	10.8	17.1	10.9	28.4
Other chemical products	8.8	8.1	9.5	9.1	7.9	13.3	8.4	9.4	37.8
Beverages	7.5	7.5	6.0	8.2	9.5	5.8	10.5	7.6	45.4
Other non-metal mineral products	12.8	9.5	5.5	6.4	3.5	4.5	4.0	6.8	52.3
Other manufac- tured industries	5.1	7.1	9.5	8.6	6.1	2.4	3.7	6.3	58.5
Petroleum refineries	0.0	0.0	0.0	-0.1	2.4	26.6	23.2	6.0	64.5
Transport equipment	4.9	4.8	10.3	6.5	3.4	2.7	3.8	5.3	69.8

Continued

Table 8.15, continued

	1970–1974	1975–1979	1980–1984	1985–1989	1990–1994	1995–1999	2000–2001	1970–2001	Cumu-lative
Tobacco products	8.7	5.2	4.7	4.8	2.9	1.1	1.0	4.3	74.1
Rubber products	3.5	2.7	4.0	5.0	4.4	1.4	0.2	3.3	77.4
Metal products (fabricated)	3.5	4.4	6.8	5.1	-0.5	0.9	1.2	3.2	80.6
Furnitures & fixtures	2.6	2.6	2.6	3.4	6.2	-1.3	-5.9	2.1	82.8
Printing & publishing	1.1	1.5	2.2	3.9	2.6	1.4	1.8	2.1	84.9
Industrial chemicals	0.0	0.0	0.0	2.5	4.6	3.2	3.4	1.8	86.7
Electrical machinery	0.5	1.7	2.7	2.1	1.7	1.8	1.8	1.8	88.5
Plastic products	0.0	0.0	0.0	1.0	6.7	2.6	2.5	1.8	90.2
Pottery & earthenware	0.0	0.0	0.0	0.2	0.7	7.5	7.2	1.8	92.0
Misc. petrol & coal products	4.4	2.8	0.3	0.1	0.9	1.7	1.7	1.7	93.7
Iron & steel	0.0	1.7	2.6	2.6	1.4	1.0	1.1	1.5	95.2
Paper & paper products	3.4	1.9	1.6	1.2	0.8	0.6	0.1	1.5	96.7
Wearing apparel	1.9	2.1	1.1	1.0	0.2	0.0	0.0	1.0	97.7
Non-electrical machinery	1.5	1.2	1.3	1.0	0.5	0.2	0.1	0.9	98.6
Wood & wood products	0.3	0.9	0.8	0.5	0.3	0.5	0.5	0.5	99.1
Leather & fur products	0.8	0.8	0.8	0.6	0.1	0.0	0.0	0.5	99.6
Glass & glass products	0.0	0.0	0.0	0.2	0.5	0.7	0.7	0.3	99.9
Professional & scientific equip't	0.0	0.0	0.0	0.0	0.3	0.3	0.4	0.1	100.0
Footwear	0.0	0.0	0.0	0.3	0.2	0.1	0.1	0.1	100.1
Non-ferrous metals	0.0	0.0	0.0	0.2	-0.1	-0.5	-0.6	-0.1	100.0

Source: Based on figures from CBN's Statistical Bulletin (various issues).

Apart from other non-metal mineral products, the shares of these subsectors in FDI stock in manufacturing remained stable for all the subperiods. The share of other non-metal mineral products declined gradually and consistently from about 13% in 1970–1974 about 4% in 2000–2001. Another noticeable structural shift was recorded in petroleum refineries. FDI in this subsector was negligible prior to 1995-1999 period. The last decade witnessed an upsurge in the FDI stock in the subsector, accounting for about a quarter of the total stock. Government policy, especially liberalization of downstream oil and gas processes coupled with the huge foreign investment in the Nigerian Liquefied Natural Gas Company, are plausible explanations for the observed trend.

FDI Policies in Nigeria

Prior to the early 1970s, foreign investment played a major role in the Nigerian economy. Until 1972, much of the non-agricultural sector was controlled by large foreign-owned trading companies, which had a monopoly on the distribution of imported goods. Between 1963 and 1972, an average of 65% of total capital was in foreign hands (Biersteker, 1987). Immediately after the civil war in 1970, the Nigerian government emerged with a new nationalistic vigour, which was embodied in the Second National Development Plan. Nigeria stuck to rather hostile policies towards FDI. The government pursued a policy of progressive elimination of foreign dominance, in terms of both ownership and management and technical control through an indigenization scheme and preferential credit to nurture indigenous entrepreneurs.

To this end, the Nigerian Enterprise Promotion Decree of 1972 was enacted, limiting foreign equity participation in sectors of manufacturing and commerce to a maximum of 60%. In 1977, a second indigenization decree was promulgated that further limited foreign equity participation in Nigerian businesses to 40%. Government investment was no longer limited to public utilities. The government increased its participation in industry through new investments and nationalization of some categories of foreign-owned businesses. Expansion of agro-industry, growth of petroleum and petrochemicals, diversification of the textile industry, development of the iron and steel industry, installation of car assembly plants, and export-oriented industry were top of the list. This new strategy was encouraged and facilitated by the 1973–1975 "oil boom", which saw government's total revenue increase by 500% in just one year.

Nigeria only cautiously embarked on a reform path in the mid 1980s. In September 1986 the government undertook a structural adjustment programme (SAP) that was meant to restructure the economy and lay the path for self-sustaining growth. This was necessitated by a balance of payments crisis as a result of a glut in the world oil market in the early 1980s. At that stage, government had invested heavily in a diversified portfolio of industrial projects. The poor returns of these projects, however, could not justify the enormous public funds that had been committed to their execution. In fact, many industrial projects in which huge amounts had been expended remained largely uncompleted. This led to government's realization that accelerated industrial development hinged critically on increased private sector participation. From this acknowledgement stemmed the abolition of the import licensing system, reduction and adjustment of import duties and tariffs, privatization of state-owned enterprises, and the introduction of the second tier foreign exchange market (SFEM) leading to the devaluation and managed float of the previously pegged naira. The SAP was not consistently implemented, however. It was frequently interrupted by subsequent political shocks and policy reversals.

Three main categories of incentives are at the disposal of governments in attracting FDI and benefiting from it (UNCTAD, 1996). These are financial incentives such as outright grants and loans at concessional interest rates; fiscal incentives including tax holidays and reduced tax rates; and other incentives such as subsidized infrastructure or services, market preferences and regulatory concessions, including exemptions from labour and environmental laws. All three types are present in Nigeria as shown in Appendix B.

Incentives can focus on location by targeting new FDI or on behaviour by facilitating foreign affiliates in a host country to undertake certain desirable functions such as training, research and development (R&D), and exporting. Generally, most incentives like those presented in the Appendix do not discriminate between domestic and local investors.

Certain specific steps have been taken to attract FDI in Nigeria, however. In 1995, the Nigerian Investment Promotion Commission (NIPC) was established through Decree 16 of 1995 and absorbed and replaced the Industrial Development Coordinating Committee (IDCC). NIPC provides for a foreign investor to set up a business in Nigeria with 100% ownership. On the provision of relevant documents, NIPC will approve the application within 14 days (as opposed to four weeks under IDCC) or advise the applicant otherwise. The applicant will then register the new company with the Corporate Affairs Commission (CAC) in accordance with the provisions of the Companies and Allied Matters Decree of 1990. The new company will finally register with the NIPC as a foreign enterprise for completeness of record. This procedure allows NIPC to determine how many of the approved applications actually got registered as business enterprises in Nigeria. NIPC also eliminates the need to apply to the Ministry of Finance for "approval-in-principle". Under the NIPC, government guarantees foreign investment against nationalization or expropriation. Compulsory ceding of shares by an existing holder to another person, as for example under the Indigenization Decree of 1972, is not allowed. Foreign companies are free to invest in any sector of the economy except for those on the "negative list", which is currently under review to give greater scope to foreign investment in key sectors. Consistent with the NIPC, the Foreign Exchange (Monitoring and Miscellaneous Provisions) Decree 17 of 1995 was promulgated to enable foreigners to invest in enterprises in Nigeria or money market instruments with foreign capital that is legally brought into the country. The Decree permits free repatriation of dividends accruing from such investment or of capital in event of sale or liquidation.

An export processing zone (EPZ) scheme was adopted in 1991; the scheme allows interested persons to set up industries and businesses within demarcated zones principally with the objective of exporting the goods and services manufactured or produced within the zones. Calabar has been designated as the primary EPZ territory and the necessary infrastructure has been put in place. The incentives that come to investors in the designated EPZ territories include:
- Tax holiday relief.
- Legislative provisions pertaining to taxes, levies, duties and foreign exchange would not apply within the zone.
- Repatriation of foreign capital investment in EPZs at any time with capital appreciation of the investment.
- Unrestricted remittance of profits and dividends earned by foreign investors in the zone;
- No import or export licences required.
- Rent-free land during construction of factory premises.
- Up to 100% foreign ownership of enterprises in the zone.
- Sale of up to 25% of production permitted in domestic market.
- No quotas on products from Nigeria exported to the European Economic Community (EEC) and the United States of America.

The inland city of Kano has also been identified as another site for the EPZ and construction work is already in progress. The Aluminium Smelting Company of Nigeria (ALSCON) in Akwa-Ibom State and the Onne/Ikpokiri Oil and Gas Free Zone serving specifically the needs of the oil industry in Nigeria have also been granted the status of EPZ. The Nigerian Export Processing Zones Authority manages, controls and coordinates all activities within the zones.

Nigeria signed ten bilateral investment treaties (BITs) between 1995 and 2002 (Table 8.16) and double taxation agreements (DTA) with the Philippines and Poland in September 1997 and 2004, respectively, as shown in Table 8.17. BITs are primarily instruments for

protecting investors, although recent agreements by a few countries also aim at liberalization. DTAs, on the other hand, are primarily instruments to reduce the incidence of double taxation and the allocation of taxable income. Nigeria's record is low compared with 533 BITs and 365 DTAs concluded in Africa so far (an average of 10 and 7 per country, respectively). Whether a country concluded BITs or not was an insignificant factor to the inflow of foreign investment, as other factors were much more important for attracting FDI.

Table 8.16: Bilateral investment treaties (BITs) concluded during 1995–2002

Partner	Year
France	1990
United Kingdom	1990
The Netherlands	1994
Turkey	1996
China	1997 and 2001
Korea, Republic of	1998
Germany	2000
Switzerland	2001
Jamaica	2002
Sweden	2002

Source: UNCTAD, BIT/DTT database; www.unctad.org/fdistatistics and International Centre for Settlement of Investment Disputes http://www.worldbank.org/icsid/treaties/nigeria.htm (accessed 15 March 2004).

Table 8.17: Double taxation agreements (DTAs) concluded during 1995–2004

Partner	Year
Philippines	1997
Poland	2004

Source: UNCTAD, BIT/DIT database; www.unctad.org/fdistatistics (accessed 15 March 2004).

FDI in Nigeria: An Assessment

Overall, Nigeria has made little progress in attracting FDI. This might sound paradoxical since the country has traditionally been one of the biggest recipients of FDI inflows in Africa. When related to the size of its economy, it becomes apparent that the amounts of FDI into Nigeria are rather small as aptly demonstrated by Table 8.18, which presents a comparative analysis of FDI inflows in Nigeria, as wells as inflows as a percentage of gross fixed capital formation, FDI stock and as a percentage of GDP, relative to Angola, South Africa, Africa and the world. A cursory examination of the table reveals that Nigeria performs poorly on all counts.

Despite its immense human and natural resources, Nigeria has failed to unleash its FDI potential largely for self-inflicted reasons. Disastrous economic and political management sent the country into a long depression resulting in a dramatic decline of GDP per capita from US$1,895 in 1980 to only US$284 in 2003. A state-driven, over-regulated economy achieved an unimpressive track record in terms of ensuring a reliable business environment and enforcing the rule of law. Many sectors were forbidden to FDI, if not to private companies in general (Ebuetse, 2000: 6). Subsequent (military-run) governments built up an empire of more than a

thousand state-owned enterprises, the vast majority of them permanently making losses (Harsch, 2000: Ariyo and Jerome, 2004). About US$100 billion was expended by the federal government for the acquisition of 590 public enterprises between 1975 and 1995, of which only 160 are economically viable. The major enterprises and utility providers such as NITEL, NEPA, NAFCON, Nigerian Newsprint Manufacturing Company Limited, Ajaokuta Steel and Delta Steel have failed and they impose major costs on the economy.

There are several causal factors in the poor performance of FDI in Nigeria relative to actual potential. Corruption and the associated advance fee fraud or "419 scam" is perhaps Nigeria's most debilitating problem in terms of attracting FDI. Nigeria has unfortunately acquired a reputation as one of the most corrupt societies in the world; since 1995 the country has consistently ranked among the bottom five nations in Transparency International's annual Corruption Perceptions Index (CPI). This "poll of polls" captures perceptions of corrupt tendencies in broad terms. Corruption constitutes a significant barrier to entry for new foreign investors, who may not have political connections or cannot be sure that those they establish will be sufficient to navigate the complicated maze of doing business in the country. Nigerian firms face an immediate disadvantage in making routine business inquiries abroad. They are perceived warily, and potential business partners or other organizations are often reluctant to share information, or even respond to inquiries for information.

The current government has taken major steps towards fighting the menace of corruption. These have included passing the Corrupt Practices Act and establishing the Independent Corrupt Practices and Other Related Offences Commission. Actual progress has been slow, however. The new thrust of the government does not appear to have changed the reality on the ground for most businesses, where corruption remains a fact of life.

A related factor is the lack of physical security and the high crime rate in Nigeria. The lack of security generally in society has several impacts on business operations. These include the obvious excessive security costs and the higher cost of attracting and housing expatriates. Working in Nigeria entails greater risk than in most other countries. The political and economic problems are deep and complex. Companies in Nigeria, whether foreign or domestic, face numerous administrative barriers or red tape as they seek to establish and operate businesses. Such barriers typically result from a combination of unnecessarily complex procedures and the aforementioned corruption that those procedures invite and sustain.

The legal framework, especially the ability to enforce property rights and contracts and to have an accessible and impartial venue for dispute resolution, is a key element of an enabling environment for private sector development. The legal and judicial systems have been severely run down and in their current form do not offer a reliable basis for dispute resolution, protection of property rights and enforcement of contracts. The tax system is complex, poorly administered and widely evaded. Business establishment procedures are complex and lengthy.

Customs procedures and their enforcement are one of the most contentious and inefficient aspects of government regulation in Nigeria. In the estimation of many shipping and logistics firms, Nigeria is perhaps the most uncertain customs environment in the world (World Bank, 2002). The labyrinth of customs regulations, import documents and government agencies involved in export and import procedures hurts Nigeria's competitiveness. False invoicing, counterfeit documentation, extortion, fraud, unclear security arrangements and other hazards increase the costs of imports by an estimated 45%. As a result of these inefficiencies, much of Nigeria's trade is diverted through Togo and Benin, and conducted on an informal basis.

Policies aimed at attracting FDI have been poorly and inconsistently implemented. A promising privatization programme began in 1988 only to be aborted in 1993. It resumed

Table 8.18: FDI in Nigeria: A comparative analysis

	FDI flows (US$ millions)						As percentage of gross fixed capital formation				
	1985–95 annual average	1998	1999	2000	2001	2002	85–95 an av	99	00	01	02
Nigeria											
Inward	921	1,051	1,005	930	1,104	1,281	27.4	52.1	79.4	31.3	34.9
Outward	364	107	92	85	94	101	10.6	4.7	4.5	2.6	2.8
Memorandum											
Angola											
Inward	229	1,114	2,471	879	2,146	1,312	29.7	86.8	28.0	66.7	..
Outward	-	-	-	-	-	-	-	-	-	-	..
South Africa											
Inward	97	561	1,502	888	6,789	754	0.2	7.4	4.7	40.5	4.8
Outward	606	1,779	1,580	271	-3,180	-401	2.9	7.8	1.4	-19.0	-2.5
Developing countries											
Inward	50,052	191,284	229,295	246,057	209,431	162,145	4.4	14.3	14.6	12.7	10.5
Outward	21,571	49,837	72,786	99,052	47,382	43,095	2.0	3.7	6.2	2.9	4.6
World											
Inward	180,901	686,028	1,079,083	1,392,957	823,825	651,188	3.9	16.5	20.8	12.8	12.2
Outward	203,414	683,211	1,096,554	1,200,783	711,445	647,363	4.6	16.9	18.3	11.3	13.6

	FDI stocks (US$ millions)						As a percentage of GDP				
	1980	1990	1995	2000	2001	2002	80	90	00	01	02
Nigeria											
Inward	2,405	8,072	14,065	20,184	21,289	22,570	3.7	28.3	49.1	51.5	42.4
Outward	9	2,586	3,957	4,358	4,452	4,553	-	9.1	10.6	10.8	8.5
Memorandum											
Angola											
Inward	61	1,025	2,921	7,977	10,122	11,435	1.8	10.0	90.0	106.9	98.3
Outward	-	-	-	-	-	-	-	-	-	-	-
South Africa											
Inward	16,519	9,121	15,099	47,418	50,246	50,998	20.5	8.1	37.1	44.0	48.7
Outward	5,722	14,864	23,433	35,227	29,155	27,755	7.1	13.3	27.6	25.5	27.4
Africa											
Inward	32,162	50,775	77,400	144,503	157,823	170,876	8.2	10.8	25.9	28.5	30.6
Outward	6,871	20,777	33,004	48,591	43066	43574	2.2	5.2	9.4	8.5	8.6
Developing countries											
Inward	307,469	551,481	920,400	2,029,412	2,173,769	2339632	12.6	14.8	31.1	33.4	36.0
Outward	64,606	133,088	310,864	817,450	806,524	849464	3.8	3.9	12.9	12.8	13.5
World											
Inward	699,415	1,954,203	3,001,995	6,146,656	6,606,698	7122350	6.7	9.3	19.6	21.2	22.3
Outward	563,997	1,762,963	2,901,059	5,991,756	6,318,861	6866362	5.8	8.6	19.3	20.4	21.6

Source: UNCTAD, World Investment Report, Various Years; www.unctad.org/fdistatistics (accessed 22 February 2004).

again in 2000 and several Nigerians are resisting it. As the World Bank notes (World Bank, 2001), while the Obasanjo administration is strongly committed to an accelerated privatization programme, significant stakeholder groups are resisting the reforms. These include public enterprise managers and employees, as well as senior government officials and civil servants, notably in sectoral ministries, who perceive that their current power and perquisites will be reduced as the privatization programme is implemented. In the National Assembly, a range of politicians view privatization as a threat to national sovereignty and an unwarranted reduction in the role of the state.

Indigenous entrepreneurs and foreign investors routinely deal with a gauntlet of administrative procedures to establish and operate a business in Nigeria. They are confused and hampered by the overlapping jurisdictions of federal, state and local governments in various aspects of commercial activity. State and local government officials further impose a myriad of arbitrary taxes, permit requirements and licences in an attempt to raise revenue from foreign companies situated in their jurisdictions.

NIPC, which aims at becoming a "one-stop shop" where prospective foreign investors can complete all the procedures, including permits and licences necessary to undertake an investment in Nigeria, lacks the authority to assist investors to cope with the myriad ministries, departments and agencies and there is insufficient private sector participation in its operations. Currently, NIPC assists investors already registered with the Corporate Affairs Commission (CAC) in Nigeria. It does not provide important preinvestment services that may significantly increase foreign investment. The Calabar EPZ, which has been in existence for almost ten years, has so far attracted only four plants, two of which are little more than sawmills that cut up primarily teak from nearby state-owned plantations.

Deteriorating infrastructure facilities, in particular in the areas of telecommunications, transport, and power supply, severely hamper the attraction of FDI in labour-intensive industries. This especially concerns efficiency-seeking investment. The poor performance of publicly provided infrastructure services in Nigeria has been a subject of considerable discussion (Anas and Lee, 1996; Jerome, 1999; Ariyo and Jerome 2004). Provision of reliable and efficient electricity, telephone, water and transport services has remained elusive in the Nigerian economy especially since the oil boom years of the 1970s. Most of the investment in the sector generated low or negative rates of return. In recent years, the problems in the sector have reached crisis proportions as the collapse of electricity systems became prominent and power supply has become increasingly erratic. Water taps remain largely without running water for most of the time; many roads (often pothole-laden) are increasingly less motorable; rail, air and sea transport services have deteriorated seriously; and the performance of telecommunication and postal services remains very unsatisfactory. The Nigerian Electric Power Authority (NEPA) produces electricity at the relatively high cost of 11 US cents per kilowatt hour compared with an international average of about 5–6 cents/KwH. Unreliable power supply from NEPA is estimated to impose an additional explicit cost of about US$1 billion on the economy every year.

In recent years, there have been several positive developments especially in the telecommunications sector where Nigeria has emerged as the fastest growing mobile market in the world. Four mobile telecommunications licences were auctioned in February 2001, and each of the four winners – NITEL, MTN Nigeria, Econet Nigeria and CIL – paid US$285 million for their licences. When the global system of mobile telecommunication (GSM) operators launched services in August 2001 more than a million lines were deployed within the first year (August 2002) and the growth rate shows little sign of abating. The two private operators, Econet and MTN, are engaged in neck-and-neck competition. By December 2002, the total

number of subscribers was around 1.8 million, with MTN recording 908,000 and Econet an estimated 775,000 (Ariyo and Jerome, 2004). The sale of a 51% share of government equity in NITEL meant to complement the GSM liberalization was a failure, however. It was fraught with false starts and political intrigues and the preferred bidder, Investors International London Limited (IILL), failed to pay the balance of the bid price.

Conclusions

On paper, anyway, Nigeria has made some important steps towards improving conditions for FDI. In practice, however, progress has been slow. In an increasingly globalizing world, many of the traditional determinants of FDI including political and macroeconomic stability, availability of natural resources, and a large and growing market remain important. There are new FDI determinants, however: a transparent and non-discriminatory regulatory environment, effective competition policies, and an efficient judicial system. Low transaction and business costs, low cost infrastructure, and human capital with diverse modern skills that can cope with emerging technologies are others. There is need to upgrade national laws and incentives to best practice levels; to lower transactions costs; to improve the supply of skills and infrastructure, and to further reform legal and judicial systems and institutions.

Beyond oil, where the returns are exceedingly high, the international investment community considers Nigeria a risky and costly place to invest. Its risk rating is worse than its economic fundamentals warrant, suggesting that there is a perception gap. Effective FDI promotion can help overcome this perception gap by getting rid of the biggest irritants to foreign investors and creating some factors that export-oriented investors seek.

Investment promotion in Nigeria currently lacks a clear focus and fails to target the right sectors or sources of potential FDI. Promotion is not, in other words, based on any analysis of national competitive advantage or "selling points". The investment promotion agency in Nigeria is a poorly funded public sector agency at a low position in the government hierarchy, with little analytical and research capacity and without the clout needed to reorient policies to attract investors. It hardly provides any after-care services and private enterprises rarely play a role in investment promotion. It cannot muster the minimum critical mass for effective basic image-building, investment prospecting and lead-generation. Nor is it geared to any national efforts to improve location determinants so that new areas of competitive advantage can be developed. The promotion agency is generally unable to offer true "one-stop" facilitation. Investors still have to go to various agencies on their own, jumping through numerous bureaucratic hoops and smoothing the way with backhand payments that further increase transaction costs.

There is need to conduct an "investor roadmap" exercise to determine exactly where the costs and barriers arise and to benchmark procedures against international best practice. FDI geared to global production networks, in particular, needs highly skilled and disciplined labour, world-class transport and communications infrastructure and efficient customs and tax procedures – all of which are currently lacking in Nigeria. The investment promotion agencies (IPAs) that usually get the highest accolades worldwide go beyond the conventional tasks of selling the virtues of their countries and offering fiscal incentives, and get into coordinating domestic factor markets with the needs of the high technology activities they target (UNIDO, 2004).

In general, while the FDI regime is improving in Nigeria, serious deficiencies remain. Political and institutional uncertainty persists in Nigeria and the weakening of the rule of law has discouraged foreign direct investment and trade flows outside the oil export sector. These are aggravated by inadequacies in complementary areas. Legal and judicial systems are inadequate to support the needs of investors. Reform is needed in corporate law, contract law, bankruptcy, labour law and property rights, which are critical to ensure that the laws are applied properly.

Addressing problems related to endemic corruption, inadequate infrastructure and inconsistent regulations remains the key to the country's future prospects of attracting more efficiency-seeking FDI. Beyond improving micro and macroeconomic fundamentals and building an investment-friendly environment, authorities in Nigeria also need a proactive (rather than passive) policy toward FDI. This would involve upgrading national laws and incentives to international standards; lowering transaction costs (i.e., the costs related to setting up business, dealing with bureaucracy, paying taxes, exporting and importing, hiring and firing workers, etc.); and improving the supply of skills, infrastructure, legal and judicial systems, and institutions.

Finally, privatization should be pursued with vigour. It is becoming a powerful instrument for attracting foreign investors, provided they can count on fair and stable rules of the game. Governments should set clear rules regarding not just privatization rules but also competition and pricing rules. Particular care should be taken in the privatization of infrastructure. Foreign investors are difficult to attract, as they face potentially large financial risks because of sunk costs, as well as political risks associated with civil war, change of regimes and expropriation. Stable and peaceful countries with a clear and transparent regulatory framework – including the rules governing entry conditions and market structures – have the best chance in attracting FDI. Governments must prevent undue market concentration, restricting mergers that would undermine competition; and introduce environmental, health and safety obligations of public services.

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Appendix A   Foreign Direct Investment in Nigeria: Inward and Outward Flows

Table 8.A1: Foreign direct investment: Inward flows

Region/Country	Inward flows								
	1980	1990	1995	1997	1998	1999	2000	2001	2002
Africa	392	2,430	5,119	10,667	8,928	12,231	8,489	18,769	10,998
North Africa	152	1,157	1,155	2,716	2,882	3,569	3,125	5,474	3,546
Algeria	349	40	0	260	501	507	438	1,196	1,065
Egypt	548	734	595	887	1,076	1,065	1,235	510	647
Libyan Arab Jamahiriya	1,089	159	-107	-82	-150	-118	-142	-101	-96
Morocco	89	165	332	1,188	417	1376	423	2,808	428
Sudan	9	-31	12	98	371	371	392	574	681
Tunisia	246	90	323	365	668	368	779	486	821
Other Africa	239	1,272	3,964	7,951	6,046	8,663	5,364	13,295	7,452
Angola	37	-335	472	412	1,114	2,471	879	2,148	1,312
Benin	4	62	8	26	35	61	60	44	41
Botswana	112	96	70	100	90	37	54	26	37
Burkina Faso	0	0	10	13	10	13	23	9	8
Burundi	5	1	2	-	2	0	12	0	-
Cameroon	130	-113	7	45	50	40	31	67	86
Cape Verde	—	0	26	12	9	53	34	9	14
Central African Republic	5	1	6	0	0	3	1	5	4
Chad	0	9	33	44	21	27	115	-	901
Comoros	—	0	1	0	3	0	1	0	1
Congo	40	23	122	79	33	521	166	77	247
Dem Rep. of Congo	110	-14	-22	-44	61	11	23	1	32
Côte d'Ivoire	95	48	268	450	416	381	235	44	223
Djibouti	0	0	3	2	3	4	3	3	4
Equatorial Guinea	0	11	63	53	392	252	108	945	323
Eritrea	-	-	-	41	149	83	28	1	21
Ethiopia	1	12	14	288	261	70	135	20	75
Gabon	32	73	-626	-587	-200	-625	-43	169	123
Gambia	0	14	15	21	24	49	44	35	43
Ghana	16	15	107	82	56	267	115	89	50
Guinea	1	18	1	17	18	63	10	2	30
Guinea-Bissau	—	2	0	11	4	9	1	1	1
Kenya	79	57	33	40	42	42	127	50	50
Lesotho	4	16	30	32	27	33	31	28	24
Liberia	72	225	5	214	190	256	-431	-20	-65
Madagascar	-1	22	10	14	16	58	70	93	8
Malawi	9	23	-19	-1	-3	46	-33	-20	0
Mali	2	6	123	74	36	51	83	122	102
Mauritania	27	7	7	1	0	1	9	-6	12
Mauritius	1	41	19	55	12	49	277	32	28
Mozambique	4	9	45	64	235	382	139	255	406
Namibia	..	30	153	84	77	111	153	275	181
Niger	49	41	16	25	9	0	9	23	8

Continued

Table 8.A1, continued

Region/Country	Inward flows								
	1980	1990	1995	1997	1998	1999	2000	2001	2002
Nigeria	-739	588	1,079	1,539	1,051	1,005	930	1,104	1,281
Rwanda	16	8	2	3	7	2	8	4	3
Sao Tome & Principe	..	..	0	0	0	1	2	6	2
Senegal	4	57	35	176	71	136	63	32	93
Seychelles	10	20	40	54	55	60	56	59	63
Sierra Leone	-19	32	-2	10	-10	6	5	3	5
Somalia	0	6	1	1	0	-1	0	0	0
South Africa	-19	-78	1,241	3,817	561	1,502	888	6,789	754
Swaziland	26	30	44	-15	152	100	39	78	107
Togo	43	23	38	23	42	70	42	63	75
Uganda	4	-6	121	175	210	222	254	229	275
United Rep.of Tanzania	5	..	150	158	172	517	463	327	240
Zambia	62	203	97	207	198	163	122	72	197
Zimbabwe	2	-12	118	135	444	59	23	4	26

Source: Compiled from UNCTAD Foreign Direct Investment Database Online http://www.unctad.org/Templates/Page.asp?intItemID=1923&lang=1 (Accessed 23 February 2004).

Table 8.A2: Foreign direct investment: Outward flows

Region/Country	Outward Flows								
	1980	1990	1995	1997	1998	1999	2000	2001	2002
Africa	1,119	2,102	2,978	3,788	1,997	2,574	1,309	-2,522	173
North Africa	126	135	137	476	367	313	228	202	267
Algeria	34	5	4	8	1	47	18	9	100
Egypt	7	12	34	166	46	38	51	12	28
Libyan Arab Jamahiriya	47	105	83	284	299	208	98	84	110
Morocco	39	13	12	9	20	18	59	97	29
Sudan	..	..	..	..	..	..	..	..	..
Tunisia	..	0	3	9	2	3	2	0	1
Other Africa	993	1,967	2,841	3,312	1,630	2,262	1,081	-2,725	-94
Angola	..	1	0	0	0	0	..	0	0
Benin	..	..	1	12	2	23	4	2	..
Botswana	2	7	41	4	3	1	2	318	2
Burkina Faso	0	-1	0	1	5	5	0	1	1
Burundi	..	..	1	0	0	1	..	..	..
Cameroon	-8	15	1	7	1	3	4	3	3
Cape Verde	..	0	1	0	..	0	..	..	..
Central African Republic	0	4	1	0	0	0	0	0	0
Chad	0	11	-3	-1	0	2	0	0	0
Comoros	..	1	..	..	..	..	..	..	..
Congo	..	3	-2	4	-8	2	4	6	8
Dem Rep. of Congo	..	..	..	..	..	..	..	..	..
Côte d'Ivoire	..	31	56	34	36	57	..	2	2

Continued

Table 8.A2, continued

Region/Country	Outward Flows								
	1980	1990	1995	1997	1998	1999	2000	2001	2002
Djibouti	..	..	..	..	..	..	..	..	..
Equatorial Guinea	..	0	0	..	0	2	-4	4	0
Eritrea	-	-	..	..	..	..	..	..	..
Ethiopia	..	..	..	228	254	-46	-1	69	7
Gabon	8	29	36	-13	-14	14	25	2	0
Gambia	..	3	7	5	6	4	5	5	5
Ghana	..	..	..	50	30	77	52	53	61
Guinea	..	..	..	1	1	3	2	2	2
Guinea-Bissau	..	..	..	..	..	..	..	..	..
Kenya	1	0	13	5	14	30	29	50	76
Lesotho	..	..	..	..	..	..	..	..	..
Liberia	231	-3	-97	501	-731	310	608	-167	-50
Madagascar	..	1	1	-2	1	0	1	..	..
Malawi	..	..	..	1	6	3	3	4	3
Mali	..	0	0	5	27	50	4	17	19
Mauritania	..	0	..	..	..	..	..	..	..
Mauritius	..	1	4	3	14	6	13	2	1
Mozambique	..	0	..	0	0	0	0	0	0
Namibia	..	1	-4	1	-1	-1	3	-13	-5
Niger	-4	0	2	8	10	0	-1	-4	..
Nigeria	3	1,824	104	58	107	92	85	94	101
Rwanda	..	0	0	1	0	1	1	1	1
Sao Tome & Principe	..	..	..	..	.	..	..	..	..
Senegal	2	-10	-3	1	. 10	6	1	-7	39
Seychelles	4	1	16	10	3	9	7	11	14
Sierra Leone	..	0	0	0	0	0	0	0	0
Somalia	..	..	..	..	..	..	..	..	..
South Africa	746	27	2,498	2,351	1,779	1,580	271	-3,180	-401
Swaziland	9	8	30	-10	24	-13	-16	9	27
Togo	0	5	6	4	22	41	1	-7	..
Uganda	..	-12	119	15	20	-8	-28	-5	-14
United Rep. of Tanzania	..	..	0	0	0	0	1	0	0
Zambia	..	..	..	..	..	..	..	..	..
Zimbabwe	..	17	13	28	9	9	8	4	3

Source: Compiled from UNCTAD Foreign Direct Investment Database Online, http://www.unctad.org/Templates/Page.asp?intItemID=1923&lang=1 (Accessed 23 February 2004).

Appendix B   Investment Incentives in Nigeria

Tax and Other Incentives

Pioneer Status
The provision of the Industrial Development (Income Tax Relief) Act with respect to Pioneer Status tax holidays applies to any manufacturing exporter who exports at least 50% of annual turnover.

Tax Relief on Interest Income
Interest accruing from loans granted by banks in aid of export activities enjoy favourable tax treatment.

Capital Assets Depreciation Allowance
The law in Nigeria provides an additional annual depreciation allowance of 5% on plants and machinery to manufacturing exporters who export at least 50% of their annual turnover provided that the product has at least 40% local raw material content or 35% value added.

Incentives to Industries

Within the past few years, the government has progressively introduced a number of incentives designed to promote investment, employment, product mix and various other aspects of industry. These incentives encompass:
- Fiscal measures on taxation;
- Effective protection of local industries with import tariff;
- Export promotion of Nigerian-made products; and
- Foreign currency facility for international trade.

Enterprises that fulfil the necessary criteria are free to apply for the following specific incentives:
- *Pioneer status:* 100% tax free period for five years for pioneer industries that produce products declared as "pioneer products" under the Industrial Development (Income Tax Relief) Act No. 22 of 1971 as amended in 1988, or such other deserving enterprises as may be approved by the Council of the Nigerian Investment Promotion Commission (NIPC).

- *Local raw materials utilization:* 30% tax concession for five years to industries that attain minimum local raw materials utilization as follows:

- Industrial sector	Minimum level
- Agricultural	80%
- Agro-allied	70%
- Engineering	60%
- Chemical	60%
- Petro-chemical	70%

- *Labour intensive mode of production:* 15% tax concession for five years. The rate is graduated in such a way that an industry employing 1,000 persons or more will enjoy the 15% tax concession while an industry employing 100 will enjoy only 6%, those employing 200 will enjoy 7% and so on.

- *Local value added:* 10% tax concession for five years. This applies essentially to engineering industries, where some finished imported products serve as inputs. The concession is aimed at encouraging local fabrication rather than the mere assembly of completely knocked down parts.

- *In-plant training:* 2% tax concession for five years on the cost of facilities provided for training.

- *Export-oriented industries:* 10% tax concession for five years. This concession will apply to industries that export not less than 60% of their products. The emphasis is on the encouragement at the pre-establishment stage of export-oriented enterprises.

- *Infrastructure:* 20% of cost of providing basic infrastructure such as roads, water and electricity where they do not exist is tax deductible once and for all.

- *Investment in economically disadvantage areas:* 100% tax holiday for seven years, additional 5% depreciation allowance over and above the initial capital depreciation.

- *Research and development (R&D):* 120% tax deductible expenses provided the research and development is carried out in Nigeria; and 140% for R&D on local raw materials.

- *Excise duty:* In order to boost local industries, stimulate trade and reduce cost, government abolished most excise duties with effect from 1 January 1998. However, in order to safeguard the health of our citizens, government reintroduced excise duty on tobacco, cigarettes and spirits. Thus, with effect from 1 January 1999, excise duties on these products are as follows:
  - Spirits and other spirituous alcohol   40%
  - Cigarettes, cigars, cheroots and cigarillos   40%

The incentives itemized here are in no way exhaustive and neither is the quantum or percentage of relief mentioned fixed for all time. The would-be investor is therefore advised to ascertain the current operative figures at the time of making his investment. Other categories of incentives that would be of interest to foreign and local investors are referred to and examined in other publications.

Double Taxation Agreements

Double taxation agreements are being negotiated and concluded with various countries. The desired effect is to eliminate double taxation on investment income.

Reinvestment Allowance

This incentive is granted to manufacturing companies that incur qualifying capital expenditure for the purpose of approved expansion. The incentive should be in form of a generous allowance on capital expenditure incurred by companies for the following:

- Expansion of production capacity;
- Modernization of production facilities; and
- Diversification into related products.

This scheme aims to encourage reinvestment of profit.

Investment Tax Allowance

Apart from the capital allowance currently in existence, consideration may be given to the introduction of investment tax allowance. Under this scheme, a company would enjoy generous tax allowance in respect of qualifying capital expenditure incurred within five years from the date of the approval of the project.

Foreign Direct Investment in South Africa

Oludele Akinloye Akinboade, Franz Krige Siebrits
and Elizabeth Niedermeier Roussot

E conomic growth in South Africa has been unsatisfactory since the mid 1970s. The average annual rate of growth of GDP at 1995 prices slowed from 5.8% in the 1960s to 3.0% in the 1970s, 1.8% in the 1980s and 1.4% in the 1990s.[1] With population growth often exceeding real output growth, per capita GDP at 1995 prices accordingly decreased from a peak of R16,347 in 1981 to R14,618 in 1999 and R14,554 in 2002.

The relatively low and decreasing rate of investment has been one of the most important constraints on the growth potential of the South Africa economy. Gross and net rates of capital formation fell sharply during the 1980s and the first half of the 1990s, and remained at low levels in the early 2000s. In recent years, the portion of capital formation used for the maintenance of the country's production capacity has generally exceeded 80%, leaving relatively little room for the expansion of capacity.

From a national accounting point of view, gross capital formation is financed from two sources: gross saving and foreign investment (which consists of net capital inflow from the rest of the world and the change in gold and other foreign reserves). South Africa's gross savings rate exhibits a decline similar to that of the gross investment rate, having fallen from a peak of 33.9% of GDP in 1980 to roughly 15% of GDP in recent years. Foreign investment has been highly unstable. South Africa experienced net capital outflows in the aftermath of major political shocks (the Sharpeville massacre in 1960, the Soweto riots in 1976 and the 1985 foreign-debt standstill, after which the country had to repay large amounts of foreign debt). Foreign capital inflows resumed in 1995, but remained below 2% of GDP.

The dual-gap analysis, first developed by Chenery and Bruno (1962) and Chenery and Strout (1966), emphasizes the important role of foreign funds in overcoming savings and foreign exchange constraints to economic growth. These considerations are particularly important in the South African context, where direct and other investment from abroad clearly has a crucial role to play in supplementing domestic savings to raise capital formation and economic growth.

Why South Africa Needs More FDI

T he econometric modelling exercise that underpinned the South African government's Macroeconomic Strategy on Growth, Employment and Redistribution (GEAR) suggests that a gross investment rate of the order of 26% of GDP is required to raise the GDP growth rate to 6% per annum (Department of Finance, 1996: 5–7).

The importance of foreign direct investment in South Africa is evident from the launching of the national investment promotion agency, "Investment South Africa", by the Department of Trade and Industry (DTI) in February 1997. In order to induce more foreign companies, the Department further launched the Foreign Investment Grant (FIG), which is offered as a cash incentive scheme for foreign investors who invest in new manufacturing businesses in South Africa. The foreign entrepreneur is compensated for the costs of moving new machinery and equipment from abroad. It covers up to 15% of the costs of new machinery and equipment, to a maximum of R3 million per entity.[2] The major reason for providing this assistance is to promote foreign investment, improve the quality of life of South Africans and ultimately enhance economic growth.

GEAR, which accompanied the country's move to democracy, emphasized the importance of FDI in South Africa. The macroeconomic strategy was seen to be a "state of the art" framework for sustainable economic growth and development with an outward orientation. Central to this strategy was the enhancement of non-gold export performance, increased private sector investment, job creation, infrastructure development and improved service delivery. Implementing GEAR has brought some challenges to the economy in terms of growth, investment and job creation since certain projected targets were not met by the set date.[3]

Trends in Foreign Direct Investment in South Africa

South Africa dominates FDI in the Southern Africa Development Community (SADC), receiving a substantial amount of new FDI inflows into the region and hosting the greatest number of foreign subsidiaries across a broad range of economic sectors. South Africa alone accounted for more than 70% of SADC inflows in 1997 and 2001, compared with the 50.8% annual average inflows in 1996–2001. This figure is twice as large as the 1990–1995 average (25.3%). An analysis of the main subsidiaries and affiliates of the largest multinationals confirms the dominance of South Africa (Jenkins and Thomas, 2002). Of 390 different subsidiary entities of the world's largest multinationals in SADC, more than 70% are based in South Africa. South Africa continues to be the most attractive market in Africa, although its lead over other African nations narrowed in 2002 and investors express a diminishing likelihood to invest there compared with 2001. FDI inflows increased from US$969 million in 2000 to nearly US$7.2 billion in 2001. This can largely be attributed to several merger and acquisition (M&A) deals and a 37% decline in the value of the rand.

As shown in Table 9.1, South Africa accounts for only a small part of the global FDI flow; during 2000–2002 that share averaged 0.33%. The FDI performance indexes calculated by UNCTAD and published in its annual *World Investment Reports* also suggest that South Africa has been comparatively unsuccessful at attracting foreign direct investment since 1994. These indexes represent the quotient of countries' shares of world output and world FDI. An index greater than one suggests that a country is attracting relatively more FDI than one would expect on the basis of the size of its economy, and vice versa. The latest available indexes are for the period 2001 to 2003, which means that South Africa's is inflated above the trend value by the inflows related to the restructuring of De Beers. South Africa's index of 1.069 nonetheless was modest for a middle-income country: Figure 9.1 shows that it was the sixth lowest in a sample of 16 such countries.[4]

Table 9.1:   Share in world FDI inflows (per cent)

	1991–96	1999	2000	2001	2002
World	100	100	100	100	100
Developed countries	60.80	76.42	80.44	71.54	70.69
Developing countries	35.98	21.25	17.66	25.42	24.90
Africa	1.81	1.13	0.61	2.28	1.69
Botswana	-0.01	0.00	0.00	0.00	0.01
Ghana	0.04	0.03	0.01	0.01	0.01
Kenya	0.00	0.00	0.01	0.01	0.01
Mauritius	0.01	0.00	0.02	0.00	0.00
Nigeria	0.50	0.09	0.07	0.13	0.20
South Africa	0.18	0.14	0.06	0.82	0.12
Uganda	0.03	0.02	0.02	0.03	0.04
Zambia	0.04	0.01	0.01	0.01	0.03
East Asia & Pacific	23.52	10.08	10.21	12.98	14.61
China	10.02	3.74	2.93	5.69	8.09
Korea, Rep.	0.48	0.86	0.67	0.43	0.30
Malaysia	2.14	0.36	0.27	0.07	0.49
Philippines	0.48	0.16	0.10	0.12	0.17
Singapore	2.70	1.23	0.89	1.33	1.18
Thailand	0.77	0.56	0.24	0.46	0.16
Latin America & Caribbean	10.64	10.03	6.85	10.16	8.60
Argentina	1.69	2.22	0.84	0.39	0.15
Brazil	1.43	2.65	2.35	2.73	2.54
Chile	0.86	0.81	0.26	0.54	0.25
Mexico	2.89	1.19	1.11	3.07	2.09

Source: UNCTAD (2003).

Figure 9.1: Foreign direct investment performance indexes for emerging market economies (1999–2001)

Inward FDI performance index
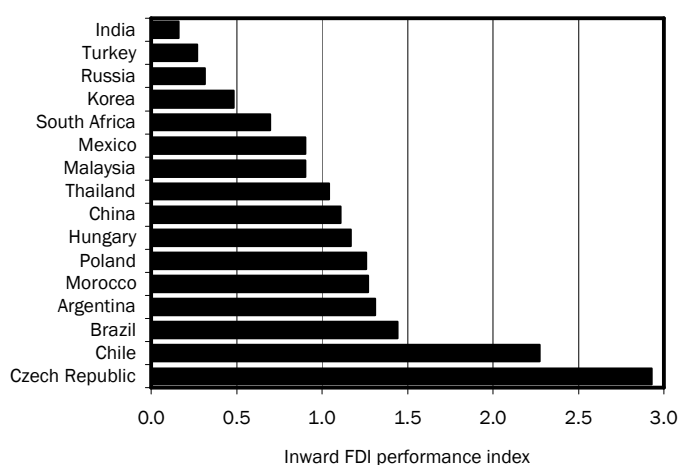
Source: UNCTAD (2003).

Trends in Levels of FDI Flows to South Africa

Consistent data on FDI flows to and from South Africa are available only from 1956 onwards. It is well established, however, that FDI played a crucial role in the earlier development of the South African economy (Gelb and Black, 2000: 177). Prior to the 1870s, when the economy focused on the exports of agricultural products to Europe, London-based banks dominated the financial system. Effective exploitation of the huge diamond and gold deposits that were discovered in the second half of the nineteenth century required large capital injections into the economy, and these were provided by direct and portfolio investment from abroad. FDI also played an important role in the development of manufacturing industry from the 1920s onwards.

Data on FDI inflows to South Africa since 1956 are depicted in Figure 9.2.[5] South Africa received FDI in most years from 1956 to 1975 (the exceptions were 1960 and 1961, when the anti-apartheid protests that culminated in the Sharpeville shootings led to capital flight). On the whole, though, the extent of such flows was modest: despite brisk economic growth, FDI inflows exceeded 1% of GDP in only 8 of these 20 years. FDI turned negative in the aftermath of the 1976 Soweto disturbances and outflows occurred in most years from 1977 to 1990. This trend was a result of an uncertain environment characterized by political instability, extensive

Figure 9.2: Foreign direct investment flows to South Africa as percentage of GDP (1956–2003)
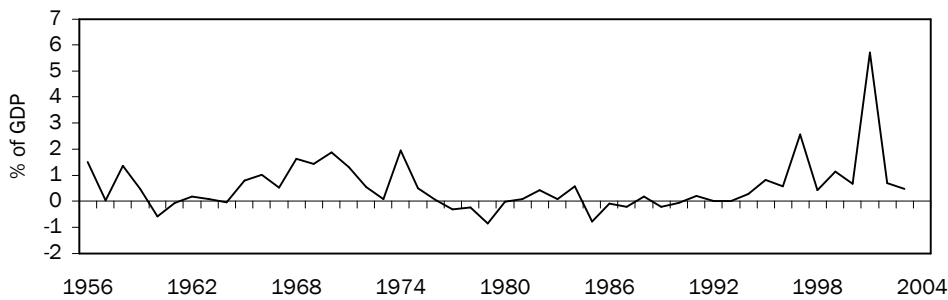
Source: South African Reserve Bank (various years).

government intervention in the economy, deteriorating economic performance and, from the mid 1980s onwards, an active campaign to encourage multinational companies to disinvest from South Africa.[6] Inflows of direct investment resumed when the transition to democracy started in 1990, and FDI has been positive in every year since the first democratic elections in April 1994. In terms of quantity, however, FDI has been disappointing: it exceeded 1% of GDP in only three years.[7] Another indication of the relatively low levels of FDI after 1994 was that inflows of foreign portfolio capital have generally exceeded FDI inflows by sizeable margins (Figure 9.3).[8] This trend contrasted with the situation from 1956 to 1990, when direct investment and portfolio investment from abroad were of roughly similar orders of magnitude.

The ratio of FDI flows to gross capital formation was 15.5% in 1997, falling to 7.4% in 1999 before reaching a peak of 39% in 2001 (SARB, 2003). This pattern was broken when problems encountered by other emerging-market countries contributed to an outflow of portfolio funds from South Africa in 2001 and a relatively small inflow in 2002.

Figure 9.3: Direct investment and portfolio investment from abroad to South Africa (1956–2003)
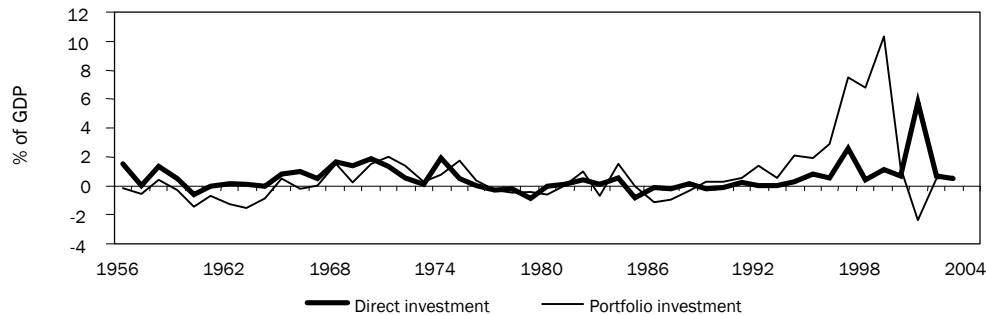
Source: South African Reserve Bank (various issues).

   In the past, foreign investors shunned South Africa for many reasons, not least because of the country's apartheid policy. Although ostensibly committed to the growth-oriented economic policies of free enterprise capitalism, South Africa during the apartheid era instituted policies that were not conducive to FDI. These policies included extensive state intervention in the economy; apartheid itself, which created economic distortions and political unrest; and a dual rand monetary policy. South African economists in the 1980s described the national economy as a free enterprise system in which the market, not the government, set most wages and prices. The reality was that the government played a major role in almost every facet of the economy, including production, consumption and regulation. In fact, Soviet economists in the late 1980s noted that the state-owned portion of South Africa's industrial sector was greater than in any country outside the Soviet bloc. The South African government owned and managed almost 40% of all wealth-producing assets, including iron and steel works, weapons manufacturing facilities, and energy-producing resources. Government-owned corporations and parastatals were also vital to the services sector. Marketing boards and tariff regulations intervened to influence consumer prices. Finally, a wide variety of laws governed economic activities at all levels based on race.

   From the mid 1970s, throughout the 1980s and on into the early 1990s, international trade sanctions and investment boycotts became weapons of choice in the world's war against apartheid. Between 1973 and 1978 total foreign investment in South Africa more than halved. Through 1976 the rate of overall growth (public and private sectors, direct and non direct investment) was over 20% having reached a high of 29% in 1975. The rate dropped sharply in 1977 to 7.6% and to 7.3% in 1978. Among the factors that appeared to have played a part in the decline were investor concerns after the political disturbances in Soweto in 1976 (Clark and Bogran, 2003). The effects on South Africa's economy were devastating. The most effective sanctions measure was the withdrawal of short-term credits in 1985 by a group of international banks. Immediate loan repayments took a heavy toll on the economy. More than 350 foreign corporations, at least 200 of which were United States owned, sold off their South African investments (Clark and Bogran, 2003). During the 1980s, the US firms in particular were under great political and civil society/market pressure to disinvest from South Africa. Altogether 256 US companies are said to have left South Africa by 1991 (Business Map, 1999).

   FDI, which was mostly negative for most of the pre-democracy years, has been positive in every year since the first democratic elections in April 1994. Quantities of FDI have been

disappointing, generally remaining below 5% of gross capital formation or 1% of GDP. The exceptions were 1997 and 1999, when two privatization transactions pushed FDI to higher levels.[9] According to UNCTAD data, the cumulative FDI into South Africa between 1994 and 1998 amounted to almost US$5 billion, growing at an average of 46% a year. The FDI inflows to South Africa reached the first peak of US$3.81 billion in 1997 (35.8% of the total Africa FDI inflows) and the second peak of US$6.79 billion (or 36.17% of the total Africa FDI inflow) in 2001 (refer to Figure 9.4). The second peak was the result of an unbundling of cross-share holdings involving London-listed Anglo American and De Beers of South Africa. Compared with other emerging economies, this was very small in value terms. China, for example, received US$203 billion in the same period, while India received US$12 billion and the Visegrad-4 (Czeck Republic, Hungary, Poland and Slovakia) US$40 billion. A substantial part of the direct investment flows into South Africa during the 1990s that were not linked to privatization initiatives can be attributed to reinvestments arising from the re-entry of multinationals that disinvested during the sanctions era. Some outward investment by South African-owned firms during the period may also have been based on reinvestments into operations from which they had been displaced by sanctions.

Figure 9.4: FDI quarterly average figures for South Africa 1996–2003
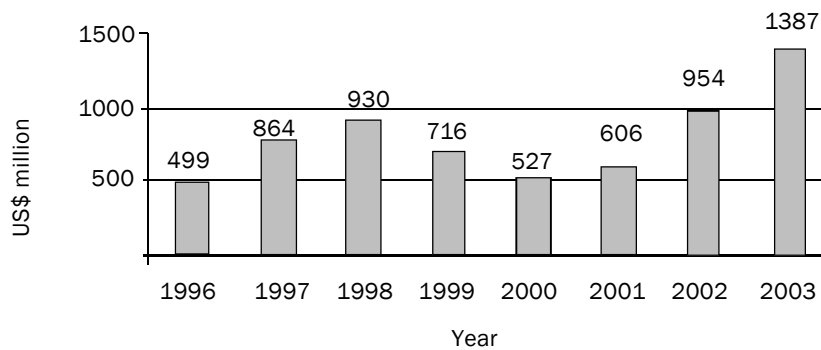
Source: BusinessMap Foundation (2004).

Origins of Foreign Direct Investment in South Africa

A series of occasional surveys by the South African Reserve Bank yielded data that enable analysis of trends in the sectoral distribution and origins of South Africa's foreign liabilities related to direct investment. These data are summarized in Tables 9.2 and 9.3.

South Africa does not benefit from regional FDI, being geographically far from major centres of multinational business and close to rather weak surrounding Southern African economies. Most FDI flows into South Africa are from countries that have traditionally had strong economic ties with the country, especially European countries and the United States.[10] At the end of 2003, European countries' share of South African foreign liabilities related to direct investment amounted to 81.0%, with the bulk of the inflows occurring before 1995. The United Kingdom's share was fully 62.0% at the end of 2003 (up from 34.5% at the end of 1995), and that of Germany 7.5%. The share of inward FDI originating from the Americas (mainly the United States) reached 21.7% at the end of 1973, but fell thereafter as the disinvestment campaign gathered momentum. It amounted to 10.6% at the end of 2003, almost all of which came from the United States.

Table 9.2: South Africa's foreign liabilities related to direct investment by source country

	1957	1973	1995	2003
Africa	1.0	2.2	1.0	1.5
Americas	17.6	21.7	14.5	10.6
Of which: United States	...	...	12.7	9.7
Asia	0.2	0.5	3.1	6.7
Europe	80.6	74.4	80.2	81.0
Of which: United Kingdom	...	...	34.5	62.1
Oceania	0.6	1.1	0.9	0.1
Other	0.0	0.0	0.3	0.0
Total	100.0	100.0	100.0	100.0

Note: Percentages may not add to 100 because of rounding.
Source: South African Reserve Bank (various years)

Table 9.3: The sectoral composition of South Africa's foreign liabilities related to direct investment

	1973	1995	2003
Agriculture, forestry and fishing	0.8	0.9	0.2
Mining and quarrying	7.7	4.3	34.0
Manufacturing	45.1	44.3	24.9
Electricity, gas and water	0.0	0.0	0.0
Construction	1.1	0.3	0.6
Trade, catering and accommodation	14.6	12.4	4.4
Transport, storage and communication	2.0	0.9	7.3
Financial and business services	27.3	36.7	28.5
Community, social and personal services	0.1	0.2	0.1
Total (including "Other")	100.0	100.0	100.0

Note: Percentages may not add to 100 because of rounding.
Source: South African Reserve Bank (various years).

Recently, the large share of inward FDI originating from the US since 1994 has been due to the return of US companies that left the country during apartheid, although the US investment started diminishing by 1999, giving way to an increased European presence. The strong investor relations between South Africa and the EU and the Americas can, in part, be explained by well-established trade (and tourism) links. Investors from these two regions have heavily invested in mining and quarrying, services, and manufacturing in the country. Investment in undertakings in South Africa by countries from Africa, Asia and Oceania has been comparatively small, but the post-apartheid period has seen some large investments from Malaysian companies.[11] FDI inflows from elsewhere in Southern Africa remain tiny, being limited by South Africa's economic strength vis-à-vis its immediate neighbours.

Regional Distribution of Foreign Direct Investment in South Africa

Table 9.4 summarizes the regional spread of FDI in South Africa. As can be seen, it is strongly concentrated in the country's business centre. Of foreign firms sampled by Meyer et al. (2002), 78% are located in Gauteng province, the economic engine of the country. In 2000, FDI in

Gauteng, which amounted to R1.69 billion, represented 19% of total investment in the country (GPG, 2003). About 40% of committed investments in the country were destined for Gauteng Province between 1 April and 25 October 2001. If Western Cape is included in the category of the economic hub of the country, 54% of committed investments went to those two provinces during that period (TISA, 2001).

Table 9.4:   Committed investments 1 April to 25 October 2001

Sector	Source	Value (R million)	Type of FDI	Region in RSA	Gauteng or Western Cape & Share of total
Automotive	Italy	71	Brownfield*	Port Elizabeth, Western Cape	Yes
Automotive	Germany	1,500	Expansion	Pretoria, Gauteng	Yes
Automotive	USA	70	Greenfield	Port Elizabeth, Western Cape	Yes
Automotive	Germany	12	Expansion	Port Elizabeth, Western Cape	Yes
Automotive	USA	12	Joint venture	Cape Town, Western Cape	Yes
Metals	Italy	100	Joint venture	Johannesburg, Gauteng	Yes
Chemicals	Switzerland	15	….		
Chemicals	Netherlands	270	New	Sasolburg, Free State	No
Chemicals	Algeria	40	New	Bethlehem, Free State	No
Chemicals	UK	50	New	Cape Town, Western Cape	Yes
Chemicals	SA/Japan	1,120	New	Sasolburg, Free State	No
Chemicals	Zimbabwe	8	New	Johannesburg, Gauteng	Yes
Chemicals	UK	50	New	Sasolburg, Free State	No
Chemicals	S. Korea	18	New	Port Elizabeth, Western Cape	Yes
Clothing & textiles	USA	50	Expansion/ Joint venture	Western Cape	Yes
Clothing & textiles	UK	150	Expansion/ Joint venture	Western Cape	Yes
Clothing & textiles	UK	169	New	Atlantis, Western Cape	Yes
Agro-processing	UK	25	New	Gauteng	Yes
Agro-processing	Germany	180	New	Kwazulu Natal	No
Agro-processing	Germany	165	New	Eastern Cape	No
Total		4,075 (100%)			2,235 (54.8%) Gauteng (40.1%)

Note: An industrial investment made on an existing commercial enterprise. Brownfields are vacant, abandoned or under utilized commercial or industrial properties where the fear of real or perceived environmental contamination and/or liability is a serious obstacle to their successful development or improvement. Brownfield projects involve the expansion and rehabilitation of existing projects that might have been initially constructed for other purposes. Some of the projects that attract brownfield investments have been avoided by other entrepreneurs because it was felt that they were commercially unviable. Often constrained by ownership issues, planning and other physical factors, the takeover of such projects often requires demolition, site clearance and in some cases site decontamination. This can be compared with greenfield investments, which are made on previous agricultural sites outside an urban area and involve setting up new plants

Source: Trade and Industry South Africa (2001).

Sectoral Distribution of FDI

As indicated above, during the early phases of the economic development of South Africa most FDI to the country went to the financial and mining sectors. After World War II, the manufacturing and services sectors attracted much more FDI than mining. By 1973, 45.1% of the FDI stock was in manufacturing, 27.3% in financial intermediation, insurance, real estate and business services and 14.6% in wholesale and retail trade, catering and accommodation. Mining and quarrying, meanwhile, attracted a mere 7.7%. The 2001 De Beers transaction had major implications for the sectoral distribution of foreign liabilities related to direct investment, pushing the share of the FDI stock of mining and quarrying to 34.0% from only 7.7% in 1973 and 4.3% in 1995. Between 1973 and 2003, FDI continued to flow into manufacturing and financial and business services. These sectors retained large shares of the FDI stock, but the shares of both decreased as a result of the De Beers transaction. Other important shifts from 1995 to 2003 were the increase in the share of the FDI stock of the transport, storage and communication sector (mainly related to new investments in information technology and telecommunications) and the compensating decrease in the share of wholesale and retail trade, catering and accommodation.

FDI in South Africa has largely targeted three sectors: financial intermediation, insurance, real estate and business services; mining and quarrying; and manufacturing. At the end of 2001, these sectors' shares of South African foreign liabilities related to direct investment amounted to 35.1%, 33.5% and 24.1%, respectively. The period from 1996 to 2001 was characterized by a sharp increase in the share of mining and quarrying, mainly reflecting the shifting of the primary listings of several South African mining houses to the London Stock Exchange. Compensating decreases occurred in the shares of manufacturing, wholesale and retail trade, and catering and accommodation despite continued investment in these sectors. Most FDI into South Africa is capital-intensive and goes to already established service sectors and new manufacturing sectors. Refer to Table 9.5 for the top ten sectors for FDI in South Africa during 1994–2002.

Table 9.5:   Top ten sectors for FDI in South Africa (1994–2002)

Rank	Sector	FDI
1	Telecommunications and IT	$3.357 billion
2	Mining and quarrying	$2.621 billion
3	Motor and components	$2.457 billion
4	Food, beverages and tobacco	$2.431 billion
5	Energy and oil	$1.935 billion (R9.395 billion)
6	Metal products and minerals beneficiation	$1.352 billion
7	Other manufacturing	$1.149 billion
8	Transport and transport equipment	$1.149 billion
9	Hotels, leisure and gaming	$942 million
10	Chemicals, plastics and rubber	$795 million

Source: TISA (2001); BusinessMap Database.

This table demonstrates that the finance insurance, real estate and business services sector remain the most important sector of attraction to FDI inflow to South Africa. Between 1986 and 2001, more than one-third of FDI inflow to South Africa went to this sector. The fact that FDI had been concentrated in this sector would suggest that the main aim has been to capture

the domestic market. The manufacturing sector, which was the most important in the early 1990, has witnessed a reduction in FDI inflow and currently accounts for a little less than a quarter of FDI inflow into the country. Inflows into the mining and quarrying sector have also sharply increased since the late 1990s and currently account for about a third of FDI inflow. Ninety-three per cent of total foreign investment was concentrated in these three sectors in 2001. Electricity, gas, water, transport, storage, communication, wholesale and retail trade, catering and accommodation, and community service accounted for about 7% of FDI inflow during the same year.[12] FDI in telecommunications and information technology is here shown to have overtaken that in mining and extraction.

Motive for Foreign Direct Investment

The type of foreign investment currently taking place appears to be motivated primarily by access to the South African and Southern African markets. A significant proportion of the recent FDI inflows have involved the acquisition of equity stakes in privatized parastatals. Natural resource seeking investment is also important in South Africa.

Resource-Seeking and Market-Seeking Foreign Direct Investment
The bulk of foreign investment into South Africa has been market-seeking FDI, as evidenced by the high value concentration in manufacturing, financial services sector, telecommunications, and food and beverages. Natural resource-seeking FDI is evidenced by investment in mining, energy and oil sectors. These types of FDI are associated with relatively longer-term, committed capital, and with "patient" investors (Maxfield, 1998). Natural resource-seeking investments are attracted by South Africa's relative wealth in natural resource stocks and related opportunities, while market-seeking investments target South Africa and the region (especially with respect to the country's political and economic integration into the region) as new output markets.

Hawkins and Lockwood (2001) find that firms that are clearly motivated primarily by a desire to access the local and regional market account for 67 of the 165 firms surveyed, while those that are probably motivated by efficiency or cost-reduction objectives make up 12 firms. The remaining foreign-owned firms are likely to be motivated by a combination of factors. The market-seeking motive could be ascribed to about 58% of firms interviewed separately from the survey process, with efficiency or cost reduction motives accounting for around 24% of firms, and resource-seeking and strategic asset-seeking motives each accounting for about 9% of firms interviewed. Market-seeking investment also looks beyond the region at markets where South Africa receives preferential market access, for example under the US African Growth and Opportunity Act (AGOA).

Efficiency-Seeking Foreign Direct Investment
Strategic investments follow where the country is identified as a strategically important base from which to enter the domestic and foreign markets, or where backward integration into domestic supply networks (for example, low-cost steel or aluminium) make South Africa an attractive location. In cases of strategic (or efficiency-seeking) FDI, investors seek more than just "cheap" labour and access to natural resources, but a much wider range of competitively priced materials and other inputs.

Efficiency-seeking investment in South Africa's export-oriented manufacturing sector has been very low. This is where multinational corporations (MNCs) locate part of their value-

added chain abroad to improve the profitability of their overall economic operations. This is the type of investment that the GEAR programme hoped to attract as part of its industrialization strategy. An exception is South Africa's automobile and components industry. Capital expenditure by eight original equipment manufacturers in South Africa for 2003 was R2.3 billion, bringing investment over the past five years to R10.2 billion. Further capital investment by manufacturers and supportive industries amounted to approximately R25.7 billion. Also, the government's Motor Industry Development Programme (MIDP) has been at the heart of this industry's export gains. The MIDP provides for a system of export incentives for local car and component makers, while gradually reducing tariffs on exports. Vehicle export from South Africa has increased at an average annual rate of 33% since 1995, and in 2003 was valued at R19.4 billion. Automotive exports now comprise 14.9% of South Africa's total exports by value. In 2002, BMW exported about 44,000 units and about 36,700 units in 2001. Daimler Chrysler exports 30,000 units, and Volkswagen 29,000 units a year on average. The industry is also a significant and stable employer, with an estimated 32,000 jobs in vehicle manufacturing and 81,000 in component and tyre production (DTI, 2003). This highlights the potential of efficiency-seeking investment to contribute towards South Africa's development objectives such as job creation (Vickers, 2002).

Foreign Firms in South Africa Are Strategic in Their Entry Mode

Foreign investors enter markets in which small numbers of firms are active and substantial market share is available. The number of competitors is on average fewer than five (mean score below 4) with market share close to 30%. In a number of sectors, foreign firms successfully increase their average market share after entry. On average, many foreign firms with initially low market shares (below 20%) very quickly increase their share above that threshold (Gelb, 2002).

Hawkins and Lockwood (2001) report the findings of a National Enterprise Survey for South Africa. Of the 54 foreign-owned operations surveyed that were established over the past decade, 33 are 100% foreign-owned. Amongst those firms with more than 10% foreign ownership, the degree of foreign ownership is above 75% in most sectors surveyed. This suggests that a high proportion of foreign investments in South Africa have taken the form of acquisitions, rather than mergers or other partnership arrangements. Acquisitions tended to occur more in the primary sector, whereas greenfield investments occurred primarily in the service sector. Mergers and acquisitions (M&As) accounted for R5.6 billion in FDI in 2000, followed by expansion investment of R3.9 billion and new investment of R2.8 billion. The dominance of M&As conforms with trends elsewhere in the world (Ryan, 2001).

Bond (undated) observes that virtually all the FDI inflows to South Africa during 1994 to 1999 were of the merger and acquisition variety rather than greenfield projects entailing the import and establishment of new plants. According to Estrin (2003), about one-third of all FDI entry is by acquisition in South Africa, although greenfield operations and joint ventures are still important entry modes. That acquisitions are a significant proportion of FDI projects in South Africa reflects the sophisticated financial markets and the quality of available local target firms (Meyer et al., 2002).[13] The country has developed networks of incumbent firms, facilitating entry by acquisition (Estrin, 2003). In sub-Saharan Africa, the highest proportion of all FDI in the form of M&As takes place in South Africa, a country where approximately 60% of inward investment adopts this mode of entry (Mwilima, 2003). Gelb (2002) found that

a significant proportion (31%) of acquisitions among investors surveyed were full and another 14% were partial. This underlines the greater maturity of South Africa's equity market, enabling asset purchases of this nature, as well as suggesting that a relatively high proportion of investors interested in South Africa see the country's asset base and structure as broadly similar to what they are familiar with.

One of the biggest FDI deals of 2001 was Saudi Oger's US$180 million investment in Cell C, the new cellular operator. Also in 2001, Malaysian Resources Corporation announced a R1.3 billion property development. Global Environment Fund acquired forestry assets worth R1 billion from Mondi and formed Global Forest Products, signalling its intention to bid for state-owned forestry assets.

Mergers and Acquisitions with FDI Component

Data from the Competition Commission of South Africa reveal that from a sample of 769 cases filed with the Commission between April 2000 and December 2002, some 109 (14%) involved foreign companies buying assets or investing in the country. Of these, 50% were within the manufacturing sector; about 13% within the wholesale sector and 9% in retail trade (Table 9.6). Other cases involved mergers and acquisitions in financial services, transport, mining and business activities. This further demonstrates the attractiveness of FDI to the manufacturing sector and amplifies the earlier discussion about FDI destination by sector.

Table 9.6:   Merger cases and FDIs (April 2000–December 2002)

Sector	No FDI cases	% of total FDI
Manufacturing	55	50.45872
Mining	4	3.66972
Wholesale	14	12.84404
Financial sector	6	5.50458
Retail sector	10	9.17432
Information technology	2	1.83486
Transport	4	3.66972
Business activities	10	9.17432
Other	4	3.66972
Total	109	100

Source: Competition Commission (2003).

Volatility of Foreign Direct Investment in South Africa

FDI in South Africa is less volatile when compared with other components of the country's capital account. This is illustrated in Table 9.7, in which standard deviations (as a measure of volatility) measures of the different variables are shown for the period 1994–2000 when capital controls on non-residents were liberalized. The standard deviations are lowest for FDI and long-term capital (which consists primarily of bank loans), suggesting that these flows are indeed less volatile than other capital transactions. Surprisingly perhaps, equity flows are markedly more volatile than FDI even though the distinction between the two is somewhat arbitrary.

Table 9.7: Indicators of volatility for South African capital flows, 1994.01–2000.03

Variable	Means	Standard deviation
Foreign direct investment	-70.49	499.23
Equity flows	467.51	789.42
Debt	443.83	1037.78
Long-term capital (mainly bank loans)	-111.40	356.06
Short-term capital	107.27	897.90

Source: Nowak (2001).

Persistence of Foreign Direct Investment in South Africa

Nowak (2001) examines a scenario whereby the monetary authorities in South Africa may wish to know what type of inflow will be repeated over a given period of time. This information is essential when considering buying inflows of capital. He tested for persistence by examining the autocorrelation properties of the major components of South Africa's capital account. The tests indicate that none of the components, including FDI, exhibits any persistence. Each type is essentially "white noise". In other words, capital that comes into South Africa in one quarter is just as likely to be followed by an outflow in the next quarter as it is by another inflow.[14]

The Attractiveness of South Africa as an FDI Destination

A 2004 survey by the United Nations Conference on Trade and Development finds that investors perceive South Africa as the most attractive destination in Africa (UNCTAD, 2005). The South African government's strategy for attracting FDI rests on three main pillars. The first is the maintenance of an attractive business and investment climate characterized by macroeconomic stability and investment-promoting regulatory and legal frameworks. The regulatory and legal framework is basically the same for domestic and foreign investors. There are no material restrictions on the repatriation of profits and the type (sectoral and otherwise) or extent of foreign investment. Exchange controls on nonresidents have effectively been abolished.

The second pillar consists of investment incentives, including tax holidays, depreciation allowances and relocation assistance to reduce investors' input costs. The Department of Trade and Industry's website (www.dti.gov.za) details the support through which government aims to attract FDI, including the Foreign Investment Grant, Strategic Industrial Projects and Critical Infrastructure Fund. Though seemingly underplayed, there are technology and human resource development incentives to raise the value of factors; the Department of Trade and Industry, for example, offers a skills support programme. This is a cash grant for skills development with the objective of encouraging greater investment in training and creating opportunities for the introduction of new advanced skills.

The third pillar of the investment-promotion strategy consists of spatial development initiatives (SDIs) and industrial development zones (IDZs) aimed at crowding in private investment through public sector financial support for infrastructure and anchor projects (Streak, 1998). These measures are discussed in detail next.

Regulatory and Policy Measures to Attract Investment

Since 1994, the South African economy has undergone a process of structural transformation. The country has implemented macroeconomic policies that seek to make the economy more outward oriented, and to promote domestic competitiveness, growth and employment. South Africa's regulatory regime and enabling environment for investment have undergone progressive transformation and liberalization since the early 1990s with a view to stimulating higher levels of public and private sector economic activity. South Africa has sequenced its reform process from first addressing macroeconomic issues and then shifting its attention to the microeconomics of investment in general and the efficient functioning of factor markets. The country's investment climate reforms are summarized in Table 9.8.

Growth, Employment and Redistribution Strategy
The most important of the economic fundamentals, as recognized in the literature, are the market-related variables that may affect market-seeking FDI. Here, there are two factors: current market size and potential market size. While a large market size generates scale economies, a growing market improves the prospects of market potential and thereby attracts FDI flows.

The national macroeconomic strategy GEAR, launched in 1996, was oriented towards a competitive global economy, with strong emphasis on fiscal discipline, investor confidence, economic stability, and a restructured public sector that would raise the efficiency of both capital expenditure and service delivery. GEAR rested on two motors for economic growth: an expansion of non-traditional (non-gold, manufactured) exports and an increase in private sector investment. GEAR also emphasized higher levels of public investment, particularly in infrastructure, in the expectation that this would crowd in private investment and improve short-term economic performance. GEAR emphasized economic growth as a powerful stimulus of FDI and stated that increasing FDI requires paying attention to the fundamental determinants of international investment decisions and the underlying macroeconomic expectations that may be relevant. These might include: political and economic stability, including macroeconomic stability and clarity about economic policy, sustained high rates of economic growth; labour market stability; investment incentives; the tariff regime; protection of property rights; and various determinants of expected investment returns.

South Africa's fiscal deficit as a percentage of GDP was systematically reduced from 4.5% to an estimated 2.4% for 2003/04; fiscal prudence has provided scope for declining debt service costs from 5.5% of GDP in 1994 to 4.1% of GDP in 2003/04. The country also exhibits a very low foreign debt to GDP ratio of 27% compared with most other emerging markets.

This coupled with strong export growth and FDI inflows, makes the risk of default on foreign debt negligible. Moody's and Standard and Poor's also reflect the positive attitude in their recent upgrades in South Africa's investor ratings. Government consumption expenditure as a proportion of GDP declined from 20% in the mid 1990s to 19% in 2003/04, and there was a sharp decline in general government dissavings from 5.8% in 1994 to 0.5% in 2001. Improved tax revenue collection has consistently outperformed targets, thanks to the successful restructuring of the South African Revenue Service (SARS) and an expanded tax base.

Favourable Monetary Policy Stance Keeping Consumer Price Inflation Low
A low inflation rate is taken to be a sign of internal economic stability in the host country. High inflation indicates the inability of the government to balance its budget and the failure of the

Table 9.8:   Policy instruments guiding South Africa's investment climate

Economic policy instrument	Various components of instrument

• Macroeconomic policy:
  - Reconstruction and development programme (RDP)
  - Growth, employment and redistribution strategy (GEAR)
  - Microeconomic reform programme
  - Integrated manufacturing strategy
	• Economic policy
	• Fiscal policy
	• Monetary policy
	• Restructuring/Privatization
	• Deregulation, improved regulatory quality
	• Trade and industrial policy
	• Competition policy
	• Labour market
	• Best practice corporate governance
	• Security of property and contractual rights
	• Black economic empowerment

• Incentives, industrial support and supply-side measures	• Fiscal and monetary • Spatial interventions (SDIs, IDZs) • Public-private partnerships (PPP) • Infrastructure • Skills, training and education • Other
• Voluntary and obligatory performance requirements (PRs)	• Export PRs • Technology transfer PRs • Research and development PRs • Employment and training PRs • Joint venture or domestic equity PRs
• Bilateral and multilateral legal instruments	• Bilateral investment treaties • Avoidance of double taxation treaties • World Trade Organization: Trade Related Intellectual Property Rights (TRIPS), Trade Related Investment Measures (TRIMs), General Agreement on Trade and Services (GATS)

• Investment facilitation and promotion	• Trade and Investment South Africa (DTI-TISA)
	• Provincial Investment Promotion Agencies
	• International Marketing Council
	• Presidential Working Groups:
	  - Trade Unions
	  - Big Business
	  - Black Business
	  - Commercial Agriculture
	• Presidential International Advisory Structures:
	  - International Investment Council
	  - International task force on information society and development

central bank to conduct appropriate monetary policy. The main objective of South Africa's monetary policy is to secure a stable financial environment, which includes low and stable inflation. To achieve this objective, the Reserve Bank adopted inflation targeting. Inflation targeting improves the transparency of the Reserve Bank's policy framework and includes accountability by the Reserve Bank to the Cabinet with regard to meeting inflation targets. Inflation targeting allows for a positive real interest rate, which is to be used as a policy instrument to control domestic inflation. The National Treasury and the Reserve Bank agreed on an inflation band of 3–6%. The target range remained unchanged for 2003, and is set at an annual average of 3–5% for 2004 and 2005. In contrast to many African countries, which experience double-

digit inflation rates, inflation in South Africa has been on a declining trend. Furthermore the exchange rate is allowed to fluctuate at competitive levels with minimum intervention from the Reserve Bank. This is considered favourable to foreign investors and can boost privatization programmes to attract FDI investments.

The Reserve Bank has full independence to adjust its policies and operations in order to achieve its inflation targets. It is therefore protected from any political objectives, something that is generally perceived to improve investor confidence. There has been an elimination of South Africa's oversold forward book, which was viewed with negative sentiment by most market participants, international rating agencies and the investment banking community.

The government has adopted the principle of national treatment for foreign investors. The Reserve Bank is therefore committed to a relaxation of access to domestic credit for foreign investors (foreign-controlled firms are subject to domestic borrowing restrictions). South Africa, in line with the liberalization of its investment regime, maintains no restrictions on the repatriation of capital investment, profits or the transfer of dividends by nonresidents. Interest payments are also freely transferable. Royalties, licence fees and certain other remittances to nonresidents, however, do require the approval of the South African Reserve Bank.

Microeconomic Reform

The government implemented a microeconomic reform strategy in 2002, to complement progress made on the macroeconomic frontier. This strategy focused on removing factors that limit accelerated growth and development within the micro economy. It focused on key crosscutting areas, including technology, human resource development, access to finance for small, medium and microenterprises (SMMEs) and Black Economic Empowerment (BEE) businesses, and infrastructure development. Key input sectors such as transport, telecommunications, and energy have also been targeted to improve microeconomic competitiveness.

Key microeconomic reforms to date include: negotiation of a new labour relations dispensation, development of new legislation and an institutional framework for skills development (including creating Sector Training Authorities to develop and promote sector-specific skills), and the development of a new small business development institutional framework and supporting legislation.

Strengthening Competition and Corporate Governance in South Africa

There has also been a major overhaul of competition policy to restrict anti-competitive practice, to eliminate the abuse of dominant positions, and to strengthen merger control as well as improve international competitiveness, to promote employment and advance the social economic welfare of South Africans. In an attempt to roll back white minority control of the economy the competition regime seeks to promote the participation of small, medium, and microenterprises in the economy and ensure a greater spread of ownership, particularly of historically disadvantaged persons. Pro-competitive regulatory measures were introduced in the South African amendment legislation in 2001.

Restructuring, Privatization and Deregulation

The government embarked on a gradual programme of restructuring, privatizing or further commercializing state-owned enterprises (but not necessarily liberalizing markets). State-owned companies such as the Airport Company of South Africa, South African Airways, Telkom and others were fully or partially privatized. This process of deregulation and restructuring also

necessitated the creation of new sector-specific regulators (particularly transport, telecoms and energy sectors). Tax reforms, fiscal discipline and the gradual liberalization of exchange control have been implemented, all aimed at increasing South Africa's attractiveness as a destination for foreign investment. The government is committed to an open capital market and the gradual relaxation of exchange controls. In February 2000, the government increased the private individual investment allowance from R500,000 to R750,000. In addition, the amount of investment applicable to SADC countries has also increased significantly. The SADC countries' limit of R250 million per new approved investment has been increased to R750 million, which also applies to the rest of Africa. The amount of foreign investment allowed in other countries across the globe was increased from R50 million to R500 million. With regard to the final and full abolition of exchange controls, the government is likely to remain cautious as long as capital flows continue to be predominantly short-term or volatile in nature.

Industrial Support and Performance Requirements

The South African government has revamped its industrial support measures by moving away from demand-side measures such as export subsidies, which were provided under the generalized export incentives schemes, towards supply-side measures.

Fiscal and Monetary Incentives. Harmful tax incentives such as tax holidays (phased out in 1999) and other ring-fenced measures have also been replaced with more effective and internationally acceptable investment measures such as accelerated depreciation for qualifying production assets. The rate of secondary tax on companies was reduced from 25% in 1996 to 12.5%. This was followed by a reduction in the standard corporate tax rate from 35% to 30% in 1999. The combined tax rate (for non-mining companies) has thus been cut from 48% to 38.7% since 1996. These reforms have attempted to create a tax environment that is internationally competitive, thereby improving the investment climate. Improved revenue collection by SARS should provide a scope for a possible reduction of the corporate tax rate in the future. The Revenue Laws Amendment Act, passed in 2002, also introduced strategic tax incentive measures to attract industrial investment to South Africa and to promote employment-generating projects in excess of R50 million, by allowing those investing in manufacturing and information technology a tax deduction of up to 100% (Maxwell, 2005).

Performance Requirements. There are no performance requirements per se except in the area of training and employment and equity requirements promoting Black economic empowerment for state procurement process and awarding of licenses in deregulated industries. Where companies voluntarily opt for an advantage from the state, such as drawing on some of the incentive schemes in place such as the Foreign Investment Grant (FIG), then performance requirements are attached to that particular scheme.

The government's sector-directed programmes and targeting of key growth industries have largely been successful (e.g., the export-oriented motor industry, with incentives provided by the Motor Industry Development Programme).

Public-Private Partnerships and Other Initiatives

The new measures are geared towards higher value-added manufacturing projects as well as strategic industrial projects, industrial development zones, critical infrastructure development, SMME development, public-private partnerships, etc. There has also been the introduction of

a new industrial policy, the Integrated Manufacturing Strategy, which focuses on the integration of interventions to enhance South Africa's competitiveness. These interventions are targeted at areas such as market access, beneficiation and value-addition, regional production, equity and economic participation, knowledge intensity and services integration, and the development of integrated value matrixes.

Trade Policy in South Africa

To enhance South Africa's investment credentials, the government has attempted to promote and facilitate investment through institutional innovation and bilateral negotiations.

Bilateral Investment Treaties
After the lifting of sanctions, South Africa actively participated in trade negotiations on both a bilateral and multilateral level. The government has targeted a number of strategic partner countries with which to develop economic relations through bilateral free trade agreements, including the European Union and SADC countries. Most African countries (50) had concluded bilateral investment treaties (BITs). South Africa is leading others in this respect. BITs clarify the terms under which FDI can take place between partner countries and tend to contribute more to the creation of a secure environment for foreign investors in the continent. They contain provisions for the settlement of disputes both between the treaty partners and between investors and the host state. BITs also cover a number of other areas, in particular, nondiscrimination in the treatment, and in some cases the entry of foreign-controlled enterprises, and other related fields. South Africa, like Egypt, Mauritius and Tunisia, has signed double taxation agreements (DTAs). By 1999 the number of double taxation agreements signed by South Africa was 47; Mauritius had 29, Egypt 27 and Tunisia 26.

National and Provincial Investment Promotion Agencies
South Africa has also established a national investment promotion agency, Trade and Industry South Africa (TISA), which is now a part of the Department of Trade and Industry. There are also provincial investment promotion agencies.

The President's Investment Advisory Agencies
There was also the creation of The President's International Investment Council (IIC), the International Task Force on Information Society and Development, and the International Marketing Council. These structures are to promote South Africa's investment credentials and image by "branding" the country, thereby helping to create a subjective preference for South Africa among foreign investors. A number of other structures have been established to advise the government on issues of the local economy.

Diversification of Export Markets and Trading Relationships
Apart from the country's traditional trading partners, South Africa has developed more extensive relations with South America, Asia and Africa. The government has been particularly keen on attracting export-oriented FDI, and in the process hopes to stimulate innovation and exports in local firms through technology, skills transfer and competitive pressures associated with FDI. It is also hoped that this will integrate domestic companies into the global economy. A case in point is the motor and components industry of South Africa.

The South African Business and Investment Environment

There are several reasons why the business environment in South Africa is conducive to the attraction of foreign direct investment. Results from Estrin's (2003) study suggest that managers of foreign subsidiaries perceive South Africa as providing a better business environment than other emerging markets, across the board in terms of six indicators: quality of raw materials and machinery; the ability to obtain real estate; the quality of professionals; the reliability of information technology and the telecommunications network; and the reliability of utilities such as electricity. The country is also evaluated to provide the strongest institutional environment for FDI, especially with respect to the issues of environment regulations, real estate and business licensing. Managers of foreign firms also perceive the policy environment to be more predictable. This supports Kearney's (2000) finding that South Africa's attractive regulatory and business environment is the main investment driver in the country. The World Bank's Business Environment Survey (reported by Vickers, 2003) finds that the registration process for new businesses in South Africa is more efficient in comparison with several other developed countries, although South Africa is less efficient with respect to contract enforcement.

A World Class Legal Framework
The South African legal framework is progressive, particularly within commercial, labour and maritime law regimes. It instils commercial certainty and a legal environment that facilitates investment and trade. Furthermore, South African law pertaining to trade and investment conforms to international norms and conventions. A range of legislation regulates business activities, protects patents and intellectual property rights, and supervises disputes and labour relations. Sanctity of contract is protected under the common law and independent courts ensure respect for commercial rights and obligations. Damages are compensatory, not punitive. Mediation, arbitration and other forms of dispute resolution are routinely used. The independence of the judiciary is guaranteed by the Constitution. No person or organ of the state may interfere with the functioning of the courts.

A Rich Array of Mineral Resources
These include gold and platinum (it is the world's leading producer and exporter of the latter), coal, chrome, copper, diamonds, iron, manganese, nickel, silver, and uranium. According to the US Department of State, South Africa's value-added processing of minerals to produce ferroalloys, stainless steel and similar products is a major industry and an important growth area.

Political and Economic Stability and Opportunity
The unsaturated markets in Africa have been identified as a major attraction for investors on the continent, but this has historically been offset by the poor political and economic conditions in many African countries, particularly the low per capita incomes. Volatility of macroeconomic policy creates both problems and opportunities for international firms, requiring them to manage the risk inherent in volatile countries, but also presenting the opportunity of moving production to lower cost facilities. For Africa, the perceptions of high-risk investment conditions have pushed up rates of return on investment in many sectors and resulted in demands for guarantees on returns even where actual risks are relatively low. Now in its tenth year of democracy, South Africa is politically stable and should be a relatively attractive investment destination. It has by far one of the continent's highest per capita incomes at US$2,293 (2002), and compares

favourably with other lower-middle-income countries. The South African market, moreover, accounts for 50% of the purchasing power of Africa.

Good Infrastructure Facilities

South Africa has modern and highly advanced telecommunications, technology, transport (roads, rail and ports) and energy provision infrastructure. The country's mobile telephone network operators are world leaders in technology while fixed line services and Internet run smoothly with operations expanding into other African countries. Its network and services markets remain largely untapped, other than for mobile, which is still far from saturated, and it has the most advanced backbone on the continent. The backbone connects to all the major undersea cable routes and can thus been seen as a gateway to Africa.

Expanding new economic infrastructure and maintaining existing facilities are important components of an investment climate reform strategy. The government has, therefore, committed significant resources to infrastructure so as to improve the quality and sustainability of capital projects and the overall efficiency, competitiveness and growth of the economy. In particular, economic infrastructure for roads, rails and ports are being prioritized. This includes the Coega deepwater port and industrial development zone (IDZ); the East London IDZ and rehabilitation of the Richard Bay IDZ and the John Ross highway; the rehabilitation and expansion of major ports, including the concessioning of the Durban container terminal; further improvements to major airports; the Dube TradePort (the proposed La Mercy airport and freight handling facility); and the Gautrain rapid rail link between Johannesburg, Pretoria and the Johannesburg International Airport. An automotive supplier park to service the local motor industry with logistical services such as warehousing, transport and consolidation has been established in Gauteng Province and is said to be the first of its kind in Africa. A study by the Edge Institute has found that a relatively high proportion of investors interested in South Africa see the country's asset base as broadly similar to what they are familiar with (Gelb, 2002).

South Africa's diverse manufacturing industry is a world leader in several specialized sectors, including railway rolling stock, synthetic fuels, and mining equipment and machinery. In addition, there are indications that speculations by currency dealers may have caused the South African rand's under-valuation, which provides increased opportunities for realizing profits from FDI should the value of the rand reach its correct value.

Low Cost of Doing Business

Factors that cause investment cost differentials across countries are categorized as cost factors. These include cost of labour, cost of capital and infrastructure costs. Cost factors may significantly influence the choice of an investment location for resource-seeking and efficiency-seeking FDI. South Africa has among the lowest electricity prices in the world and is known for the superior supply quality of this utility. A recent survey by the Economist Intelligence Unit (EIU) ranked South Africa as highly cost competitive (22nd of 31 countries surveyed – 1 being the highest cost). The current challenge is to maintain low price increases by creating a competitive market and large-scale investment in production capacity, among others.

High Annual Rate of Return on Investment

In 1996, the annual rate of return on South African investments was an appealing 18–19%, compared with 14% on investments in Latin America, 12–13% on investments in Asia, and 9% on European investments. South Africa's relatively well developed financial market makes up over 11% of all emerging markets' market capitalization. Moreover, South Africa's stable returns

of 11% for the 1994–1999 period, combined with relatively low risk, as measured by a variance of 0.007, beat out most other emerging markets as a reliable destination for portfolio investments (Assefa, 1999). In 2003, South Africa's stock market returns, in US Dollar terms, yielded 42% (*Business News*, 2004).

Low Corruption Level

Evidence elsewhere suggests that corruption reduces private investment owing to higher costs and increasing uncertainty on the part of the investor, and leads to price distortions. Transparency International collects data on the perception of corruption, mainly on the basis of private sector surveys. Corruption is defined as the misuse of entrusted power for private gain and ranks from 10 (no corruption) to 0 (highly corrupt). The organization prepares a table annually that shows the ranking of 91 countries. In general, African countries score low.[15] Only Botswana (rank 26), Namibia (30) and South Africa (38) are ranked in the top 50. Scores below 5.5 are perceived to indicate significant problems with corruption. On the basis of this ranking, it is suggested that corruption in South Africa is not as serious as obtains in the rest of Africa. This is good for attracting foreign direct investment.

Market Size

We pointed out earlier that the size and growth of the host market is a particularly important determinant of horizontal FDI. South Africa's gross domestic expenditure (GDE, the sum of final consumption by households and general government and gross capital formation) amounted to US$122 billion in 2000, having grown at an average annual rate of 1.4% since 1990.[16] The South African market is huge in the context of SADC and sub-Saharan Africa as a whole: in 2000, South Africa's GDE amounted to 70% of that of SADC and 38% of that of sub-Saharan Africa. In the global context, though, the South African market is neither particularly big nor very fast growing. Of the 15 emerging-market economies included in the comparison in Figure 9.1, for example, nine had higher GDEs than South Africa in 2000 (Argentina, Brazil, China, India, Korea, Mexico, Poland, the Russian Federation and Turkey) and only the Russian Federation had a slower GDP growth rate from 1990 to 2001. Furthermore, most of these comparator countries are part of regional markets that are much larger than SADC. The extent and growth of the markets for many products in South Africa are constrained by the exceptionally high degree of income inequality, while the long period of import substitution (1924 to the 1980s) has enabled domestic firms to firmly establish themselves in the vast majority of markets for consumer goods. All in all, the limited extent and comparatively slow growth of the South African and SADC markets are major constraints to market-seeking FDI.

Labour Productivity

South Africa has shown marked improvement in general labour productivity – by 6.2% in 2001 and over the past five years by 4.9% per annum, nearly double the productivity growth as benchmarked against the USA. (Figure 9.5 illustrates.) Particularly in the automotive industry significant improvements in productivity have been driven by international investments, which contributed to transform the automotive industry into a globally competitive manufacturer and exporter. Productivity in the automotive industry is on par with low-volume countries. Between 1996 and 2001 South Africa's productivity had increased from 7.5 to 12.6 vehicles per employee per annum. This was in contrast to the slow rise in Australia where figures improved from 16.1 in 1996 to 17.7 in 2000. The South African industry has relatively low levels of automation and a complex product range of relatively low volumes in global terms (TISA, 2001).

Figure 9.5: South Africa's labour productivity index, 1997–2001
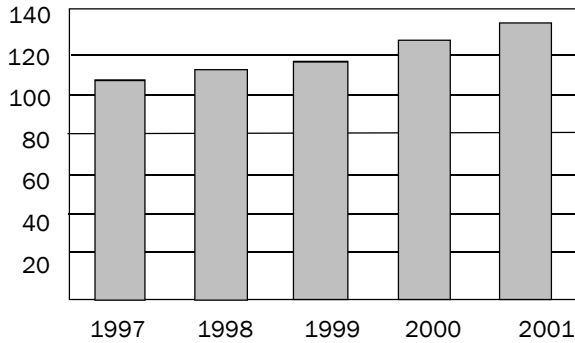
Source: South African Reserve Bank (several years).

Growing Domestic Investment

It has been argued by some authors that South Africa does not have a technical shortage of capital, but rather lacks viable, bankable projects. South Africa's national savings exceed its national fixed investment, so that there is no savings or resource gap. SARB has similarly noted that most of the 1990s was characterized by corporate excess savings (that is, the difference between gross savings and gross capital formation), and this may reflect companies' negative assessment of potential risk-return possibilities. Local firms have corporate savings in excess of US$300 billion (Abedian, 2003). The private sector was said to be awaiting its cue from increased government spending on infrastructure and a shift in the balance of state spending away from consumption. Private fixed investment has tended to move in the same direction as public fixed investment. It was argued that for South Africa to win the confidence of foreign investors as a investment viable market, domestic firms need to lead the way and show trust in the economy. This will involve addressing the underlying confidence issues in the economy.

Moreover, South Africa enjoys long established capital markets – the JSE Securities Exchange was founded over a century ago. With a market capitalization of R1.083 billion it is the world's fifteenth largest stock exchange. Institutional investors dominate the markets, with an increasingly concentrated asset management industry. Owing to the highly developed nature of South Africa's capital market, it is able to finance current levels of viable, bankable projects. When the rand depreciated in the past, local capital became a cost-effective substitute for foreign direct investment.

South African businesses are beginning to follow government lead in investing in the domestic economy. The South African government plans to invest a massive R121 billion (US$21 billion) in the energy and transport infrastructure between 2005 and 2010. Local corporate giants have hence been announcing multi-billion rand investments in the country. SABMiller is committed to an expansive investment plan, involving R5 billion (US$865 million) in the next five years (*Financial Times*, 2005). Sasol has pegged its capital spending at R15 billion, while cement and lime producer PPC intends boosting its annual capacity by a million tons by investing R1 billion. Transnet and Eskom have earmarked R165 billion for infrastructure development, and investments forecast for vehicle manufacturers total R3.5 billion – a five-year high. Renewed interest in local investment follows buoyant economic forecasts for the country: interest rates are down, the rand is strong, consumer spending is up and business confidence is positive – an upswing that has been felt in most sectors (*Business Day*, 2004).

Rights to Entry and Establishment

The South African government actively encourages investment in the national economy. South Africa's FDI framework is largely non-prescriptive and liberal, with few provisions relating to foreign investors that do not apply equally to resident investors. In fact, the country's capital and profit repatriation regime applicable to FDI is far more liberal than the remaining capital controls that still apply to residents. Whereas government-funded investment promotion agencies, such as TISA, may try to nudge FDI into particular sectors (especially the priority sectors identified in the government's Integrated Manufacturing Strategy), it is up to investors to make any investment decisions themselves. There are generally no restrictions on the type or extent of investments available to foreigners. Restrictions would usually relate to a particular industry. In banking, for example, a foreign bank establishing a South African branch may be required to employ a certain minimum number of local residents and maintain a minimum capital base of at least R1 million. Restrictions also exist regarding the ownership of immovable property by foreign companies.

Constraints to Attracting FDI into South Africa

The actual value of FDI inflows into South Africa has remained fairly low. This is largely because of the perception that the risk premium in South Africa is not being reduced by macroeconomic developments such as price and exchange rate stabilization, while the slow pace of privatization and uncertainties about Black Economic Empowerment initiatives may also be deterring potential investments. Compared with other countries, such as South Korea, when they opened up to foreign investors, South Africa has received relatively little foreign investment inflow.

The World Bank (2003) identified some ten constraints to firm investment in South Africa. These include those relating to the labour market, the macro economy, business environment, social issues such as crime, corruption and anti-competitive practices, etc. These are highlighted in Figure 9.6.

Figure 9.6: Top ten constraints to firm investment in South Africa, 2003 (percentage of firms identifying problem as a "major" or "very severe" obstacle)
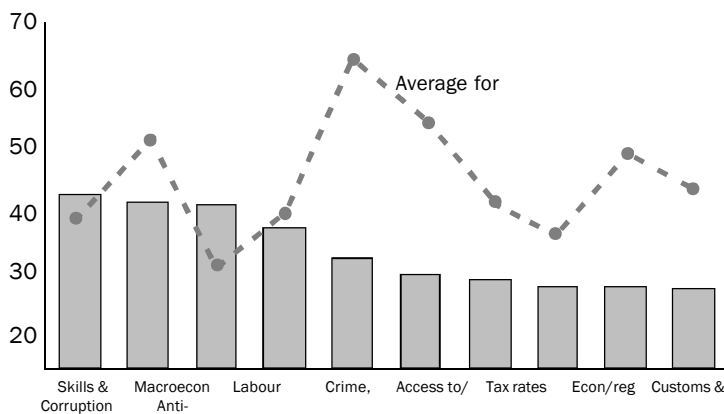
Source: World Bank (2003).

Domestic Market Structure and Potential

The domestic market is relatively small and segmented. Also, there are concerns about the country's economic prospects: There has been a pattern of secular deterioration in the real growth performance of the South African economy for decades. The rate of real GDP growth slowed and became more variable between 1970 and 2001. Real average annual GDP growth fell from 5.8% in the 1960s to 3% in the 1970s, 1.8% in the 1980s and 1.4% in the 1990s. From the mid 1970s onwards, population growth often exceeded real output growth. GDP per capita at constant 1995 prices thus decreased from a peak of R16,347 in 1981 to R14,554 in 2002.

The problem with the South African economy is not that it is not growing, but that it is growing by less than it needs to in order to induce mass production type investment projects. Key to South Africa's industrial performance is the ability to attract export-oriented foreign direct investment, which will reinforce the current momentum of export orientation (Vickers, 2003). The macroeconomic reforms pursued since 1994 have not resulted in significant economic growth nor created employment. Aron and Muellbauer (2002) suggest that high real interest rates policy (the result of tight anti-inflationary monetary policy) also significantly constrained economic growth in the country during the 1990s.

Highly Concentrated Industries. Under state protection, many firms adopted anti-competitive practices over several decades, so that South African firms exhibit the highest four-firm concentration ratios in the world. This includes both horizontal oligopolization as well as vertical integration, which leads, through tied contracts, to a lockout of any foreign investor in the main inward-oriented production, warehousing, distribution, marketing and retail networks (Vickers, 2003).

Declining Infrastructural Comparative Advantage. South Africa may be losing its competitive edge in infrastructure quality: Although the country developed a sophisticated business infrastructure for many years, its competitive advantage in this respect is diminishing as other countries show a clear improvement over time. Meyer et al. (2002) arrive at this conclusion when they examine the supply of inputs to foreign subsidiaries in a number of emerging countries, including South Africa. In South Africa the supply of utilities is scored high by foreign investors. Most problems appear to emerge with the supply of raw materials and components and of machinery and equipment; a considerable gap emerges between these two items and other local inputs. South Africa's ports have not been able to meet the challenges posed by the increase in volume and composition of the country's trade. The government is in the process of concessioning the Durban container terminal as a way of remedying the situation.

Poor Market Intelligence of Foreign Investors. The poor understanding of democratic South Africa is a significant constraint to foreign direct investors making long-term investment decisions. Attempts by South Africa to define and project itself as an investment destination distinct from the rest of Africa has met with limited success (Kearney, 2000). Potential investors very often view South Africa as another African commodity exporting country, and are often unaware of the extent of the diversification and strengthening of the economy into high-value manufacturing and the expanding role of the service sector in the country's GDP. South Africa therefore needs to craft a unique investment identity for itself by actively marketing its commercial potential, identifying targeted opportunities, and facilitating the eventual investment (hence the roles of the International Marketing Council and the International Investment Council).

South Africa's Regulatory and Institutional Conditions

The institutional-regulatory environment is related to consistency in public policy reforms as they affect business confidence. Business confidence and market sentiment are highly sensitive to opaque regulations and regulatory uncertainty. There could be logistical, transport and bureaucratic costs inherent in policy reforms and these will have implications for business. Gelb (2002) finds that some investors perceive that there has been a deterioration in the country's institutional-regulatory environment.

Regulatory Policy on Access to Resources. To be effective South Africa's pro-competition regulatory strategy requires a highly skilled and resourced regulator to ensure a level playing field and, in turn, to instil confidence in investors. In the telecommunications sector, the highly consultative first phase of policy reform in South Africa identified the need for a sector regulator to implement policy, to create a transparent and certain regulatory environment for investors and consumers, and to contribute to building a stable and well-functioning market. The resulting legislation, however, reflected the need of the government to retain control of the terms of agreement with the incumbent's strategic equity partner, Thintana. The relevant ministry had to establish its credibility with the international investment community by ensuring protection of the biggest investment on the continent at the time (the Thintana 30% stake in Telkom) and of course at the same time protect its own asset.

The Act as a result permitted the ministry to retain core regulatory powers, which seriously undermines the authority of the regulator and its ability to create an attractive environment for further investors. The requirement that regulations be approved by the ministry created a serious regulatory bottleneck, with regulations vital to the development of the sector – most particularly the critical interconnections and facilities-leasing framework and the rate regime review for the incumbent – being delayed in the ministry for months and even years. This has allowed various interests to lobby the minister after decisions have already been reached by the regulator in accordance with the public processes required by law, creating uncertainty in the industry and often resulting in time-consuming and costly court challenges to gain clarity. Most significantly it has negatively affected the investment environment, with several major investors vowing publicly, after the controversial licensing of the third mobile cellular operator, to never become financially involved in the telecommunications sector (Gilward, 2004).

Price Regulation. The regulatory strategy adopted by the country's regulators has involved some form of price regulation as a means of ensuring improved access to vital resources by the historically disadvantaged groups in the country.

Price regulation is traditionally identified as a determinant of investment. One of the most critical regulatory issues in a developing country is getting services to be efficiently delivered and cost-based. The public interest rationale for regulation in developing countries focuses primarily on securing access for those citizens who do not receive services at all. This often requires increased tariffs – to cost-based levels – for those that already have services, to allow for getting services out to those who do not. In most developing countries, those who already receive services tend to represent a small and influential elite, who have usually been the beneficiaries of subsidized local services. Without regulatory clarity, the effect of their resistance to cost-based price increases could result in reduced infrastructure expansion, either due to lack of investment because of the inability of investors to receive a reasonable rate of return, or because companies already invested in the country are not able to generate sufficient revenues to invest internally in network expansion.[17]

A further problem relates to the apparent disjuncture between official regulations and their implementation. Several investor surveys highlight the problem of regulatory policy and practice not being aligned, so that while the rhetoric might sound attractive to investors, failure to implement investor-friendly regulations or the perpetual challenging of regulations, may frighten investors off (Gilward, 2004).

Black Economic Empowerment (BEE) Initiative. Many business organizations in South Africa share the view that BEE initiatives increase their costs and reduce their competitiveness relative to those of their competitors. It is estimated that meeting initial targets to boost black involvement in the mining industry, for example, would cost about R10 billion (Menell, quoted in Avmin, 2004). These costs reduce the effectiveness of South African businesses as competitors on the world stage. The number of corporations achieving international competitiveness appears to be shrinking. The more these companies are burdened with additional costs, the less likely that they will succeed (Paton, 2003: 22). The uncertainties surrounding the enactment of a BEE mining charter – a mechanism by which Black ownership of equity in the mining industry could be progressively increased to an initial target of 26% – has led mining companies like Anglo American and Xstrata to put on hold further investment in the country (McKay, 2002). This has resulted in decisions by some of South Africa's big corporations to relocate control of their companies out of the country, in the demand by owners to diversify their South African asset holdings into non-South African assets, in low levels of foreign direct investment and in the high levels of White human capital outflow from the country (Hosking, 2003). BusinessMap (2003) notes a rising trend in disinvestment from South Africa, although small in absolute terms, which is often related to BEE and the need to roll back white minority control of the economy through the implementation of equity targets.

Access to Finance and the Cost of Capital. Interest rates in South Africa have been relatively high, compared with the country's major trading partners (e.g., the US and Europe), averaging 18% between 1996 and 1999, and peaking at more than 25% in 1998 in a major credit crunch. There is, however, a general long-term downward trend in interest rates. It is common knowledge that high interest rates raise the cost of capital, discourage direct investment and encourage volatile portfolio investment. In light of the country's tight monetary policy, there is a strong link between interest rates, inflation and the depreciation of the rand. The latter's depreciation in late 2001 led to increases of one percentage point, four times each, in the prime interest rate in 2002. The rand's appreciation in 2003 has eased inflationary pressures, leading to a number of interest rate cuts during 2003. On the downside, the rand's depreciation led to an inflation spiral and a series of interest rate hikes, which do not benefit consumers. For existing foreign investors, a 40% profit margin in 2001 also shrank to 3% after the rand's fall. A constantly declining currency is, therefore, a disincentive to investors. The rand has appreciated dramatically since then, gaining 14% against the dollar during 2003, along with its 40% gain during 2002, making it the best performing currency in 2002 (compared with worst performing currency against the US dollar in 2001).

There is mixed evidence on the impact of depreciation of the real exchange rate in the host country on FDI inflows. Foreign investors may gain or lose from a devalued exchange rate. They may gain because of larger buying power in host countries. Also they can produce more cheaply and therefore export more easily. This may therefore attract resource-seeking and efficiency-seeking FDI. However, foreign firms may not enter if they believe that depreciation may continue after they enter a country as this would imply costs that are too high to justify

their investments. The borrowing restrictions placed by the exchange control authorities also serve as a deterrent to foreign investment.

For investors, a stable and predictable rand is more important than a strong one. Gelb (2002) notes that investors have limited the number of greenfield investments in South Africa as a way of mitigating the adverse effects of exchange rate fluctuations, which can result in asset devaluation in home currency terms. Other strategies being adopted by investors include favouring partial acquisitions and investing in services so that their investment is not tied in physical capital and is more easily reversible.

Limited Financial Incentives. In South Africa only limited financial incentives are offered to foreign investors. Government policy has been focused at concentrating infrastructure into industrial development zones and using funds to improve transport through investments. Big investments do receive limited incentives in the form of tax breaks and small businesses can access grants. However, these grants are increasingly targeted at research and development and technology-oriented start-up companies. Critics of the incentives policy are of the opinion that if the country wishes to compete with other developing countries for FDI, it needs to match the more generous packages on offer elsewhere. Others suggest that once FDI has been secured, it is a mistake for governments to restrict foreign operations to protect local companies. The most popular of such restrictions are local content and joint venture requirements. Forcing local firms to compete with foreigners is essential to diffuse the impact of foreign investment and to improve firm's production efficiency and labour productivity.

Social Risks Affecting Business

At the top of the list here are the conditions that make headlines worldwide: the HIV/AIDS epidemic and rising crime rates, both of which are regarded as sources of increasing costs of doing business.

The HIV/AIDS Pandemic. There are currently approximately 4.7 million to 5.3 million HIV-infected South Africans, accounting for 10% of the total number of infections in the world. The pandemic affects the most productive segment of the society, the very group of people on whom foreign investors depend for attracting labour. Its impact on South African businesses has been high, ranging from increased medical aid contributions to the costs of provision of additional health care for infected workers, absenteeism, funeral contributions and others. The high incidence of HIV/AIDS in the country could also contribute to a slowdown in multi-factor productivity growth and add to the erosion of South Africa's social capital. This is an important risk factor, which necessarily affects risk-adjusted rates of return on investment.

The South African government approved a comprehensive drug-treatment programme in November 2003 that will include the provision of free anti-retroviral drugs in public hospitals. Government will spend an estimated R296 million until 31 March 2004, a further R4.2 billion will be spent from 2004 to 2008 along with a universal roll out of Nevirapine to prevent mother-to-child transmission of HIV. The South African government has increased the budget allocation for HIV/AIDS from R342 million in 2001/02 to R3.6 billion in 2005/06. These measures may contribute to assuring foreign investors of the seriousness of government to tackle the pandemic and reduce its business impact.

High Crime Rates. South Africa struggles to counter the negative effects of violent crime on domestic and foreign investment. According to police figures South Africa's annual murder

rate is 52 out of 100,000 people – one of the highest murder rates in the world. The number of car hijackings has been coming down since 2001/02, reaching the lowest point in eight years at 12,434 hijackings in 2004/05. In the last financial year, however, this trend was reversed, with a 3% increase in recorded hijackings. Car theft also decreased steadily between 1998/99 and 2004/05, although it increased by 3% in the last financial year, reaching a rate of 183 per 100,000 people (85,964 incidents). It is the trend for cash-in-transit (CIT) robberies that has been the source of most concern, with statistics showing a substantial increase of 74% between 2004/05 and 2005/06 (from 220 to 383 incidents) (Institute for Security Studies, 2006). Notwithstanding the decline in other crime statistics, South Africa still has the highest per capita rate of reported rape in the world. Crime hampers business operations directly by increasing costs due to losses from looting, arson, theft, extortion, and fraud, increased security and protective measures, and medical expenses for injured employees. Crime also reduces output because of altered employment practices – avoiding "high-risk" but potentially productive employees, instituting shorter working hours, etc. – and increases the cost of property insurance. Inflows of FDI require long-term commitments. Because concerns about security and the general economic perspective for South Africa have been in the headlines in the country, these could have deterred many potential investors (Gelb and Black, 2000).

Concluding Remarks

This chapter discussed trends in foreign direct investment by examining levels of inflow, origins and sectoral distribution. The attractiveness of South Africa as an investment destination was highlighted alongside regulatory and policy measures being implemented to attract foreign direct investments. It is suggested that South Africa's business and investment environment are conducive to the attraction of foreign direct investment. Domestic investors are also beginning to follow government's lead in committing resources to investment in the country. This should serve to further encourage foreign investment inflow. South Africa is beginning to record important gains in attracting foreign investment as a result of increased investor confidence in the economy.

There is need for South Africa to craft a unique investment identity so as not to be perceived as just another African country. The country needs to improve the social environment by cracking down on crime and attending to the HIV/AIDS pandemic, both of which appear to negatively affect investors' sentiment towards the country. The approach of sector-specific voluntary compliance with the policy of Black Economic Empowerment will ensure business confidence in this policy. The short-term costs of achieving the objective of black economic empowerment will reap long-term gains in terms of a lower Gini coefficient along racial lines, which will open the formal economy up to a greater cross section of the population. This will stimulate economic growth and stability and hence increase foreign direct investment resulting in a virtuous circle.

Notes

[1] All data discussed in this section were drawn or calculated from series published in the South African Reserve Bank's Quarterly Bulletin.

[2] The Department Trade and Industry, Foreign Investment Grant.

[3] www.tips.org.za

[4] Vickers (2003: 2) concurs that the levels of FDI flows to South Africa since 1994 have lagged those of competing developing countries and emerging markets with similar risk profiles.

[5] The data were drawn from the balance of payments tables in the South African Reserve Bank's Quarterly Bulletin. It represents the liabilities portion of net direct investment, which is defined as "investment by foreigners in undertakings in South Africa in which they have individually or collectively in the case of affiliated organizations or persons at least 10% of the voting rights".

[6] Gelb and Black (2000: 178) report that some 225 US corporations and about 20% of UK firms left South Africa between 1984 and 1988 alone.

[7] These were 1997 and 1999, when privatization transactions pushed FDI to higher levels, and 2001, when the restructuring of shareholdings in the De Beers mining company caused a large inflow of foreign capital. The privatization transactions were the sale of a 30% stake in the telecommunication utility Telkom to the SBC/Telekom Malaysia consortium in May 1997 and the sale of a 20% stake in South African Airways to Swissair in July 1999. In the second quarter of 2001, a financial holding company headquartered in Luxembourg acquired full ownership of De Beers by buying out minority shareholders. Although classified as an FDI flow, the economic effects of this transaction are more akin to those of a portfolio flow (Gelb and Black, 2000: 181).

[8] The foreign direct investment series in Figure 9.3 was drawn from the balance of payments tables in the South African Reserve Bank's Quarterly bulletin. It represents the liabilities portion of net direct investment, defined as "investment by foreigners in undertakings in South Africa in which they have individually or collectively in the case of affiliated organizations or persons at least 10% of the voting rights" (SARB, 2003: S-84).

[9] These were the sale of a 30% in Telkom to the SBC/Telekom Malaysia consortium in May 1997 and a 20% stake in South African Airways to Swissair in July 1999.

[10] The population for Gelb's (2002) study of companies that invested in South Africa after 1990 confirms the broad pattern described here. Of these 562 foreign companies, 282 (55%) originated from Europe, 152 (30%) from North America and 58 (11%) from East Asia (Gelb, 2002: 7).

[11] The two largest transactions were the 1996 takeover of South African petroleum company Engen by state-owned Petronas, and the 1997 acquisition of a 30% stake in telecommunications utility Telkom by a consortium consisting of Telekom Malaysia and US-based SBC International.

[12] According to the *Financial Times*, the statistics are somewhat misleading. Most of the foreign interests and assets in South Africa have been there for many years, while the flow of foreign investment into new factories or businesses remains modest for a market of South Africa's size (Mallet, 1998).

[13] A reason for this is the domestic market power of South African firms, making it costly to "buy" market share in the country. The implications are that in contrast to the other SADC countries, most FDI in South Africa does not create further industrial capacity or jobs, at least not in the short run.

[14] Nowak (2001) suggests that this is not a reason to avoid targeting capital inflows (evidence of negative autocorrelation, however, probably would be). Rather, it suggests that as a general rule, the SARB would need to exercise considerable caution when buying inflows to reduce the net open forward position (NOFP). Nonetheless, in certain cases involving large one-off inflows of FDI, the SARB may have sufficient prior information to make an assessment as to whether the inflow is unlikely to be reversed. This would probably be the case, for example, with privatization proceeds or inflows associated with the restructuring of De Beers' shareholdings.

[15] Countries such as Nigeria, Uganda, Kenya and Cameroon are found at the bottom.

[16] The data quoted in this subsection were sourced or calculated from World Bank (2002).

[17]For more detailed argument of this positions see Samarajiva (2001) 'Making Regulation Pro-Poor', <www.itu.int/TELECOM>.

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FDI Flows to Sub-Saharan Africa: Uganda Country Case Study

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Since the 1970s the most important foreign capital flows to developing countries have been foreign aid, workers remittances or unrequited private transfers, and foreign direct investment in that order. Over time, foreign aid has fallen slightly as workers remittances and FDI have risen substantially although FDI has continued to lag behind in importance. Other forms of capital flows that gained prominence in the 1990s were private net foreign borrowing and foreign portfolio equity. In the case of private debt, the mid 1990s rise was significantly offset in 2001 and 2002 as poor countries began paying more debt than they were borrowing new from international banks. FDI inflows to developing countries gained momentum during the second half of 1990 and after rising significantly to US$179.287 billion in 1999, declined to US$143 billion in 2002 (World Bank Report, 2003). These developments indicate a significant rise in relative terms compared with an average of US$105.395 billion at the start of the decade. Despite the declining trend of FDI flows by 2002, Africa continued to receive a fairly large share as a ratio of FDI to gross national income, which remained fairly significant at an average of 2.5% between 1996 and 2002.

In the wake of sharp increases in FDI inflows to developing countries during the second half of the last decade, the share of net FDI flows to sub-Saharan Africa remained at about 4.9% in 2002, compared with an average of 4.0% over 1996–2000. This was significantly lower than flows to East Asia and Pacific and Latin America and the Caribbean, however, where averages since 1996 have been in the range of 25–40% of total flows to developing countries. Nevertheless, it is somewhat heartening to note that some countries in sub-Saharan Africa have done well in attracting FDI, with Angola and South Africa in the lead.

In general, there has been a shift in emphasis from foreign aid to other forms of development financing. More attention has been given to encouraging private enterprises to take the lead role in growth and development as a result of a basic change in attitudes towards development over the last decade. Most developing countries are now deregulating their domestic economies, liberalizing foreign trade, and welcoming foreign investment through more and more aggressive investment promotion strategies. It is believed that this foreign direct investment will bring along with it benefits of more investment, greater productivity, more employment and rising

incomes. Moreover, in contrast to foreign aid, the amount of money from foreign investment potentially available to poor countries is immense in relation to their economies.

The literature indicates that FDI responds most to political, economic and infrastructure features. In addition to social and political stability, ready markets, high rates of return, inexpensive and skilled labour, and cheap local inputs attract FDI. On the other hand, the literature suggests that inadequate or expensive infrastructure and risk repel FDI. For poor countries, studies have shown that they usually have insufficient quantities of capital equipment, such as large machinery and modern production lines, and generally inferior levels of production technology. Consequently, the rate of return on new foreign investment can be very high especially for capital-intensive industries. For example, the average return on US investment to Africa over 1991–1996 was 30%. This compares with 21% for Asia and Pacific, 14% for Latin America and 16% for all developing countries (Asiedu, 2002). In addition, the low production costs obtaining where an educated and disciplined labour force is available at relatively low wages, along with competent managers, increase the attraction.

On the other hand, high initial investment costs have been often cited as deterrents to investment in developing countries. These include complicated and lengthy company registration procedures and intrusive rules for the location and manner of investment, and the need to install infrastructure specifically for the investment. Risks due to political upheavals, which may upset established laws, agreements or business practices, pandemics such as malaria and HIV/AIDS, crime and corruption are additional factors known to deter investors.

In this chapter, on the basis of Uganda's experience, we analyse the various types of FDI and the relative magnitudes of the components. We also examine the destination of the FDI among the sectors of the economy and assess the economic, political and other factors that might have influenced the sectoral allocation.

The rest of the chapter unfolds in the following manner: a discussion of the evolution of FDI in Uganda, a look at the types, destination by sector and the sources of FDI, and a review of the determinants of FDI in Uganda. Some conclusions and recommendations wrap up the presentation.

The Evolution of FDI in Uganda

In general, Uganda has achieved sustained economic growth accompanied by a significant reduction in inflation since the mid 1980s. Strict fiscal discipline, a tight monetary stance and a flexible exchange rate regime have allowed the country to reap the benefits of a market-oriented reform agenda. Openness to trade has allowed investments in economic activity in which the country possesses comparative advantage while concessional donor financing has funded the overall external deficit. Along with the adoption of a disciplined macroeconomic framework and economic reform measures, the government has actively sought to reassure investors of the safety of their investments. This has been achieved through, among other things, becoming a signatory to the Multilateral Investment Guarantee Agency (MIGA), the International Convention for Settlement for Investment Disputes between States and Nationals of other States (ICSID), and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Moreover the pace of privatization, which is believed to be quite fast compared with most African countries, has further facilitated rapid inflows of FDI. We discuss these developments under four regimes: post independence up to 1970, the 1970s, 1980 to 1985, and 1986 to 2002 (see Obwona, 2001).

The Post Independence Period up to 1970

Before independence, 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 its development programmes. The government's attitude towards FDI was clearly demonstrated in the Uganda Industrial Act of 1963, which placed emphasis on the promotion of both foreign and local investors. The government strategy sought to promote industrialization at the expense of agriculture, with the former viewed as having both backward and forward linkages, a potential to create markets for the other sectors as well as more employment. The Uganda Development Corporation (UDC) formed by the British in 1952 enhanced government role in industrialization process of the country. The state and a few Asian private investors like the Madhvani and Metha groups boosted the industrial growth of the country in the post independence era.

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 of 1964. However, this did not stop the government from slowly moving towards the nationalization of foreign investment in later 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% equity in some of the businesses it had started. These included 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 (CMC), which was viewed as a socialist stand. At the time, the economy was predominantly controlled by a few British-Asians who owned the commercial and industrial sectors of the country, a situation government saw as unsustainable and therefore requiring change. The CMC was followed by the 1970 Nakivubo Pronouncement, which spelt out strategies to implement the CMC. The pronouncement increased government's controlling interest from 51% to 60% 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 army led by Idi Amin overthrew the civilian government.

The Amin Era: 1971 to 1979

This period was marked by the "Economic War" of 1972 and resulted in the expulsion of the British-Asians, expropriation of the assets and businesses of foreign investors (mostly Asians) and the 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% share holding, and reverted to 49% in some industries. But this was later followed by the 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.

The investment climate for foreigners in Uganda during this period was very hostile. The problems of political instability and insecurity, nationalization, and the collapse of the East African Community were compounded by the requirement that a foreign investor be naturalized as a Ugandan to do business in the country. Failure to meet this requirement including other

additional rules was considered sabotage and was liable for severe punishment, which ranged from deportation to execution. So in effect, FDI was outlawed. The Ugandans who took over lacked capital, expertise and connections to continue. There were shortages of almost everything, which led to price hikes. The country lacked foreign exchange and creditworthiness. Towards the end of their rule, the military government realized the importance of FDI and tried to revive it through the 1977 Foreign Investment Decree, which exempted foreign investors from import duty and sales taxes on plant and machinery for investment in approved enterprises. The exemptions were not retrospective and only applied if the investment exceeded US$571,000.[1] Investors were reluctant to risk their money at that time because Amin was always unpredictable and thus 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 an over-valued currency with an unrealistic exchange rate that undermined investments by inflating the cost of imported inputs, equipment and spare parts. It had a negative impact on investors' capital structure that included foreign hard-currency obligations. In the circumstances obtaining at the time, 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 these problems, many firms resorted to purchasing foreign exchange on the parallel markets, where they paid a premium over the rate that would be effective if a more liberalized official exchange rate regime were in place. The military government was overthrown in 1979.

The Period from 1980 to 1985

Although an elected government came into power in 1980, FDI continued to elude the country, mostly on account of past expropriations of foreign investments. 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 with an average of 2.3 for LDCs (Africa) during the same period.[2] As a result of the increasing external pressure and change in government, Uganda began to respond to the economic crisis at the time, through the restoration of formal sector economic activity and the raising of the level of production by creating incentives for both Ugandan producers and foreign investors. In addition, to correct the bad image created in the Amin era, a bill was presented to and passed by parliament for the return of properties of the foreign investors.

Other priorities included the restoration of confidence in the Uganda shilling, elimination of price distortions and the improvement of fiscal and monetary discipline. The Uganda government implemented the first phase of a stabilization and adjustment policy package, with the advice, guidance and assistance of the International Monetary Fund (IMF) and the World Bank. Subsequently, the Uganda People's Congress (UPC) government, which took over power in December 1980, adopted the following measures:
- Realignment of the external value of the shilling, resulting in a depreciation of the external value of the shilling.
- Dismantling of price controls.
- Provision of incentives through the upward adjustment and realignment of producer prices.
- Introduction of policies to encourage foreign investment and the return of companies that had been nationalized during the military regime to the original owners.

These measures achieved some short-term success in reviving the economy – somewhat dampening inflation, reducing parallel market activities and smuggling, and improving the balance of payments position. The country therefore seemed on a steady path to stabilization. But the economy collapsed again in June 1984, mainly because the programme depended on continued inflow of donor funds, which was insufficient and unpredictable. The reform or stabilization programme was therefore never fully implemented. The situation was made worse as resources were diverted to fighting off Museveni's guerrilla insurgency in the "Luwero Triangle". The Obote government fell in 1985.

The Period from 1986 to Date

To reverse the downward trend in FDI inflows in the previous period, the National Resistance Movement (NRM) government undertook a number of steps to turn Uganda into an attractive alternative location for investment. At the macroeconomic level these efforts included wide-ranging economic policy changes such as foreign exchange and trade reforms. Other measures included the simplification of administrative procedures applicable to foreign investors, the conclusion of bilateral investment protection and promotion treaties, and accession to various multilateral treaties facilitating FDI flows.

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. However, privileges and property rights enjoyed under previous legislation by holders of licences were to continue and were to be reviewed under the code. The code provided for the creation of the Uganda Investment Authority (UIA) to facilitate the procedures for those interested in investing in the economy.

The broad function of UIA is to promote, facilitate and supervise investments in Uganda. Specifically, among others, the functions of UIA include:
- Initiating and supporting measures that enhance the investment climate in Uganda for both Ugandan and non-Ugandan investors.
- Promoting investment in Uganda through effective promotional means.
- Granting approvals for the commencement of new businesses.
- Collecting and disseminating up-to-date information on incentives available to investors.
- Assisting incoming and existing investors by providing support services.
- Recommending to the government national policies and programmes designed to promote investment in Uganda.

In order to encourage foreign investors, a number of investment promotions 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, mining, power generation, and tourism. Attractive incentives have been provided to prospective investors as well. Uganda has scored high marks in investor perceptions of investment protection and of a favourable policy towards the remittance of profits and dividends.[3] Investors' recognition of Uganda's commitment to attract foreign investment is further evident from the fact that the Uganda was ranked 58th in the world and 9th in Africa in 2001 according to the inward FDI performance index compiled by UNCTAD.[4]

The post 1985 period has also been characterized by privatization, which has facilitated rapid inflows of FDI. In 1995, Uganda's Public Enterprise Reform and Divesture (PERD)

Secretariat was restructured into two units, with one unit being completely in charge of matters related to divestiture. A Minister of State for Privatization was appointed. As per the PERD statute, 107 public enterprises were identified for transfer to the private sector. This transfer of public enterprises to the private sector in Uganda has been achieved through sales of shares by competitive sale, pre-emption rights and public floatation, while the sale of assets has been through liquidation, competitive sale, debt equity swaps, leases and joint ventures. Other methods used have included management/employee buyouts, trustees and restitution. In 2001, some 105 enterprises had been divested worth an estimated sales value of US$149 million. (See also Table 10.1 for a summary of Uganda's efforts to privatize public corporations.)

In addition to privatization of public enterprises, foreign investors wishing to participate in the privatization process and/or invest elsewhere in the country, were accorded special incentives under the investment code. These incentives included tax holidays up to five years, tax exemptions on plant machinery and repatriation of up to 100% of dividends. Some of these incentives have since been eliminated or rationalized.

Table 10.1: Summary of privatization of public enterprises

|	Transactions completed						
	Before 1997	1997	1998	1999	2000	2001	Value (US$ million)
Sub-Saharan Africa	2,543	254	151	112	91	19	7,355
Uganda	85	2	...	3	11	4	149
	Transactions by sector						
	Agri prod & processing	Financial	Manufacturing	Services	Trade	Other	
Sub-Saharan Africa	788	159	1106	819	408	330	
Uganda	21	5	33	34	12	...	

Source: African Development Indicators - World Bank Report 2003.

Composition, Destination and Source of FDI in Uganda

Data from the private capital flows survey conducted in 2001 indicated that by 2000, total inflows of FDI to Uganda were composed of 51% equity capital, 12% reinvested earnings and 37% net inter-company loans. Preliminary estimates from the 2003 survey suggest a change in this trend in 2001, with both equity capital and reinvested earnings rising to about 80% and 26%, respectively, as net inter-company loans drop significantly to -6%, indicating net outflows on account of payments of inter-company loans taken in the previous periods. (Figure 10.1 illustrates.)

On a gross basis, FDI investment in form of inter-company loans contributes the largest share of total FDI amounting to about 56% of total inflows compared with 38% from equity capital. Indeed, this is the case for most developing countries where inter-company borrowing exceeds equity capital due to the higher returns associated with it, and partly explaining the rapidly growing private sector debt.

Figure 10.1:   Composition of Uganda's FDI
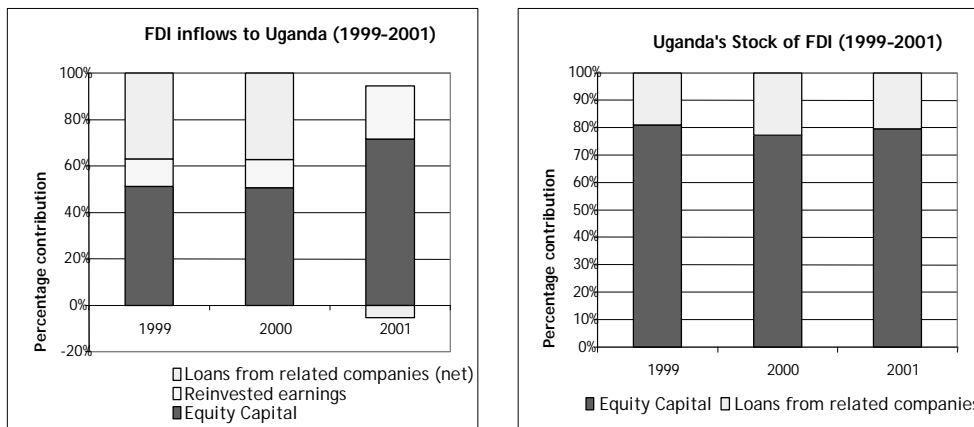
Source: Private Capital Flows Survey 2001 and preliminary estimates for 2003.

The rise in retained earnings in 2001 was contributed mainly by the financing, insurance and business services sector because of the high profitability of the financial sector, more specifically the banking industry. The rise in equity capital in 2001 was mainly due to increased investment in wholesale, retail and catering,[5] which contributed 20% to total equity capital inflows; financing, insurance and business services, which in turn contributed 13%; and the manufacturing sector, which contributed about 7% of total equity capital.

The stock of FDI in Uganda has remained fairly the same over the past three years with two main components: equity capital and inter-company loans. Of the total stock of FDI, equity capital is estimated at about 80%, while inter-company loans are estimated at about 20%. Despite the high inflows of inter-company loans, the rise in the stock of has not been so prominent partly due to the high outflows to service this debt. In addition, the presence of a higher stock of equity capital confirms the relatively high profitability of equity capital in Uganda and many African countries, contrary to the widely accepted view in international literature that debt yields higher rates of return compelling a higher stock of inter-company loans compared with the stock of equity capital.

Destination of FDI

There is compelling evidence that FDI in Africa has been attracted largely by one or more of the following factors that significantly determine the sectoral distribution: specific location advantages, host country policies, recent economic and structural reforms, and natural resources. While FDI inflows in individual African countries may have been driven by some combination of these four considerations, there is strong evidence that one or a limited subset of them is predominantly more important in most countries. The distribution of FDI by sector in Uganda is summarized in Table 10.2.

Uganda in the past was shunned by investors, but has over the past 15 years attracted a significant number of investors mainly in response to the implementation of far-reaching economic and structural reforms.

Table 10.2: Sectoral Distribution of FDI, 1991 to 2001 (percentages)

	1991-98	1999	2000	2001
Agriculture, hunting and Forestry	7	...	0	3
Mining and quarrying	6	5	4	3
Manufacturing	52	57	54	41
Services	33	38	42	53
Electricity, gas and water	0	1	1	0
Construction	2	1	2	1
Wholesale and retail trade and catering and accommodation	10	13	13	17
Transport, storage and communication	9	11	12	8
Financing, insurance, business services	11	12	13	25
Community, social and personnel services	2	1	1	2
Other	2	0	0	...
Total	100	100	100	100

Source: Bank of Uganda and Uganda investment Authority.

Manufacturing Sector

The largest portion of FDI has been attracted by the manufacturing sector, which had more or less collapsed after the expulsion of the Asians and the nationalization of most of the industries. The privatization of public companies, return of confiscated enterprises and properties to the Asians expelled during the Amin era, and the proactive role played by the UIA are some of the other factors that have positively affected the attraction of FDI to the sector. It should be noted however, that while the manufacturing sector bears the largest portion of FDI inflows to Uganda, a substantial part of this investment has been in the rehabilitation of old industries that were given back to their original owners and not through the creation of new production capacity. This partly explains the declining trend in FDI inflows to this sector from about 52% of total FDI inflows for the period 1991–1998 to about 41% in 2001.

This foreign investment has been concentrated in mainly beverages/soft drinks and breweries for the local market, sugar, cement, footwear, packaging, plastics, and food processing. In addition, joint ventures have been established between local enterprises and international manufacturers in some of the industries such as South African Breweries, Coca Cola and PepsiCo in the breweries and beverages/soft drinks industries. These have resulted in the recapitalization of the existing industries attracting substantial amounts of FDI to the sector. Linkages with other sectors such as those with exporters for the case of manufacturers of packaging materials industries (mostly owned by nonresidents) have also spurred the growth of FDI in the sector. A survey of foreign firms in Uganda by UNCTAD in 1998 showed a decline in the use of imported inputs, partly because these inputs were available locally with a significant portion produced within the same companies.

Service Sector

Consistent with the developments on the global scene, the services sector FDI has grown rapidly in Uganda. In 1999, the stock of FDI to the service sector was about 38% of total FDI, but by the end of 2001, it had risen to about 53%. The increase relative to manufacturing is in part due to the importance of the services sector in economic activity. The technological progress associated with the dominance of the manufacturing sector in the past has also contributed to increased demand for services connected with the production of goods and to facilitate the

separation of goods production from services production. Typical examples of these services are accounting, computer services (data processing and software), and warehousing, transportation and communication and business services.

The services sector has seen a rise in FDI inflows on account of a growth in financial services, due in part to opportunities arising in the banking sector as a result of the privatization of the largest commercial bank in the country (Uganda Commercial Bank – UCB) and the strategic investment objective of some global banks that are interested in acquiring retail banking in emerging markets with mainly long-term interests. These include Stanbic Bank of South Africa and Citibank. Other forms of FDI to the financial services sector have mainly been through increased retained earnings in most of the large banks that are foreign owned mainly to improve their services through the creation of new products. A large share of FDI inflows to the services sector has been a result of Uganda's privatization programme, which has resulted in the sale of entities engaged in the provision of a variety of services including airport handling services, hotels and telecommunications.

In addition, the liberalization of the economy coupled with local demand for services like mobile telephony has attracted investments from big players on both the regional and international scene, such as Vodafone and MTN. Moreover, income growth and technological progress have boosted the provision of services through various forms of cross-border relationships in several sectors, including management and franchise contracts in hotels restaurants and car rentals, as well as joint ventures in some business, recreational, legal and accounting services, along with civil engineering and other services in which a local partner is required for marketing and distribution for firms that tend to provide services through subsidiaries such as financial institutions.

Mining Sector

Attraction of FDI in the mining and quarrying sectors has mainly lagged behind the other sectors for a number of reasons. The mining industry in Uganda, which dates as far back as the 1950s, was mainly engaged in the exploitation of copper deposits and contributed about 30% of Uganda's exports. The political and economic disruptions during the 1970s grossly reduced its contribution to exports and GDP. A revival of the sector started in the 1990s, but the key issue deterring the growth of the sector and subsequently FDI inflows has been the lack of sufficient information. While policy issues on mining and the laws and regulation governing the sector have been to a large extent resolved, little or nothing has been done in terms of research on mining prospects in the country. Consequently, it would therefore take an interested investor a huge preinvestment cost in exploratory work to determine the availability of the mineral. Nevertheless, the presence of a wide variety of mineral resources has spurred interest from a number of international companies contributing to large amounts of FDI including co-financing to mainly the mining of cobalt, limestone for cement production and exploration for oil and gas. For example, Heritage Oil and Gas, Ltd., and Energy Africa, Ltd., are exploring for petroleum in the Semliki Basin, while Hardman Petroleum Africa NL and Energy Africa, Ltd., are also exploring in the vicinity of Lake Albert.

Agriculture and Forestry Sector

Like the mining sector, the agricultural sector has generally lagged behind the other sectors in attracting FDI. In the past, the major constraint was the issue of land; this was resolved, however, and land is available for lease from government. In general, FDI in this sector has mainly been biased towards the export sector, primarily in flower farming, fish and crocodile farming, and

coffee growing. About 26 varieties of flowers are grown, 80% of which are exported with the balance going to the domestic market. Government has made efforts to attract commercial farmers in the coffee sector but has succeeded in getting only one investor who is currently growing a high yielding variety of coffee (clonal coffee). Despite the large demand for timber, particularly for construction and furniture products, there has not been any FDI inflow to this sector. The main hindrance of FDI inflows to this sector has been government's failure to identify available tracts of land for leasing to potential agricultural-based industrialists in capital/technology-exporting countries.

Source of FDI Inflows

The source of FDI inflows shows that the stock of FDI in Uganda is predominantly from the UK and Bermuda, averaging about 24% and 22%, respectively, of total FDI stock (see Table 10.3). The large portion of FDI inflows from the UK and the contribution from Canada is largely due to the political decision by the President of Uganda to allow Asians expelled[6] during the Amin era to return to Uganda and to repossess their properties, most of which were manufacturing industries and real estate properties. Their return, followed by the rehabilitation and injection of capital in their repossessed properties, has contributed significantly to FDI inflows to Uganda.

Table 10.3: Source of FDI to Uganda, 1999 to 2001 (percentages)

	1999	2000	2001
Belgium	...	2	2
Bermuda	21	21	25
Canada	5	4	4
France	...	2	1
India	2	2	1
Kenya	10	9	11
Mauritius	3	4	6
Netherlands	3	4	4
Singapore	2	2	1
South Africa	11	12	3
Sweden	2	2	0
UK	25	22	24
USA	3	2	2
Other	13	12	17
Total	100	100	100

Source: Bank of Uganda and Uganda Investment Authority.

There has also been an increase in FDI from other developing countries on the continent with Kenya and South Africa in the lead. The stock of FDI held by developing countries grew from about 26% in 1999 to about 30% in 2001. This is a reflection of both the increase in wealth and the lifting of capital controls in many developing countries. In addition government's efforts to join regional groups such as the Common Market of Eastern and Southern Africa (COMESA) and the East African Community (EAC) have facilitated the inflow of FDI from countries within the region. The significant inflows of FDI from Bermuda suggests that there is

investment in Uganda from offshore havens, particularly from investors based in African countries who would rather keep their funds in these havens in order to minimize risk until they are ready to bring them in as FDI.

Determinants of FDI

Although many aggregate econometric studies have been conducted, a broad consensus on the major determinants of FDI has been elusive (see, for example, Asiedu, 2002). This lack in consensus can be partially attributed to the lack of reliable and accurate data on FDI flows and its potential determinants, particularly at the sectoral level, and the fact that most empirical work has analysed FDI determinants by pooling a group of countries that may be structurally diverse.

What is clear from the various studies, though, is that despite the fact that most profound shifts among FDI determinants result from integrated international strategies especially complex ones, the traditional economic determinants related to large markets, trade barriers and non-tradeable services are still at work and account for a large share of worldwide FDI flows. In this regard, some of the largest national markets remain unmatched in size by the largest regional markets. In addition, the general trend towards the reduction of trade barriers through the reduction or even abolition of tariffs and quotas remains a significant factor for developing countries in attracting FDI and continues to generate most of the FDI in import substitution ventures while discouraging efficiency-seeking FDI. In terms of non-tradeable services and perishable goods or goods intended to be adapted to consumer preferences or local standards, the market-seeking motivation and the corresponding locational attractiveness of the host country remain strong factors.

FDI in General

A number of studies have examined the determinants of FDI for different countries. Determinants are many and diverse. Scaperland and Balough (1983), for example, argued that host country market size plays an important role in attracting FDI, especially when the host-country market allows the exploitation of economies of scale for import substituting investment. Other studies have identified the cost of labour as a significant factor in location consideration, most especially when investment is export oriented. Studies and surveys have also found that investors would also like to operate in countries where the government maintains liberal policies for the employment of expatriate staff.

The level of the country risk or a summary measure of the economic and political risk has also been found to have a strong impact on FDI flows. Sachs and Sievers (1998) argued that political stability is one of the most important determinants of foreign investment location in Africa. In terms of minimum economic risk, investors prefer locating affiliates in countries where market uncertainty is lower. A number of measures for country risk have been used. Besides the use of country risk indicators compiled by business institutions such as Business International and Institutional Investor, some studies have used measures of volatility in economic variables such as exchange rates, fiscal imbalance etc as measures of risk.

Linda and Vijaya (2001) cite lack of infrastructure, cumbersome government regulations and restrictions on equity holdings by foreigners as the major obstacles to FDI in the developing

world for both small and large economies. Other factors determining FDI in particular to small countries include the effects of a successful large project in terms of making the country known to the world, raising interest among potential investors. Surveys of investors conducted by various business institutions together with those on perceptions conducted by investment promotion agencies have indicated that a supportive institutional environment, such as the existence of an effective and equitable legal system, and the presence of an efficient and well functioning banking and financial system are important for investment location decisions.

The level of openness of an economy has also been found to be important in attracting investment. This is evidenced by the success of the East Asian economies that experienced strong export-led growth over the past two decades (Lipsey, 1998; Barell and Pain, 1996). Some studies also indicate that the removal of exchange controls has an important bearing on investor location decisions. Foreign direct investment also tends to flow to countries where there is already a substantial volume of FDI. Ivar and Line (2002) argue that investors give priority to countries in their geographic vicinity and that they show a preference for countries with cultural or linguistic linkages to their home country (for example, Mauritius with the Hong Kong textile gurus).

Lucas (1993) contends that the exchange rate may have a "residual role" with respect to exchange rate risk for example in determining the value of repatriated profits or threatening restrictions on such remittances. Anupam and Krishna (2002) are in agreement with the fact that African countries, which have sought to contain inflation and stabilize exchange rates through the adoption of sound fiscal and monetary policies, have fostered growth, stimulated wider participation by the private sector in economic growth and secured significant FDI. In addition, the proactive approach to removing regulatory and structural impediments to private sector participation in economic activities is another factor advanced for having a positive impact on investor sentiments. In an econometric study by Athanasios (1998), openness to international trade, freedom of capital transactions with foreigners and competition in the domestic market were found to have positive and statistically significant coefficients for the member states of the West African Economic and Monetary Union.

Finally, FDI can be said to be influenced by two additional factors:

* A high level of economic development, as reflected in the availability of adequate infrastructure, both physical and human, and a relatively high per capita income would be expected to be beneficial for foreign investors.
* Regional integration arrangements may trigger FDI inflows; for example Mexico attracted Japanese FDI, targeting the North American Free Trade Agreement (NAFTA) regional block market.

Specific to Uganda

The determinants of FDI in Uganda can be grouped into three major categories: the policy framework, business facilitation and economic determinants.

The Policy Framework

Uganda has made significant progress in regaining political stability in recent years. Conditions in a large section of the country have improved considerably compared with the period before 1986. A survey on foreign investment prospects in East Africa found that a stable political climate was the most important precondition to do business in the region.[7] In addition, Sachs

and Sievers (1998: 39) noted that political stability including the predictability and reliability of the regulatory framework affecting business was the most basic factor for companies considering investment in Africa.

The process of political stability, which started when Museveni gained control of the country was boosted by the formation of the popularly elected Constitution Assembly 1994. The Assembly amended and approved the draft constitution, which was passed in 1995 and implemented with the strong support of the donor community. This was the key step towards a stable political regime. Observance by government of the constitutional right to freedom of speech – a right considered as a critical input towards the democratization of a state – was the second most important factor towards a stable political regime. The increased press freedom and mushrooming of radio stations are some of the indications of a genuine free press in Uganda, more especially when compared to the 1970s and early 1980s. The third and most critical step towards the realization of a stable political climate was marked by the generally peaceful, free and fair election of Museveni conducted in 1996. His re-election in 2000 confirmed the public's confidence in him in terms of delivering peace and economic growth.

Nevertheless, there has been some insecurity in some sections of the country. In particular, the Northern Region and parts of the Eastern Region have been destabilized by unending insecurity caused by the armed conflict between government forces and the armed rebels of the Lord's Resistance Army whose bases are located in Southern Sudan. This conflict has not deterred investors, however, as most of them are based in the South, a safe distance away from the troubled North. Thus, foreign investors have expressed their confidence in the country as manifested by the continued inflow of FDI.

In regard to macroeconomic stability, the government of Uganda has implemented wide-ranging policies intended to eliminate both structural and financial bottlenecks. Some of the key government reforms that have been undertaken in the last decade are:

- Fiscal and monetary policies
- Exchange rate liberalization
- Trade liberalization
- Public sector management reforms
- Financial sector reforms
- External debt policy
- Privatization
- Poverty eradication strategy
- Harnessing regionalism (e.g., EAC, COMESA trade blocs, etc.)

These reforms have targeted prudent fiscal and monetary management, improved incentives to the private sector, reforms to the regulatory framework, and development of human capital. A lot of success has been registered as evidenced by the buoyant growth, the free flow of market-based foreign currency, low inflation and an improving balance of payments position (see Table 10.4).

Uganda's economy has grown at an average growth rate of 6.6% since 1998. Trending together with the overall economic growth, other economic variables have also improved substantially. For example, Uganda has witnessed considerable improvement in its overall investment rates, and the overall public deficit excluding grants has declined. The high growth rate of GDP has been cited as one of the major attractions to telecommunications investors in Uganda.

Table 10.4: Sectoral Distribution of FDI 1991 to 2001 (percentages)

	1998	1999	2000	2001
	Percentage change			
Real GDP at factor cost	9.1	6.2	4.8	6.4
GDP deflator at factor cost	1.0	4.8	3.4	1.9
Official mid exchange rate	14.6	17.7	13.0	6.5
Bureau mid rate	14.1	17.8	12.9	6.6
	Percentage of GDP			
Exports	8.1	8.2	8.1	8.2
Imports	-16.5	-16.4	-16.3	-17.5
Current account excluding official transfers	-6.1	-6.0	-6.4	-5.7
Current account including official transfers	-30.2	-26.5	-15.0	-13.1
External public debt	55.5	60.2	59.8	63.2
Gross reserves (in months of imports of goods and services)	6.4	6.6	7.2	7.9

Source: Bank of Uganda and Uganda Bureau of Statistics.

The stable and low single-digit inflation is another key attraction for FDI. The triple-digit inflation resulting from decades of economic mismanagement and fuelled by continuous printing of money to finance government's deficit has since been controlled. Fiscal restraints implemented in the early 1990s have been the principle reason for the control of inflation. This was followed by a sequence of foreign exchange reforms, which culminated in the introduction of forex bureaus and the current market determined rate. The result has been a growth in the foreign exchange reserves and a convergence of the official and forex bureau mid rates. Subsequently, the direct and indirect benefits reaped by foreign investors have sent a positive signal to prospective investors abroad.

The balance of payments, which in turn is also closely linked to the exchange rate, is another key variable highlighting the macroeconomic stability of the country. With the exception of 1998 when Uganda experienced a coffee boom, exports have generally been growing steadily and have averaged about 8% of GDP. The significant trade deficit has been offset by a combination of both donor aid and private transfer inflows. In addition, government policies aimed at abolition of export taxes, dismantling of government monopoly in the export of agricultural products and diversification of exports have contributed to a steady increase in non-coffee exports, mitigating falling coffee prices. The increase in private transfers and the growth of non-traditional exports are encouraging signs of confidence vested in Uganda. Persistent export biases, however, along with reliance on primary agricultural exports and trade distortions as a result of protectionism in potential markets continue to undermine the balance of payments.

In terms of Uganda's debt burden, the excessive borrowings by Uganda in the late 1980s, which was often on non-concessional or commercial terms mainly to finance the reconstruction programme, increased total outstanding debt by about 82% to US$2.6 billion at the end of 1990 from about US$1.4 billion at the end of 1986. By the end of the decade, the most essential debt payments were paid with much difficulty, putting severe pressure on foreign exchange and thus the importation of essential commodities. Uganda was therefore on the verge of bankruptcy. The formation of Uganda's first integrated debt management strategy in 1991, which intended to overcome the looming debt payment crisis was therefore the first step towards

ensuring that the debt be lowered to sustainable levels. This was temporary, however, as the debt stock to multilateral creditors grew significantly, prompting government in 1995 to form the Enhanced Debt Strategy aimed at dealing with this rising debt. In particular, a Uganda Multilateral Debt Fund was created and achieved much success in channelling debt relief resources to the payment of maturities falling due on multilateral creditors.

In 1996, Uganda became the first country to benefit from the Heavily Indebted Poor Countries (HIPC) debt relief initiative. HIPC created savings worth about US650 million for Uganda over a 30-year period. Later Uganda benefited from the follow up to HIPC, the Enhanced HIPC Debt Relief Initiative, further relieving the government's huge public debt. These developments together with government's commitment to follow its debt management strategy have enabled the country to crawl out of the debt crisis it faced in the late 1980s. This has contributed to a reduction on the pressure exerted on the foreign exchange regime thus contributing to an improved regulatory framework for FDI.

In general, these ongoing efforts to improve the macroeconomic stability of the country and the efforts of President Museveni travelling around the world to promote Uganda's new image could have been perceived by potential investors as evidence of government's long-term commitment to create a more stable and business friendly environment partly explaining the high FDI inflows.

As for trade policies, which are believed to be a key factor influencing FDI flows to a country, Uganda has linked its economy closely to international trade. Government policy has focused on liberalizing the economy by undertaking a comprehensive programme of trade reforms designed to open the economy and increase its competitiveness.

The openness of the economy commenced with the elimination of non-tariff barriers, followed by reduction of tariffs at a low level within the eastern and southern African regions. The policies implemented under the trade regimes by government included reducing tariffs and variances within the tariff structure towards a uniform tariff in regional groupings, reducing import bans, and eliminating licensing and administrative allocation of import financing. Other steps were to remove export taxes and take away removing marketing boards monopoly over cash crop exports. By removing export taxes and marketing board monopoly over cash crop export, an enabling environment for private sector participation in the export sector was created that opened opportunities for FDI inflows towards export-oriented agribusiness.

In addition, Uganda has taken measures to expand its market by embracing regional integration through the East African Community (EAC) and COMESA. These developments signal a commitment to adhere to liberal policies and to bring about a momentum to continue with the liberalization process in both FDI and trade. Subsequently, the decision to be a part of these different regional organizations confirms to investors that Uganda is keen on being a partner in the liberal existing policy framework within the region and of its commitment to strengthen standards of treatment and protection of investors and to encourage policies that ensure the proper functioning of markets. However, the trade policy has been complicated by the lack of a coherent and coordinated approach to openness within the African region.

As noted earliers, Uganda has signed all principal international conventions related to FDI and is a member of all relevant international institutions that deal with issues related to FDI, including MIGA, ICSID, and the Convention on the Recognition and Enforcement of Foreign Arbitral Awards. With respect to the national policy framework for FDI, Uganda like many other developing countries seeking to attract FDI, implemented its own Investment Code in 1991. The code offers security and incentives to investors in an attempt to offset the risk and increased cost of investing in a developing country. With this rationale behind the incentive scheme in mind, the key allowances to investors granted in the Investment Code are expected

to be itemized and put into perspective for comparison with other candidate countries for investment in the region by prospective investors. In particular, the investment code offers both fiscal and non-fiscal incentives.

Finally, as alluded to earlier, the first speed of privatization has played a significant role in the attraction of FDI to Uganda. While privatization does not necessarily imply that foreigners are allowed to purchase stakes in privatized enterprises, its absence virtually eliminates the possibility of FDI in many industries and countries (UNCTAD, 1998: 183). In Uganda, key sectors such as the services and manufacturing have attracted FDI through government's sale of shares to foreign investors.

Business Facilitation

Efforts have been made in Uganda to facilitate business and to reduce red tape. Nonetheless, this still remains a problem for investors in Uganda. The size, effectiveness and efficiency of the public sector has been and continues to be a source of debate in Uganda. The underlying concerns revolve around the effectiveness of the public sector in the management and delivery of services and the transparency with which these services are delivered. During the 1970s and 1980s the public service was unresponsive to private sector needs and was inefficient because of bureaucracy, extreme laxity, corruption, nepotism and poor corporate governance.

In light of this, several public sector reforms were undertaken, the most important being the establishment of the Public Service Review and Reorganization Commission (PSRC) in 1989. Further, in 1991 the Uganda Investment Authority (UIA) was created under the Investment Code to among other things facilitate investors by serving as the point of contact for investors interested in Uganda and as a one stop shop. The elimination of lengthy bureaucratic delays and administrative bottlenecks through the empowerment of the UIA was the first key attraction established by the code. However, the UIA is not an entirely true one-stop shop because it is not empowered to grant all licences required to commence business operations in addition to not being able to guarantee access to serviced land to investors. Nevertheless, the UIA provides information to prospective investors on how and when a formal approval process regarding investment in a project will end.

The other bottleneck that has persisted is widespread corruption in government institutions. This is partly attributed to the low pay of public servants. A number of efforts have been made to reduce corruption such as the institution of the office of the Inspector General of Government, which is charged with investigating cases of corruption. In addition, government has issued a decree that all high-ranking employees of government declare their wealth including members of parliament.

In terms of facilitation, Uganda has offered a number of incentive schemes to foreign investors. These include the following:

- Provision of different capital allowances for different locations in the country, start-up costs, scientific research expenses, training expenditure, mineral exploration expenditure and industrial buildings.
- Provision of a competitive uniform corporation tax of 30%, which compares favourably with tax rates in other countries within the region. This excludes mining, for which the corporation tax ranges between 25 and 45%.
- Tax exemptions, which include import duty exemptions[8] on motor vehicles and personal effects of foreign investors and their expatriate workers, exemptions on plant and machinery, and VAT refunds to all investors registered as VAT traders on construction materials used for the manufacture of exports. Also included are duty drawback facilities for exporters

and carry forward losses (which refers to the possibility of a company's profit in the current accounting year to be offset by losses in the previous accounting periods, meaning that the profits cannot be taxed until all prior losses have been recovered).

Foreign investors are also permitted to borrow money from domestic sources and are allowed to remit their funds for repayment of loans or for payment of dividends of shareholders, royalties or management fees or profits or proceeds from the disposal of assets. Protection against compulsory acquisition is provided by the constitution. Property rights are also guaranteed by the constitution and Investment code. Agreements on double taxation and investment protection have been reached between Uganda and a number of its trade partners such as UK, South Africa, Netherlands, Kenya and Tanzania.

With respect to regional competitors for the same FDI, Uganda's incentive schemes rank among the most generous along with those of Tanzania. In addition to the incentives provided, foreign investors together with their expatriate workers are assisted to obtain work permits, which has encouraged foreign investors to reinvest.

The UIA has also been actively involved in the promotion of the country abroad as a good investment destination. This has been achieved through outward-bound mission trips across the world and inward-bound missions where prospective investors are shown various project opportunities and introduced to local businesses as potential joint venture partners. With respect to its promotional activities, the UIA has successfully launched investment facilitation campaigns in Europe and the United States and in 1997 emerged as the best investment promotion agency in Africa. It compares favourably with some of the most effective agencies in the world. In addition to the activities of the UIA, the president of Uganda has personally been involved in promoting the country to potential foreign investors by offering attractive promises.

Economic Determinants

A number of economic factors have played a crucial role in the attraction of FDI to Uganda, although these vary considerably in importance for different types of projects and sectors.

Resource-Seeking Investment. In Uganda, the role of natural resource extraction has been significant. The most significant examples of projects undertaken in this category of FDI include Kilembe Mines engaged in copper mining, Kasese Cobalt Company engaged in the mining of cobalt, and Hima Cement and Tororo Cement both engaged in the manufacture of cement. The abundance of tourism attractions is another natural resource that has served as an attraction to investors. Renowned as the "Pearl of Africa", Uganda has a wealth of game stock, lakes, rivers, green and ice-capped mountains, a diverse ecology, and rain forests. This has attracted FDI in tour and travel business, provision of hotel facilities, development of tourism on the islands of Lake Victoria, etc. Other resources include abundant fish stocks, which have resulted in fish emerging as one of Uganda's key export commodities after coffee. The many natural resources found in Uganda may not be a sufficient factor for attracting FDI, however, since a number of African countries with significant amounts of natural resources have not ranked high in the attraction of FDI. In addition, apart from minerals and tourism, Uganda has neither specific technological know-how nor industrial clusters of considerable size to warrant interest among foreign investors as providing a pool of highly specialized personnel. Consequently, while it is true that natural resources have played a key role in attracting FDI to Uganda, they cannot pass as a sufficient factor on their own and therefore have been supported by efforts to create an enabling environment.

Market-Seeking Investment. Like most African countries Uganda does not provide much attractiveness to investors as a market compared with other developing regions. This is partly because despite the high rates of GDP growth, the disparity in the distribution of wealth reflected by the fairly high poverty levels remains an obstacle to the provision of a substantial market. However, few countries in Africa provide the sort of strategic location Uganda offers. The country is located at the heart of East and Central Africa, a region that includes some of Africa's economically important countries. This location within the sub-Saharan region grants Uganda commanding importance as a base for regional investment in addition to trade. Further, Uganda has joined COMESA, a regional grouping of 20 countries with a market of over 300 million people. In addition, Uganda is a member state of the EAC. On the international scene, Uganda offers preferential access to the European Union and the United States for a number of commodities. Consequently, a number of investors have taken the strategic decision to locate their projects in Uganda in consideration of this factor. Prominent among these are textile manufacturing companies such as Tri-Star, Ltd., and Phoenix Logistics, Ltd., set up to exploit some of these opportunities such as the AGOA scheme. In the financial sector Citibank Uganda views Uganda as a suitable location for tapping the emerging regional market.

Other market-seeking investments have mainly been in the foods and processing, trade (most especially retail trade), soft drinks manufacture, and breweries. Operators of large retail stores from the region such as Metro and Shoprite from South Africa and Uchumi from Kenya have come in to exploit the potential market in the urban areas. Services, especially telecommunication and financial, are another area in which Uganda has attracted some market-seeking FDI. Corporations such as Standard Bank and MTN of South Africa have expanded their operations into Uganda. In the agricultural sector, Uganda has had few foreign investments targeting the domestic market. The most prominent ones are the Kibimba rice growing scheme and the Kakira and Lugazi sugar cane plantations.

Efficiency-Seeking FDI. Unfortunately Uganda has not been able to attract this kind of FDI. This is mainly because efficiency-seeking FDI requires a combination of factors such as infrastructure facilities plus a workforce with skills that permit timely and cost-efficient production and delivery of goods to overseas markets, supported by liberal trade policies and easy access to markets of industrialized countries.

On the workforce front, the Government of Uganda has made some positive strides towards improving the human resource, which include developing the Education Sector Investment Plan 997–2003 and the Health Sector Strategic Plan. Programmes such as universal primary education, which was introduced in 1997, have contributed to massive enrolment and the reduction in gender differences in enrolment rates following the removal of school fees. Significant progress has also been made in improving some health indicators such as the continuing decline of the prevalence of HIV/AIDS and successful efforts to eradicate polio. These efforts are all intended to raise the level of education and the health of Ugandans to increase productivity.

Uganda also presently produces about 10,000 university graduates annually with varied skills in finance, management, engineering, medicine and other areas vital to the development of the country. Many more thousands graduate from technical institutions. Moreover, workers speak English and are generally trainable. Most important is that Uganda has had no history of labour disputes and industrial strikes. It is against this background that government through its strategic exports promotion programme attempted to attract some efficiency-seeking FDI mainly in the area of information and communication technology (ICT) and textiles. Investment in

ICT has not been forthcoming, though, mainly because of poor infrastructure. Some investment in textiles has been realized, but cannot be fully attributed to efficiency factors alone.

Other infrastructure inadequacies also constrain this type of FDI. For example, refrigeration facilities at the main airport are insufficient for perishable exports. Moreover, the country's landlocked position makes transportation more expensive compared with its competitors.

The other reason why efficiency-seeking FDI has not been attracted to Uganda despite government efforts is the impact of the long history of civil war and conflict that have plagued the country in the past, making it even harder to improve infrastructure and the skills level. In addition, when it comes to other factors that determine efficiency-seeking FDI, such as infrastructure and access to international markets, Uganda has still more to do on this front.

Concluding Remarks

The analysis has shown that a host of reasons explain the attraction of FDI to Uganda in the recent years. Privatization and the return of previously confiscated properties of expelled Asians have led to considerable FDI, which cuts across the various sectors. In addition, a stream of different policies that have been implemented to achieve macroeconomic stability together with the peace in a large part of the country brought by the current government have attracted new investments and served as signals to potential investors of governments' commitment to make Uganda a suitable location for new projects.

What are the lessons that can be drawn from this analysis? There is no single determinant that explains the recent success Uganda has had in attracting FDI, but rather a combination of a number of factors. Although different factors have affected the amount of FDI coming to Uganda, among the lessons that can be drawn for other countries are the following:

- A predictable and consistent policy and macroeconomic environment in a stable political climate is an important factor in attracting FDI. These two components are essential in establishing the foundation for a positive investment climate. A decade and half of relative peace and steps towards democratic institutionalism have left investors with little doubt about Uganda's future political environment.

- The successful implementation of privatization is a potential source of attracting FDI, as has been the case for Uganda.

- A high rate of GDP growth as experienced by Uganda in the past decade underlines the importance of growth-oriented policies and is an attraction to market-seeking FDI. The overall growth prospect of the economy, coupled with the ability to freely transfer funds, provides a business-friendly environment to potential foreign investors.

- Effort made towards regional integration is critical to attracting market-seeking investment. There is evidence of movement of FDI from within the COMESA region with Kenya and South Africa as the frontrunners. Although the regional integration has focused mainly on the removal of tariff and non-tariff barriers between member states, there is evidence to show that these efforts have significantly affected FDI flows between the member countries in the form of cross border projects. Such cross border projects resulting from integration efforts have been useful in increasing both commerce and investment mainly from large economies to smaller economies.

- The aggressive investment promotion activities by the Uganda Investment Authority and the President of the Republic of Uganda, together with the deregulation, have yielded increases in FDI flows to the country. The UIA has in many respects provided less bureaucratic assistance to potential investors in most aspects of investment and has quickened the pace with which new projects have taken off. In addition, potential investors have been visited abroad and lured to the country by generous incentives, most especially to domestic focused FDI.

- Reforms undertaken among the incentive schemes and related government agencies to fulfil the criteria for investment promotion, administrative simplicity and revenue generation have contributed significantly to FDI attraction. However, there is more room for improvement particularly with the incentive scheme provided. The creation of the Tax Appeals Tribunal has also helped to alleviate investors' fears of the Uganda Revenue Authority levying arbitrary heavy taxes on foreign investors.

Despite the various efforts Uganda has made in attracting FDI, there still remain a number of liabilities. These include poor quality infrastructure, corruption and the need to further improve institutional support. Although most investors are more than happy to take advantage of the generous incentives offered by government, the incentives alone are rarely sufficient to secure FDI. Consequently, the government should:

- Continue enhancing the business environment by a further improvement in institutional support. The UIA should be given the authority to carry out its duties as a fully-fledged one-stop shop for investors. This would enable the already highly effective UIA to carry out its duties more efficiently and enhance policy credibility of Uganda while reducing significantly the high administrative costs, simplifying the procedure and eliminating opportunities for corruption. UIA in its promotion programmes should target those countries that have shown interest in investing in Uganda such as South Africa, UK and Kenya, instead of having generalized campaign programmes. Further, the campaign programmes should target sectors with higher potential as exhibited by the current investment pattern. Finally, UIA should provide "service support" to the investors already established on the ground, as they are the ambassadors.

- Improve the risk coverage schemes on both a bilateral and multilateral basis. This would further attract FDI to Uganda particularly for high value investments. The existing investment insurance schemes are perceived as distant and unfriendly and yet foreign investors have continued to show interest in attaining some protection against non-commercial risk.

Overall, Uganda has done well in attracting FDI given the obstacles that had to be overcome, such as the historical and inherent impediments. The hope for further strides in this direction is bright as long as the political and macroeconomic stability is maintained and even improved where possible.

Notes

[1] The 1977 exchange rate was approximately eight Uganda shillings to one US dollar.

[2] See *World Financial and Statistical Tables,* 1995.

[3] Uganda was rated 4.96 out of 6.04 with regard to FDI protection policy pertaining to remittance of dividends and profits.

[4] *World Investment Report 2003*.

[5] New entrants engaged in this sector such as the large supermarkets are believed to have contributed significantly to the high equity capital in this sector.

[6] An estimated 70,000 Asians engaged in different sectors of the economy were expelled in 1972.

[7] *Economisti Associuation*, March 1994, vol. 1: 62.

[8] These are referred to as first arrival privileges.

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