

**Aid-Foreign Direct Investment Linkages: A case study  
of Aid and Foreign Direct Investment in Uganda**

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Fulfilment of the Requirements for the Degree of Doctor of  
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## **Abstract**

Whilst many hold to the orthodox view that aid can promote the take-off to long-term self-sustaining growth and development in recipient countries as Rosenstein-Rodan (1961), Chenery and Strout (1966) and others have hypothesised, it is far from being realised in SSA economies. This has provoked concern for the effectiveness of donor policy and the appropriateness of recipient macroeconomic orientation. In the main the argument revolves around the aid effectiveness debate. This can be decomposed into its constituent elements: allocative efficiency and effective utilisation. The facts are poor countries and those in SSA in particular have received large inflows of foreign aid. In fact, According to Easterly (2007), Western donors have provided some \$2.3 trillion dollars of development assistance over the period from independence in the 1950s/60s to the present; yet with a few exceptions, they are generally poorer in per capita GDP terms in the 2000s than they were in the 1970s. However, reforms SSA economies since the early 1990s have transformed the political and economic landscape of the continent and this reflected in the re-engagement of the international business and development communities. However, the flow of FDI to these countries is still low in absolute terms (1.6 per cent of world FDI inflows with 26 middle-income countries accounting for 95 percent inflows) and the remaining 5 percent distributed across 140 LDCs. This low level of private inflows to poor developing countries is well below that required to generate widely agreed the annual average growth in GDP of 6 per cent for a considerable period of time (UNCTAD, 2000) to tackle their high level of poverty and under-development. The size of this challenge is highlighted by the decline in economic growth and trade of the region's economies over the last three decades. For instance, only 2 of 39 SSA economies (UNCTAD, 2000) were better off in the 1990s on growth and trade than they were in the 1970s. Again, according to UNCTAD (2000) the 1980s was associated with a decline in annual average growth to 2.2 per cent from 3.5 per cent in the 1970s. The trade deficit for the region exceeded 4 percent in the 1980s compared to less than 1 per cent in the 1970s. According to the UN Office of the High

Representative for the LDCs and Landlocked DCs and Small Island Developing States, LDCs' exports accounted for only 0.6 per cent of world merchandise trade in 2004.

The international development community has sought new ways and means to improve both the effectiveness and volume of inflows to these countries. Both justification for and the means of achieving these are articulated in the "Paris Agenda" on Aid effectiveness and the earlier Pearson Commission (1969) which established a need for developed countries to donate resources equivalent to 0.7 of their Gross National Income (GNI) to poor developing countries. The Zedillo Report of the High Level Panel on Financing for Development estimated the sum of public funding to these countries to achieve the required rate of growth to achieve the 6 growth rate of GDP and reduce aid dependency and poverty at \$50 billion (2001). The Gleneagles G-8 agreed to provide this sum at its 2005 ministerial meeting in Scotland by 2011. However, there is serious doubt that this target will be achieved and current financial and budgetary crisis in donor countries adds to this concern.

This thesis is therefore focused on the empirical evaluation of the AID-FDI relationship. As little of the FDI associated with the international activities of Multinational Enterprises (MNEs) go to LDCs, the linking of Aid to FDI may address concerns for higher inflows of FDI where aid creates the infrastructure required by MNEs. The Aid-FDI convergence may also address general concerns for Aid effectiveness through 1) enhanced effective utilisations and 2) improves allocation. The Aid-FDI may also be an appropriate solution to poor infrastructure endowment in LDCs in its catalysis of higher level of private sector participation in the infrastructure sector. This provides an opportunity to demonstrate the Aid-FDI interaction i.e. its co-financing of private and public investments in LDCs such as Uganda.

With an anticipated relationship between aid and FDI, the primary data for this research was gathered through interviewing a selected sample of Uganda's principal development partners (taken from the OECD DAC list of major donors). This was complemented by questionnaire survey of foreign investors i.e. UK firms operating subsidiaries in Uganda, and the Uganda Investment

Authority for their view and experience with the aid-FDI interface. The final stage of the research study will attempt to identify potential complementarities such as from aid to FDI. The Aid-FDI interaction is estimated for its impact both at firm level i.e. its catalysis of FDI inflow, the co-financing of private foreign investment and enhancement of GDP growth rate. The latter is estimated using time series pool macro data for 23 SSA countries in a conventional production function with individual country dummies and the variables employed in percentage terms.

### **Donor: Aid-FDI Interaction-Policy Implications**

Uganda has secured external assistance from three of its principal development partners for the modernization and diversification of its agriculture with some significant development of the horticultural sector. The industry now account for up to 80 percent of some varieties of cut-flowers imported by buyers and intermediaries based in the Netherlands. However, recent concerns for the ‘carbon foot print’ of goods imported into the EU calls into question the long-term prospects for the industry and the agricultural sector generally. The failure of multilateral discussions on further liberalisation in the international trade in agricultural produce; principally those in the static WTO Doha negotiations, pose further risks to current future investors in the sector.

The above developments are compounded by the activities of anti-globalisers, environmentalists, and the growing awareness and concerns of consumers for the environmental impact of the industry: air freighting of cut flowers and other agricultural produce from Uganda to EU markets. This may result in a change in demand for imported agricultural produce in western markets. Injection of climate disaster risk reduction policies by western government and members of the international development community in response to pressure groups adds to difficulties confronting development policies linked to the modernization and internationalisation of rural agriculture in poor states such as Uganda. However, the recent discovery of significant oil deposits will inevitably result in Uganda becoming an oil based economy and the prospect of further decline in traditional sectors such as agriculture and rapid urbanization and higher income disparity between a growing rural population and a declining but increasingly poor and marginalised rural

community. Arresting the decline of rural communities will mean maintaining and improving investment and long-term strategic focus on the industry. This will also require further efforts to expand the market access in important markets such as the EU and USA; highlight the contribution the industry makes to employment and poverty reduction in rural communities.

## **Donor-Private Sector Interaction**

We conclude from our empirical study that in majority of these interactions i.e. project jointly financed by Aid and FDI; the policies and actions of the donor does not fully accord with their acknowledgement of the importance and complementarity of the AID-FDI interface. The private sector partner has regretted taking aid funding as it was often associated with a complicated procurement process, resulting in considerable delays, additional work-load in meeting complicated requirement of a variety of donors. The net result in some cases is that planned investments have not taken place in line with the schedule of the investor in terms of timing and the scale of the project. This suggests a need for donor-investor convergence both in terms of policy objectives and at the operational level. In truth, our results do suggest that the donors should see themselves as public investors and on the basis of this re-orientation also converge determinants and performance criteria with that of private investors.

## **Aid-FDI: A Quantitative Evaluation**

Econometric estimating using multivariate analysis in fixed and random estimation failed to establish a significant relationship between the Aid-FDI interaction term and economic performance as measured in percentage increases in GDP growth rate. However, both the exports of goods and services and labour force participation rate were positive and significant at 5 per cent. Aid, bank credits were negative and insignificant whilst FDI, gross fixed capitals were both positive but insignificant. Transformation of the variables to a linear form had no significant impact on the outcome of our estimation.

The qualitative approach in which a number of Uganda principal development partners taken from the DAC listing of top 10 donors, identified a number of projects in which Aid co-financed investment projects in the power generation, agro-processing, tea plantations and horticulture. Whilst the potential impact of these projects are by virtue of their scale unlikely even in the medium term, to have an impact on the wider economy. However, the recently announced US\$700 million Bujagali hydro power project is a good example of AID-FDI convergence and the exception to our general observation of relatively small scale investments. What we conclude from our analysis and discussion is the need for donors and recipient countries such as Uganda and LDCs generally to have a higher degree of policy convergence for the private-public investments and better and more efficient procurement policy with recipient countries and donors demonstrating greater sensitivity for the impact of their terms and conditions linked to private sector participation i.e. co-financing of private investment. It is also clear that donors have divergent objectives and these have cost implications for recipients and consequences for aid effectiveness and productivity. From this we conclude that harmonization and efforts to develop specific specialisation in line with donor competence is vitally important. This could for instance, allow some donors to focus on providing additional resources including technical assistance to the agricultural as part of a multi-donor effort to promote the development of the sector. This could include investments in related infrastructure. As labour force participation rate is positive and significant, donors could seek ways and means of maximizing the labour absorption by the agricultural sector as exports were significant and positive and as further expansion of the agricultural sector is important for growth and central to the reduction of rural poverty in Uganda. Finally, the methodological shortcomings of this thesis are discussed in the discussions and conclusions with the identification of alternative approach to resolve them as well as the identification of their implications for future empirical investigations.

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## Abbreviations

ACP	African Caribbean and Pacific countries
COMESA	Common Market for East and Southern Africa
DFID	Department for International Development
FDI	Foreign Direct Investment
DAC	Development Association Corporation
ESAU	Economic and Statistical Analysis Unit
LDCs	Least Developed Countries
IFC	International Financial Corporation
MDG	Millennium Development Goals
MIGA	Multilateral Investment Guarantee Agency
NIEO	New International Economic Order
NEPAD	New Economic Partnership for African Development
OECD	Organisation for Economic Corporation and Development
ODA	Official Development Assistance
SSA	Sub-Saharan Africa
TICAD	Third International Conference on Aid and Development
USAID	United States International Development
WIR	World Investment Report
UIA	Ugandan Investment Authority
UNCTAD	United Nations Conference on Trade and Development

# Chapter 1

## Section 1.0

### Introduction

The grinding poverty of Sub-Saharan Africa (SSA) is an acknowledged and enduring embarrassment for the international community. This is summed up in the opening statement of the WEO (2000) report: *"Perhaps the most striking exceptions to the otherwise remarkable economic achievement of the Twentieth Century has been the persistent failure to break the cycle of stagnation and poverty in the poorest countries."* Today and for many years, world leaders and the international development community have faced the challenge of what can and should be done. This concern is highlighted by the fact that six decades of political independence, and \$2.3 trillion (Easterly, 2007) of aid and development assistance to Least Developed Countries (LDCs), have not significantly improved their economic performance or their poverty levels. A combination of slow economic growth and low domestic savings and investment has meant over dependence on erratic public inflows (UNCTD, 2001).

Capital flow to LDCs has gone through three distinct phases over the period 1970s to the present (World Bank, 1999). From the mid-1970s to the 1980s it was characterised by rapid increases resulting from syndicated lending with the level of aid sustained whilst its overall share fell, ending abruptly in the early 1980s with the debt crisis and reduced bank lending. Whilst Africa's stock of FDI in absolute terms grew over the period 1980-2000, but its share of global stock of FDI declined from 5.3 percent to 2.3 percent in 2000 (Basu & Srinivasan, 2002). However, the 1990s was associated with renewed lending to LDCs with private inflows amounting to 5 percent of GNP (UNCTAD, 2005) of some recipient countries from a mix of portfolio and FDI thus restoring the 1970/80s position. However, the position of SSA economies was characterised by a small increase in inflows as measured in GNP terms. The removal of the statistics for Nigeria give a very bleak position for the rest of SSA with net inflows in the 1990s lower than that recorded for the 1970s.

What is particularly interesting is the fact that some 40 per cent of capital inflows to SSA economies (including Nigeria) were transferred back to creditor countries as repayment and profit remittances. As for recent flows, these represent a decline in FDI as measured in GNP. The recent history of financial inflows to SSA economies as outlined above invokes concerns for the failure of these economies to meet the so called; Dual Gap or the 'two-gaps': savings and foreign exchange constraints. This failure is exaggerated by regular terms-of-trade shock, decline of export markets; reduce capital inflows, military conflicts/ civil disorder, and/or droughts. Overcoming the two-gap is therefore vitally important to the process of capital accumulation and the financing of the growth required to undo the consequences of decades of under achievement in LDCs. SSA economies are recognised to be geographically the most in need of external capital inflows and its associated managerial and technical expertise.

The fact that per capita income is too low to sustain the required level of economic growth (World Bank, 1999) and as FDI lags behind growth, the traditional focus of these economies, until recent times, was on the inflow of public funds. Both bilateral and multi-lateral sources were aggressively sought by countries across SSA as their savings and foreign exchange have declined over the 1980s. This decline is also associated with a significant deterioration in the terms of trade, and trade imbalances, linked to macroeconomic reforms. Even with significant efforts to secure a greater share of FDI inflows to the developing world, liberalisation has not significantly improved the inflow of FDI.

The tragedy of SSA economies is that they have collectively experienced continued decline in aid inflows (Lal, 1992) and no upsurge in FDI as seen in many emerging economies in the final decades of the last century. Recent trends in capital inflows are more focused on policy dimensions and the lessons for LDCs is the need to reduce the aid dependency of countries such as Uganda through: 1) escalating its per capita income to a level appropriate for higher level of domestic savings above the rate of output i.e. enhancing the total amount of investable resources in the absence of further public inflow i.e. aid. The second approach is sustained growth and its transformation of the



investment environment for domestic and overseas investors with the expectation that this would result in a decline in the need for aid. The above discussion suggests a need for an ‘initial big-push’ to achieve long-term growth to improve both domestic savings and private sector inflows to sustain growth. The current consensus in the group of leading industrial economies, the G8 has embraced this approach with recent undertakings to double aid to SSA countries by 2010. The relative amounts of private to public inflows to oil and non-oil-based economies is listed in Table 1. This table also shows that oil based economies achieved significantly more FDI: approximately two times more than non-oil economies. Whilst the latter obtained more aid, external debt amounted to some 163 per cent of total exports compared to the lower figure of some 150 per cent for oil producing countries and for Africa as a whole debt level of 49 per cent of GDP and as per cent age of total exports Africa’s external debt is 156 per cent. With both oil and agricultural commodities exports often characterised by wide fluctuation in prices, this calls into question the sustainability of these debt levels with implications for government budgets and specifically spending on social programs such as health, education and anti-poverty programs.

High debt level and historically poor inflows of private capital is the justification for focus on growth and enhance private inflows of capital. This approach is made with reference to the recent experience of a number of South-East Asian countries/ economies which have successfully overcome inadequate domestic resources and chronic levels of poverty over the 60s and 70s as a result of long periods of high GDP growth rate. For SSA economies growth of 6 percent (UNCTAD 2005) is argued to be necessary for a period of 10-20 years to break the regions aid dependency. The new thinking is that Aid should support expansion of recipient to trade thus the establishment of the Aid-for-Trade initiative –see Table 2 for the major donors of Aid for trade. LDCs have begun to respond both to their poor absorptive capacity and chronic level of poverty, relative decline and economic marginalization and embrace a range of macroeconomic reforms. FDI is now actively sought by all African countries, but despite this late conversion to market-based macroeconomic reform, the gap between the wealthiest developed economies and the least developed countries of

Sub-Saharan Africa (SSA) has become a particular concern for the international community (World Bank, 1999) and (Short, 1997).

**Table1 External flows, Domestic Savings and Investments: 1998-2005 (Average)**

Indicator	Oil economies	Non—oil economies	Africa
ODA and Official Aid (\$billions)	6.9	16.0	22.9
FDI, net inflows (\$billions)b	11.1	5.5	16.7
Workers remittances and compensation of employees, received ( \$billions)c	8.4	6.0	14.4
Gross Domestic Investment (% of GDP)d	22.2	19.1	20.6
Gross Domestic Savings ( % of GDP)e	26.7	15.5	20.9
External debt ( as % GDP)f	53.2	5.7	49.3
External debt (% of total exports)g	150.2	162.5	155.8

Source: World Development Indicators, 2007; OECD (online database) February 2008; IMF World Economic Outlook database, April 2007; OECD 2007 (online database) October 2007. In Economic Report on Africa and the Monterrey Consensus: Tackling Performance and Progress

Notes: a: FDI and ODA the data are for 1998-2006. The remaining indicators are for 1998-2005. The following countries have been excluded due to the lack of data: b Libya and Namibia; c. Angola, Central African Republic, Chad, DRC, Djibouti, Equatorial Guinea, Eritrea, Seychelles, Somalia, Zambia, Zimbabwe; d. Central African Republic, Liberia, and Somalia; g. Equatorial Guinea, Libya, Namibia, and Somalia.

The failure of the SSA LDCs to break decades long severe poverty stands in contrast to advances in the economies and welfare of other parts of the developing and developed world. The concentration of these underperforming economies in the Sub-Saharan region and South Asia resulted in Sen's (1999) remark that "South Asia and Sub-Saharan Africa stand out as the regions where short and precarious lives are concentrated in the contemporary world." The failure of domestic macroeconomic policy is both cause and the result of the lack of capacity to adjust to external shocks (Carlson et al, 1997) which has resulted in institutional decay and deterioration in national prosperity. Stieglitz (1989) offer the view that differences in economic or organisation i.e. how institutions such as markets in LDCs mediate the interactions between individual factors of production as the principal factor accounting for economic underperformance and income inequality between developed and developing countries. The dissolution of the developing state and its association with dependency and subjugation to bilateral and multilateral external donors

(Clapham, 1996) challenge and may even impede this new orientation amongst LDCs. The relative importance of Aid/ODA to developing countries and to Africa is listed in Table 1 and the historic issues and problems associated with donor and recipient motives are summarised in Table 3. However, the severity of economic and welfare decline in SSA economies has generated a new pragmatism among the LDCs.

## **Section 1.1**

### **A New Perspective on Growth and Development**

With an outline of recent developments in thinking on development and the reorientation of macroeconomic policies LDCs is highlighted. This section also provides context for the development of our hypothesised Aid-FDI convergence. It outlines the evolution of a pragmatic approach to the formulation of policies focused on development in poor countries and the reduction of the power differential between recipients and their international development partners. Central to this is the contribution of ideas and new perspectives on the role of the state in developing countries by the Bretton Woods Institutions; the International Monetary Fund (IMF) and the World Bank; and their advocacy of markets and market mechanisms in the development process.

Recent revision of the new growth theory (Mosley, 2004) suggests that the performance of state institutions partly determines the incentive to investment and thus economic growth. This is reflected in the wide scale adoption of market-oriented macroeconomic policies and initiatives to promote the expansion of the private sector. Furthermore, the emergence of a global economic interdependence (UNU, 2000) and a new international economic order (NIEO) has renewed interest in the growth impact of private rather than public assistance.

The private sector is now viewed as the harbinger of growth and development. From this renewed interest by international investors and multilateral agencies (IMF, World Bank) in policy changes within these failing economies which have contributed to the emergence of an enabling domestic environment for international and domestic investors. Note for example the Private Sector Development policy initiative (PSD) of the World Bank and her sister organisations: UNCTAD,

IMF, IFC and others. The IMF, OECD and World Bank have become advocates of a liberal approach to investment flows and investor protection. The three institutions have argued that cross-border capital flows (private and concessional), can, under appropriate policy (Killick, 1996) conditions, make a significant contribution to the process of adjustment and Macro-economic re-alignment, Doukas {(1987), (Shaw, 1992)} and stabilisation, growth and development. This enthusiasm for cross-border capital flows and its link with growth and development is reinforced by the General Agreement on Tariff and Trade (GATT), now World Trade Organisation (WTO), (Morrissey, 1995).

The WTO has become a major agitator for liberalisation, even though its main achievements have been in the area of trade and tariffs between developed countries. Recent innovation by the WTO has produced the Aid-for Trade Program for poor developing countries. The sectorial distribution of participant donors and the list of top ten recipients are listed in Table 2 (Page x and y, respectively). This focus on liberalisation is reflected in the policy stance of multilateral agencies such as the World Bank which has linked trade liberalisation to its Structural Adjustment Programs (Killick, 1993) from the 1980s. This is re-enforced by the IMF in its structural adjustment programs. The IMF associates state intervention with the displacement of the private sector, the engine of growth. These organisations have focused their structural adjustment programs on the primacy of the private sector and its capacity to attract foreign inflows, (Turner, 2001).

This thesis is, however, primarily concerned with the empirical evaluation of the hypothesised link between aid and FDI and the potential impact of this conjugation on inward investment, the growth and development process in capital and infrastructure poor LDCs such as Uganda. This hypothesis emerges from a consideration of the relationship between capital accumulation and growth enhancement (Hansen and Tarp, 1998). Orthodox formulation of the relationship between economic growth and accumulation of capital is encapsulated in the Harrod-Domar growth theory and its influence on contemporary development doctrine.

Whilst the orthodox explanation of the relationship the poor growth and development performance of poor countries were largely accounted for their low quality of their human and physical infrastructure endowment in the 1950s and 60s this view prevailed up to the 1990s (Stieglitz, 1989). However, current diagnoses of failure in developing countries conclude that increases in inflow of physical capital to these countries is focused on the social sector and issues relating to capacity, transparency, and accountability and governance. The shift in focus from concerns for economic performance to development; as measured by social indicators such as those in the MDG is the new argument for donor generosity and the principal measure of aid effectiveness. Notwithstanding the above, significant amounts of aid is now focused on facilitating and expanding the economic and trade capacity (see Table 2) of recipient countries.

## **Section 1.2**

### **Growing Inequality between Countries**

Growing diversity in per capita income between the developed and developing countries is the focus of a number of internationally agreed policies to bridge this gap. This is accompanied by actions to reduce the incidence of consumption and income poverty. This Concern for the relative decline of developing countries is echoed in the foreword to the May 2000 World Economic Outlook: “The world is entering the twenty first century with the largest divergence ever recorded between rich and poor.” This is supported by the UNDP (2002) report: “Human Development-past, present and future”, in which the organisation estimate that some 850 million of the 4.6billion people living in developing countries are illiterate, with nearly a billion without access to safe water and twice as many lacking access to good sanitation. Wide-scale income poverty is indicated by the estimated 1.2 billion people living on less than \$1 a day and 2.8billion on less than \$2 per day, at 1993 purchasing power parity (PPP). Earlier recognition of this growing gap between the developed and developing world was echoed in the 1999 World Bank and IMF annual meetings, respectively. Both organisations make an explicit link between concessional lending and poverty reduction (May, 2002). However, the complex relationship between growth, human and social development is

acknowledged in the 1996 African Development Bank report: “Fostering private sector development in Africa” (1996). The authors: Goldin, Rogers and Stern (2000) argue that although growth is generally acknowledged to be the principal cause of human and social development, the link is far from being automatic. ‘Good growth’ is expected to generate employment, long-term reduction in inequalities, and enhanced effective utilisation of finite resources. The implied objective is one of achieving long-term growth and its translation into human and social development. However, recognition of the multidimensionality of poverty (World Bank, 2000) led to the view that poverty is not just a lack of income, but also inadequate health and educational services, the degree of susceptibility to external shocks and the ability to exercise effective control over personal destiny is now recognised as important measures of development.

In Stieglitz’s (1998) “broader” conceptualisation of development, development is social transformation, not the traditional perspective with its focus on the accumulation of physical and human capital. For Stieglitz, social transformation embraces a willingness to change old ways of thinking and doing things. This requires new patterns of social organization, and the modernisation of the traditional socio-political and economic relationship between genders and social classes, countries and regions. The development of new institutions and capabilities are viewed as vitally important facilitators of social transformation.

This is echoed in Van den Berg’s (2001) statement that: “it is the quality of the labour force, its accumulated experience and Human capital, its education system, and so on, that determines an Economy’s ability to create new ideas and modify or renounce old ways of doing things.” Sen (1999) views development as more about individual freedom and the realisation of individual capabilities than advances in collective welfare.

**Table 2 Top 10 recipients of aid for trade (2002-05)USD Millions, commitments (2005 constant prices)**

Region	Income group	2002	2003	2004	2005	Baseline average 2002-2005 (volume)	AfT over total World AfT (%) <sup>b</sup>	AfT over total sectorial ODA	Aid as % of GNI (2005)
Asia	Other Low Income	1455	1130	1495	1484	1391	9	51	3.7
Asia	Other Low Income	1196	1462	1757	1097	1378	9	38	0.2
Asia	Lower-Middle	596	1366	1322	925	1052	7	52	0.9
Asia	Lower-Middle	858	1070	506	399	708	4	29	0.1
Asia	Least-Developed	509	863	777	347	624	4	32	2.1
Africa	Lower-Middle	619	480	540	389	507	3	51	1.0
Africa	Least-Developed	367	542	422	564	474	3	42	17.1
Asia	Lower-Middle	591	373	336	364	416	3	54	5.1
Europe	Lower-Middle	376	369	351	364	365	2	35	-
Asia	Other Lower Income	383	508	186	292	342	2	36	1.5
		6950	8162	7691	6223	7257	46.0		

Notes: b calculated as the average of annual shares: AfT: aid for trade: GNI: GROSS National Income

Source: OECD Creditor Reporting System and the World Development Indicators; Aid for Trade at a Glance: 1<sup>st</sup> Global Review 2007

Whilst there is serious doubt that only a few, if any, of the SSA countries will meet the development targets agreed at the Second Tokyo International Conference on Africa (1998), these goals were adopted by the United Nations at its Millennium Summit as the Millennium Development Goals (MDGs). Thus far some 189 countries have signed up to them.

### **Section 1.3**

#### **New Development Goals**

Implied in our Aid-FDI hypothesis and interaction is the joint or combined impact of this convergence on economic growth and development in poor LDCs such as Uganda. The principal focus of recent Aid policy is the achievement of the TICAD 11 and MDG with a focus on the potential contribution of the private sector in the attainment of social indicators. Greater emphasis on FDI inflows and macroeconomic initiatives are focused on enhancing the inflow of both type of capital to finance the goals to which Sub-Saharan countries have committed themselves

. Concerns for the quality of aid as for instance reduced effectiveness through aid-tying and donor motives are listed in Table 3 as principal contemporary and current problems that have compromised the ability of these inflows to achieve their principal objectives. These emerged from the 1998 Second Tokyo International Conference on International Development (TCAD11). These targets constitute the (TICAD 11) Agenda for Action, which incorporate strategies for regional economic and social development. Welfare and social indicators include: the reduction of the number of out-of-school children, and illiterate adults, the number of children dying in infancy and childhood and the number of mothers dying during pregnancy and childbirth. Significant reductions in the number of malnourished people living in SSA countries, is another important target of the TCADII.

The achievement of these targets is expected to enhance the welfare of the population as well as constituting the precursor assets for enhanced income generation by the poor as well as providing



**Table 3 Chronic problems in aid, past and present**

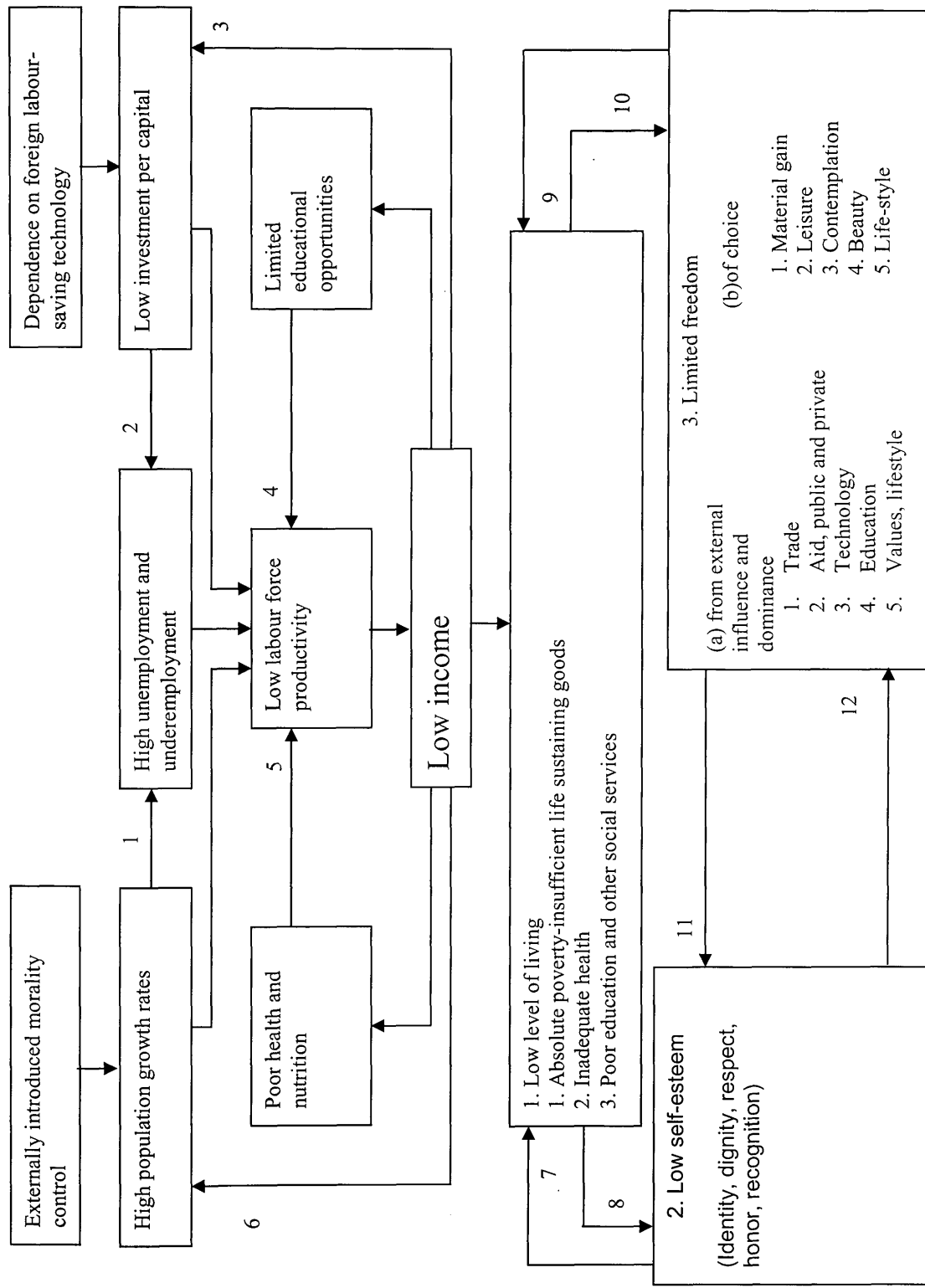
Aid problem or idea	Pearson Commission (1969)	Contemporary statements (2005-2006)
More aid to poorest countries	“IDA (International Development Association of the World Bank) has decided to make a special effort to assist the poorest members in project preparation so that they can benefit more fully from IDA financial assistance! (p.226)	The Commission for Africa ( 2005, p. 99) calls for “allocating aid to countries where poverty is deepest”
Donor coordination is a problem	“The present multiplicity of agencies and their lack of coordination lead to much unnecessary duplication of effort”. (p. 228)	UNDP (2005): “weakly coordinated donors, many of them operating overlapping programs”
Be selective about whom you give aid	“Increased allocation of aid should be primarily linked to performance.” (p. 133)	IMF and World Bank (2005, p. 168) “Broad consensus has emerged that development assistance is particularly effective in poor countries with sound policy and institutional environments”
Aid tying is a problem	“Aid-tying imposes many different costs on aid-receiving countries... (Costs) frequently exceed 20 per cent (p. 172) the donors should “consider the progressive untying of bilateral and multilateral aid.” (p. 189)	The IMF and World Bank (2005, p. 172): “Untying of aid significantly increases its effectiveness.” and “donors agreed to continue to make progress on untying aid.” (p. 173). UNDP (2005, p. 102) notes “price comparisons have found that tied aid reduces the value of assistance by 11% - 30%.”
Move away from Food Aid	“one of the most conspicuous forms of tying aid has been food aid...it has sometimes also allowed some low-income countries to neglect agricultural policy” (p.175)	The IMF and World Bank (2006b, p. 83): “transfer of food in kind was found to be about 50 percent more costly than locally procured food and 33 percent more costly than food imports from a third country....”
Technical assistance is a problem	“Technical assistance often develops a life of its own, little related in either donor or recipient countries to national or global development objectives.” (p. 180)	The IMF and World Bank (2006b): technical assistance “is often badly coordinated among donors and poorly prioritized.”
Debt relief	“There has already been a sequence of debt crises....debt service problems of low income countries will become more severe (p. 72) “We recommend that debt relief avoid the need for repeated rescheduling.” (p. 157)	Commission for Africa (2005, p. 328): “For poor countries in sub-Saharan Africa which need it, the objective must be 100 per cent debt cancellation as soon as possible...the relief provided under (recent initiatives) has not been wide enough, or deep enough.”

Source: Easterly W (2007) Are Aid Agencies Improving? Brookings Global Economy & Development. Working Paper 09 # New York University, 2007

the basis for sustained economic growth and social stability. Inefficiencies in the allocation of resources (see Table 3 for examples of these) and the poor delivery of public goods, notably health care, and education are increasingly recognised as significant determinants of labour productivity (UNDP, 2002). This relationship is offered as explanation for the low productivity of poor countries such as those of the Sub-Saharan region. Uganda is a good example of a country with low productivity even in the presence of a rising workforce. This is argued to result from poor standard of health and education (Ugandan Government Poverty Reduction Strategy Paper (PRSP, 2001).

Current concerns for the level of inequality between nations and intra-country variations in per capita income date back to the first half of the last century. Ahluwalia writing in 1976 argued that the relationship between distribution of income and the process of development as the “oldest subject of economic enquiry”. It occupies center stage in the analysis of the dynamics of economic systems. Its temporary obscurity during the reign of neoclassical theory was revived with Kuznet’s (1955) attempt to explain the relationship between growth and inequality. The resulting understanding of the income-inequality relationship was based on the theoretical explanation that income inequality is characteristic of the initial phase of economic growth (Vanhoudt, 2000). Economic development is accordingly, associated with an inverted U-shape curve, and a widening of the income gap with initial economic growth is generally observed. Subsequent closure of this gap occurs after a period of sustained i.e. advanced economic development-see figure 1 for an illustration of the multi-dimensional issues: facilitators and barriers to the process of development. Kuznets explanation was greatly influenced by contemporary theoretical explanations of economic growth. A central aspect of these theories was the migration of labour from traditional rural labour intensive industries such as agriculture to the more productive mechanised industrial sectors in line with later contribution by Lewis (1979).

The rural-urban divide was observed, empirically, not to decline with economic growth. From these assumptions, Kuznet concluded that the development process of a typical economy would be characterised both by higher per capita incomes and elevated level of income inequality as rising numbers of workers migrate to the more productive sectors of the economy. However, existing theories of income distribution are of limited value as they focused on the functional distribution between labour and capital (Ahluwalia, and Chenery, 1974).



Key: 1 High labour supply, 2 Low savings, 4 Inadequate managerial skills, 5 Poor attitude to work, 6 High fertility, 7 Poor attitude and poor motivation, 8 International transfer of material values, 9 'Backwash effect' of international power relationship, 10 International economic technological and cultural 'vulnerability', 11 Non control of own destiny, 12 Willingness to be dominated dependent.  
 Source: Todaro P M (1985) Economic Development in the Third World, 3<sup>rd</sup> Edition (Publisher: Longman)

In the main, these are characterised by a view of income distribution as one determined by the level of employment and remuneration of factors of production: capital and labour. The area of differentiation is the relative importance accorded to the dynamics of market forces and the determinants of wages and product prices. Neo-classical theories assume competitive equilibrium in all markets and thus derive factor returns from pure production relationship and demand patterns under a given factor supply environment. In contrast, the classical and Marxist wage theory forms the basis of the majority of dual economy model, which assumes relatively fixed real wages with the surplus appropriated by the owners of capital. The inadequacy of existing theories for the present study is due mostly to their failure to incorporate other dimensions of the determinants of the functional distribution of income than the absence of consensus on these factors (Stieglitz, 1998). The main omission is the treatment of the distribution/ possession of various forms of assets and the failure to account for the fact that household income is derived from the ownership of specific assets such as, land, human capital. It is clear from this that poverty is significantly the result of ownership of wealth creating assets.

However, the distribution of public goods provides governments with the opportunity to satisfy their own supporters. However, Bell (1974) argues that the more uniform the distribution of public goods and privately held assets, the lower the leakage's of intervention. Wide variation in income and occupational status are more likely to be tolerated when the operating policy embraces equality of opportunity. Policy, according to Ahluwalia and Chenery, (1974) need to operate on a broader spectrum i.e. not just on the functional distribution of income but on factors of production owned by the lower-income groups. In time the pattern of ownership of these complementary assets: human and physical provide the basis for policy intervention. Reallocation of public investment has as its main objective, the efforts to increase total employment i.e. raising total wage bill and consequently the proportion of income to lower-income groups. Upgrading the pattern of concentration of human capital is a precondition for the success of strategies focused on greater labour absorption in the

modern sector. The scope for substituting labour for capital is poor where the environment is characterised by low levels of human capital (Ahluwalia, 1974) and Sylwester (2000), respectively, i.e. where the skills level of the work force is low as is typically the case in rural areas.

## **Section 1.4**

### **Principal Contribution**

This thesis makes a contribution to our current understanding of the interrelationship between aid and FDI and contributes to the aid effectiveness debate. The latter is viewed from a donor, private sector and host country perspective. Whilst the orthodox view contends that aid will finance gaps in domestic savings and the scarcity of foreign exchange and thus facilitates economic expansion and development in LDCs; empirical evaluation of the impact of public inflows on recipient countries has failed to provide evidence of aid enhancing economic growth. With a focus on the above issues, this thesis develops the Aid-FDI interaction as a mechanism for estimating the impact of aid on host countries. This thesis therefore seeks to develop a model that elaborates on how recipient countries may address concerns by donors for aid effectiveness and the phenomena referred to in the economic literature as donor ‘fatigue’. The second contribution made by this thesis is the identification of a convergence in donor and recipient macroeconomic and development policies. By implication this also suggests a link between Aid and FDI and by extension determinants of MNEs investment activities with that of international public bodies such as the World Bank, IMF, and the International Development Association, other multilateral and bilateral donors. The efforts of poor countries such as Uganda to grow their economy on the basis of a higher share of global FDI inflows, suggest a need for such countries to identify the best mix of policies to achieve this. Poor infrastructure, combined with a reputation for economic mismanagement across the SSA region is the context in which efforts are being made to enhance the continent’s share of global FDI and Aid.

The fact that LDCs generally have a deficit in the assets required by MNEs: physical infrastructure, and human capital, means that absorptive capacity of these countries to FDI is low. Whilst this may

be less true for Aid inflows, donors are now concerned for governance, the correction of institutional failure, hence their focus on capacity building and governance. Efforts to correct these ‘distortions’ in recipient countries has resulted in mechanisms to allow a wide range of domestic organisations, ranging from, community groups to trade unions to shape the development of Poverty Reduction Strategy Papers (PRSP). This document with its targets for: development and poverty reduction have become the basis for donor support. The occupation of donors with these issues is clear indication of the aid effectiveness debate. As the above issues may influence the level donor contributions; they may also be viewed as ‘determinants’ of public inflows and constitute the absorptive capacity of recipient economies with respect to Aid.

Our survey of Uganda’s principal development partners have identified the policy implications of continued donor engagement and the identification of means of addressing donor concerns for aid effectiveness. For example donors have provided technical assistance for the privatisation of the power sector and the World Bank group is playing a major role with a number of its related organisations: the International Financial Corporation (IFC), the private sector division of the bank, the Multilateral Investment Agency, (MIGA) contributing some US\$300 to support a major hydropower project (Bujagali) in Uganda. These facilities will support a major investment in Uganda power sector. Clearly this is an example of the AID-FDI interaction as the World Bank facility has complemented private sector investment. On a smaller scale, we have identified Aid-FDI interaction in the agro-processing sector with USAID providing risk premium to a major foreign bank enabling it to make loans to rural farmers lacking conventional collateral. The UK Department for International Development (DFID) has provided support for the development of the agricultural sector through facilitating the market for agricultural inputs, storage and distribution.

The Dutch Government has helped the horticultural sector with grants and technical assistance, whilst the World Bank has provided financial support (grants) for a power generation from agro-waste. These projects have established the viability of the Aid-FDI interaction, however, evaluation at the macro level for its impact on the economy was challenging as these projects are too few and

relatively small. This suggest that aid inflows have benefited communities at regional and sub-regional level i.e. benefits are not widely dispersed due to their nature or lack of a transmission mechanism—thus some potential beneficiaries are unable to access the benefits associated with such investments.

## Section 1.5

### Theoretical Contribution

The direct impact of aid on economic growth is controversial. Historically, the late 1940 and early 1950s witnessed the establishment of the aid industry: the Marshal plan for post WW (II) Europe and the 1950s saw the beginning of UK aid industry as a rising number of her former colonies achieved their independence. Since then claims for the growth enhancing impact of aid has been subjected to robust empirical evaluation. The emerging consensus is that the evidence does not support a direct impact of a significant magnitude on host economies. The new view suggests either a poor or no relationship between these inflows and economic performance in recipient economies.

We find that aid and our Aid-FDI (interaction term) in our regression using a production function is negative and insignificant for both random and fixed estimation with and has a large negative correlation. For example without lags it was  $-2.86e-13$ . However, for a simple linear regression  $t$  is negative for the interaction term but significant at 5 per cent when aid is lagged at two period ( $-2.44$ ) and  $t$  is  $-2.54$  with four period lag of aid. The linear regression without lags produces  $t$  at  $-1.99$  for the interaction term. The fixed effect produces positive and significant values for labour force participation and exports of goods and services ( $t$  is  $2.43$  and  $2.70$ , respectively-without lags. With FDI two period lag  $t$  are  $-4.21$  for FDI,  $2.84$  for exports of goods and services and  $2.25$  for labour force participation rate. All other variables are insignificant. The introduction of a four period lag on aid in the fixed-effects model produced a negative and insignificant  $t$  value for the interaction term, however, both exports of goods and services and labour force participation rate were positive and significant at the 5 per cent level ( $2.57$  and  $2.13$ ). At this level aid is negative and insignificant and other variables are positive but insignificant at the 5 per cent level.

## **Section 1.6**

### **Contribution to the Aid Effectiveness Debate**

We have made some practical suggestions for the principal actors in the aid effectiveness debate. These range from the need of donors to converge the determinants of aid with that of FDI in order to better support and enhance the absorptive capacity of host countries and to better engage with the private sector catalysing private sector investments in important infrastructure sectors such as power generation, transport, and telecommunications. Private sector investment in the agricultural sector and especially export-oriented agro-processing and horticulture have significant potential to reduce rural poverty and thus private investment may complement Aid/ODA inflows in this context making a major contribution to the Poverty Eradication Action Plans (PEAP) of countries such as Uganda. Our introduction of the Aid-FDI interaction term to the production function is a means of empirically assessing the link between aid and economic growth through the intermediary of the conjugate i.e. the joint impact of the two types of capital. This approach makes it possible to link macro level analysis to micro-level i.e. project financed by a mix of Aid and FDI. At the same time it allows us to identify the experience and policy orientation of donors, foreign investors and host countries such as Uganda.

## **Section 1.7**

### **Methodological Contribution**

The difficulties experienced in this study with respect to the employed methodology are identified in the empirical and theoretical literature. It is a known fact that macroeconomic data for SSA economies are generally poor both in terms of its quality, reliability and availability. The relatively short number of observation plus the lack of consistency in the period covered means that we were restricted to using data for the period 1987 to 2005. And hence the decision, in the light of this limitation, to employ cross country pooled time-series approach. The introduction of country dummies allows us to recognise high levels of heterogeneity between countries and potential country-specific structural factors. The absence of data on human capital except for the online Barro



& Lee data set with its five yearly measures meant we were unable to introduce this important variable into our production function as this would require its conversion to annual measures in line with our macro-variables.

However, the fact that we used a combination of methodologies: survey questionnaire of Uganda's principal development partners and foreign investors means that we were able to identify the policy implications of our findings and conclusions for these important stakeholders. The development of the Aid-FDI interaction term and its quantitative evaluation for its impact on the economic growth as measured in GDP terms is a significant contribution to studies of growth and development in SSA economies and LDCs generally.

## **Section 1.8**

### **Research Objectives**

This thesis has two broad objectives. Firstly to determine ways and means by which aid can facilitate increase flows of FDI to relatively poor developing countries with specific reference to Uganda, a well-known graduate of a number of International Monetary Fund and World Bank Structural and Adjustment programs and a major recipient of foreign aid. The second objective is to identify mechanisms through which aid can be utilised to harness FDI for greater impact on the growth and development process in recipient countries. The first of our two objectives invokes concerns for the determinants of FDI whilst the second is focused on the impact of FDI. The orthodox view is that countries poorly endowed with human capital, physical infrastructure, and inappropriate policies are characterised by low absorptive capacity to FDI. Furthermore, these economies are expected to achieve less than optimal returns from the relatively small amounts of foreign capital that they manage to attract under these conditions.

The justification for this approach and for this study is the widely reported declining flow of aid to LDCs (World Bank, 1998) and their poor record in attracting FDI. In truth, this dilemma and the historic dependence on aid are somewhat similar to that of a housewife, confronted with vitally

important domestic obligations and reduced income. The fundamental issue is one of meeting rising obligations with a diminishing purse: making more out of less. This thesis is therefore focused on aid effectiveness through the Aid-FDI linking as a means of achieving greater FDI inflows and enhanced effectiveness. This thesis constitutes a new approach in the aid-effectiveness literature in two important respects: firstly, it develops a new conceptualisation and model: the aid-foreign direct investment conjugate. This new species is proffered as a viable alternative to aid only and FDI only impact on LDCs. Secondly, it attempts to engage the debate on recipient policy approach to foreign direct investment i.e. the structuring of aid policies to influence recipient FDI policies for greater effectiveness in attracting FDI inflows and enhanced effective utilisation.

## **Section 1.9**

### **Why a Case Study of Uganda?**

The designation of Uganda in the 1990s by the international development community as a star pupil of Structural Adjustments has made her a subject of enquiry to determine the validity of the various claims and the policy factors which responsible of the transformation as well as the assessment of actual performance of the economy and what these suggest for reforms in other indebted poor countries within and outside the continent. However this section begins with a brief account of Uganda's recent politico-economic development.

Uganda is a poor landlocked country with high population growth rate which currently stands at some 30 million (Ugandan Government, 2006/7). Uganda is chosen for her widely acclaimed achievement (Figure 3) in the 1990s (World Bank, IMF and the international development community) as 'success story' of Structural Adjustment. The fact of the country's high poverty and dependency ratio (Figure 2) and the fact that Uganda has experimented with pro-growth and anti-poverty macroeconomic initiatives since 1986 is another important reason for choosing her. The poverty reduction strategy of the government is one of assisting the poor to raise their income (Holmgren, 1998). However, the sustainability and effectiveness of policy in this area is linked to real progress in the development of human and physical capital. The work of the United Nations

Development Programs (UNDP) in Uganda dates back to the early 1970s with its initial focus on institutional capacity building. It was brought to a standstill by armed conflict in 1979 and the removal of the Amin's regime. In the aftermath of the conflict the organization turned its attention to the provision of humanitarian assistance. The second program started was initiated in the 1980s but it too was interrupted by armed conflict. Here the focus was capacity building in state institutions. Third country program started 1988-1991 and focused on the rehabilitation of the country's human and physical infrastructure, rural development and agricultural productivity. The fourth program was implemented between 1992 and 1996. The focus turned from rehabilitation to development. The program claimed a number of successful outcomes. These included: improvements in the efficient management of a number of ministries; better management of transport infrastructure, consumer markets and macroeconomic stability (UNDP, 2002). The fifth program or the First Country Cooperation Framework 1997-2000 (CCFI) focused on governance for poverty reduction, private sector development and decentralisation of the machinery of state.

The empowerment of local government and the formulation of local efforts and strategies to reduce rural poverty were integrated with central government anti-poverty policies and strategies. The current UNDP program of assistance is the sixth such program, the Second Country Cooperation Framework 2001-2005 (CCF11). The contribution of the United Nations Development Programs (UNDP) is linked to the governments Poverty Eradication Action Plan (PEAP), which includes poverty monitoring and the achievement of targets incorporated in the country's development plan. The focus on the twin goals of poverty reduction operates through policies, which improve the income earning capacities of rural communities and individuals. Efforts in this and related areas are linked to good governance and the achievement of the Millennium Development Goals (MDGs). The overall effort of the sixth UNDP program is one of promoting the incorporation of the MDGs into the national development objectives as articulated in the PEAP. The government's antipoverty and development framework has the following goals:

1. The creation of an enabling environment for rapid and sustained economic growth and structural transformation.
2. Strengthening good governance and security.
3. Increasing the ability of the poor to raise their incomes through access to productive assets.
4. Improving the quality of life of the poor.

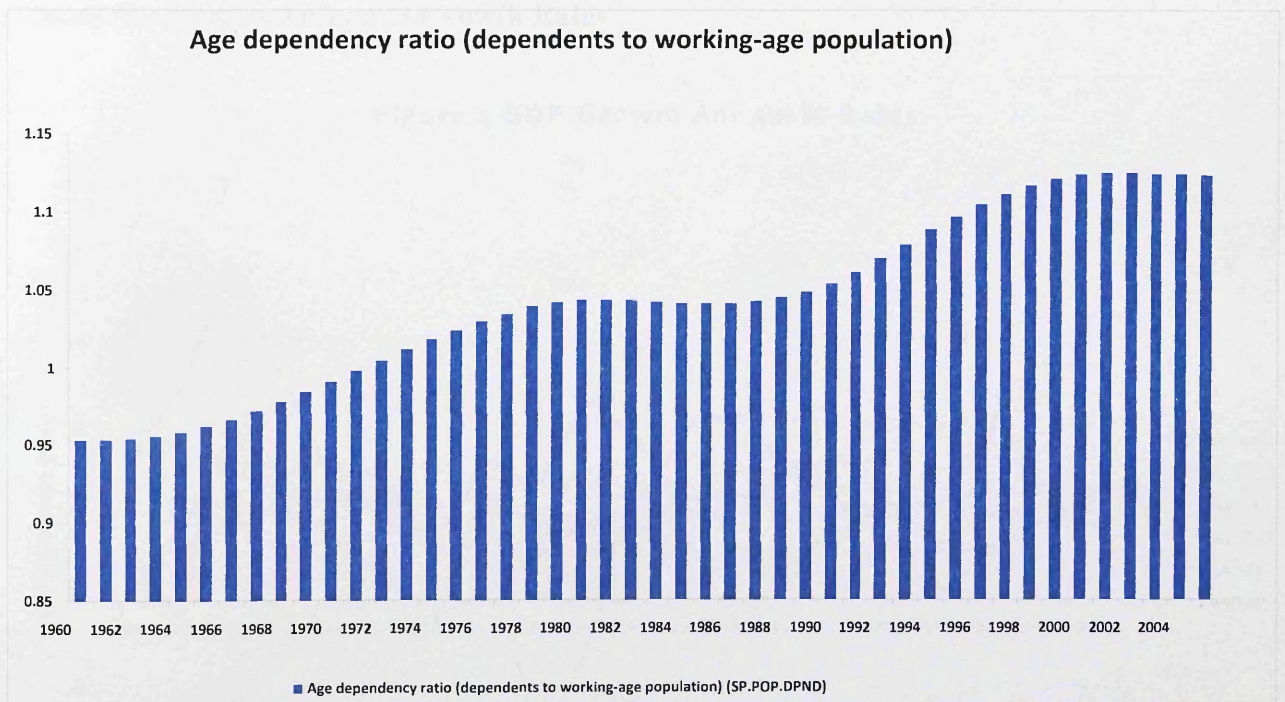
Speke made the first European contact with Uganda in 1862 and a later visit by Stanley in 1875 marked the beginning of British interest and subsequent British colonial rule in Uganda. Stanley's visit to the Kabaka found a highly organised system of government, unlike that in neighbouring countries. The country was observed to be very isolated from the international community with little or no formal trade links with the external world.

As a result of her unsustainable high level of external debt and partly as a result of its reforms program, Uganda was the first of the Highly Indebted Countries among the LDCs, to qualify for assistance under the (HIPC) initiative. The country arrived at its decision point in April 1997 and progressed to the "completion point" some twelve months later. At this point external creditors agreed some USD650 Million (USD350 Million in net present value) debt reduction. This assistance by the IDA of the World Bank under the HIPC initiative was made conditional on structural and social performance. For instance the Ugandan government's agreed to borrow exclusively from concessional lenders. Notwithstanding, this commitment, total debt stock expanded.

The investment statistics for the 1990s were lower than that for the latter part of the 1980s. Private investment was found to be concentrated in the import-substituting sector, which was dominated by the larger domestic companies. Over the period 1991 to 1995 the percentage of exports turnover exported by this sector increased by only 1 per cent. Uganda has experienced high levels of external debt for several decades. This is indicated by the debt ratios in the 1990s of some 1,400 percent (debt-to-export ratios) and debt-service ratio of over 60-70 percent. The 1980s was associated with public debts of 16-17 percent of GDP. This was accompanied by publicly guaranteed external debt of some USD

3.147billion, equivalent to 62.7 percent of GDP. Some 76 percent of the country's external debt was owed to multilateral institutions with non-Paris Club bilateral creditors accounting for 11 percent and Paris Club creditors, 10 percent, commercial creditors accounting for only 3 percent [(UNCTAD, 2001), (OECD, 2000) (Trade and Development Centre, 2001), and (World Bank, 1998)]. This highlighted the need for the country to secure inflows of private capital to finance the reforms of state-owned firms and to address the deficit in the finance of her infrastructure especially in the area of power generation and its distribution (see chapter 2 for a detailed accounts of this and the policy context), telecommunications and transport. Financial inflows are also targeted as part of the privatisation programme and this was confirmed in our empirical survey of the Ugandan Investment Authority (UIA)-see chapter 2, 4 and 5 for examples of policy reforms focused on enhancing inflows of FDI to the infrastructure sector.

**Figure2 Age Dependency Ratio**



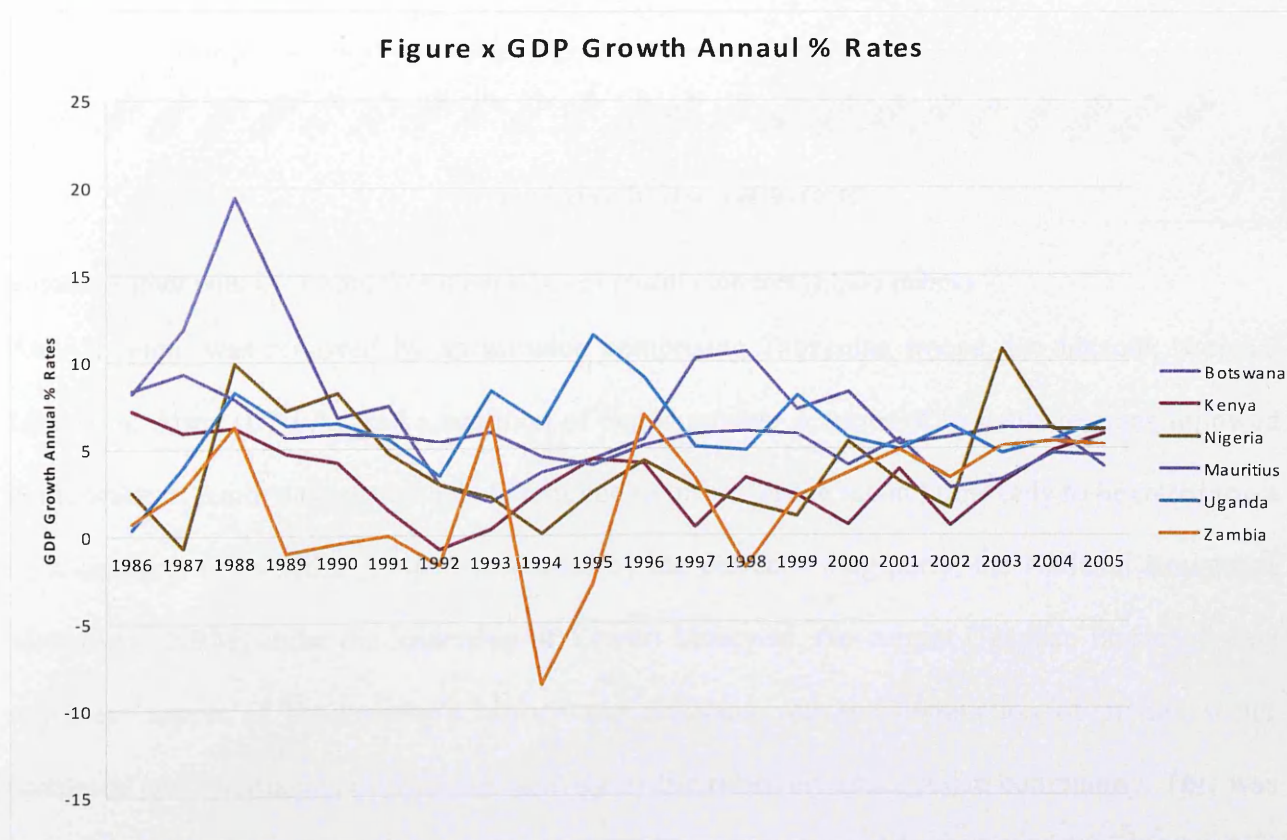
Source: Author with Data from World Bank Development Indicators (ESDS online)

The colonial experience was short lived with the country achieving its independence in 1962 after some sixty years of British Colonial rule. At independence Uganda's population was estimated to be 7 million people and a non-African population numbering approximately 100,000 of which 80

per cent were Asians, who were introduced by the British as indentured labourers. The remaining 20 per cent were mostly Europeans and a few thousand Arabs. The 1959 census indicated that 40 per cent of the population was children under the age of 15—indicating, according to Clark, Williams et al (1993) a high burden of child dependency. Statistical analyses of the country's population performance lead to the prediction that the population would grow to 14 million by the end of the century i.e. the beginning of 2000. In fact, the population has grown by some 300+ percent to a current 30 million (Ugandan Government, 2006/7).

This study cites the recent post-independence experience of Uganda as a good example of the response of the international community in providing external assistance to low-income developing countries and Sub-Saharan LDCs in particular. Uganda has experienced many of the external shocks, and internal political and civil strife that has been the common experience of many Sub-Saharan LDCs.

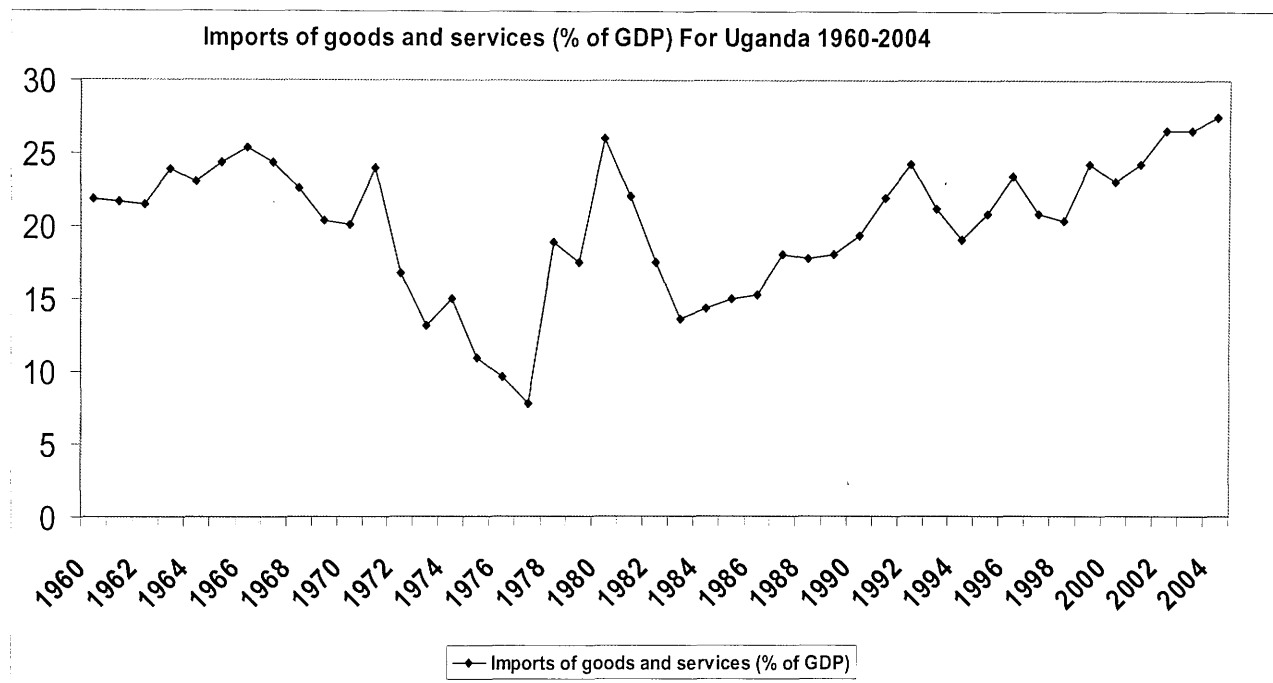
**Figure3 Six country Annual % Growth Rates**



Source: Author with Data from World Bank Development Indicators (ESDS online)

Uganda is also one of several former British Colonies which have struggled, in the post-colonial period, to achieve a stable democratic system of government, and efficacious domestic macroeconomic policies. The country has experienced a succession of generally short-lived regimes except for that of Idi Amin, which lasted some eight years from the early 1970s to the early 1980s. The decline of the economy in the early 1970s is reflected in the Figures 4 and 5.

**Figure 4 Imports of Goods and Services (% of GDP) for Uganda 1960-2004**



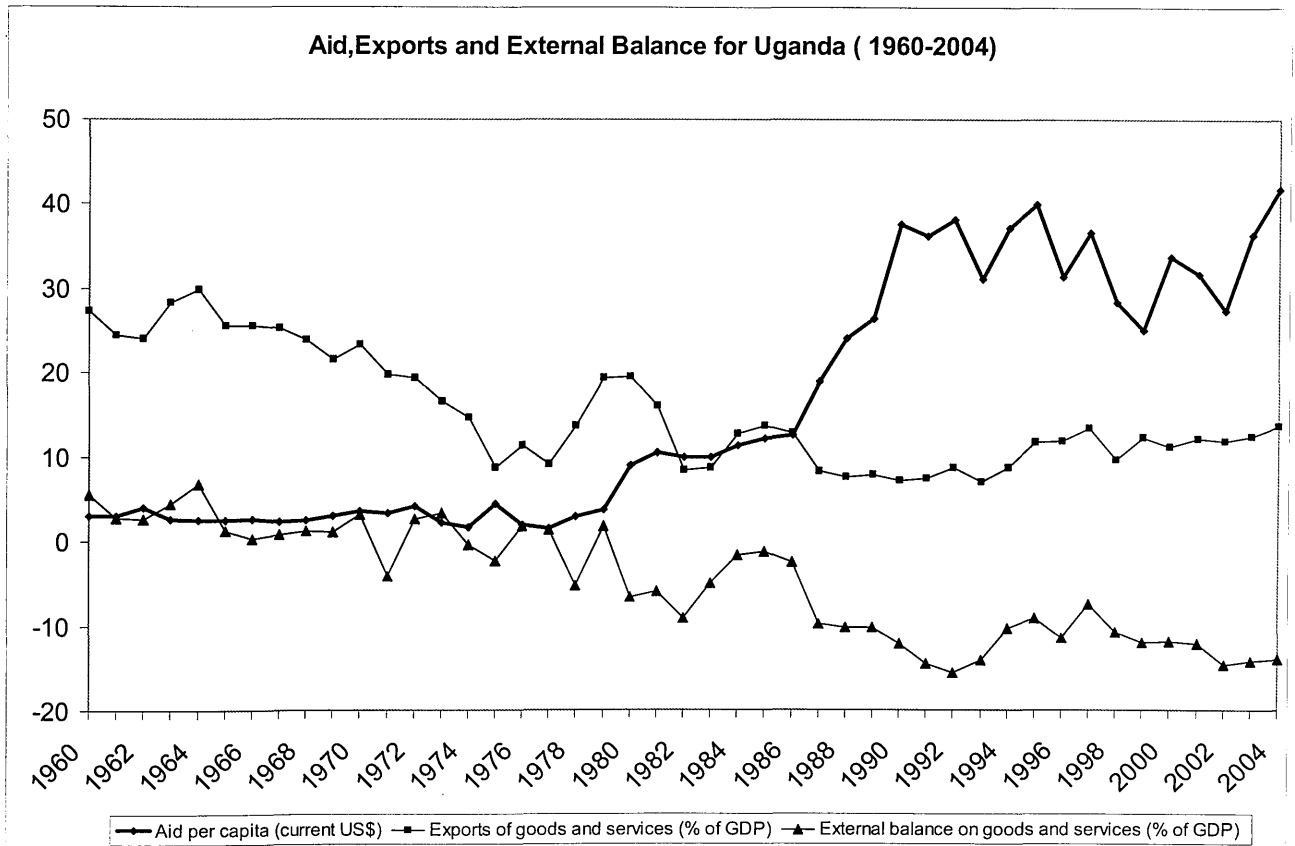
Source: Author with Data from World Bank Development Indicators (ESDS online)

Amin's reign, was removed by an invasion comprising Tanzanian troops, the Uganda National Liberation Army (UNLA), and a coalition of exiled groups. A series of unstable regimes followed in the wake of Amin's departure. Obote returned to office for the second time only to be overthrown by a coalition of guerrilla groups, dominated by the current ruling party, the National Resistance Movement (NRM), under the leadership of Yoweri Museveni, the current Ugandan President. One important aspect of the country's history and economy was the domination of private sector (domestic and international) economic activity by the relatively small Asian community. This was reversed in the late 1970s with their mass deportation and the confiscation of their businesses (under Amin) assets and private properties. The resulting rapid decline of the country's economic

base and continued political instability contributed to wide scale poverty of the population. Further decline of the country was made unavoidable by international sanctions against the government.

The arrival of the NRM administration in 1986 is associated with significant macroeconomic reform under the tutelage of the IMF and World Bank. The rein of the present Museveni administration is associated with a number of social and economic gains according to the IMF and World Bank. This thesis will also attempt to determine how donor contribution such aid and renewed inflows of FDI have influenced the recent growth and development performance of the Ugandan economy. Clearly for SSA economies such as Uganda the challenge is one of improve its share of global FDI with low absorptive capacity and concerns by donors for aid effectiveness: its effective utilisation. One approach to this is to use aid to improving absorptive capacity and simultaneously enhancing its effective utilisation and allocative efficiency.

**Figure 5 Aid, Exports and External Balance for Uganda (1960-2004)**



Source: Author from World Bank Development Indicators (on ESDS online)



## Section 1.9.1

### The Structure of the Thesis

This thesis is organised as follows. Chapter 1 explains the context and issues relating to growth and development in poor countries such as Uganda. From considerations of the relevant earlier studies and the conceptual issues we developed the Aid-FDI as a possible mechanism for addressing concerns for effectiveness of public inflows to poor countries such as Uganda: allocative efficiency and effective utilisation and as a means of enhancing inflows of FDI. Chapter 2 critically discusses the principal conceptual issues in the theoretical literature on FDI and Aid, respectively, and their relationship to economic growth in LDCs. Chapter 2 also explores the empirical literature on the financing of infrastructure citing recent examples of Aid-FDI co-financed projects World Bank sponsored privatisation initiatives and focuses on the establishment of infrastructure financing for LDCs. This extended to cover developments in Uganda in which policy makers have come to recognise that the poor state of their physical infrastructure is a major impediment to their effort to enhance inflows of FDI as a means of achieving long-term growth and development. In the final section of this chapter we provide examples of infrastructure finance in Uganda and discuss the contribution this is likely to make towards economic growth and poverty reduction.

This investigation thus establishes the conceptual basis for exploration of the relevant empirical analysis of the role of aid and FDI in poor developing countries such as Uganda. It attempts to identify significant policy changes and their relationship to subsequent social and economic outcomes from the post-independent period to the present. Chapter 3 we undertake a critical review of the empirical and theoretical literature on the determinants of FDI and its impact on recipient's growth and trade. These are complemented by a discussion of Aid policy and FDI inflows.

Chapter 4 provides a qualitative assessment of the of Aid-FDI link on GDP growth with a survey of the country's major development partners. This survey also asks respondents for the views of a range of economic and policy issues including questions on infrastructure and its impact on operating and investment decisions. This begins with a review of the empirical research literature and a selection of

a suitable method for the present research. Chapter 5 introduces a number of contemporary themes ranging from tropical agriculture and related concerns for the impact of the industry on carbon emissions and global warming with specific reference to landlocked countries such as Uganda and the importance of monetary stability and price competitiveness for its export sector which is dominated by commodities. We report our findings of Uganda's major development partners and foreign investor's experience of our hypothesised Aid-FDI link and the policy and economic context this interaction.

Further effort to assess our hypothesised Aid-FDI interaction term is made in chapter 6 with the introduction of a quantitative approach and econometric assessment of the Aid-FDI. This assessment is made using a number of macroeconomic variables data obtained from the online ESDS World Bank database in a single equation of a reduced form of the two linked hypotheses presented in this work: that aid facilitate enhanced inflows of FDI and combined the two types of inflows might promote growth in recipient countries such as Uganda. Chapter 6 also complements the qualitative approach taken in chapter 4. We discuss the findings of our quantitative assessment of the Aid-FDI link. This proceeded by a discussion of the employed methodology and an exploration of factors relating data gathering and the specification and development of our model. In chapter 7 we offer our summary and conclusions with an attempt to determine what the earlier studies and evaluation of our Aid-FDI link suggests for Ugandan policy makers and for the SSA region.

## **Section 1.9.2**

### **Conclusions**

What we conclude from this chapter is the disappointing performance of LDCs and their associated high levels of poverty and poor development and social indicators. This has altered the international community to the need to seek ways and means to relieve the suffering of the citizens of these failing states. The two important aspects of solution to this problem are: domestic policy reforms and debt forgiveness. Donor focus is on financing reforms of domestic economic policy allied to

institutional reforms, multi-party politics, transparency, good governance and the achievement of the MDGs targets. This implies a new orientation of trade and investment policies in LDCs and efforts to obtain a larger share of global trade and investment flows. Concerns for aid effectiveness by donors and the relative unattractiveness of poorly endowed LDCs is the context in which these policy initiatives are debated and implemented. This suggests a need to improve the impact of both public and private inflows to developing countries. The mechanism offered in this thesis is a linking of Aid to FDI i.e. our interaction term: Aid-FDI. Here we suggest a model in which aid is used to improve the absorptive capacity of poor countries such as Uganda by co-financing infrastructure and private sector projects.

## **Chapter 2**

### **Literature Survey of Aid and Foreign Direct Investment**

#### **Section 2.0**

##### **Introduction**

With an assessment of the policy implications for our case study country, Uganda, this chapter provides an overview of the main theories on Foreign Direct Investment (FDI) and Aid, respectively. It is not comprehensive in its coverage but identifies the major areas of debate in the theoretical literature. This is complemented by reference to a number of empirical studies. The present effort also complements subsequent chapters which have explained the determinants and impact of FDI on recipient economies. Whilst the current chapter is focused on the theories of FDI and Aid respectively, subsequent coverage in chapter 3 is focused on the determinants of FDI and its impact on host country trade and economic growth. As relationship between FDI inflows and its impact on economic growth is controversial, and as explanations of recent trends in FDI flow have sort to discriminate between the different types of FDI, chapter 3 will therefore make a contribution in this area.

#### **Section 2.1**

##### **The Evolution of Theories on FDI**

Initial theorising on direct foreign investment treated the phenomena as an example of international capital movement (Kindleberger, 1969). The pre-occupation with the variety of forms through which these cross-border movements occurred were elevated to primacy of place in academic studies on direct foreign investment. This perspective linked FDI to neo-classical trade theories followed by a focus on industrial organization theories, the locational/geographic, theories on economic growth or growth economics, development economics and political economy. The operation of equities, exchange markets, the issue of new securities i.e. bonds, stocks and other financial instruments were examined for their determinants. This led to the differentiation of direct

investment from other kinds of international capital movements on the basis of its association with varying degree of control, technology, management and marketing expertise. Much of these early studies were concerned with the activities of United States multinational firms and the capital movement features of direct investment elevated to primacy of place. This perspective resulted from US balance of payment problems and the imposition of a set of voluntary controls on direct investment in the early 1960s (Kindleberger, 1969), which were converted to mandatory restrictions some three years later.

The rapid development of capital markets in the US and Western Europe in the mid-60s stimulated further interest in the capital aspects of FDI. This was accompanied by new theoretical conceptualisations on its determinants and on the emerging links between national capital markets. Furthermore, the relationship between these integrating markets and the first generation of multinational firms became a matter of great interest for academic economist. Furthermore, the development of markets for whole companies as in cross-border acquisition and mergers was also a matter of theoretical interest in contrast to the trade in marketable securities through organised and well established markets. However, economists soon found a number of anomalies with theoretical formulations and hypotheses which sort to explain foreign direct investment in terms of capital movements. The first of these anomalies resulted from the empirical observation that investors often failed to take capital with them when acquiring foreign assets; instead, they would raise the required capital locally i.e. in the local capital market. In this case gross capital movement occurred -with the acquisition of the asset designated as 'outflow' and the incoming liability (an inflow)-but not net. Other than this the acquisition of a foreign asset could occur through the exchange of assets: patents, technology, or machinery and against equity claims; thus avoiding the flow of capital through the exchange associated with capital movements. On this basis, direct investment occurred through the reinvestment of profits, with the outflow of funds being matched by revenues on past investment, but again no movement of capital through the foreign exchange markets.

These developments suggested that direct investment is more readily attributed to capital formation, and not necessarily associated with cross-border flows. The second problem associated with the capital movement hypothesis result from the observed fact that direct investment often takes place simultaneously in two directions. For instance, British companies invest in the US and US companies invest in the UK. This two-way flow of capital is the result of investors adjusting their portfolios as risk minimisation, or to reduce taxation exposure, confiscation or other negative externalities to security of investment, or its growth, rate of return/yield and maturity cycle. The author concluded that these concerns and deficiencies in the capital markets hypothesis mean that direct investment may be associated with capital movement, but in truth it is not universally true. Notwithstanding, this observation, the issue of definition has been very problematic as direct investment has long been defined as capital movement involving control by investors.

In legal terms control is achieved when the investor has equity ownership amounting to 10, 25, 48, 51, 95, or 100 per cent of the foreign asset and/or subsidiary. However, the 1968 mandatory restriction on foreign direct investment by US Multinational Enterprises (MNEs) chose 10 per cent as the criterion (Kindleberger, 1969). From an economist perspective ownership is vested in decision making and taking. It follows that control is only significant in so far as it affects behaviour. Furthermore, control is now associated with significant political dimension. This has been the case historically in the LDCs post WW11 and post-independence for many former colonies. This is, according to the author, the result of unresolved international disputes and historic enmities. In the case of the former, self-determination and national sovereignty as the US assumed the rights to instruct domestically based multinationals to direct the activities of their foreign subsidiaries in line with national interest, with host governments challenging these rights. The political dimensions of the two elements of control: the intervention of governments to achieve national objectives with respect to the behaviour of multinational enterprises headquartered in their jurisdiction in contrast to the economic and legal, attempts of other countries to resist them.

## Section 2.2

### **The Internationalisation of Production & FDI**

Foreign production is traditionally the focus of literature on the activities of multinational enterprises. In this the relationship between capital flow and the activities of multinationals is explained under 'the growth of the firm'. The MNE was conceived as simply an arbitrageur of equity capital from economies which produced low rates of return to countries short of equity capital and which generated higher marginal rates of return. The latter are equity poor. This differential rate of return is cited as the major motivation and driving force for the movement of capital across national borders. This explanation embedded the MNE in a body of general-equilibrium theory about the inter-relationship of internal trade, international movement of factors of production, and distribution of income. A number of empirical implications follow from this theorising: MNEs should be significantly in numbers in countries best endowed with capital (where its domestic marginal productivity is therefore lowest).

They should export capital to countries/economies short of capital and those generating the highest marginal productivity of capital. Hymer (1960) found that the theoretical role of the MNE as capital arbitrageur were neither developed analytically nor tested empirically. He argued that the capital arbitrage hypothesis was an inadequate explanation of certain pattern of behaviour observed in MNEs.

These were:

The United States, a long established net exporter of foreign direct investment was a net importer of portfolio capital. The resulting question highlighted the fact that equity capital, according to this hypothesis is cheaper and portfolio capital, on the other hand, dearer in the United States relative to the international community. These observations suggest that US investors are keen risk takers.

There is a two-way movement of MNEs across national borders and some host countries are also the domestic base for MNEs and subsidiaries of foreign multinationals. It follows from the above that if the movement of foreign direct investment is purely arbitrage of capital, large financial

intermediaries would dominate in this activity. In fact, large non-financial and primarily manufacturing companies show a weak level of correlation with long term interest rates in individual host countries.

Hymer's challenge of the capital arbitrage explanation also laid the foundation for a microeconomic perspective of MNEs by pointing out that they are not randomly distributed among industries and competitive conditions in particular product markets influence foreign investment. The capital arbitrage hypothesis fails on two counts: International differences in expected profits are insufficient to stimulate foreign direct investment and cross-border flows are not dominated by large financial institutions.

### **Section 2.3**

#### **Output and Market Size Hypothesis**

The first of these two hypotheses, the output-hypothesis operate at the micro level and it is based on the assumption of a positive relationship between the output (sales) of a firm in the host market and its foreign direct investment. On the other hand, the market size hypothesis is applied at the macro level with GDP and/or GNP used as a measure of market size. These are proxy measures of market size/output. The components of these hypotheses are derived from the domestic behaviour of firms, which demonstrate a positive relationship between increasing sales and the level of domestic investment as well as a strong association between investment and rising GDP. Jorgensen's model (1963) provided a measure of explanation for the above. Although derived from neo-classical domestic investment theories Jorgensen's model is cited by Agarwal (1987) as the best theoretical model of its kind i.e. output hypothesis although it is a variation of the Cheney (1952) and Koyck (1954) flexible accelerator model. According to Agarwal, studies on the market size hypothesis are deficient in that they are not forthcoming in their assumptions and on the objective function of their theoretical models. Accordingly, it is not possible to attribute to them the same or similar theoretical background as those in the output hypothesis. For the author, the inherent weaknesses in the theoretical underpinning of this hypothesis resulted in empirical studies, which sort to demonstrate



an association between market size and inflows of FDI to host countries. It is further argued that studies of output and market size hypotheses are often confused in that it is often difficult to assign some studies to the appropriate nomenclature i.e. whether for instance a study should be included in the group of hypotheses associated with the assumption of market failure.

The author finds favour with the output hypothesis citing it as more “prestigious”, and as a product of a superior theoretical treatment whilst acknowledging the popular use of market size hypothesis over the past several decades. These findings were supported by Steven (1993) who found significant statistical evidence for a positive relationship between the flow of US FDI and the manufacturing output of a number of host countries. These included Argentina, Brazil and Venezuela over the period (1957-1965). This position is supported by Bandera and White (1968). The latter found statistically significant association between US FDI in Europe’s EEC (now EU) countries and their gross national product (GNP). The authors concluded that the various motivations reported in Behrman’s (1962) studies could be interpreted as a desire to enter expanding markets as indicated by the growth of GNP of the host countries. Further examination of US FDI by Scaperlanda and Mauer (1969) in an attempt to empirically test the market size hypothesis as it relates to US export of FDI to the EEC, over the period 1952 to 1966, yielded results which allowed the conclusion to be drawn that the market size hypothesis was supported statistically. However, these findings were later challenged by Goldberg’s studies (1972). The author concluded that these investment flows could be explained by reference to the growth of the host market (EEC) and not by its size. Goldberg’s study made use of a larger sample of developing countries than that used either by Steven (1969) and Reuber et al (1973), respectively and produced statistical evidence which showed that the flow of US FDI (on a per capita basis) into less developed countries (LDCs) was positively correlated with the size of host country as indicated by GDP; not with its rate of growth as in the rise in GDP and in accordance with earlier studies by Bandera and White (1968) on US FDI in the EEC. Reuben et al’s test of the relationship between the flow of FDI and changes in market size as indicated by expanding GDP or value adding

manufacturing subsidiaries in LDCs with time lag found no conclusive evidence for a relationship between the two variables. Furthermore, interviews of the company executives by the researchers did not produce links between annual FDI flow to changes in sales or output.

Takahashi (1975) neo-classical profit maximising model which explain short-run changes in US FDI, produced results which indicated that investors' optimal real capital stock is a function of price levels in the host economy and increase or decrease in value with corresponding price changes in the investing country. These findings applied to domestically oriented FDI. The relative performance of the host economy and the investing nation, the differential growth rate of gross national product (GNP) constituted the two important independent variables and regression analysis confirmed them as proxy for market size and determinant of US FDI.

Root and Ahmed (1979) found economic integration to be a significant discriminator of FDI. Schwartz (1976) found that inflows to the EEC and LAFTA were positively correlated to sales, however, in relation to market size, the relationship to inflow varied between two regions, absolute size of the market of the recipient country emerged as the principal determinant of FDI in the case of the EEC, however, growth rate of the market was the major determinant of US FDI flow to LAFTA economies. Schwartz (1976) explained the above on the premise that whilst the initial inflow of FDI may be determined by the size or growth, sales and profit will determine Subsequent/ later and additional investment. Overall, these studies have supported the market size and output hypotheses-not withstanding significant inconsistencies and variations in variables, assumptions, data, specification and methodology. The output and market size hypotheses suffer from the following failures:

- 1) Both hypotheses are founded on questionable assumptions associated with neo-classical theories of domestic investment.
- 2) Market size may influence FDI inflow, which is inclined to production for domestic consumption but not for export-oriented activities.

- 3) A large number of studies of market size hypothesis failed to differentiate between the different types of FDI.
- 4) Although statistically related, GDP and FDI, the structural relationship between the two are not clearly understood, Reuben et al (1973).
- 5) Output hypothesis statistics incorporate FDI tied-up in inventory and financial assets, when, in fact, it should only include investment in plant and equipment in host country in keeping with the analogy of domestic investment theory.
- 6) Output statistics are subject to distortions and deficiencies as reported profits in the case of differential rates of return hypothesis. Decision on initial FDI may be significantly different from that on later expansion of further inflows, Wender ( 1955 ) Penrose (1956 )
- 7) Subsidiaries once established have their own investment criteria, so initial investment must be analysed differently and compared to initial investment decision Penrose (1956).

Lucas (1993) used a model of derived demand for capital with multiple product monopolist, was to investigate the relationship between investment inflow i.e. FDI and production costs for seven Asian countries in the seven countries. All seven countries included in the study were major recipients of FDI inflow. The author recognised a number of commonalities: common policy initiatives by the governments of the regions; effort to restrain wage inflation, the role of organised labour. The results obtained by Lucas suggest that the impact of increased labour costs had higher capital intensity, thus supporting a negative relationship between labour compensation and FDI inflow.

The impact of industrial dispute on investment inflow of the type concerned with in this study was inclusive although analysis of the data produced some weak evidence/link for a negative relationship between the two. The author also found evidence for a lower elasticity between inflows and cost of capital (inclusive of tax) than to increases in labour compensation rates. The validity of this conclusion is tempered by the difficulty of determining cost of capital. The results also support a positive relationship between rises in costs differential between the investor's home base and the

host country i.e. a rise in investors' home country is weakly associated with an inflow of FDI. However, Lucas did not find systemic evidence to link cost differential across the seven economies with enhanced inflows. For Lucas the irrelevance of relative cost would suggest that policy makers cannot rely on lower relative costs as an inducement for FDI. This study also provided some weak support for a positive link between the size of domestic consumption as indicated by the level of consumption spending and the rate of FDI inflow. The results obtained also provide a weak link between increasing foreign reserves and FDI inflow. The latter was found to be responsive to income in major export markets. The finding that FDI is more elastic with respect to aggregate demand in export markets of the seven economies than with respect to domestic demand was highly significant as the sample economies are celebrated for their export orientation. The latter approach has been recognised for its significant contribution to the development of the economies of the region Killick(1993). Furthermore the region has also become, in recent times a major source of FDI investment.

The decline of the developed countries as host of FDI in flow was demonstrated by Lucas (1993). The author presented figures, which shows a decline in inflows to developed countries during the 70s and 80s whilst at the same time Asia, for example, share of aggregate inflows rose from 8 per cent of the world total (1972 - 87) or 29 per cent of FDI in developing countries. This grew at 49 per cent by 1987. Furthermore, the author argues that the economies of the region were, with little exception, established on a development strategy characterised by export-oriented and out-ward orientation. It is therefore reasoned that the domestic market size was unlikely to be of much relevance in the earlier stages of the development process across the region. Furthermore this study established that labour costs had little unanimity across the region. The critical issues for Lucas, is labour quality.

## Section 2.4

### Explaining MNEs Investment Behaviour

This section outlines some of the theoretical arguments which have attempted to explain the international behaviour of MNEs as it relates to their decision to establish foreign-based facilities and FDI. The initial development of these hypotheses was based on Hymer's (1960) thesis and later refinement by Kindleberger (1969). The authors argued that foreign-based companies must have a unique ownership advantage that allows them to achieve superior position in the market of host countries with competing firms. That is to say, they make good disadvantages in foreign markets and in overcoming these negatives and otherwise unfavourable circumstances achieve higher profits than local firms. Comparative disadvantages range from lack of customer knowledge, taste, legal system, institutional framework, business and socio-cultural systems. Amongst the comparative advantages the foreign (Agarwal, 1976) firm must have are brands, patented trademarks, non-marketable technology, managerial skills, and superior ability to deliver customer centered benefits. These firm specific advantages allow them to participate in foreign direct investment (FDI).

This section also discusses the implications of the monopolistic competition hypothesis and its explanation of FDI. This perspective on the firm and its investment behaviour resulted from the weaknesses inherent in earlier hypotheses – Capital arbitraging and its links with decision-making and its association with capital formation, technology and management expertise. These have limited capacity to explain the growth of the firm. For as long as foreign markets continue to be served by imports, as well as by local production by subsidiaries; the idea that direct investment is a function of markets, is unconvincing. According to Kindleberger (1969), the level of effective control over the investment is the decisive factor in understanding direct investment. However, the author left unanswered his question: 'why do some firms want control and not others?' Hymer's (1960) take on direct investment require a perspective in which investment activities are viewed from the theory of industrial organization rather than the theory of international capital movement. Operation abroad in environment characterised by higher costs and greater risks and unfamiliar

political and legal constraints requires a higher rate of return. If however, the picture is much less complex and capital arbitrage is the proper explanation of direct investment, then this differential rate of return would suffice. However, higher relative rate of return is an insufficient explanation, as capital would move through capital markets rather than through firms involved in the production and distribution of goods and services across national borders. Here, Kindleberger argues that according to industrial organization theory, firms are less efficient than capital markets which are exclusively concerned with the international movement of capital under competitive conditions.

Accordingly, investing firms must obtain relatively higher rates of return than local firms in the host countries, not just higher rates relative to companies in their own base. These higher rates of return must be seen in the context of the costs of operation across borders and the expenses associated with distance, and time lost in communicating (Caves, 1971) information for decision-making, the greater cost of correcting mistakes and errors. A foreign investor must have advantages over existing firms or be potentially competitive in their local markets. It follows from this that unless the foreign firm possess advantages, which cannot be readily copied by local rivals, it will not sustain a position in a competitive and unfamiliar environment. However, firms that possess some transferable advantage that cannot be acquired by local firms will achieve a competitive advantage and higher relative rates of return than local firms. This possibility of higher rates of return based on patent is based on the imperfect market hypothesis. According to this explanation, perfect international markets for technology, management, labour skills, and local firms would inevitably serve competing foreign markets.

However, in an imperfect international market for goods and factories, direct investment flows will allow foreign firms with patents to displace local firms in their own domestic markets. The advantage to foreign firms is increased by government interference in competition – via preferential tax treatment and/or incentives. Cheaper factor cost does not explain why production is not undertaken by local entrepreneurs; who have a relative advantage over foreign investors.

Kindleberger argues that foreign firms require more than compensating advantage before direct investment will occur. It is thus concluded that market imperfection, in itself is an incomplete explanation and investing firms need more than monopolistic advantage. The conditions under which monopolistic firms produce direct investment are indicated under the following headings:

- Departure from perfect competition in goods markets in checking product differentiation, special marketing skills, retail maintenance, administered pricing;
- Departures from perfect competition in factor markets, including the existence of patented or unavailable technology, of discrimination in access to capital, of differences in skills of managers standards into firms rather than hired in competitive markets;
- Government limitations on output or entry.

Elaboration of the above points begins with some remarks about goods markets. This market results from product innovation and differentiation. Kindleberger cites the “prevalence” of branded goods in consumer markets as evidence of this assertion. He also argues that oligopolistic firms, i.e. which possess certain advantages not shared by rivals are able to secure a competitive advantage of other firms and particularly in foreign markets where this unique asset is more readily exploited by its owner. The exclusive ownership of these advantages/patents constitutes a barrier to entry, thus allowing the owner to achieve a monopoly status. Its rates of return will be relatively high to those of local firms in foreign markets. Dunning (1979) highlighted benefits of ownership advantage as: superior technology, innovative capacity and product differentiation, in the case of United States companies. To these Lall (1980) added Capital intensity, economies of scale, and superior skills. Coves (1971) argue that two conditions must be met for direct investment to occur: the return on the investment must be greater than the investment, the return; because it is based on advantages in a foreign market must be allied to production abroad where the advantages are standard. The need for a relatively higher rate of return is justified by the costs incurred in data gathering, analysis and decision-making. What is suggested here is a risk premium to account for a greater level of uncertainty. Traveling and communication costs may be of a magnitude to dictate that the

investment is of minimum size in order to achieve critical mass as well as providing a return sufficient to meet the cost associated with it. It follows from this that as these costs are likely to be relatively large FDI is generally associated with large firms.

Foreign production is preferred to a number of alternatives – licensing, selling or renting of trademarks, technology, managerial or marketing skills to foreign operators on the exporting of goods which capture a competitive advantage in local markets. Production-related direct investment is according to this reasoning occurs when the source of the competitive advantage cannot be transferred in association with the above factors. Vernon (1966) argues from the product cycle perspective i.e. the product cycle hypothesis in which innovation and production occurs in the developed markets. The location of initial production and the innovation, which precedes it, is determined by the input need of the two processes: research and development (R&D) – co-ordination between the research personnel and production marketing. Later competition in the market for the product and increased standardisation, and input requirements changes in export markets provide a basis for production in foreign markets. Thus, foreign direct investment and the technology displace exports (Lall, 1980).

## **Section 2.5**

### **Distribution of FDI to SSA Economies**

In this section we outline the stylised facts on the flow of FDI to Africa with a focus on Sub-Saharan Africa. This chapter compliment by a detailed analysis of Uganda's FDI experience. Subsequent chapters have a detailed discussion of the government's privatisation program and its focus on enhancing the inflow of FDI to the economy overall and to the infrastructure sector in particular. The latter provides opportunities to demonstrate our hypothesised FDI-AID interface and the policy implications for LDCs and their strategy for improving private sector inflows.

One of the most disappointing stories of Sub-Saharan Africa is the seemingly intractable problem of encouraging higher levels of private capital to non-traditional sectors of the economy (Moss and



Ramachandran, 2005). In truth, this is a failure to engineer private sector-led economic transformation. The figures show a poor response by foreign investors to ongoing policy initiatives such as the privatisation of state monopolies and the opening up of many sectors of economy historically excluded from private (domestic and/ or foreign) participation. The utility sectors: telecommunication, transport and power are largely now open to foreign and domestic firms. The privatisations of state-owned companies have provided opportunities for inflows of equity, new technologies and modern management practices. The need for foreign investment is reflected in efforts to put in place investor friendly macroeconomic policies: liberalization and privatization of state-owned monopolies linked to infrastructure-liberalisation: devaluation of national currency and a host of incentives and multilateral and bilateral trade and investment agreements. These are highlighted in section 2.6.

Policy makers in poor developing countries and especially those in SSA economies have recognized the need to improve their international competitiveness for FDI as they have traditionally depended on public inflows and these declined over the 1980s and 1990s. The Emerging consensus is a need for significantly enhancement of private capital inflow. The World Bank for instance is both an advocate of private sector development programs in Developing Countries (DCs) and Least Developed Countries (LDCs) (World Bank, 1995). In response to these pressures and partly because of their significant indebtedness to international lenders and their dependence on concessional inflows: ODA and grants, the majority of them have initiated wide scale economic reforms from the 1990s to expand the role and contribution of domestic firms and foreign investors. These developments are formulated in Structural Adjustment Programs (SAP) and Enhance Structural Adjustment starting in the 1980s and Debt Forgiveness programs to qualifying countries. Many of these countries are located in SSA. Reforms linked to market friendly policies were argued to be vital for the long term growth and development of SSA economies and part of a package of Western assistance to tackle poverty and Aids in DCs and LDCs. The macroeconomic environment

in which these initiatives are being framed is one characterised by liberalisation, devaluation of exchange rates and policies which are generally investor friendly. The overall expectation of policy makers is that these developments will foster long-term economic growth and development thus providing greater opportunities for private sector firms (Woll, 2008) to participate in the growth and development of the economy. And for FDI to play a greater role in the structural transformation of the economy through the emergence of new industries and non-traditional patterns of employment which are (Ram, 1987), Landau (1986) capable of simultaneously creating demand for new skills and the capacity to absorb and exploit more advanced technologies.

The flow of capital to developing countries has undergone a sizeable revolution in that whereas the 1970s was associated with official loans and aid, recent inflows as in the 1950s is characterised by Foreign Direct Investment (FDI). The rise of official flows was made on the basis that Least Developed Countries (LDCs) were incapable of financing their growth and development from exclusively domestic sources. This coincided with poor credit worthiness and the impact of the 1970s oil crises and the resulting drying-up of international flows to the developing world in the early 1980s.

## **Section 2.6**

### **Recent Inflows of FDI to SSA and regions**

This section of the chapter critically assesses the experience of SSA countries over the past several decades. The focus is on the aid and private financial Flow to these countries. Whilst the 1980s were associated with further declines in both types of inflows to SSA countries, the 1990s were associated with resumption in private inflow. This was sufficiently large to compensate for the decline in public inflows. The catalyst for enhanced inflows was macroeconomic policies characterised by market liberalisation and the privatisation of state-owned assets (Ram, 1987) and Noorbakhsh and Paloni (2001). Unlike earlier foreign capital inflows, most of the inflows were in the form of non-debt FDI and bonds. According to Akyuz and Cornfold (1999), in nominal terms,

the flow of capital on a net capital inflow basis increased by over twenty-fold since the 1970s. However, relative to the increase in the purchasing power of developing countries i.e. their ability to buy foreign imports of goods, the import price index, net capital inflows increased by a more modest five-fold. The growth in private inflows Akyuz and Cornfold (1999) when viewed from the share of output of recipient economies, enhanced inflows represented an improvement in contrast to the decline of the 1980s rather than a long-term resurgence. Whilst the resurgence of the 1990s was significant, as a percentage of aggregate GNP, it was lower than that achieved during 1975-1982.

**Table 4 Aggregate net capital inflow to developing countries: by type of Flow, and net transfers, 1975-1998**

	1975-1982	1983-1989	1990-1998
Total net inflow	Percentage of GNP		
Including China	4.91	2.87	5.0
Excluding China	5.45	2.97	4.22
Official inflows	1.58	1.57	1.03
ODA Grants	0.53	0.62	0.56
Other official	1.05	0.96	0.47
Private inflows	3.33	1.29	3.97
Non-debt-creating-inflows	0.42	0.55	2.21
FDI	0.42	0.53	1.67
Portfolio equity	0.00	0.02	0.54
Bonds	0.11	0.05	0.52
Bank credit	2.46	0.44	1.17
Short-term	1.10	0.10	0.72
Long-term	1.36	0.34	0.44
Memo item			
Portfolio inflows	0.12	0.07	1.06
Interest payments	1.49	2.58	1.79
Profit remittances	0.93	0.54	0.56
Net capital transfers	2.48	-0.26	2.65

Source: UNCTAD Secretariat estimates, based on World Bank, Global Development Finance, 1999, taken from: Akyuz, Y and Cornford, A: Capital Flows to developing countries and the reform of the international financial system (1999).

The distribution of FDI is uneven across SSA countries. The Lion's share is accounted for by only four countries and in accordance to their natural resource endowment and established patterns of

extraction and export of their mineral resources. For SSA the leading recipients of FDI are Angola, Botswana, Nigeria and South Africa (Salisu, 2003). With the exception of South Africa, these are oil rich or diamond rich countries with a long period of investment in extraction and exports. Of the \$2.5 billion stock (2002) of FDI in developing countries, SSA economies only account for a small fraction of this, some 5 per cent. On the other hand, Asia and Latin America account for 56 and 30 per cent, respectively. Notwithstanding, the relatively poor position of SSA countries with respect to the aggregate stock of FDI, present achievement resulted from significant economic and political reforms in the 1980s.

Annual FDI flow to SSA countries in the early 1991 amounted to some 4.6\$US billions and grew to 11.0 \$billion by 2002 (World investment report, Table 5). The corresponding figures for East Asia are \$ 59.83billion (1991) and 95.13 billion by the end of 2002. For Latin America & the Caribbean the figures are 27.07 \$US billion (1991) and \$ 56.02 billion at the end of 2002. Foreign Direct Investment (FDI) as a per cent of Gross Domestic Investment (GDI) to SSA countries grew by nearly 600 per cent from a low of 0.69 per cent in 1970 to 4.08 percent at the end of 2001 and East Asia & the Pacific from 0.70 per cent in 1980-1989 to 3.0 per cent by the end of 2001 and from 0.72 to 3.67 per cent at the end of 2001 for Latin America & the Caribbean (World Development Database, 2003). As a percentage of fixed capital formation, FDI to SSA countries over the period 1970 to 1979 amounted to 2.07 per cent and this grew to 21.67 per cent by the end of 2001, 0.0 per cent for East Asia& the Pacific (1970-1979) which grew to 8.98 at the end of 2001. The corresponding figure for Latin America & the Caribbean is 3.08 (1970-1979) and 18.92 at the end of 2001. For SSA countries the share of global FDI flow has declined from 1.81 (1991-1996) to 1.69 at the end of 2002, 10.64 (1991-1996) to 8.6 per cent at the end of 2002 for East Asia& the Pacific.

**Table 5 FDI Inflows (\$ billion): Regional Distribution**

	1991-96	1999	2000	2001	2002
World	254.33	1079.08	1392.96	823.83	651.19
Developed Countries	154.64	824.64	1120.53	589.38	460.33
Developing Countries	91.50	229.30	246.06	209.43	162.15
Africa	4.61	12.23	8.49	18.77	11.00
East Asia & Pacific	59.83	108.81	142.21	106.94	95.13
China	25.48	40.32	40.77	46.85	52.70
India+	1.09	2.17	2.32	3.40	3.45
Latin America & Caribbean	27.07	108.26	95.36	83.73	56.02

+ India is in South Asia but is included for comparative analysis

Source: UN, *World Investment Report 2003: FDI Policies for Development: National and International Perspectives* (New York: UNCTAD)

## Section 2.7

### The evolution of Policy for FDI enhancement

The improvement of regulatory regime in favour of FDI, permitting profit repatriation is complemented by a package of incentives such as tax-exemptions to enhance foreign investment (UNCTAD 1997). Many of these policy initiatives emerged in the late 1990s (UNCTAD, 1997). Notwithstanding, historic animosities and ambivalence, a large percentage of SSA economies (26 of 32) had embraced liberal macroeconomic policy allowing wider and ‘deeper’ private sector (domestic and foreign) participation in the economy and the repatriation of dividends and capital (WIR,2003). Improvements in property rights-laws, wide-scale trade liberalisation and the opening up of important infrastructure such as power generation and its distribution, telecommunications and transport to foreign investors has created additional opportunities for enhanced inflow of FDI to many African countries. Annual inflows have risen from \$1billion in the 1970s to \$9.3billion (2000-2002), clearly undermining the orthodox view of FDI as imperial expansion and neo-colonial rule. However, recent development in economic policy signals the end of the long historic skepticism towards foreign private capital. Certainly the growth in competition for FDI has

challenged the ambivalence of SSA economies to foreign investors with a willingness to confront their recent history of exploitation and domestic policy failure.

**Table 6 Net FDI inflows to Africa**

Net FDI flow ( current billions of \$)	Pre-Monterrey (1998-2001)	Post-Monterrey (2002-2005)
Africa	11.9	18.1
Africa excluding NA	9.7	13.4
North Africa	2.2	4.7
Net FDI flow ( as % of GDP)		
Africa	2.1	2.4
Africa excluding NA	2.9	2.8
North Africa	1.0	1.7

Source: Economic Report on Africa 2008: Africa and the Monterrey Consensus: Tracking Performance and Progress

The demise of South Africa’s apartheid regime and the pivotal role assumed by the said across the region and internationally means that it is expected to become a regional “growth pole” and the major component of the Southern African Development Community (SADC). With a GDP of \$125 billion, approximately three times (WIR, 2003) that of the aggregate for the other 13 members of the SADC, South Africa will direct the pace of growth and development of the cluster. Furthermore, South Africa’s large domestic market and many technology-based companies will provide opportunities for enhanced inflows of FDI and technology to the region with the possibility of sizeable spill-over for member countries. As SSA countries cannot maintain trade and investment policies based on the inflow of FDI to large protected markets i.e. tariff-jumping FDI nor on the imposition of performance requirement and regulated market access so the need for regional clusters such as SADC is clear.

Clusters such as SADC addresses a major challenge for SSA economies:the relatively small size and lack of scale economies and the absence of significant domestic demand for manufactured goods. These weaknesses support the move to establish regional and sub-regional clusters such as SADC and COMESA. More will be said about these and their strategic importance to improving the inflow of FDI to Africa and SSA economies in particular.

**Table 7 Net Private Capital flows to developing countries by region (US\$ Billions), 1998-2005**

Year	1998	1999	2000	2001	2002	2003	2004	2005
East Asia & Pacific	6.5	28.8	28.0	39.2	58.9	81.5	125.4	137.7
Europe & Central Asia	66.7	50.9	51.5	33.1	59.7	101.1	160.2	191.7
Latin America and the Caribbean	98.5	95.8	85.2	59.5	28.2	49.9	59.3	94.4
Middle East & North Africa	8.1	2.6	3.3	4.8	8.3	7.8	8.3	14.6
South Asia	5.3	3.5	9.7	5.8	10.1	15.8	22.7	23.6
Sub-Saharan Africa	13.7	16.7	9.9	12.1	6.3	15.8	20.7	28.44

Source: World Bank Debtor reporting system and Staff estimates

## Section 2.8

### FDI and Regional Clusters

This section of the chapters links to the previous section in further exploration of regional clusters as possible solutions to small domestic markets of SSA economies as well as a means of giving tangible weight to the process of regional capacity building, economic and political convergence and with this a common view on trade and investment policies.

One of the many enduring negatives associated with African countries is the image of Africa as a whole and SSA countries in particular with inter and intra-country military conflicts, often involving violent crimes against the civilian population and the total collapse of the rule of law and the institutions of government. Recent conflagrations included several states coalescing around different warring factions in the Congo Republic drawing in a number of neighbouring states such as Uganda, Rwanda, Zimbabwe and others and as far south as South Africa.

However, in recent times policy makers in these countries have come to recognise, with the aid of external assistance and sanctions, the need to address the underlying causes of conflict and the need to establish mechanisms for their prevention and effective resolution. The establishment of NEPAD in (WIR,2003) which embraces locally derived solutions to local issues, a system of Peer Review and consultation has begun to address both the negative perception/ image of would-be investors as well as embarking on sub-regional drive to improve governance, political accountability and

general investor concerns. The establishment of investment promotion agencies (IPAs) and sub-regional clusters such as the Southern African Development Community (SADC) and the Common Market for Eastern and Southern Africa (COMESA) are providing opportunities for policy convergence and the emergence of significant markets for manufactured goods, common trade and investment rules and hence increased opportunity for manufacturing and market seeking-FDI. These developments may trigger the improvement of regional trade related infrastructure and harmonized trade procedures; facilitating intra and extra regional market access.

**Table 8 FDI as a percentage of GDP inflows: Regional Share (1970-2001)**

	1970-79	1980-89	1990-99	2000	2001
Sub-Saharan Africa	0.69	0.29	1.09	1.89	4.08
East Asia & Pacific	na	0.70	3.48	2.81	3.00
China	na	0.52	4.09	3.56	3.82
India+	0.04	0.04	0.39	0.51	0.71
Latin America & Caribbean	0.72	0.78	2.21	3.87	3.67

+ India is in South Asia but is included for comparative analysis

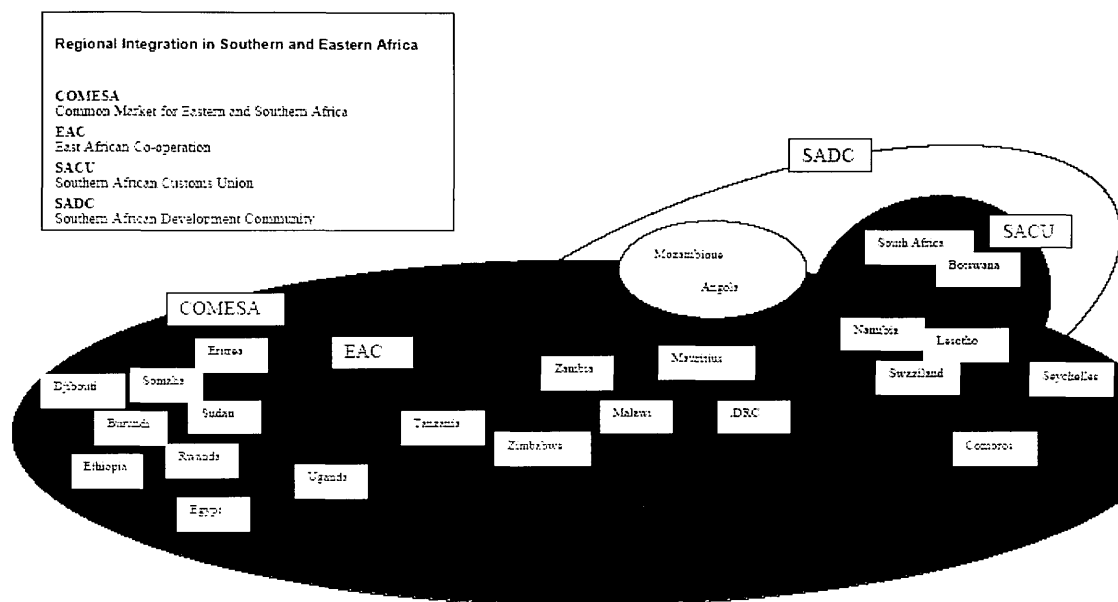
Source: World Bank, World Development Indicators Database 2003 (Washington DC, World Bank Publications).

The development of these regional clusters (Figure 6) is clear indication of the efforts in these respective regions to facilitate integration of markets and intra-regional trade and investment policies. As market size is widely viewed in the empirical and theoretical literature as a major determinant of market seeking FDI (UNCTAD, 1995), the integration of regional markets will provide additional attraction to FDI, overcoming traditionally highly fragmented small markets of the region (Tillett, 1996). A significant number of SSA countries have affiliated to the World Association of Investment Promotion Agencies (WAIPA), providing national agencies with a variety of services such as ‘best practice’ policies, training for national investment promotion agencies and affiliated members: information and guidance on trade and investment. A rapid increase in the number of bilateral agreement between the economies of the region and with extra-regional trade partners is seen as a means of conveying their good intentions towards FDI as well as



agreeing transparent and equitable conditions for foreign investors. According to UNCTAD (1998) African countries concluded some 184 bilateral investment treaties, resulting, according to the organization, in the establishment of a “more secure environment for foreign investors on the continent.”-see Table 9.

**Figure 6 Regional Integration in Southern and Eastern Africa**



However, on taxation treaties such as the double taxation treaties (DTTs) progress has been slow among SSA countries with Mauritius, Tunisia and Egypt accounting for the majority of these (UNCTAD, 1998). A significant point here is that these economies have a relatively long and successful history of FDI inflows. However, a majority of African countries are signatures to MIGA and the convention on the settlement of investment dispute between states and national of other states (ICSID). These developments represent a convergence of trade and investment policies between African states and non-African countries.

**Table 9 Bilateral Trade Agreements**

Organisation/ Convention	MIGA	ICSID	CREFAA	WIPO
No of members	41	42	26	40

MIGA= Multilateral Investment Guarantee Agency, ICSID = International Convention on the Settlement of Investment Disputes between States and Nationals of other states, CREFAA =Convention on the Recognition and Enforcement of Foreign Arbitral Law, WIPO = World Intellectual Property Organisation.

### **Section 2.8.1**

#### **The spill-over process**

Analysis of the contribution of TNCs to the international dissemination of technology associate the process with the external effects or spill-over from FDI. Spill-over are said to occur when the TNC cannot capture all the attendant benefits resulting from the establishment of affiliates in host countries. These include for example: enhanced productivity of local firms, greater efficiencies, access to more advance technologies, management techniques, new product ideas and markets and greater access to skilled labour force. The latter resulting from higher levels of investment in training and development programs by TNC affiliates.

The investment activities of TNCs in overseas market is characterised by and differentiated from that of local firms in that they carry with them significant amounts of advance technologies and proprietary knowledge (Wang, 1990) and managerial expertise which confers firm-specific advantages enhancing their competitive position in the market relative to that of local firms which have the advantage of local networks, established customer-base and a reputation in the market. The entrance of a subsidiary operation may pressure local firms to imitate their technical and managerial processes in order to maintain their market share and customer base through gains in productivity, cost reduction and greater efficiency.

The view that spill-over is the principal vector of technology dissemination is supported by the fact that the technologies common to the affiliate of TNCs is often not available to local firms (WIR, 2005). If it were it would undermine the rationale for the establishment of affiliates in markets where it is present. Conceptually, TNCs have the principal means of extracting advantage from its superior technological endowment: production for export in its domestic market, alternatively, it

may sell its technologies to overseas firms, or establish an affiliate, allowing direct control of its technologies and operations. The decision to take the latter step is dictated by the fact that the market for technologies are generally imperfect, increasing transaction costs in the event of sales of technology to an external firm (Kindleberger, 1969). Another fact which supports this decision is the danger of under-pricing proprietary technologies and the potential threat of rival firms with access to this technology. For the TNC the obvious response is internalisation and the establishment of overseas affiliates in preference to licensing and other arrangements which may involve technology transfer.

The tendency to established overseas subsidiaries is all the greater when the technology is closely linked to the principal activities of the TNC especially when it is associated with greater profitability and enhanced competitiveness (WIR, 2005). For local firms the main opportunity to acquire FDI-related technologies is through reverse engineering of the products produced by the local affiliate and/or from former employees of the affiliate with knowledge of the technologies and processes used by the affiliate. It is evident from this that spill-over is generally more significant in the diffusion of advance technologies in countries well-endowed with a highly skilled worker force (WIR, 2005). An addition and contemporary process which supports the importance of spill-over in the diffusion technology is direct contact with users during the final stages of innovation i.e. test-marketing and 'early-adopter' assessment and evaluation; reducing the risk profile of the product (UNCTAD, 2005) as new customers obtain information from existing users on performance and price factors.

Foreign affiliates may by this means facilitate the adoption new technologies and product. The contagion effect is probably more important for LDCs which are by definition short of skills and technology (Mundell, 1957). Finally the overall expected positive outcome/effects of FDI on host economies is attributed to the inherent characteristic of TNCs as benefiting from economies of scale, ability to finance capital intensive projects/operations whilst exploring advance technologies.

The former allows TNCs to erect barriers to new firms with superior ability to raise capital for new projects or processes.

## **Section 2.8.2**

### **Conclusions**

What is clear from the above discussion is that whilst capital-poor developing countries are theoretically likely to gain more from even a relatively small amount of foreign capital, their low absorptive capacity, relative small domestic markets and tendency to pursue policies antagonistic to the interest of foreign investors, means that they command very little of the growing flow of global private equity capital, FDI. The magnitude of the challenge confronting LDCs is again indicated by the fact that their lack of economic diversity means that the little FDI they attract goes to traditional sectors and sectors for which markets are limited by policies pursued by the developed economies i.e. systems of subsidies such as for the trade in agriculture. The combination of these factors have constrained the ability of policies makers in these countries to diversify their economies away from over dependence on the primary sector. Trade distorting subsidies and a general decline in the terms of trade have reduced the incentive for technology intensive pattern of production even in traditional sectors in these economies.

What is also clear from the above analysis is the poor response of investors to development in SSA economies. In the main, investors have been slow to respond to changes of policies and the institution of trade and investment procedures which are recognised as a significant departure from long held practice of import-substitution. The fact that these changes result in a significant decline in government revenues and a consequent on the ability of the government to finance important public services such as health care and education, means that these changes are unpopular with a large section of the population. Furthermore, the privatisation of state-owned firms and the removal of monopolies and the reduction of barriers to trade may result in significant job losses in these firms and industries. To a good extent economic policy is driven by the need for LDCs to respond to the demands and prescription of their international development partners: principally the IMF

and World Bank. The latter is now an advocate of private sector development as outlined in its Private Sector Development initiative (PSD) advocating a greater role for the private sector in national development plans.

### **Section 2.8.3**

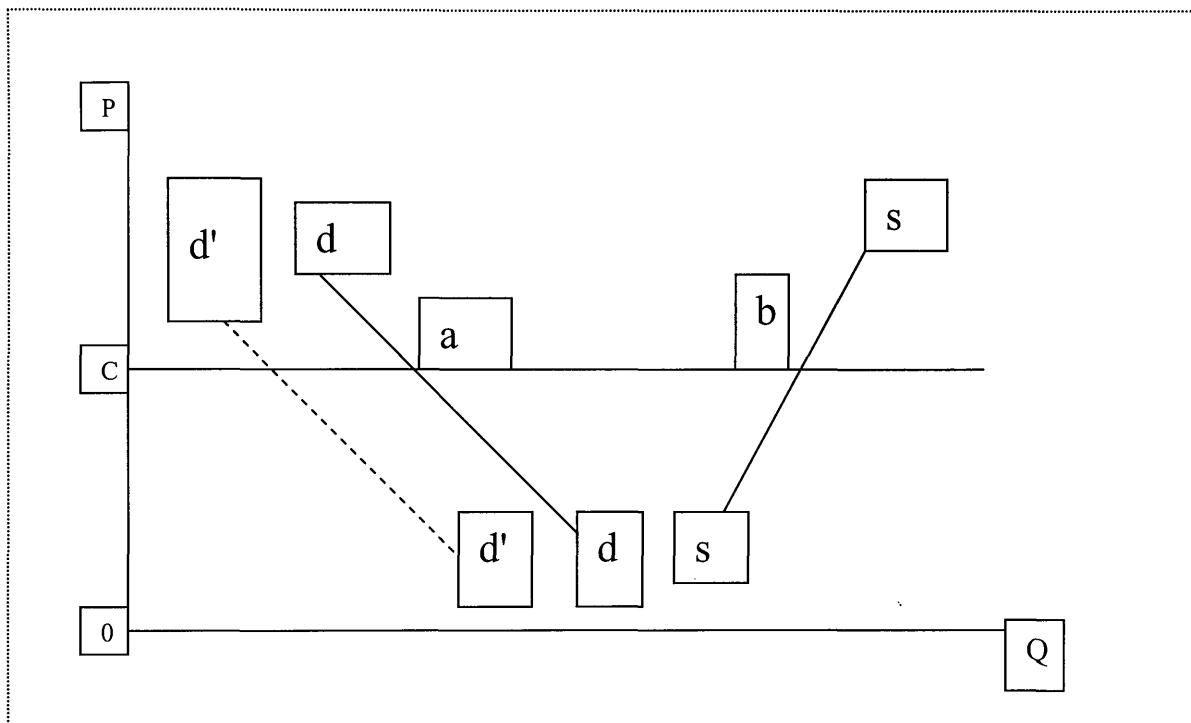
#### **The Two Gap Aid Model**

This section critically discusses the implications for Least Developed Countries (LDCs) of the two and three gap models, respectively and their origins. Empirical studies are introduced to explain in more details the practical issues relating to the inflow of resources either from trade or donor countries. The scenarios under which these gap occur and their resolution is discussed in some detail. The implications for economic growth and development is emphasised both from a review of the theoretical literature and from empirical studies. Finally the assumptions on which these models are based are critically discussed and the implications for policy development in LDCs are teased-out, identifying the principal objections to the models. The growth and development of an economy is at some stage in time characterised (Chenery 1969) by a situation in which one or a few of the factor(s) required for continued development is available in quantities less than that required with a consequent slowing or ending of the growth and development. In this case the injection of the resource in shortest supply to remove the bottleneck may result the resumption of growth and optimal utilisation of growth factors.

In their theoretical formulation and explanations of this bottleneck, Chenery et al, focused on a saving and investment gap and an import/export gap. According this explanation it is possible to derive a specific saving rate from a targeted rate of growth of the economy. This rate is associated with a capital-output ratio as the datum. Likewise, a fixed relationship between import and growth is established, allowing the level and rate of growth required to be determined. It follows from this that a savings gap will occur when domestic accumulations are inadequate to meet the required target when imports are at an inappropriate level. Under these conditions, aid fills the savings gap,

allowing the required rate of investment to be met. When, however, the savings are at the appropriate level, but imports are below the required level, a trade gap is produced.

**Figure 7 Savings Gap and Domestic Accumulation**



The function of aid in this situation is to finance higher levels of imports thus allowing the target to be achieved. The underlying assumption is the inability of the recipient to generate exports from savings. Central to Chenery's explanation of the two-gap phenomena is the focus on structural arguments in which the trading pattern of a developing country under specific sets of conditions is used to demonstrate the evaluation of the gaps. For instance, the economy can neither increase its exports nor reduce its imports without first industrialising its pattern of economic activity.

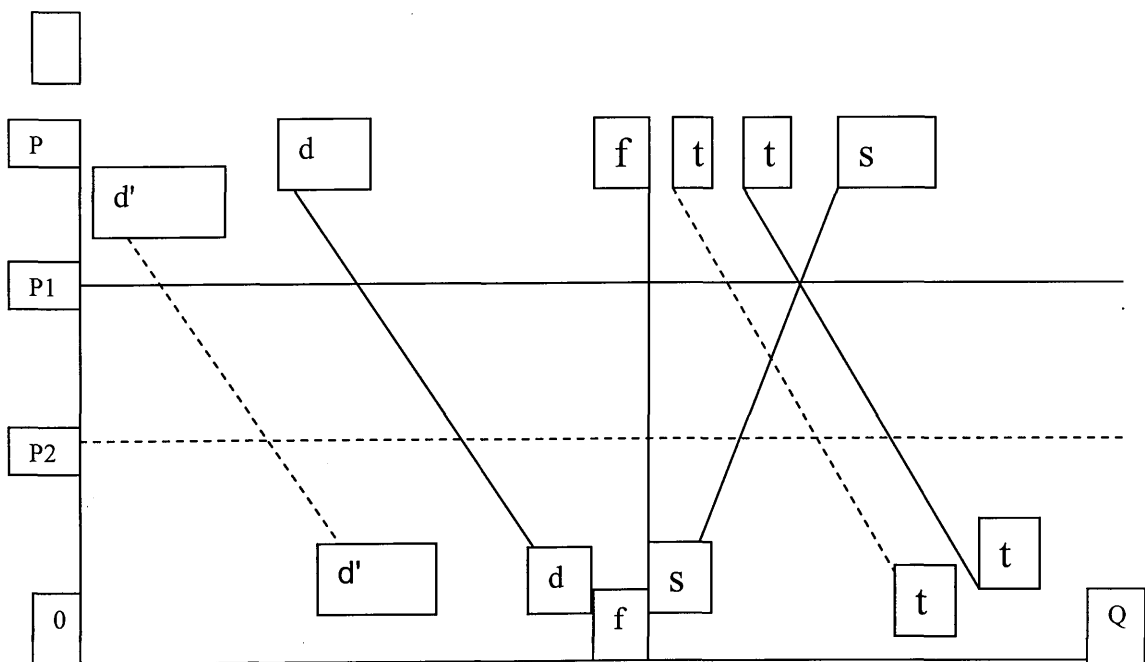
The demand for income generated by exports is determined by conditions in the foreign markets—significant increases in the demand for exports would also require higher levels of investment in productive capacity and improvements in organisational and institutional factors. The demand for imports results from limitation in domestic production and limited flexibility as well as reflecting changing consumer taste. These developments are illustrated in Figure 7. Assuming these inflexibilities, when trade gap is greater than saving gap, and resources generated from production

cannot be applied to the production of more capital goods or exports, Chernery argues, that the savings potential of the economy is “wasted”.

To overcome this predicament, additional resources are argued to be necessary: aid and time. The assumption made here is that all capital goods are imported, and all exports are consumer goods, and the stock of consumer goods or foreign exchange revenues remain at the same level. Under these conditions savings are only possible if consumption and exports are reduced, see figure 8. In figure 7,  $dd$  represents the domestic demand curve for a consumer good and  $cf$  of the foreign component i.e. with perfect elasticity. Hence the total demand curve is  $daf$  and the supply curve,  $ss$ , with the quantity supplied at equilibrium price,  $oc$  being  $cb$ .

The level of domestic consumption is  $ca$  and  $ab$  the export component. The latter representing savings and the imports are capital limitations on capital accumulation and hence on saving and so is related to reduce growth in this model. With an increase in the saving rate, the domestic demand curve is displaced to  $d'd'$ , resulting in reduced domestic consumption and increases in exports and capital formation under these conditions, there is no trade gap distinct from the saving gap.

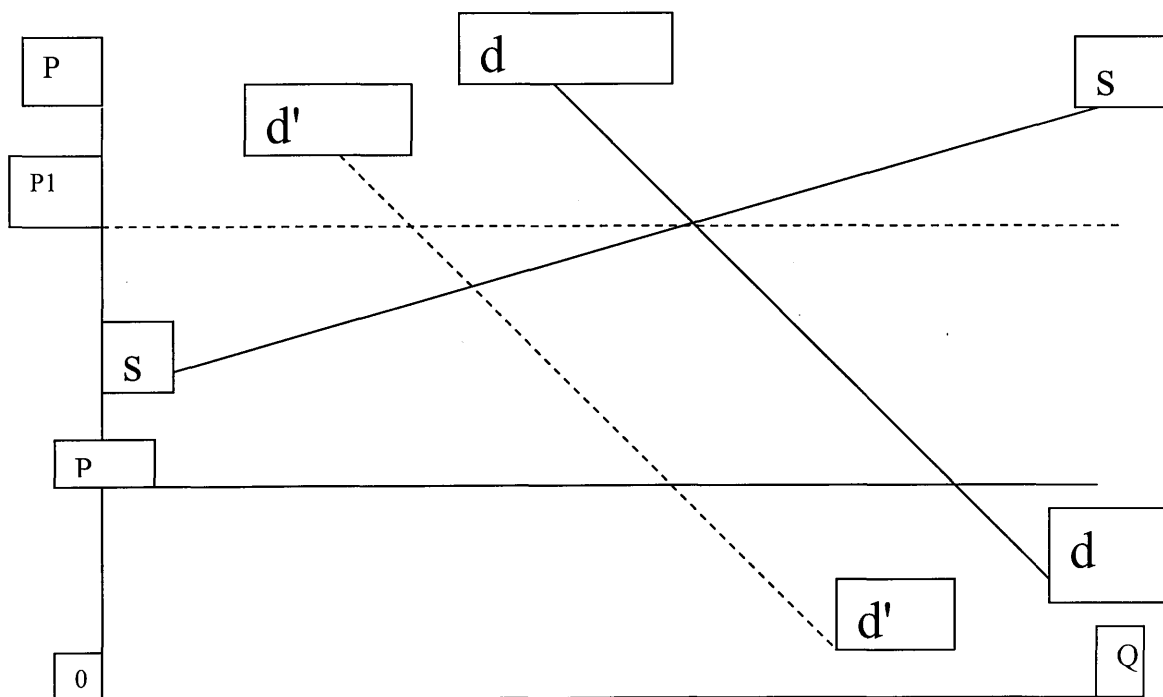
**Figure 8 Domestic Demand Exports and the Saving Rates**



In figure 8 the foreign demand is assumed to be vertical and the curve  $tt$  is produced by summing horizontally  $dd$  and  $ff$ . The shift of  $dd$  to  $d'd'$  reflects increases in the saving rates but even with this reduction in price to  $OP_1$ , there is no change in the volume of exports as the foreign demand curve is completely inelastic. The fall in price produces increases in domestic demand until a new equilibrium is established at  $P_2$ , or result in unemployment.

This outcome is also produced if  $ff$  is associated with an inelasticity  $>0$  but  $<$  unity over the relevant range. If, however,  $ff$  is  $>$  than infinity, price falls in line with the level of domestic demand, and the rate of capital formation increases with reviving saving rate. However, increases in saving rate becomes more expensive as a given rate of saving requires a correspondingly large rate of capital formation with a large share of resources devoted to export production than that associated with price  $P_1$ .

**Figure 9 Trade Gap and Savings Rate**



Maximum capital formation is associated with an inelastic curve. When the target rate of growth requires a maximum growth rate of capital greater than this, the trade gap cannot be bridged improving the saving rate. It is evident from the above that explanations of the tow gap phenomena require assumptions about the elasticity of the foreign demand curve. Economies with high levels of



trade protection are often characterised by supply side problems. The foreign demand curve is horizontal at  $OP_1$  (in figure 8). However, at this price, domestic supplies are unwilling to export 100 percent of production of this good as they are protected from foreign competition. The domestic demand curve  $dd$  is displaced to  $d'd'$  with increase saving rate with no improvement in export is produced. Under these conditions, devaluation will increase foreign demand and a significant reduction in foreign exchange would be expected to push  $P1f$  to  $P2f'$ . The overall result: producing higher saving rate and greater capital formation, reducing the possibility of the two gaps appearing.

#### **Section 2.8.4**

##### **Evolution of the two gap model**

The trade pattern of developing countries is reflected in figures 7 & 8 with the former illustrated in the trade and saving experience of traditional exports, where devaluation would result in a decline in foreign earnings. In the case of Figure 8, we have a situation in which a new non-traditional export has become established. The pattern of demand may be horizontal or near-horizontal. The lack of price or cost based competition may result in poor international sales. It is clear from this that devaluation would have the effect of increasing its sales and earning potential. Where a country has a large traditional sector and a relatively small new sector, devaluation alone is unlikely to promote higher levels of foreign exchange. However, (dual exchange rates) devaluation in conjunction with a duty on the traditional sector would produce increases in foreign exchange earnings.

The emergence of the two gaps is assured by policy failure and without the application of devaluation and export duty, its occurrence is not structural by the absence of appropriate policy. The assumption is made in the above discussion that the economy had no capital goods sector and that only these kinds of goods are introduced to the economy. However, if a capital goods sector exists, this would allow the economy to convert savings to domestic capital without the need for international trade. This would reduce the level of capital formation required to achieve the target rate of growth of the economy (i.e. output) at lower level of exports than under alternative scenarios

as described above. However, given the lower rate of exports and foreign exchange bottlenecks, from poor demand, this may not be sufficient to meet the target growth rate of the economy.

Chenery's explanation of the evolution of the two gaps evokes the aid-supported exchange rate effect on investment allocation relative to post-aid and reduced aid environment. It is reasoned that: the reduction of aid produces a system characterised by inflexibility and prohibiting the necessary adjustment to avoid the occurrence of the two gaps. This explanation is challenged by Bruton (1969) in the first instance on an empirical basis: that Chenery had produced no evidence that in countries such as those cited in the study: Greece, Israel, Taiwan and the Philippines that investment allocation was based on the higher equilibrium exchange rate presumed to be appropriate post-aid or in a situation where aid had been reduced. Bruton's argument is that the successes of these countries were due to factors other than those identified by Chenery and Strout (1966). These authors asserted that a more convincing argument/case against the latter is the importance of exchange rate, namely that the same exchange rate could be appropriate with aid influence and aid outflow. The competition and specifically the distribution of investment between the consumer goods sector, the capital goods sector and productivity growth, is more important than exchange rate. Bruton also argues that with sufficiently large domestic capital goods market, the required savings could be transferred into the physical capital required to achieve the targeted rate of growth of output. Furthermore, the occurrence of the two gaps would be eliminated by appropriate expansion of capital goods sector during aid inflow. So significant expansion of the domestic capital goods would, under these circumstances, eliminate the foreign exchange gap.

### **Section 2.8.5**

#### **Trade and Savings Limits**

The heterogeneity and complexity of social, political and economic structures common to LDCs means that no single theory can adequately explain the effects of foreign aid on these countries. Gap analysis developed from attempts to discuss the alternatives available to underdeveloped countries, LDCs. Its focus is on the factors which determines or limit accelerated growth and the use of

external inflows. According to Chenery (1965) the two gap analysis has two principle meanings: 1) as a description of an existing structural disequilibrium, 2) as a potential limit to future growth.

Two gap analyses assume that past policies may have been imperfect. The main issue in some policy failure is the time required to increase savings and exports needed to support accelerated growth. Fundamental to the understanding of gap analysis is the productivity of external assistance, the allocation of investment, balance of payment disequilibrium or lower savings rates. Whilst the Two Gap Model is focused on the combined impact of 'savings constraint' and foreign exchange constraint' on the growth of developing countries, focus on the fiscal constraint has identified it as a third gap, restricting the growth potential of a poor developing country.

The fiscal impact of aid on poor developing countries such as Uganda is empirically demonstrated by the vitally important role of aid in the government budget, for example approximately 50 percent of the Ugandan national budget is made up of foreign aid. In a recent study by the Economic and Statistical Analysis Unit (ESAU, 2005) aid was found to sustain increases in public expenditure, resulting in higher levels of capital budget expenditure. The authors also concluded that whilst aid had a positive impact on recurrent budgets (increasing it for these two countries) i.e. in the case of Uganda and Zambia, it was more limited and of relatively short duration. The impact on Malawi was a reduction in recurrent expenditure. However, aid is associated with lower revenues in Zambia but higher levels in Malawi and Uganda. It helped Malawi only to reduce its domestic borrowing. The authors concluded with three general observations relating to budget support which were predicated on the assumption that recipient countries will have in place: prudent budget strategies, priorities consistent with the individual circumstances of individual countries suggesting a need for policy and institutional analysis incorporating econometric evidence. Institutional rigidities in public expenditure planning may result in separated resources for recurrent and development budgets. These expenditures are therefore not completely fungible and are thus not optimally composed for their particular application. A single injection of aid may result in claims on recurrent and development budget resources. The main point of interest here is the need to

anticipate and neutralise potential/tendency to fiscal instability and the need to maintain fiscal stability.

**Table 10 Summary of Fiscal impact of aid**

Country	Effects of a unit of aid on ( ratios)		
	Revenue	Government Investment	Government Investment
India	0.0	0.0	0.0
Pakistan	-3.6	0.1	-2.4
Philippines	-0.1	0.02	0.02
Costa Rica	0.05	-0.02	0.07
Cote d'Ivoire	-0.92	-0.11	-0.11
Ghana	0.82	0.09	0.60

Source: MC Gillivray and Morrissey (2001) Osei et al (2003) in ESAU, 2005

The empirically estimated effects of external inflows into three countries on fiscal aggregates over three decades using time-series data for the three countries for three decades are summarised in the table below-Table 11.

**Table 11 Summary of econometric results**

		Impact of inflows on:			
		Development Budget	Recurrent Budget	Domestic Revenue	Domestic Borrowing
Malawi					
	Grants	++	--	+	--
	Foreign Loans	+	?	+	--
Uganda	ODA	++	--	+	--
	Grants	++	+	+	--
	Foreign Loans	++	++	++	--
Zambia	ODA	++	++	++	--
	Grants	++	+	--	+
	Foreign Loans	+	+	--	--
	ODA	++	+	--	+

Symbols: ++ strongly positive -- strongly negative + moderately positive  
 - Moderately negative ? Ambiguous -- insignificant

Notes:

a) positive effects on domestic revenues are lagged; b) estimated effects on development and recurrent budgets are not robust, ODA effect is estimated only for a total expenditure, c) positive effect on recurrent budget in current year, in later years effect is negative but insignificant.

It is clear from Table 11 that response to inflow is country specific although some had similar economic experience and macroeconomic re-orientation in the late 1980s and 1990s. All three countries in this discussion are major aid recipients and participants in the highly Indebted Poor Country debt-forgiveness program. Uganda showed the best response to aid on budgets both

development and recurrent with domestic revenue achieving growth of 6 percent from 1980s, rising per capita income by nearly 4 percent and whilst poverty headcount is diminished. The aid-growth relationship should be viewed according to the ESAU (2005) study aid impact on development budget expenditures and the improvement in the incentive structure for the private sector. In the case of Uganda, the growth performance of the economy in the 1990s is attributed to greater policy stability, transparency and predictability of its trade and investment environment for the private sector. Improvement of its basic infrastructure: transport, power and telecommunications were also cited as significant contributors to improved economic performance.

### Section 2.8.6

#### The three Gap model

We account for the origins of the three gaps beginning with explanation of the saving gap. This is derived from national accounting in which Bacha (1990) asserted equality between income and absorption. From this assumption we have:

$$I = (Y - C) + (M - X) \quad (1)$$

Where I = fixed capital formation, Y is domestic output (GDP), C is (Private + Government) Consumption, M is imported goods and non-factor services, and X is exports of goods and non-factor services. Excess of imports over exports is equal to foreign transfers and the difference between net capital inflows, F and net factor services overseas, J3

$$M - X = F - J \quad (2)$$

Replacing (2) in (1)

$$I = (Y - C) + (F - J) \quad (3)$$

When income is at its potential level,  $Y^*$ , and private consumption is given exogenously, equation (3) yields the savings constrained level of investment which is designated IS and thus, the savings-constrained potential growth rate of output, if ICORS are assumed to be constant- (assuming fixed consumption could be replaced by Keynesian consumption function with adjustment to results.

$$IS = (Y^* - C) + (F - J) \quad (4)$$

When the first term is the Right-hand-side is denominated internal (or domestic) savings and the second foreign transfer-the value of J is shifted from first to second term producing equation (5).

$$IS = (Y^*-J-C) + F \quad (5)$$

The first term is now national savings (or savings out of national income) with the second foreign savings from equation (4) as variation in interest rates is determined by overseas lenders not the debtor country. These exogenous decisions constitute the main changes in J. This also applies to capital inflow to an economy subject to significant credit constraints. Foreign transfers, F-J are beyond the influence of policy makers in the recipient economy. Another important assumption here is that all external debt is sovereign i.e. owed by the government. Thus equation (4) generates the concept of a 'primary budget surplus in current account-a natural control variable for the recipient government. From equation (5), the concept of 'government savings,' is only partially under discretion when debt servicing obligations constitute a sizeable portion of the budget. This is illustrated when consumption is decomposed into its private and public components. In this case private consumption is designated CP, and public, G, domestic income, Y is similarly treated to produce private Yp gross government income, Tb, then from (3)

$$I = Sp + (T-G) + (F-J) \quad (6)$$

Where  $Sp = Yp - Cp$  is private savings

Assumptions/Condition:

All foreign capital inflows finance government budget, and all factor service outflows are financed out of government income, (6) sources of investment financing is decomposed to produce private savings, Sp, primary budget surplus in current account, T-G, and net foreign transfers to the government, F-J ( factor payment) is derived from government budget, net income is thus represented by T-J. Treating all variables on RHS as exogenous and Yp fixed at full employment level of income, Yp\* (6) produces the 'savings gap'

$$IS = Sp^* + (T-G) + (F-J) \text{Where } Sp^* - Cp \text{ is} \quad (7)$$

private savings at the potential output level.

## Section 2.8.7

### The Foreign Exchange Gap

The constraint operating here is derived from equation (2) with the following assumptions: (1) imports are divided into complementary capital goods import,  $M_k$ , and (2) other imports  $M_o$ . Net export is defined as the difference between export and other imports:

$$\therefore E = X - M_o \quad (8)$$

When  $M_k$  is given by:  $M_k = mI$

$$\text{Where } 0 < m < 1 \text{ is the import content of investment} \quad (9)$$

Replacing (8) and (9) into (2) produce equation (10):

$$I = (I/M) [E + (F - J)] \quad (10)$$

It is also assumed that net export,  $E$ , cannot surpass a critical value  $E^*$ , given by world demand, the foreign exchange constrained level of investment designated  $IE$  is given:

$$IE = (I/m) [E^* + (F - J)]$$

As  $m < 1$ , a comparison of (7) with (11) yields the Chenery result that foreign transfers produces a greater impact on the growth rate of the recipient constrained by foreign exchange than on savings constrained economies.

## Section 2.8.8

### The Fiscal Gap

Bacha's (1990) explanation of the fiscal gap constraint on growth cited the example of Brazil, a middle-income country whose growth is principally constrained by government budget limitations than by foreign exchange. This is demonstrated by the decomposition of capital formation to produce government investment  $I_g$  and private investment  $I_p$ .

$$\text{Thus producing } I = I_g + I_p \quad (12)$$

From the above (12) government budget constraint is given by:

$$I_g = (S_p - I_p) + (T - G) + (F - J) \quad (13)$$

Assuming a direct relationship between government investment and private investment, the former determines the latter such that at maximum, its value is

$$I_p = K^* \cdot I_g, K^* > 0 \quad (14)$$

The above formulation suggests a leading role for government investment in infrastructure and its promotion of the private sector through sponsorship of basic industries; the so called crowding-in hypothesis as was empirically demonstrated in the post-WW(11) development of Central Europe. However, in inflationary economies, the carrying-power of public investment over private investment is argued to be the result of, or function of, the inflation rate; long-term higher rate of inflation would send a negative signal to investors as it would suggest a lower rate of return on future investments. It follows from this that the relationship between inflation and growth in a fiscally constrained economy is significantly more negative than indicated in equation (14) in which  $K^*$  is assumed to be a fixed parameter and independent of the rate of inflation.

Another important assumption is the absence of a market for government bonds and on this basis the only means of financing budget deficit is through money expansion. Private savings is possibly at the out-put level, when  $S^*p - I_p$  is positive. Governments can capture this excess savings only through Seignorage. The latter is assumed to be a function of the propensity to save and  $p$ , the rate of inflation.

Thus:

$$S_p - I_p = dH/p = f(p, h)$$

Where  $dH$  is variation in nominal money holdings and  $P$ , the price level. The relationship between inflation and Seignorage is given by the Laffer curve in which Seignorage increases with inflation but subsequently decreases with it as illustrated in Figure 1.



## Section 2.8.9

### Criticism of Gap Models

Whilst the two gap models may serve some useful function in providing a basis for forecasting the volume foreign capital inflow necessary to achieve the targeted rate of growth for a recipient under a specific set of conditions in which a particular constraint is in operation; criticism have focused on the basis assumptions on which the models are based. One of these expectations is fundamental structural reform of the economy of the recipient to a more effective and productive use of foreign inflows to produce sustainable growth. The expectation of structural change was first identified in the 1970s and 80s as the available evidence led to the conclusion that this did not occur notwithstanding large increases of foreign aid to developing countries and the resulting disappointing growth and development performance of these countries.

The structural transformation predicted by Chenery and Strout (1966) did not materialise and developing countries were still characterised by rigid patterns of domestic production and international trade, a testament to their continued dependence on traditional commodities. The associated volatility in their export earnings was a direct result and consequence of fluctuations in external market demands and unfavourable terms of trade. These developments contradicted the exogenous export growth assumed in the two gap models. Changes in the demand for basic commodities is explained by a variety of factors: shift in industrial production in developed economies, the drive towards more technology intensive activities in which efficiency and greater demand for semi-processed intermediate goods and the corresponding decline in the need for basic commodities. These developments are also linked to relocation of production in low cost emerging economies in south-east Asia: namely China and India. For commodity dependent economies the outcomes of these developments are structural balance of payment problems and shortages of foreign exchange.

Another important explanation for the failure of these models is the assumed zero substitution between inputs by Chenery and Bruno (1962). Although these authors acknowledge that this

process would take some time and that it would be determined by the introduction of new technologies. Another aspect of this assumption is the view that capital and labour are received in fixed-proportions and the emergence of a fixed capital-output function on the basis of convenience necessitated by limited data and inconclusive production estimates.

Further criticism of the two gap model was advanced by Luxton (1979). Here the author argued that the employment of the models to estimate savings gap was undermined by the size of the parameters assumed in the model and the outcome of the estimation is determined by for example, the propensity to save, imports and the incremental capital out-ratio. These are derived from historic data and which are assumed to constant for predictive purposes and with non-substitutability between savings and consumption on the one hand, and between domestic and imported resources on the other resources on the other. Luxton (1979) identified examples of governmental initiatives which have successfully established financial institutions which have enhanced domestic savings through higher rates of interest on savings. Mexico and The Philippines are examples of countries which, according to the author, where state owned development banks have through the issue of bonds, increased domestic savings. These examples challenge the assumed constancy in the propensity to save in the Chenery and Bruno models. Another important observation and criticism of the models is the variation of import requirement between different industries resulting in a possible lowering of the aggregate import requirement for the economy. In this case the saving constraint is expected to be the major bottleneck. However, industrial sectors with high import requirements for foreign exchange would be expected to have a greater constraining influence on growth. For Luxton, (1979) the solution to this problem is to consider the parameters in the models as upper and lower limits, not constraints as designated by Chenery and Bruno.

Detractors argue that the causal order in the Chenery and Bruton model does not reflect the reality of donor-recipient interactions or the motivation and aid distribution criteria of the former. Namely, donors are not focused on filling the larger of the two gaps when aid allocation is decided. If this

was the case, then according to Fei and Ranis (1968), recipients would be satisfied by higher levels of imports, lower exports and lower savings. As donors consistently donate less than the maximum gap, recipients are obliged to make adjustment in the opposite direction. Empirically the three-phase thesis is (Luxton, (1979) incapable of historic verification even when a country has completed all lifecycle. This is accounted for by the fact that the models present only a partial picture of a complex situation restricted to the need for foreign aid. However, Bruton (1969) argues that foreign aid is “gap producing, not gap bridging and acceptance of this fact can disrupt, rather than catalyse development.

According to Ahmad (1990), whilst the two gap models have focused on the mechanism of how capital inflow to developing countries remove binding constraints and its impact on the growth of output, foreign assistance has wide-scale influences on a number of strategic variables (such as: savings, exports, and imports) which in turn determines economic performance and the development of recipient countries. However, not all of these influences are captured by two gap analysis. In the two gap model, foreign capital is expected to increase the total amount of investment in the economy. However, in many LDCs foreign capital (Griffin, 1970) substitute for domestic savings or finance higher levels of domestic consumption through enhanced imports of consumer goods in the case of famine or emergency relief. It is therefore questionable whether foreign capital inflow as modeled in the two gap theories is employed exclusively for investment purposes.

Excessive emphasis on the importance of capital accumulation is another criticism of the two gap model. The fact that this emphasis invokes the Harrod-Domar framework and its association with explanation growth in developed economies means that its application to LDCs as a basis for their analysis and the development of economic policy is inappropriate. These models are also criticised for what they do not include or take account of: land distribution, science/technology, types of goods produced, macroeconomic and social policies, and the ability and quality of entrepreneurs.

These important variables form the basis for economic growth and development. Models such as, for example, the endogenous Growth theory as discussed in earlier section of this chapter, in its explanation of economic growth is focused on human capital in facilitating economic growth and development and it is therefore more appropriate framework for analysing LDCs and the role of capital in their growth and development.

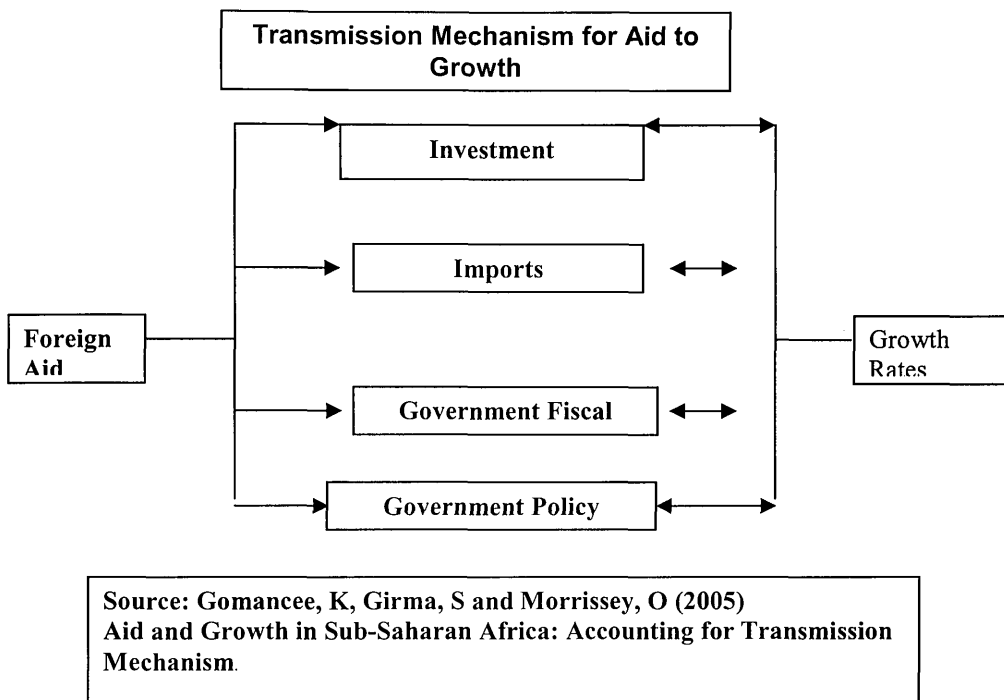
### **Section 2.8.9.1**

#### **The Aid-FDI link**

Here we outline the rationale for the Aid-FDI link and subsequently empirical evidence supporting this hypothesis. The policy implications of this interaction are critically discussed and explored in the case of Uganda. Critical to this discussion is the efforts of the international development community to address the poor state of the country's infrastructure and the fact that financing infrastructure is a major issue for Uganda and this is generally true for SSA countries. Uganda's dependence on rural agriculture and the fact of her poor infrastructure endowment counters efforts to improve the productivity, growth and employment contribution of the sector. Agriculture requires supporting infrastructure such as road transport to port facilities in neighbouring jurisdiction and increased investment in power generation to support efforts to reduce the cost and poor reliability of utility power.

The relative importance of the two types of flows on the growth performance of the recipient economy will have some significant bearing on donor and recipient policies, respectively. It will suggest a particular macroeconomic policy for recipient countries. For example, if Aid is required to finance infrastructure and/or trade for enhanced FDI inflows, policy makers will need to put in place policies what reflect the needs of the private sector and especially that of foreign investors as domestic sources of private capital are small and therefore insufficient to meet the needs of the economy. Aid on the other hand, may finance policy reforms as well as co-financing infrastructure projects. Policy makers will have to secure inflows of aid for this purpose i.e. means of providing investors with an investment environment characterized by appropriate infrastructure.

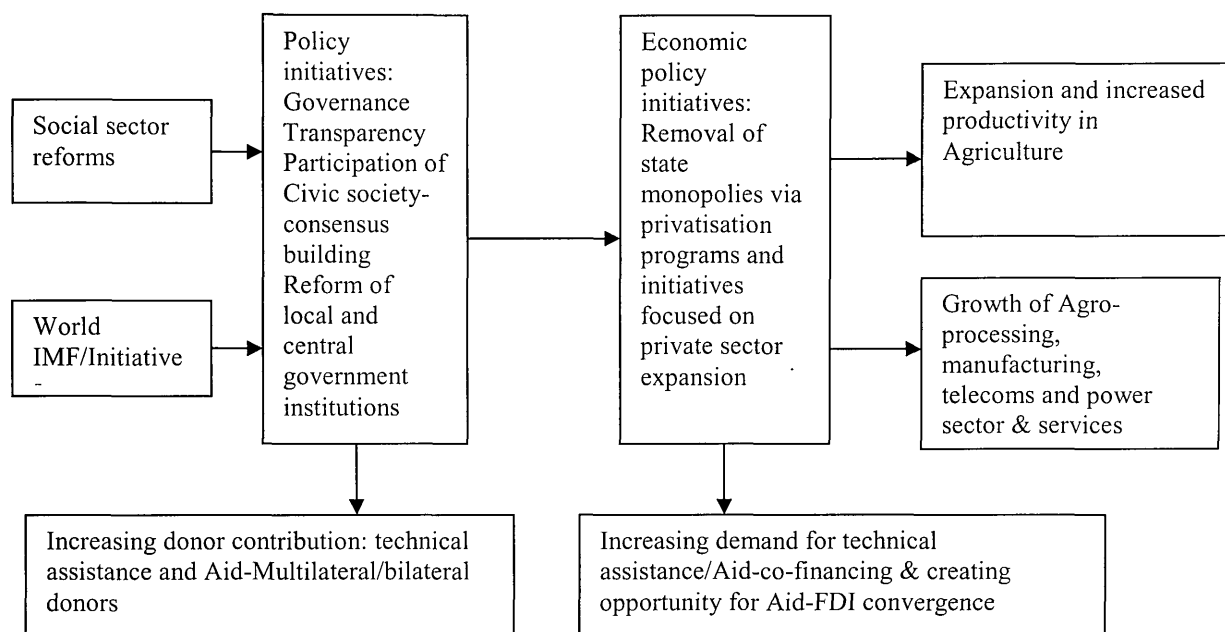
**Figure 10 Transmission Mechanisms for Aid to Growth**



These infrastructures may consist of a variety of human capital such as the skills level and educational attainment of the local labourforce, institutional and regulatory bodies, property rights laws and policies relating to the ownership and control of productive assets. This also provides a transmission mechanism through which the impact of aid on recipient economies may be assessed empirically, again with implications for recipient growth and development policies, see Illustration Figure 10. Physical infrastructure includes telecommunication, power and transportation facilities. The quality of these public goods is considered a vitally important determinant of FDI inflows and the productivity of private capital. The ability of the state to provide basic services such as education, health and welfare is argued to depend on the quality of its infrastructure (see chapter 2). The effective utilization of aid to create infrastructure which supports and enhances the absorptive capacity of the recipient economy has become a major focus of macroeconomic policy and again a potential transmission mechanism for the Aid-growth relationship. For donors, this provides a basis for the allocation of aid and its effective utilisation. Donors may for instance provide aid as technical assistance for sector-specific reforms and/or general macroeconomic policy revision: meet

short-term financial needs e.g. provide foreign reserves and budget deficits as well as financing the import of investment goods closely linked to promoting economic growth in the recipient country.

**Figure 11 AID-FDI Convergence Mechanism: A macro perspective**



Source: Author (2008)

In the case of Uganda, donor finance (aid) supported the development and implementation of market based macroeconomic policies: privatization of state-owned firms in the power, telecoms and power sectors. Aid also acted as a cushion during the transition process i.e. helping to offset the impact of the removal of a number of consumer subsidies as a risk premium for private sector lending to small-scale farmers as was determined in this research for Standard Chartered Bank lending to rural farmers in Uganda. Overall the impact of aid on growth in recipient economies and the transmission mechanism is suggested above in Figures 10 & 11.

Using pooled panel macro data for a sample of Sub-Saharan economies over the period 1970 to 1997, and concluded from this that investment and government spending on imports is the principal transmission mechanisms that explains the impact of aid on growth in recipient economies.

We have already noted that the available evidence points to a decline in the relative value of concessional flows to LDCs. The task is one of achieving greater effective utilization of public inflows. The linking of private inflows i.e. FDI to Aid is hypothesised in this study as a possible

solution to this difficulty i.e. an alternative transmission mechanism. Whilst most studies of aid effectiveness as in the current study has focused on the aid-growth relationship, Mosley, Hudson and Verschoor (2004) focused on the aid-poverty in the 'new conditionality' context with the innovation of their pro-poor (public) expenditure index. Accordingly, these authors conclude that corruption, inequality and the composition of government spending are significant explanatory factors in aid effectiveness. The formulation of poverty reduction strategies in Poverty Reduction Strategy Papers (PRSP) is recognized as a bias for donor selectivity i.e. aid distribution between and within poor developing countries. Of course the widely accepted MDGs now constitute a greater instrument for donor selectivity and the fact that these targets are all within the social sector, suggest aid inflows are generally if not exclusively focused on development targets and not necessarily focused on economic growth and expansion of productive capacity apart from schooling and anti HIV/Aids programs, see net ODA sectorial distribution in Table 12. The data presented here suggest that public inflows are more of the educational-social/development type and less focus on economic reforms or investment in physical infrastructure. This extrapolation would make assessment of aid-growth relationship less capable of traditional evaluation based on assumption of aid financing imports or investment in the real economy.

The DAC data also demonstrate a lack of convergence/harmonisation between donors as the pattern of inflows i.e. sectorial distribution is varied with some extreme differences in priority, see Tables 12a and 12b. Whilst Japan, USA and Germany provide a significant support for economic infrastructure the other principal donors in our list are principally focused on the social sector again, provoking concerns for the earlier contributions by Street and Sutch (1971) on the relationship and/or link between aid and private inflows of capital such as FDI. The first of these reasons/explanations argues that pre-investment studies are frequently financed by official aid, thus making subsequent private investment possible and profitable. The second argument cites the provision of public goods: physical and social infrastructure (schools, hospitals, roads and public utilities) as frequently financed by private overseas investment. The third argument cites the

importance of service charges by foreign investors; i.e. high service charges are supported by official loans on soft terms.

The final and fourth argument cites the fact that LDCs have generally low credit rating and under developed capital markets. Accordingly, these states are argued to be dependent on external capital and official aid to finance their growth and development. The linking of aid with FDI is supported by the view that aid may be used to improve the attractiveness of joint ventures, helping governments and private investors in LDCs to acquire increasing equity stake where this is economically justifiable in the long-term. Adherence to this approach to development is reinforced (Darrat, 1987) by reference to empirical studies which have demonstrated a positive correlation between exports and economic growth. Aid is also argued to supplement a shortage of foreign exchange as well as adding to total domestic investment, the Gap Model. Furthermore, aid inflows may, according to Lipton and Toye (1990), finance deficits on trade. However, Killick (1993) challenges what he perceives as prescriptive money based growth formulations, in the case of the "Asian Miracle". Nevertheless, export-oriented policies (Morrissey, 1995) are advocated for developing countries as an important facet of their overall development strategy. Durbarry, Gemmell et al (1998), and Mosley and Hudson (1996) challenge the growth and development impact of several decades of aid flow. These authors argue that whilst the objectives of Overseas Development Assistance (ODA) is commonly argued to be the development of recipient countries Levy (1987 and 1988), and poverty reduction (Collier and Dollar, 2004), six decades of capital transfer is assessed as having had an inconclusive (Frey and Eichenberger, 1994) and or marginal impact on the performance of recipient countries. The suggested link between export and growth, has served to further highlight the role and significance of domestic savings ratio and capital inflows. These flows are accorded the status of major agents in the development process and the "take-off" into sustained growth.



**Table 12a Sectorial distribution of Net bilateral ODA by DAC Members (percentage of Total ODA)**

Sectors	Denmark*	EC/UE*	German*	Ireland*	Japan	Netherlands*	Norway*	Sweden*	Total DAC	UK*	USA*
EduHe, P+OSI	37	38	27	65	22	36	44	35	32	27	43
Economic Inf	12	16	14	3	25	7	8	6	11	3	13
Production	10	10	5	5	8	4	5	5	5	4	6
Multi-sector	8	8	12	5	4	6	10	6	6	4	5
Program Ass	5	10	2	7	2	4	4	5	3	2	4
Debt Relief	12	25	37	0	30	12	1	7	25	40	10
Emergency Aid	5	12	5	19	4	5	16	12	7	10	14
Unspecified	8	6	5	8	8	28	12	26	12	16	16

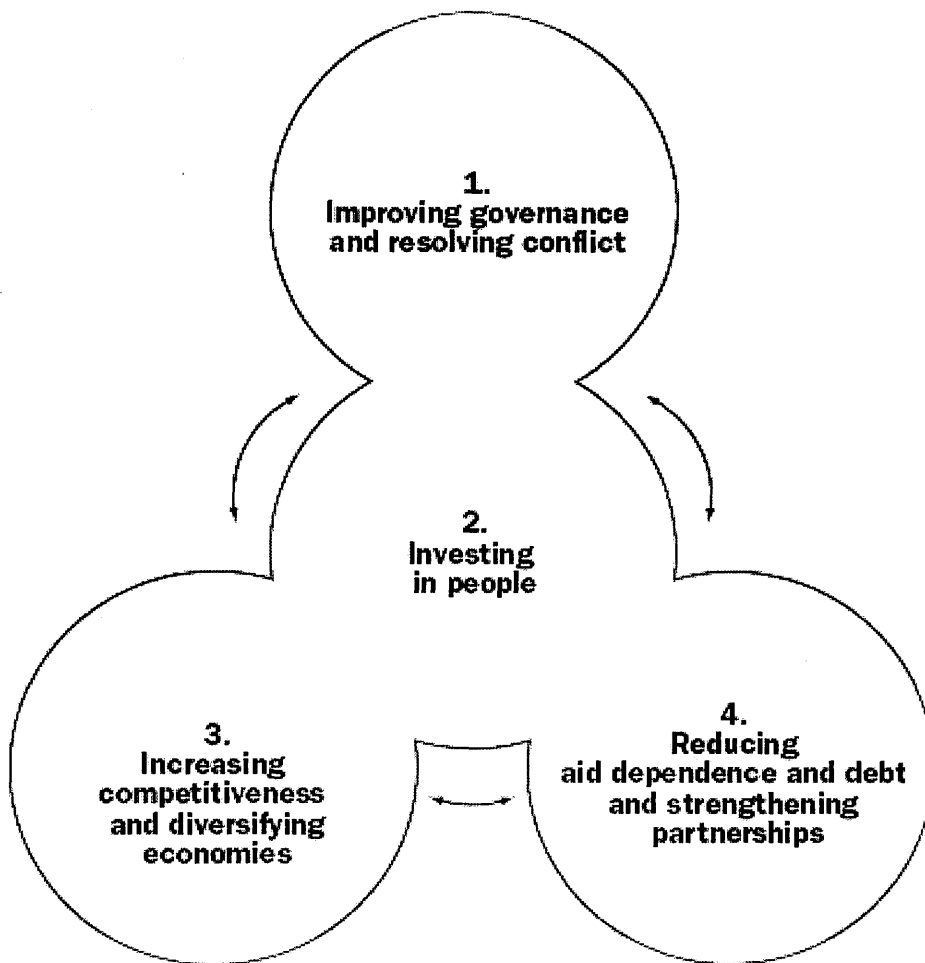
Source: OECD DAC. World Bank (2005/2006) \* countries are donors to Uganda

Key: EduHe, P+OSI= Education, Health & Population & Other Social Infrastructure, Economic Inf= Economic Infrastructure, Programs Ass= Programs Assistance (Author's calculations from DAC website)

**Table 12b Bilateral ODA by Sector (2005-06) OECD DAC World Bank**

Uganda	EduHe, P+OSI	Economic Infrastructure	Production	Multi-sector	Program Assistance	Debt Relief	Emergency Aid	Unspecified
Sectors	40	3	7	2	25	10	14	2

**Figure 12 Africa's Circle of Cumulative causation**



Source: United Nations Handbook of International Trade Development Statistics, Various Years.

The relationship between macroeconomic policy of the recipient and the inflows of foreign direct investment (FDI), were the focus of World Bank, IMF and OECD conditionalities. The extent of this development inspired some commentators and academics to argue that the World Bank's conditionalities have become a bargaining game between recipients and donor or as agents of the donors (Killick, 1993). Dunlevy and Seiver (1987) argue that LDCs need to generate an excess of exports over imports to support their investment goals. The low per capita income associated with poor private sector capital formation served to press home the point that outward-oriented macroeconomic policies centered on exports is the only credible basis for growth and development.

Figure 12 represents the mutually important dimensions of the development process. Economic modernisation and with it enhanced competitiveness and diversification (3 and 4) linked to a reduction in aid dependency. The implied rationale: growing the domestic economy expands the tax-base and thus reducing the need for aid inflows over the long-run. However, the perspectives of the present study suggest that aid linked to FDI is the mechanism through which this may be achieved. Improvements to the stock of domestic human capital and governmental institutions are also highlighted in this model as linked to the previous virtues: economic transformation and removal of the aid dependency. The implications is clear: donor organisations are the principal drivers of the process as focus is first governance allowing members of the international development community to establish an element of contractual obligations with partner countries and recipients - so recipients are virtuous subcontractors.

The shortfall in domestic capital formation can be made good, according to Dunlevy and Seiver, by one of two alternatives: 1) government mobilisation of foreign capital i.e. savings through aid, loans and or FDI and 2) mobilisation i.e. appropriation of private sector income. FDI made a significant contribution to the development (Islam, 1992) of a number of developing countries by augmenting the domestic resources of capital deficient states.

Figures 12 illustrate the competing and complementary role of external assistance to poor developing countries. What is clear is the 1 and 2 are addressed in social sector programmes and 3 and 4 are more of the economic and domestic policy ownership and seeks to target the particular needs of the country and not so much the imposition of a standard response - common feature of the 1980s Structural Adjustment Programmes.

Islam (1992) argues that capital rich America initiated foreign assistance programs for the shattered economies of Western Europe post WWII first highlighted the importance of FDI to growth. This concern with rapid economic development spill over to the capital poor developing countries. These have turned in increasing numbers to foreign capital as the engine of growth and development.

However, for low income and credit poor LDCs, failure to attract significant levels of FDI have resulted in a dependence on aid and concessional inflows. However, the poor performance of these inflows over four decades, i.e. their impact on economic development and growth has triggered debate amongst the donor community and development economists. Two views prevail: the orthodox pro-aid view and the radical anti-aid view.

The orthodox view contends that foreign capital inflows have a substantial positive impact on recipient countries-see later section on FDI impact. The mixed performance of capital importing LDCs over the past four decades runs counter to the received wisdom and empirical studies demonstrating a negative relationship between capital inflow and growth in a number of developing countries. This has encouraged the development of the anti-aid view. This views aid as substituting rather than complementing domestic resources and in attracting inappropriate technology (Islam, 1992), and distorting domestic factor productivity. Lensink and Morrissey (1999) argue that the nature of the donor-recipient relationship and the stability of the aid flow to developing countries are major determinants of the impact of public inflows on recipient countries. It is further argued by the authors that irregular inflows may signal donor disappointment which may inturn dissuade private investors as well as other members of the donor community. Aid effectiveness is expected, according to this view, to depend on economic policy. Whilst the authors are clear in their rejection of a direct link between aid and growth under the endogenous growth theory, they argue that its influence is mediated through its impact on the determinants of growth, such as domestic investment and savings.

Current development strategy is focused on mainstreaming trade as a central pillar of recipient country development strategy (World Trade Organisation & OECD, 2009). These efforts are linked to policies to enhance institutional capacity and the stock of human capital, address, social sector and infrastructure constrains on the development process.

**Table 13 New Concept of Development**

	Human Development	Human Development	Human Development
Expanding Capabilities to enlarge the choices people have in their lives	Expanding Capabilities to enlarge the choices people have in their lives	Expanding Capabilities to enlarge the choices people have in their lives	Expanding Capabilities to enlarge the choices people have in their lives
To enjoy political freedom and to be able to participate in community life	To be knowledgeable, educated and free to express oneself	To be able to survive and enjoy good health	To enjoy a decent standard of living
Civic liberties and political freedoms	Open and informed social dialogue	Public pressure and responsive actions	Public pressure and responsive actions



**Democracy**

Democratic institutions and practice characterised by: contestation of power, participation of people, and accountability of the powerful. The strength of these links varies. They are stronger for political freedom and participation; strong for knowledge and information; and weaker for survival, health and economic well-being.

Source: Stieglitz, 1998

The Private sector contribution to trade development is now viewed as a necessary prerequisite for attracting or expanding the absorptive capacity of recipients for Aid for trade inflows; and this is complemented by: appropriate policies, country-specific factors which determine or shape policy development and convergence, and the central position of trade issues in donor-recipient interaction.

**Table 14 Multi-country Programmes by category**

	2003-05 average	2006	2007
Trade policy & regulations	100.0	274.8	196.8
% of total Trade policy & regulations	15.2	26.3	28.7
Economic infrastructure	347.3	1120.1	1352.2
% of total Economic infrastructure	3.1	8.9	9.9
Building productive capacity	625.3	1125.6	1030.3
% of total Building productive capacity	6.8	11.3	9.3
Trade-related assistance	--	--	0.3
% of total Trade-related assistance	--	--	36.4
Total multi-country	1072.7	2520.5	2579.6
% of total Aid for Trade	5.1	10.7	10.1

Source: AID for Trade At a Glance 2009: Maintaining Momentum (World Trade Organization & OECD)

The volume and ‘quality’ of foreign aid inflow is determined by the extent of this indirect influence: bilateral and multilateral components and the element of official grants and loans. The fiscal behaviour of the host government is also assessed to be critical to the effectiveness of these inflows. The focus of the international community has, according to Doukas, Harrigan and Toye (1995), shifted to policy performance.

**Table 15 Donor Countries and 0.7% Commitment**

Countries already at 0.7%	
	ODA in 2005 as % GNI ( Gross NationalIncome)
Denmark	0.81%
Luxembourg	0.87%
Netherlands	0.82%
Norway	0.93%
Sweden	0.92%
Recent Commitment to Reach 0.7%	
Belgium	Reach 0.7% by 2010
Finland	Reach 0.44% by 2007 and 0.7% by 2010
France	Reach 0.5% by 2007 and 0.7 % by 2012
Ireland	Reach 0.7% by 2007
United Kingdom	0.47 by 2007-2008 and 0.7% by 2013
All members of the EU 15	0.56% by 2010 and 0.7% by 2015

Source: Facts on International Aid

This linking of concessionary inflow to programs has created a window of opportunity for the international donor community, although conditionality has been a part of IMF practice since its establishment, some fifty years ago (Mosley, 1992). This approach to lending was adopted by the World Bank and bilateral agencies concerned with program assistance (Killick, 1993), (WIR, 1998) and balance of payment support in the 1980s. The recession of the 1980s, and the collapse of the export performance of the LDCs, resulted in dependence on foreign inflows at a time when private capital had become very discriminating.

This has enabled major bilateral and multilateral aid donors to respond with structural adjustment allied to policies that required a reduction of the function of the state and an enhanced role for the private sector. Under these initiatives there was a widening of the scope of conditionality by institutions such as the European Bank for Reconstruction and Development (EBRD) to include good governance, multiparty system of government and adherence to Human Rights practices (Mosley, 1992).

## Section 2.8.9.2

### Infrastructure and the FDI-Aid Link

#### Introduction

IN this section of the chapter we outline the rationale for the Aid-FDI link beginning with an outline of the stylized facts on the debate on the growth and development process in LDCs and the various constraints operating on these economies, see Table 13 for illustrations of these. The failure of decades of cross-border public finance (Bauer, 1961, 1971) and recent macroeconomic policy initiatives to improve the long-term investment and growth performance of Sub-Saharan economies, has resulted in efforts to identify poor infrastructure and the generally poor quality of public services as the principal bottle neck and constraint on growth and development (World Bank, 1994, 1996, 1999) in under-performing developing countries and LDCs in particular. This chapter considers the efforts of the Ugandan government privatisation policy and its role in making good the country's documented poor infrastructure. This chapter also provides an opportunity to identify examples of infrastructure investments financed by a mixture of Aid and FDI i.e. demonstration of our Aid-FDI interaction. Ugandan's effort to engineer an infrastructure-based growth and development is critically discussed from a policy perspective. The fact that Uganda has poorly developed infrastructures: human and physical [(World Bank, 1994, 1996) and Morrissey et al (1998)] and the fact that the quality and rate of investment in these public goods are closely linked to the performance of developing economies (Pfefferman, 2000) is a matter of great importance for domestic policy makers and their international development partners. Highly indebted poor countries such as Uganda, have a limited capacity to finance public infrastructure either from domestic sources (public and private), and have therefore recognised the need to secure foreign sources of finance. This has created a need to put in place investor-friendly macroeconomic policies (Jechoutek and Lamech, 1995) and specific sector reforms. We discussed the significant elements of these reforms and their success or otherwise in stimulating foreign inflows: private and public.

### Section 2.8.9.3

#### Financing Africa's Infrastructure Sector

This section of the chapter outlines the context of recent efforts to improve resource flow to the infrastructure sector and in so doing it identifies the principal issues relating to the operational efficiency, quality and funding requirement of the sector. This provides a basis for later empirical investigation and discussion of funding initiatives and our FDI-Aid interaction for Uganda as possible solutions to the generally low level of funding and efficiency gaps SSA infrastructure sector.

Whilst the majority of sources of Africa's infrastructure finance (an estimated \$US30.0 billion) is procured from domestic sources. Annual spending/investment amounting (Briceno-Gormendia, Smith et al, 2008) to \$US45 billion, represent a marked increase in the historic trend as indicated in Tables 19 and 24. This figure includes state owned enterprises, extra-budgetary funds and external finance. External inflows include in this instance ODA and private sources of finance totaling some \$US15 billion. Overall public sources are the major contributors to investments in water, energy and transport with the exception of the least stable LDCs.

Domestically sourced infrastructure finance is obtained from central government tax receipts and allocated through centralized budgets with operating and maintenance costs met by user charges collected by the provider. According to Briceno-Gormendia, Smith et al, (2008) current level of public financial commitment are higher in low income countries in GDP terms, accounting for 5-6% of GDP, see Table 19. When investment only is considered, ODA, private finance and non-OECD combined is greater than domestically sourced public investment to the infrastructure sector (Briceno-Gormendia, Smith et al, 2008). The private sector account for the single largest source for of infrastructure investment and this is the equivalent of domestic public investment in the sector. Whilst non-OECD sources from countries such as the Arab states, China, India, ODA is a significant source of inflows and are often concentrated in energy, rail in resource rich countries and in these countries ODA is especially significant source of investment to water and transport for



states characterised by high level of economic political and social volatility. On the other hand, private finance is the principal source of finance to the ICT sector.

With an estimated annual funding gap of \$US31 billion largely in the power sector (Briceno-Gormendia, Smith et al, 2008) addressing a number of inefficiencies in the sector would represent additional annual purchasing and/or investment of \$US17 billions of present resources. The authors estimate unwanted or excess investment i.e. \$US 3 billion of financial commitment/allocation to some infrastructure sectors beyond that which is warranted i.e. “excess expenditure” public investment in ICT infrastructure. Poor budget execution means that public investment resulting from institutional bottleneck is estimated to account for a potential loss of up to 30 percent effectiveness in public investment. According to (Briceno-Gormendia, Smith et al, 2008) this loss could be eliminated by improvement in the procurement process. The present study found examples of poor procurement process in Uganda which resulted in project failure i.e. planned investment cancellation and the reduction of earlier investment commitments and examples scaling back in relation to cogeneration power project and withdrawal of a number international contractors/investors from the Bujagali hydropower project, see chapters 5 and 6. With a relatively large stock (30%) poorly maintained infrastructure SSA countries are estimated (Briceno-Gormendia, Smith et al, 2008) to be in need of rehabilitation and this is significantly higher in the case of rural infrastructure. Regular maintenance in the road sector is according the authors means that every spent \$US1 could result in a reduction of \$US4 of rehabilitation. Poor revenue collection combined with over employment especially in the water and power sectors result in revenue losses amounting to an estimated 0.5 per cent of SSA GDP. Briceno-Gormendia, Smith et al, (2008) estimate that combined these inefficiencies amount to 60 percent of the funding gap related to the power sector.

Africa’s infrastructure prices are high relative to international standards, however high tariffs do not meet the operating costs and in many instances significant subsidies are provided to large industrial

users and revenues may also be uncollected due to under-pricing especially in the water and power sectors. Another finding of the present study is the view of a number of respondents that Uganda's low income means rural electrification requires significant subsidies.

#### **Section 2.8.9.4**

### **Private Sector Participation**

The World Bank established a series of initiatives focused on addressing a number of management problems in public infrastructure entities in the 1980s to the early 1990s. These initiatives were based on a survey of infrastructure projects in 40 countries, which had received World Bank financial support as a means of improving their performance. These are listed in Table 5 below. The emergence of Public-Private Partnerships (PPP) and Independent Power Providers (IPP) is acknowledged as examples of private sector responses to state deregulation and liberalisation. These collaborative ventures are seen as the principle solutions to lack of capacity and a means of making good poor efficiency in the production and distribution of public goods. This is followed by a brief account of the factors, which have encouraged private sector participation in the provision of public services. This accompanied by some recent data on the flow of infrastructure-related Foreign Direct Investment. Later discussion is focused on the relationship between infrastructure and growth from a dual perspective: theoretical and empirical. Included here are a number of theoretical model of the investment behaviour of two types of firms as an aid to the understanding of the investment behaviour of firms under different infrastructure scenarios. Finally, the Ugandan experience is offered as an example of the relationship between poor provision of complementary public infrastructure and disappointing economic performance.

The effort of the Ugandan government to secure greater infrastructure-related inflows of FDI is associated with wide-scale sector reform and privatisation of state-owned power assets. In this respect, the actions of the government are typical of those commonly pursued by poor developing countries, and are here introduced as examples of the actions of developing countries to secure long-term infrastructure based growth and development.

**Table 16 Common management problems in public infrastructure**

Sector	Numbers of loans	Unclear goals	Source of problems		
			Financial	Lack of management	Accountability & autonomy
Electricity	48	27.1	33.3	72.9	31.3
Water	40	25.0	40.0	70.0	35.0
Telecommunications	34	14.7	35.3	52.9	32.4
Rail	39	15.4	20.5	53.8	33.3
Road	35	8.6	22.9	40.0	40.0
Port	28	21.4	35.7	32.1	42.9

Source: World Bank, World Development Report 1994: Infrastructure for Development

The role of international private sector investment in public infrastructure is assessed as vital to the achievement of these objectives: growth and development. The emerging consensus in development thinking and by extension in development co-operation is according to Schulpend and Gibbon (2001), based on the simple logic:

1. Poverty reduction is the primary objective of development;
2. Central to development is economic growth;
3. Economic growth is best attained through the operation of market forces; and
4. The role of governments is to provide an appropriate environment which facilitates the growth of the private sector and that this pattern of expansion of the private sector is linked to poverty reduction.

It is clear from this that governments have a major role to play. The changing role of the state's relative to that of the private sector is indicative of a new pragmatism amongst developing states. The traditional dominance of state in the provision of public goods is challenged by a number of developments: the unviable state facilities, unsustainable level of public debts and the inability to finance the infrastructure financial gap (Tables 17, 19 and 24). The combined impact of these developments is the undermining of state monopoly in the ownership of infrastructure assets and their operation. Under this new paradigm the accumulation of wealth and the generation of

employment are increasingly confined to the private sector. The state is thus relegated to the role of creating an enabling environment, in which the production of services and goods are the exclusive objectives of private enterprise.

**Table 17 Africa’s Infrastructure Deficit**

Normalized units	Sub-Saharan Africa Low-income countries	Other Low-income Countries
Paved-road density	31	134
Total road density	137	211
Main-line density	10	78
Mobile density	55	76
Internet Density	2	3
Generation capacity	37	326
Electricity coverage	16	41
Improved water	60	72
Improved sanitation	34	51

Source: V Foster and C Briceno-Garmendia (Editors), *Africa’s Infrastructure: A time for Transformation*. Taken from Yepes and Foster 2008

The long-held predominance of the state as the exclusive agent of economic development, planning, management of economic development, in owning resources and producing goods and services (Schulpen and Gibbon, 2001) was subjected to some new thinking in the 1960 and 1970s. Within the development co-operation, the need to move from technical solutions to poverty reduction-oriented country assistance was re-enforced by the second oil crisis at the end of the 1970s and the resulting debt crisis at the beginning of the 1980s. The authors argued that these developments played a significant role in ‘dethroning’ government-led model of economic development; replacing it with macroeconomic policies, which enshrined a reduced role for the state and a greater role for the private sector. This policy was further justified by reference to the anticipated outcome of the economic liberalisation process: economic growth. This re-engineering of macroeconomic policy along liberal lines was also meant to recover ground lost to advocates of import-substitution industrialisation, the ISI model (Bhagwati, 1988), in-ward orientation and dominant position of the

state as architect of industrial planning centered on the anti-export bias. The deficiencies of these policies were according to Schulpen and Gibbon (2001) characterised by: inefficient industries, foreign-exchange shortages and a bias against agriculture. The experience of the outward looking and export-oriented southeast 'Tigers' stood in contrast to that observed amongst Sub-Saharan economies. In fact, the 'miraculous' performance of the latter provided a basis for new policy prescriptions in the 1980s.

The disqualification of the state as the pre-eminent economic agent received the personal support of the leading advocates of market forces during this period: Reagan and Thatcher (Killick, 1989). At this point government intervention was viewed as an impediment to growth and development, so too the provision of cross-border public finance, aid. The frustration of donors is attested to by Mosley's (2001) assertion that UK government white papers on overseas development "were born of a period of quite serious disillusionment with the ability of states, in both North and South, to produce international development." The so called counterrevolution provided an opportunity for radical policy revision driven by the failure of previous policies and the further decline in the economic and social wellbeing of developing countries. Furthermore, the bankruptcy of state owned facilities and the generally poor credit status of LDCs have propelled even the most reluctant state to embrace foreign investors. The infrastructure with its demand for largescale and long-term funding has made the greatest effort to attract foreign aid and private inflows. This effort is reflected in structural adjustment and stabilisation policies focused on engineering growth based on the creation of new infrastructure (World Bank, 1994) and or the upgrading of existing facilities. Having established a link between poverty reduction and growth, the infrastructure endowment-growth relationship has become the centerpiece of development cooperation and external country assistance. In exchange for financial assistance, developing countries have been required to undertake a number of reforms. These included:

1. Alignment of exchange rates with economic performance i.e. avoidance of overvaluation;
2. Market based interest rates; and

3. Reducing the size of government and the extent of government intervention in the private sector;
4. Phasing out of government subsidies for agriculture and the equalisation of domestic and imported energy prices;
5. Dismantle controls on trade and investment.

The adoption of these policies provided a basis for the World Bank and other multilateral donor policy i.e. aid support was made conditional on the implementation of these policies. However, the failure of these policies and the SAL to improve the economic performance of participating economies and the commonly observed negative social impact of wide-scale reduction in public spending on services, particularly to rural communities, resulted in a revision in SAL by the end of the 1980s. This adjustment effectively created an opportunity for higher level of government involvement than was allowed under the original SAL of the early 1980s. This revision was labeled 'adjustment with a human face' or the adjustment of the Washington Consensus (Kellick, 1989), (Schulpen and Gibbon, 2001). According to the latter, macroeconomic policy have three fundamental components: liberalised trade, macroeconomic stability and appropriate i.e. market based prices. It thus argued that removal of government interference would result in efficient allocation of finite resources and rapid growth. This was complemented by aid conditionality policy of the major donors by the end of the 1980s and the early 1990s. Advocates for policy reforms, and reduction of the role of the state, and of the system of government, also encouraged (Stokke, 1995) participation, and the promotion of civic society. The conviction with which these policies were held and promoted by the international development community was encouraged by the decline of the socialist world and the view that the Western path to development was the only one. Fukuyama's 1992 End of History essentially argued that the final-state of human development is characterised by capitalism, economic liberalisation and liberal democracy.

Sustained criticism of the neo-classical macroeconomic development strategy and its adherence to the doctrine of the universality of market forces, the reluctance of a significant part of some community to accept market mechanisms, were viewed as an indication of ( Schulpen and

Gibbon,2001) market failure. Furthermore, continued high levels of poverty and inequality, the absence of goods and services, which could not be provided profitably by private sector firms, again provided an opportunity for government intervention under the policy instrument of ‘good governance’. According to Kellick, this development has created a framework in which development results from a co-alignment of public and market forces.

**Table 18 Africa’s high-cost Infrastructure**

Infrastructure sector	Sub-Saharan	Other developing regions
Power tariffs ( \$ per kilowatt-hour)	0.02-0.46	0.05-0.10
Water tariffs (\$ per cubic meter)	0.86-6.56	0.03-0.60
Road freight tariffs (\$ per ton-kilometer)	0.04-0.14	0.01-0.04
Mobile telephone (\$ per basket per month)	2.60-21.00	9.90
International telephone ( \$ per 3-minute call to the United States)	0.44-12.50	2.00
Internet dial-up service (\$ per month)	6.70-148.00	11.00

Source: V Foster and C Briceno-Garmendia (Editors), Africa’s Infrastructure: A time for Transformation.

The World Bank (1991, 1994, 1996, 1997, and 1998) recognised the legitimacy of the public and private sectors. The role of the private sector is, according to this thinking, one of producing and distributing consumer goods efficiently, whilst the role of the governments is one of providing a supporting environment characterised by transparent regulatory framework, good property rights laws, co-coordinating investment in infrastructure, maintaining stable macroeconomic environment and providing services to the poor. These recommendations provided a guideline for the development of the private sector and were later reinforced by the 1997 World Development Report in which the Bank, again, provided guidelines for the involvement of the private sector as a strategic partner of the state. The report identified the need to subject public services to competition as a means of improving the effectiveness and efficiency with which they were generated and delivered by state owned bodies (Table 18). The former demarcation between state and the private sector was challenged by the Bank’s report. It envisioned a collaborative relationship between the state and the private sector. Here the state is accorded the role of prime mover in the development of public-private partnerships.

High levels of private sector participation in the provision of public services either through privatisation of state owned facilities or the opening up of the infrastructure sector to private sector operators is associated with a number of anticipated positive outcomes for the economy and the sector concerned. These expectations are, according to Nellis (1994) based on the association between ownership and performance. The expected superior performance of private ownership over state ownership is based on the following arguments:

- Private ownership establish a market for managers, thus resulting in higher-quality managers;
- The equity and debt markets subject managers to high levels of scrutiny and discipline than do publicly owned enterprises;
- State owned firms are subject less scrutiny than private firms
- Private firms generally experience a lower level of political interference;
- Private firms are supervised by self-interested board members and shareholders, rather than disinterested bureaucrats.

Private sector participation in the ownership and delivery infrastructure services is motivated by the need to secure new markets and for better yields on investments. Low and declining yields (Anayiotos, 1994) in the mature power, telecommunications, water, and transportation markets of the developed economies have driven investors to seek higher rates of return in emerging and developing economies.

### **Section 2.8.9.5**

#### **Financing private Sector Participation**

The recent flurry of theoretical literature on the link between the productivity of developing and developed countries equates the quality of their infrastructure Abel and Bernanke (2001), Karaspan (1995), Jimenez (1995), World Bank (1994, 1997, 1998, 1999, 2001), Albouy and Bousba (1998), Reinikka and Svensson (1999), and Dailami and Klein (2001) to their long-term economic growth and development prospects. This relationship is reflected in World Bank 1994 private sector enterprise survey and investment report which devoted much of its coverage of investment flows to developing countries on the financing of infrastructure in the Least Developed Countries, LDCs.



The level of investment in infrastructure and the resulting improvement in the delivery of public services has become a central dogma of domestic development strategy and the rationale for external assistance.

For the international community and multilateral donors such as the IMF, DAC and World Bank, infrastructure development has become the basis for renewed lending to poor countries although the long-term trend is reduced inflows of public funds to the infrastructure and enhanced investments on the social sector. Renewed support of the infrastructure sector is linked to the 1990s investment liberalisation and the privatisation of former state-owned assets.

**Table 19 Overall Infrastructure Spending Needs for Sub-Saharan Africa (\$ billions annually)**

Infrastructure sector	Capital expenditure	Operational and maintenance	Total spending
ICT	7.0	2.0	9.0
Irrigation	2.9	0.6	3.4
Power	26.7	14.1	40.8
Transport	8.8	9.4	18.2
WSS	14.9	7.0	21.9
Total	60.4	33.0	93.3

Source: V Foster and C Briceno-Garmendia (Editors), *Africa's Infrastructure: A time for Transformation*.

This development created the conditions for private sector to become long-term financiers and providers of public services. According to Izaguirre (2001) in 1990-98 private operators had committed themselves to 1,700 infrastructure projects in developing countries. The value of these projects was estimated to be worth US\$500 billion.

The opening of the infrastructure sector to foreign investments encouraged the growth of long-term capital to developing countries, over the 1990s (Table 20). The author claims that Foreign Direct Investment (FDI), and equity flows to developing countries grew by some three hundred per cent over this period. Nothing is said here about its geographic allocation. However, Albouy and Bousba

(1998) estimated that US\$131 billion of investments were contracted in the period 1990-97, with green-field generation facilities accounting for 56 percent of these investments.

**Table 20 FDI inflows to power projects: number of projects (Cumulative FDI)**

Year	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Cumulative number of projects	68	100	187	458	698	967	1281	1636	1909	2124	2321

Source: World Bank PPI Database (Cumulative inflow of project finance 1990-2000US\$140 billions)

These flows were interrupted by the decline of developing economies in the late 1990s- a reference to the contagion that resulted from the Asian crisis and the collapse of investor confidence in emerging markets. However, Albouy and Bousba (1998) provide a break of these figures on a regional basis. Asia accounted for the majority of these inflows, with 103 projects and contracts valued at some US\$54 Billion. This was followed by Latin America, with 28 projects valued at US\$7.0billion. The lion's share of IPP projects is concentrated in seven Asian countries: China, Indonesia, the Philippines, India, Pakistan, Malaysia, and Thailand. These economies were characterised by rapid growth over the period and a rapid rise in the demand for power. In contrast the Latin American power investments was driven by the liberalisation of the sector. Albouy and Bousba estimated that the 137 IPP projects (Giga watts) valued at US\$65 billion attracted US\$51 billion of private investments. The balance being made up of a mix of guarantees or credit, 5 percent from multilateral donors, 11 percent from export credit agencies and the final point, 7 percent from bilateral donors. Albouy and Bousba (1998) analysis of power related investments in some ten countries demonstrated that IPP projects have allowed the transfer of a significant element of the risks associated with these investments: construction and management to the private sector. These contracts also accounted for 52 percent of the fuel availability risks through third party agreements and contractual agreements with fuel suppliers as equity partners.

## Section 2.8.9.6

### State Provision of Infrastructure

Here we provide a brief account of the role of government as a strategic partner to private sector infrastructure investors. The focus is on the provision of government support to private sector investors in infrastructure projects. We cite a number of possible mechanisms through which recipient countries can share the risks associated with large-scale investments by private firms, see Table 22.

**Table 21 Infrastructure Investment Funds**

Fund (and manager)	Core Investors	Investment targets
AIG Asian Infrastructure Fund (AIG Asian Infrastructure Management Company Ltd)	American International Group Government Of Singapore Bechtel Enterprises	Region: Asia-Pacific (35-50% in China) Sector: Power, Telecommunications, and Transport Size: US\$1,000-1,200million
AllianceScan East Fund L.P. (Scan East Managing Partner Ltd)	Alliance Life Assurance American International Group International Finance Corporation EBRD	Region: Eastern Europe, Baltic, CIS Sectors: Power, telecommunications and other industries Size: US\$22-50 million
Asia Brown Boveri Funding Partners (ABB Funding Partners, LP)	Asea Brown Boveri Institutional Investors	Region: Canada, Mexico, and the USA. Sectors: Power, transport and related industries Size: US\$42-100million
The Asian Infrastructure Fund (Asia Infrastructure Fund Management Company Limited)	Peregrine Investment Holdings Soros Fund Management IFC, Asian Development Bank Frank Russell Company	Region: Asia (40% in China) Sectors: Power, telecommunications, and transport Size: US\$750-1,000million
Central European Telec Investment, L.P. (Central European Telec Investments, Managers, Ltd)	Creditanstalt Bankverien Pan European Financial Services, IFC	Region: Central and Eastern Europe (Poland and Hungary) Sector: Telecommunications Size: US\$42-100 million
Global Power Investments Company, L.P (Global Power investments Company, Ltd)	GE Capital Corporation Soros Fund Management, IFC	Region: Global emerging markets Sector: Power Size: US\$550-2,500 million
Scudder Latin America Trust for Independent Power (Scudder, Stevens, & Clark, Inc)	IFC NRG Energy, Inc. CMS Energy, Inc Corporacion Andida de Fomento	Region: Latin America and Caribbean Sector: Power Size: US\$200-600 million

Source: Fund memorandums, IFC board papers Taken from: A. Anayiotos (1994): Infrastructure Investment Funds: World Bank Public Policy For the Private Sector

Dailami and Klein outline In Tables 21 and 22 the various means and instruments used by governments and private sector participants in infrastructure projects. The available options are to some degree determined (Jechoutek and Lamech, 1995) by the investment grade of the country. However, this is a complex issue as the pattern that emerges sometimes defies prediction based on the country's economic status, and credit profile. State support of infrastructure-related investments amounts to cash flow support to private firms and investors as 'special assurance' that payments and contractual agreements entered into with state-owned entities will be made when required. Payment in the designated currency and central government guarantees, project risks, such as the capacity of public entities to fulfill payment obligations may be transferred to the state as country risk. This exposure (full credit guarantees) may be reduced by (Dailami and Klein, 2001) by power purchase agreements. It follows that countries with poor credit ratings are required by investors to provide full financing through, for instance, export credit agencies whereas countries with better credit ratings, may offer guarantees for individual risk factors. The authors argue that multilateral organisations and export agencies appears to substitute for international contract enforcement mechanism.

**Table 22 Financing Infrastructure projects**

	Number	Pattern
Multilateral Banks and Export Credit Agency Debt	37	Greater incidence of debt assistance by multilateral banks and ECAs in non-investment grade emerging market (27)
Government Guarantees	28	Nearly three times as many government guarantees in non-investment-grade countries (24) than in investment-grade countries (9).
Informal Agreements <sup>a</sup>	28	Although 9 agreements were issued in Mexico, use of informal agreements is more common in investment grade countries (11).
Multilateral Banks and Export Credit Agency Guarantees	26	Slightly more examples among non-investment-grade emerging markets (15) than in investment-grade countries (11).
Government Equity Participation	18	Greater incidence of government equity participation in investment-grade countries.
Government Debt (Senior and Subordinated)	14	Equal split among non-investment- and investment-grade countries.
Multilateral Equity Participation	13	Much greater incidence of equity share-holding by multilateral banks and ECAs in non-investment-grade emerging markets (11).
Government Grants	12	Greater incidence of government participation through grants in non-investment grade countries (8).
Preferential Tax Treatment	2	Limited use of preferential tax treatment in investment grade countries.

Source: Dailami and Klein, Government Support to Private Infrastructure Projects in Emerging Markets, World Bank 2001.

Note: Financing packages of 78 projects (39 power, 26 transport, 7 water/waste, 4 telecommunications, and 2 gas) were disaggregated and then tabulated by type of mechanism and source of funds. All 78 projects have direct participation by private sector through the provision of debt, equity, or both. A: informal Agreements include comfort letters, side agreements, non-binding tariff increases, and other similar agreements.

Constrained public budgets, and the drive for greater efficiency (see Table 7& 12), are according to Izaguirre, partly responsible for this rapid rise in private participation in infrastructure. Foreign investors were by the end of the 1990-1998 the principal financiers of infrastructure in developing countries. The Mansoor and Klein study reported that private infrastructure finance to developing countries grew at an annual rate of 67 percent between 1990 and 1994. However, post 1994 this declined to an average of 14 percent, some 5 percent below the rate of growth of total private flows to developing countries.

**Table 23 Top Ten Sponsors of energy projects with private participation in developing countries, 1990-1999**

Sponsor	Projects	Total investment US\$ billions (1998)
AES Corporation	35	12.7
Enron.corp	23	12.5
Electricite de France	22	11.5
Endesa (Spain)	11	9.1
Southern Energy Inc	10	7.6
CMS Energy Corporation	17	6.7
Cia. Naviera Perez Companc	8	6.2
Endesa (Chile)	15	5.7
Tractebel	17	5.6
Enersis	7	5.3
Total	156	68.2

Source: World Bank, PPI project Database: Taken from: A k Izaguirre: Private Participation in Energy, World Bank, 2001.

The provision of infrastructure is shifting towards a demand-lead situation (Dailami and Klein, 2001) in which the private sector play a greatly expanded role and influence the maintenance and

investment level, and the provision of public infrastructure. The World Bank has estimated this need for infrastructure investment at some US\$ 200 billion per annum for developing countries. The size and urgency of this investment gap (see Tables 24, 27, 28 and 19) made the participation of the private sector vitally important. Furthermore, the generally poor state of the domestic financial markets and the ability to raise significant funds locally or access to international debt markets has focused policy makers on the needs of international investors and with this the need to implement investor friendly policies.

**Table 24 Infrastructure Spending and Addressing Sub-Saharan Africa’s Infrastructure Needs**

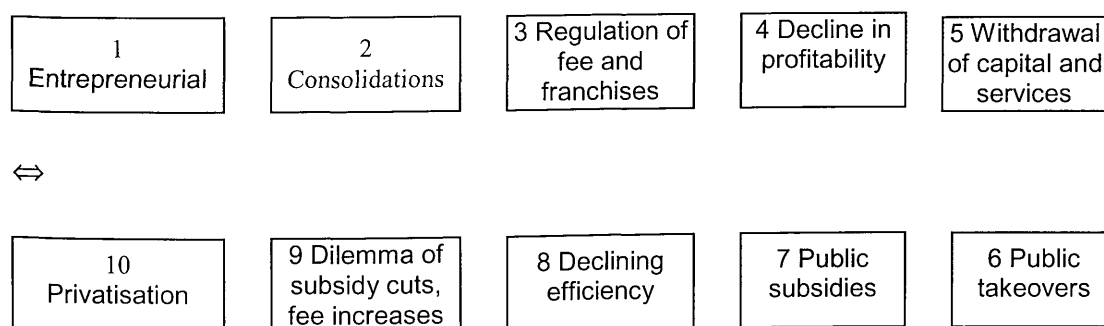
Infrastructure sector	Operation & maintenance/ public sector	Public sector	ODA	Non-OECD	Private	Total	Total spending
ICT	2.0	1.3	0.0	0.0	5.7	7.0	9.0
Power	7.0	2.4	0.7	1.1	0.5	4.6	11.6
Transport	7.8	4.5	1.8	1.1	1.1	8.4	16.2
WSS	3.1	1.1	1.2	0.2	2.1	4.6	7.6
Irrigation	0.6	0.3	-	-	-	0.3	0.9
Total	20.4	9.4	3.6	2.5	9.4	24.9	45.3

Source: Bricelo-Gamendia, Smith, and Foster 2008

The involvement of the private sector is the outcome of four developments in developing countries:

1. The poor performance of state-managed infrastructure providers;
2. Fiscal constraints and the inability of governments to meet infrastructure investment needs;
3. The imposition of World Bank, International Monetary Fund (IMF) and donor conditions, which have created conditions which favour private sector investment, deregulation and liberalisation (advocated market based macroeconomic policies);
4. Political reforms and the demand of citizens for better public services

**Figure 13 The privatisation-nationalisation cycle**



Source: Gomez-Ibanez and Meyer (1993): Taken from Mansoor and Klein: Government Support to Private Infrastructure Projects in Emerging Markets (World Bank, 2001).

The above developments had their origins in debt crisis of the 1980s and the resulting poor credit rating of developing countries. Developing countries and LDCs were severely constrained by unsustainable levels of public debt and a consequent decline of public services. In an effort to improve their growth and development prospect, these countries turned to the international community for solutions. Dailami and Klein (2001) study of private sector participation in infrastructure projects in developing countries estimated, from World Bank figures, that public sector borrowing requirement of this class of economies had declined from 6 percent of Gross Domestic Product (GDP) in 1982 to 1 percent in 1993. The authors noticed that this decline coincided with a rise in infrastructure investment requirement. According to Mansoor and Klein, the 1990s were marked by a movement towards private sector participation in infrastructure and deregulation in developed and developing countries alike. Over this period (1990-1996) the World Bank estimated that total net flows to developing countries expanded from US\$101 to US\$285 billion per annum. Cross boarder private inflows for the period grew from US\$44 billion to US\$244 billion. However, official or public inflows declined from \$56 to \$41billions or by 73 per cent.

Investment in infrastructure is according to World Bank figures (World Bank, 1997) dominated by international private sector finance. Dailami and Klein (2001) found this to be true for even countries with high savings rates. This observation is explained by reference to the need of investors to diversify and risk manage and the inability of local financial markets to support capital intensive projects. The trend towards private sector funding is associated with a displacement of public investment by private sources. This is linked to a decline in the rate of growth of public borrowing from private investors. Over the period this grew from \$63 billion to just under US\$85 billion. The share of ODF as a percentage of total inflows, declined from 56 at the start of the period to 14 in 1996. In contrast, the corresponding inflows to the private sector grew from \$37.8 billion to \$199.7 billion (World Bank, 2001). These flows are listed in Tables:18, 24,25 and 26.

**Table 25 Long-term Resource flows to developing countries**

Year	1990 In US\$ billions	As a share of total	In US\$ billions	1996 As Share of Total
Total flows	100.6	100	284.6	100
Sources				
ODF	56.3	56	40.8	14
Private flows	44.4	44	243.8	86
Recipients				
Public sector	62.8	62	84.8	30
Private sector	37.8	38	199.7	70
FDI	(24.5)	(24)	(109.5)	(38)
Portfolio equity flows	(3.2)	(3)	(45.7)	(16)
Nonguaranteed debt	(10.1)	(10)	(44.5)	(16)
Bond	(0.1)	(0.1)	(20.8)	(7)

Source: World Bank: Taken from Mansoor and Klein: Government Support to Private Infrastructure Projects in Emerging Markets.

### Section 2.8.9.7

#### The Ugandan Experience

Uganda shares a common deficiency with her fellow SSA LDCs, a low provision of most public infrastructure. The fact of country's geography i.e. landlockedness means good road and air links are vital to her growth and development. A number of recent studies (World Bank, 1994, 1998, 1999 and 2001) have highlighted the significant costs incurred by Ugandan exporters for road transport. The Trade and Development Centre, a joint World Bank and World Trade Organisation entity estimated that transportation costs amount to 40 percent of export prices. The Morrissey and Rudaheeranwa (1998) study of Uganda's Trade Policy and Export performance identified the costs of transportation and distribution as having a negative impact on both the attempt to diversify the economy and improve the competitiveness of the export sector. For instance, the growth of non-traditional export such as perishable goods is severely constrained by the inadequate state of the transport infrastructure. The government's Action Programs (2001) which was presented at the third United Nations Conference on LDCs, May (2001), acknowledged "poor infrastructure as the



primary constraint on the development of the economies of poor countries". Unreliable power supply, poor road network and telecommunications; were identified as constraints on the growth of the private sector. The importance of this high cost is reflected in studies which have estimated that transportation costs account for as much as 40 per cent of export prices. This is a major constraint on the drive to increase the competitiveness of the export sector. The social implications for communities isolated by poor transportation i.e. they are, in many cases excluded from the consumption of government social services: health services, schooling and formal economic participation. There are six important considerations here:

1. The link between the quality of recipient infrastructure and its growth and development prospects;
2. Theoretical and empirical links between improving quality of infrastructure and gains in productivity and competitiveness of LDCs economies;
3. The inability of LDCs to finance either the rehabilitation of inefficient infrastructure and or the production of new ones;
4. Empirical data have demonstrated that private sector participation in the provision of infrastructure services is associated with greater access for users, lower costs and an overall improvement in efficiency;
5. The above developments have created a need for domestic and foreign private operators to both invest in and deliver infrastructure services.
6. It follows from 5 that LDCs governments are under pressure from bodies such as the WB and other multilateral donors to create institutional structures, regulatory regimes and legal environment supportive of domestic and foreign investors.

This is a controversial area as public sources of investment have traditionally dominated the provision of structures and the delivery of services. However, deteriorating economic performance and rising dependence on foreign inflows, particularly among the Sub-Saharan LDCs, has created opportunities for private actors. However, authors such as Bauer (1961 and 1967) argue for a market driven and demand-lead process of overhead capital creation and against public funding of infrastructure. Bauer's argument assumes that higher productivity growth generates a demand for appropriate levels of infrastructure as well as providing the necessary finance for investment in its

provision. It follows from this that rich countries are better placed to provide public infrastructure, such as schools, hospitals and roads. Another criticism of public funded infrastructure is the common practice of some LDC governments to focus primarily on political factors when deciding on public investment in infrastructure. This is argued by Karaspan (1995) and Dailami and Klein (2001), respectively, to be wasteful of limited resources and limits growth in the economy and efficiency. This latter point will be addressed by my focus on the effective utilisation of Aid inflows. In short, the Aid-FDI is hypothesised as a means of improving effective utilisation of Aid in financing infrastructure. The participation of private sector organization, profit maximising firms would be expected to counter the tendency of SSA LDCs to allocate resources on primarily political basis. The above developments (points 1-6) provide me with an opportunity to explore my hypothesised Aid-FDI interface. I will undertake an empirical investigation of a number of infrastructure projects. These projects will be chosen for their demonstration of the Aid-FDI link in as much as they have made use of these two types of financing. An integral aspect of this study is the impact of the Aid-FDI link on the economy of the recipient. The particular concern here is the effective utilisation of declining Aid inflows to LDCs. The policy environment in which this conjugation occurs is another critical aspect of this study. I therefore propose to explore the contribution of infrastructure to the growth and development process in a number of LDCs. If physical infrastructure is as important as the development community agrees, then I expect to find macroeconomic disturbances in countries which have made significant investment in infrastructure. I would expect the contribution of Aid-FDI financed projects to make a bigger contribution to the growth performance of the recipient economy.

In Uganda, the case study country, the available data from bodies such as the World Bank (WB Uganda Private Enterprise Survey, 1994, 1996, 2000) and the Government of Uganda (2001) are supportive of a link between poor infrastructure and poor economic and social progress. This data and its analysis, discussion and implication for this study are introduced in subsequent sections of this chapter. In this section of the chapter we outline the efforts of the Uganda government and its

international development partners (public and private bodies) to provide the perquisite complementary capital for the achievement of a number of social/welfare and macroeconomic outcomes.

The principled objective of the country assistance strategy is the managed reduction of poverty. This achievement is linked to the growth prospect of the economy. Essentially, high and sustainable growth is expected to make these objectives achievable. However, foreign and domestic investors, not the public sector are expected to play the lead role in promoting growth. The World Bank (1994, 1996, 1999, 2001) have recognised that inadequate infrastructure of poor countries has made these attainments doubtful, unless and until significant improvements are made to the current poor state of these domestic complementary public capital. The World Bank has played a significant role as policy advocate i.e. advancing the case for a regulatory environment which will support higher level of private sector involvement as well as providing a variety of financial instruments to third private sector investors in public infrastructure. The bank has focused on three main areas of policy:

- Wide-scale sector reform to support the efficient management of power projects through significant private sector participation;
- Assisting the process by which low cost/ least-cost means of supply are made available to meet local demand; and
- Increasing the uptake of electrical services by the rural poor as a means of facilitating rural development.

These policy objectives are particularly pertinent to the Ugandan experience as World Bank figures indicate that only three percent of the country's population (The Bujagali Hydropower project appraisal papers, World Bank and International Finance Corporation, 2001) have access to electrical services i.e. connection to the national grid or utility power. This 3 percent access is concentrated in the three major urban cities of Jinja, Kampala and Entebbe. This disappointing piece of statistic is in contrast with the good performance of the economy in the 1990s. In this period high growth levels was associated with improvement in living standards. Rural communities have not experienced the benefits associated with this period of sustained growth. Instead, Uganda's rural communities have

continued in a state of severe poverty and untouched by the benefits of modern goods and services. These privations are, according to the Bank, the result of inadequate infrastructure, which has both constrained economic growth in these communities as well as adding to the lack of integration with regional, national and international markets. Whilst International assistance, such as that provided through the International Development Association (IDA), has expanded domestic provision and enhanced Uganda's generation facilities, the World Bank (1994, 1996, 1999, and 2001) argues that this has not improved the management and efficiency of local generation. The former state owned Uganda Electricity Board (UEB) was badly managed; highly indebted and incapable of financing even a modest portion of its own operating expenses and debts. Hence, the role of the Bank as advocate of wide-scale sector reform and the promotion of private sector participation in the financing, construction and management of new and former state owned facilities.

The provision of reliable and efficient electricity services to the rural community is linked to the World Bank and Ugandan government efforts to promote sustainable growth as a means of combating poverty. To this end the bank has played a key role in the unbundling and privatisation of the UEB on the basis that this would improve access and efficiency of the sector through private sector participation. Uganda's hydropower resources have received considerable attention. The Bujagali hydropower project is an example of the World Bank country assistance strategy. The 1999 comprehensive power sector reform contained a new Electricity Act, followed by a sector regulator. The first act of the regulator was the unbundling of the UEB into three components: generation, transmission and distribution. This development was associated with a substantial increase in tariffs. These reforms were accompanied by concession generation and distribution agreements with private sector firms as a means of transferring the risks associated with these activities, expanding access and improving the efficiency of the sector. Albouy and Bousba (1998) argue that the financing Independent Power Producers (IPPs) is very attractive to financial institution as the relative advantage to sponsoring states/governments is questionable. Here the authors argue that the

need to manage the liabilities contracted by governments is critical. For instance, government exchange rate guarantees, may inflate the cost well above the level to private sponsors.

Jechoutek and Lamech (1995) argue that public-private partnerships in project-financed by IPP entities have failed to produce results. Again Albouy and Bousba (1998) argue that the financing of these projects would receive greater private sector support and specifically corporate balance sheet support. This is said to provide greater security to lenders and possibly cheaper capital. This latter point is made in the context of the high level of debt (60-70 percent) associated with IPP financing. The sustainability of these projects is expected to improve with these changes to the financial structure of public-IPP projects. Albouy and Bousba's concern for recipient government liabilities and the distribution of risk, offers a useful context for this debate. Some of these points are addressed in, for instance, the wide-scale reform of the Ugandan power sector.

The shift from government ownership and management assets, to private sector construction, ownership and management is incorporated under the World Bank sponsored reform of the sector in the late 1990s. However, the current Bujagali hydropower project does entail government guarantees once the initial liquidity facility has expired. At this point the government will make good the debts of the local distributor, the Uganda Electricity and Transmission Company (UETC) to the AESNP, the subsidiary of the US private owner of the Bujagali hydropower project. This facility is jointly financed by US\$234 million of Export Credits, up to US\$100 million of International Financial Corporation (IFC) loans, US\$115 million of International Development Association (IDA) Guaranteed Loan Facility, US\$55 million loan from the African Development Bank and equity of US\$115 million plus net interim energy revenue of US\$3 million. The total value of the investment amounts to US\$582 million. The US Company AES withdrew from the Bujagali hydroproject citing procurement problems and lack of goodwill on the part of the Ugandan government and the failure of the said to make necessary policy reforms-failure to pass a bill in parliament to correct failures in procurement and related measures.

The expected outcomes of the Ugandan Government's reform of the sector are: the transformation of the commercial operations of the system; enhancing the quality of supply and, the creation of a dynamic and competitive and attractive market for new suppliers. The government forecast an 8 percent annual increase in demand for electricity power over the next decade (Ugandan Government papers, 2001). The Bujagali hydropower project is in keeping with government's development objectives: namely, the eliminating the constraining influence of inadequate power supply on economic growth (IDA project appraisal document, 2001) and the eradication of rural poverty; the development of the country's significant hydropower potential; enhance private sector investment in the sector and; the development of the export potential of the sector. The Bujagali project will provide a unique opportunity to observe the implementation of the Ugandan government's explicit commitment to the creation of a competitive domestic market in the construction, operation of power generation assets. Another rationale for reform of the sector was to mobilise private sector investment. This project is expected to promote private sector ownership and management of power generating facilities and the development of future policies for the sector.

As the project involves both private and public funds, it will provide an opportunity to empirically test my hypothesised Aid-FDI link. This determination will be made in the context of the Ugandan government's policy for the sector. It is therefore hoped that this study will identify the appropriate macro and sector policy which will enhanced the Aid-FDI interface. I will demonstrate the applicability of these findings to other Sub-Saharan economies and those in which growth is constrained by inadequate public infrastructure. The present assessment is that the country has a very poor quality of provision and that this is universally true of all infrastructure services. This has clear implications for the growth of the economy. In fact the World Bank (1996) and the Ugandan government (2000), respectively have both acknowledged that the country's inadequate infrastructure is a major impediment to its economic and social progress.

Government focus on the reduction of rural poverty and the general improvement of living standards and economic growth has resulted in policies to encourage the private sector to participate

in the rehabilitation and extension of public infrastructure services. Here we cite three important categories of infrastructure: communication, transport and power generation. The sectors are identified by the government as critically important to its overall strategy of improving the welfare of its citizens and the prospects for economy. The reform of the sectors is synonymous with the privatisation and economic liberalisation process. However, a significant and important aspect of these developments initiatives is the capacity of the domestic private sector to participate in the creation of new public infrastructure and/or the renewal of dilapidated facilities. This limitation is tacitly acknowledged by the government in its appeal to the international community and donors to provide coordinated support for the reform of the sector in line with its priorities, see section above on government priorities for the reform of the infrastructure sector.

The current study will attempt to determine the conditions that would encourage collaboration between international private and public capital (the hypothesised Aid-FDI interface) in the provision of public goods, i.e. infrastructure. In its recent publication: Infrastructure reform in Uganda (Ugandan Government, 2001), the government of Uganda acknowledges that the effective utilisation of limited public funds is vitally important as the volume of investment does not universally result in better facilities. The government has therefore identified a number of guidelines and priorities for public and private sector involvement in the sector. These are:

- Infrastructure development and maintenance must be made more responsive to economic and social needs;
- Wasted expenditure and effort through inefficiency, the adoption of inappropriate solutions and corruption must be driven out;
- Government priorities, plans and policies need to be fully clarified, effectively coordinated and efficiently executed; and
- The international community, and particularly the donor community, needs to provide coordinated support, focused on the priorities and needs of the government and the people of Uganda.

This commitment to infrastructure reform has resulted in enabling legislation and policies as a means of facilitating the process. The current ownership is vested in government controlled and managed bodies. The desire to remove these liabilities from the government budget is urgent in the face of fiscal and other constraints. However, the government (Ugandan Government papers, 2001) acknowledged that reform in the sector has been both slow and erratic. The process is under ministerial guidance and a team of dedicated civil servants in the Privatisation and Utility Reform Unit.

**Table 26 Investment in Infrastructure Projects with Private Participation in Developing Countries by sector and Region, 1990-1998. 1998 US billions**

Sector	1990	1991	1992	1993	1994	1995	1996	1997	1998	Total
Telecommunication	6.6	13.1	7.9	10.9	19.5	20.1	33.4	49.6	53.1	214.0
Energy	1.6	1.2	11.1	14.3	17.1	23.9	34.9	46.2	26.8	177.1
Transport	7.5	3.1	5.7	7.4	7.6	7.5	13.1	16.3	14.0	82.2
Water & Sanitation	0.0	0.1	1.8	7.3	0.8	1.4	2.0	8.4	1.5	23.3
Region										
East Asia & Pacific	2.3	4.0	8.7	15.9	17.3	20.4	31.5	37.6	9.5	147.2
Europe & Central Asia	0.1	0.3	0.5	1.5	3.9	8.4	10.7	15.3	11.3	52.0
LA & Caribbean	12.9	12.3	17.1	18.0	18.4	19.0	27.4	45.1	66.3	236.5
Middle East and North Africa	0.0	0.0	0.0	3.3	0.3	0.1	0.3	5.2	3.6	12.8
South Asia	0.3	0.8	0.1	1.2	4.3	4.0	11.4	13.7	2.3	38.1
SSA	0.0	0.0	0.1	0.0	0.7	1.0	2.0	3.5	2.3	9.6
Total	15.6	17.4	26.6	39.9	44.9	52.9	83.3	120.4	95.3	496.2

Source: World Bank PPI Database: Taken from Roger, N (1999): Recent Trends in Private Participation in Infrastructure.

The current study is focused on the hypothesised link between Aid and Foreign Direct Investment (FDI), the Aid-FDI interface. I have therefore decided to investigate this link in the financing and operation of overhead capital, public infrastructure. Uganda has been identified as a suitable candidate [(World Bank, 1994, 1996, 1998, 1999, 2001, and Morrissey et al, 1998)]. The choice of Uganda is supported by reference to earlier economic development studies and the recent



macroeconomic and social/welfare experience of the country. Chapter 6 contains a detailed account of the methodology and its justification and rationale. The data in Table 27,32,33 and 34 offers some evidence for the importance of infrastructure and its impact on a number of industrial and commercial sectors of the Ugandan economy. The fact that agriculture is rural and employs some 80 per cent of the working population (World Bank, 1994) does suggest that for a landlocked country such as Uganda, improvement in the transportation and road networks, would create significant gains for private firms, greater access to markets for rural farmers and incentives for subsistence farmers to become commercial actors i.e. generate excess production for sale in markets.

The World Bank's 1994 survey of private sector enterprise concluded that small companies are the most severely impacted on by poor infrastructure provision. The report's findings are summarised in Table 54. The inadequate infrastructure is said to constrain the ability of small firms to expand their activities, as well as imposing extra costs and delays for both the importation of inputs and the export of finished goods. For instance, power breakdown i.e. disruption had its greatest negative impact on micro, large and very large businesses.

**Table 27 Infrastructure Constraints**

Constraint	Order of significance
Power breakdown	3.5
Voltage fluctuation	3
Telecoms problem	2.7
Quality of roads	2.6
Land/Industrial space	2.6
Waste disposal	2.2
Commercial trucking	2.0
Waste Water disposal	1.9
Air freight services	1.8
Railway transport	1.7
Ports/shipping	1.6

Source: World Bank Survey

4 = major problems, 1 = no obstacle

As far as the importance of road transport is concerned, the government's 2001-2010 Action Programs for development (ADP) mentions, for example, that imports average some 70 days from point of origin to final destination in Uganda. This is compounded by an average of 90 days loss of production due to power cuts.

**Table 28 Infrastructure constraints on private firms by size, 1994 (average scores: 1= no obstacle, 5=severe obstacle)**

	Micro (1-5) n=46	Small (6-20) n=86	Medium (21-50) n=72	Large (50-100) n=26	Very Large (over 100) n=35	Average score
Lack of land or space	2.77	2.45	2.65	2.65	2.45	2.58
Power breakdown	3.28	3.54	3.30	3.85	4.0	3.52
Power Fluctuations	3.05	2.90	2.71	3.31	3.68	3.02
Telecommunications	2.82	2.76	2.75	3.07	3.05	2.84
Water supply	2.35	2.34	2.40	2.42	3.05	2.40
Waste disposal	2.08	1.92	1.91	1.76	2.57	1.93
Industrial waste disposal	2.20	1.89	1.90	2.42	1.88	2.07
Commercial transport	1.42	1.84	2.29	2.04	2.44	2.00
Roads	2.28	2.28	2.87	2.96	2.03	2.67
Railway transport	1.23	1.67	1.79	1.77	2.03	1.75
Ports and shipping	1.00	1.45	1.60	2.03	2.65	1.72
Air freight services	1.07	1.59	1.65	2.00	2.44	1.76

Source: World Bank: Uganda Private Enterprise Survey, 1994

Airfreight is considerably more important for large to very large firms. This importance also reflected in the quality and availability of ports and shipping facilities. In Table 29 the sectorial importance of the above facilities is determined through a ranking system. Here power breakdown and power fluctuations are the most important variables overall. The agricultural industry ranked power breakdown as the most important service. This service was also ranked as number one by the other four sectors: Industry, Commerce, Services and construction. However, services and commerce provided the second and third highest ranking for power breakdown. Power fluctuation had the highest overall ranking and railway, the lowest overall ranking. The Agricultural sector

(1.67) and construction ranked waste disposal (overall ranking 1.93), as the least important constraint.

**Table 29 Infrastructure Constraints on private firms by sector, 1994 (average scores: 1= no obstacle, 5=severe obstacle)**

	Industry n=75	Agro- industry n=34	Commerce n=53	Services	Construction n=27	Average
Lack of land or space	2.80	2.47	2.34	2.67	2.33	2.58
Power breakdown	3.37	3.65	3.56	3.60	3.48	3.52
Power Fluctuations	3.01	2.90	2.94	3.08	3.20	3.02
Telecommunications	3.01	3.12	2.42	2.85	2.77	2.84
Water supply	2.51	2.56	2.21	2.43	2.18	2.40
Waste disposal	1.98	1.67	1.90	2.03	1.81	1.93
Industrial waste disposal	2.11	2.32	1.94	1.97	2.20	2.07
Commercial transport	2.42	2.27	1.71	1.59	2.16	2.00
Roads	3.13	2.96	2.14	2.27	3.15	2.67
Railway transport	2.01	1.75	1.52	1.40	2.28	1.75
Ports and shipping	2.28	1.55	1.46	1.27	1.95	1.72
Air freight services	2.24	1.46	1.54	1.47	1.87	1.76

Source: World Bank: Private Enterprise Survey, 1994

Private sector participation in infrastructure (PPI) started in New Zealand and Chile (Karaspan, 1995) and the United Kingdom in the early part of the 1980s. The period 1984-1994 witnessed the initiation of some 900 PPI projects across a wide range of industries, ranging from telecommunications in Cuba to multi-sectoral developments in economies as diverse as Colombia to Albania. Over the period 1988-1994, the Bank for International Reconstruction and Development, the World Bank, provided financial support for over 500 infrastructure projects. This accounted for a third of all World Bank participation over the period.

These projects included the privatisation of public utilities, on lending to private sector, lease and franchising operations and management contracts. The establishment by a number of joint World Bank, International Financial Corporation (IFC) and the Multilateral Investment Guarantee Agency

(MIGA) encourages private sector participation. This has included the establishment of a number of investment funds to facilitate private sector participation. The sectorial coverage of the World Bank in PPI are summarised in tables: 30, 31, and 32-see below. Those involving collaboration with the IFC are listed in Table 30. The instrument employed by the bank is indicated as well as the extent of its involvement. The provision of adjustment loans for single sector or multi-sect oral policy enhancement are said to depend on a commitment by recipients to wide-scale liberalisation and the creation of a domestic regulatory environment which facilitates private sector participation in the provision of infrastructure and public services. According to Karaspan the World Bank's PPI programs have three important components. These are:

**Table 30 World Bank and IFC PPI Projects by sector, 1988-1994**

Sector	World Bank	IFC
Multiple	10	3a
Telecommunications	10	23
Transport	21	11
Water and Sanitation	6	2
Power	22	29
Energy	6	6
Solid Waste	1	0
Direct Poverty alleviation	16	0
Total	92	74

a refers to infrastructure leasing operations, all in India

Source: Omer Karaspan (1995): Public Policy for the Private Sector (October, 1995) and World Bank, Private Sector Development Department, PPI Group.

1. Supporting the design and implementation of a stable, comprehensive, and consistent legal and regulatory environment for PPI;
2. Promotion of the development of a significant domestic capital market to allow local participation in the funding of PPI projects;
3. Management of local social and political risk through public awareness through campaigns-dissemination of information and the provision of a social safety net.

The provision of World Bank investment loans is also argued to have played a catalytic role in the privatisation of publicly owned infrastructure services. From Table 58 it can be seen that 47 per

cent of these loans support the establishment of the necessary legal and regulatory environment for PPI as well as funding the public investment that complement and facilitate private sector participation. Poland and Albania are offered as examples of this catalysis of private sector in which the rehabilitation of the roads facilitated the emergence of private sector trucking and road maintenance and repair facilities. It can be seen in Table 31 that twelve of the fifteen investment loans involving franchise arrangements were made for Sub-Saharan economies, 3 in Latin America, and 1 in east Asia and the Pacific region. These loans are associated with technical assistance and specifically, the preparation and design of management contracts, leases, or concessions for the provision of infrastructure services. The statistics indicate that (Table35) franchise and management agreements/contracts are the dominant mode of operations in Africa (SSA). These agreements range from telecommunications in Guinea, airlines in Chad, power in Mali, Guinea, Sierra Leone, and water in the Gambia over the period 1988-1994.

**Table 31 World Bank PPI operations 1988-1994**

Instrument	Latin America	Africa (SSA)	Middle East& North Africa	Europe&C entral Asia	East Asia and the Pacific	South Asia	Total
Adjustment: single sector	2	1	0	0	0	0	3
Adjustment: multi-sector	5	0	0	0	0	0	5
Technical Assistance	4	2	0	1	1	0	8
Investment Lending	14	33	1	6	10	12	76
On-lending to private sector	3	1	0	1	3	5	13
Direct Poverty alleviation	3	12	0	0	1	0	16
Public investment facilitating PPI	8	20	1	5	6	7	47
Franchising	2	12	0	0	1	0	15
Funds	0	0	0	0	0	2	2
Total	25	36	1	7	11	12	92

Source: WB, PPI Bank Project database: Taken from Karaspan (1995): The World Bank Contribution to private sector participation in infrastructure.

The focus on poverty reduction by national governments and multilateral agencies such as the World Bank especially in the developing world particularly in LDCs has identified a link between improving quality of public infrastructure, the delivery of infrastructure services and the decline in the incident of poverty. This is particularly associated with private sector participation in PPI projects.

Take for example the AGETIPs (*Agence d'Exécution des Travaux d'Intérêt Public contre le sous-emploi*) models which are employed by the Senegal's public works and employment loan (1989). The AGETIPs are privately owned small public works contractors which have undertaken contracts valued between US\$50K and US\$100K for a variety of public maintenance contracts and projects such as local roads, and other community facilities. Contracts are opened to competitive bids with the stipulation that labour intensive methods of working are employed. This condition favours small contractors and job creation and the development of the private sector through the provision of additional supports such technical assistance and consultancy.

Table 32 shows the value of investment in four major public infrastructure sectors across five regions. The figures indicate that the Sub-Saharan region obtained very little private sector investment in these sectors over the period 1990 to 1994. However, the region achieved some US\$100 million of investment in 1992. This rose to US\$700 million in 1994 and 5 billion in 1997 but this declined by over one billion by the following year, 1998 to some 2.3 billion. The aggregate figure for the nine-year period amounted to 9.6 billion US\$.1995. By 1998 this peaked at 3.

**Table 32 Investment in Infrastructure Projects with Private Participation in Developing Countries by sector and Region, 1990-1998. (1998 US billions)**

Sector	1990	1991	1992	1993	1994	1995	1996	1997	1998	Total
Telecommunication	6.6	13.1	7.9	10.9	19.5	20.1	33.4	49.6	53.1	214.0
Energy	1.6	1.2	11.1	14.3	17.1	23.9	34.9	46.2	26.8	177.1
Transport	7.5	3.1	5.7	7.4	7.6	7.5	13.1	16.3	14.0	82.2
Water & Sanitation	0.0	0.1	1.8	7.3	0.8	1.4	2.0	8.4	1.5	23.3
<b>Region</b>										
East Asia & Pacific	2.3	4.0	8.7	15.9	17.3	20.4	31.5	37.6	9.5	147.2
Europe & Central Asia	0.1	0.3	0.5	1.5	3.9	8.4	10.7	15.3	11.3	52.0
LA & Caribbean	12.9	12.3	17.1	18.0	18.4	19.0	27.4	45.1	66.3	236.5
Middle East and	0.0	0.0	0.0	3.3	0.3	0.1	0.3	5.2	3.6	12.8

North Africa										
South Asia	0.3	0.8	0.1	1.2	4.3	4.0	11.4	13.7	2.3	38.1
SSA	0.0	0.0	0.1	0.0	0.7	1.0	2.0	3.5	2.3	9.6
Total	15.6	17.4	26.6	39.9	44.9	52.9	83.3	120.4	95.3	496.2

Source: World Bank PPI Database: Taken from Roger, N (1999): Recent Trends in Private Participation in Infrastructure

### Section 2.8.9.8

#### Conclusions

The theoretical and empirical literature have both identified the importance of infrastructure for the welfare of the population of a country and this in recent times is well established in poor developing countries such as Uganda. In truth much of the motivation for increased donor contribution is critically inspired by concerns for the poor state of the infrastructure of LDCs. In the theoretical literature, poor infrastructure endowment is linked to and explains the low absorptive capacity of LDCs to FDI. Poor infrastructure also imposes costs on firms as they have to spend more on making good unreliable utility power as in our case study country. The world Bank 1995 private sector survey and the authors recent survey of a number of Ugandan's major overseas investors, identified the unreliability of utility power as a major barrier to the efficient operation of their businesses and in some instances this has resulted in a reduction in manufacturing investments as well as addition to their costs and hence a decline in their competitiveness on international markets. With the poor transportation infrastructure, roads, and rail links to ports in neighbouring countries, Ugandan exporters experience high costs which is likely to reduce the profitability of their operations and put at risk additional investments to her relatively small export sector. Furthermore, as MNEs are the principal source of FDI, it is critical that these deficits in infrastructure endowment are made good by the government in order to obtain the FDI inflows to increase the growth and poverty and development targets agreed by the Ugandan government and the international community i.e. the MDGs. However, significant increases in the tariff charged to customers may become politically challenging for reform minded governments. The fact that Uganda is a country in which only 10 percent of the population had access to utility power, means that the current supply is inadequate to meet present needs especially from firms. Whilst potential demand may be

great, per capital income of households is very low and this suggest a need for subsidies to producers and/or distributors. It clear from this that it is not possible to remove totally the risk associated with the operation of the industry from the public purse to private sector.

The fact that the IFC and the World Bank have provided some \$US300 million to the lead investor in the Bujagali hydro power project is clear evidence that the industry is not fully operating in a strictly private sector mode. Such a large injection of aid evokes concerns for the social to private rates of return for this and other similar investments i.e. where they are financed by a mixture of private capital, aid and FDI. This is also a demonstration of our Aid-FDI interaction term.

However such 'smart subsidy' may be justified on the basis that incomes are low and this may result in poor affordability, low uptake as tariffs are high. Investors may therefore require a subsidy to reduce tariffs and the risk profile of the investment. In this case, Investors must take a long term perspective on profitability as current demand does not mean economic viability. And this has implications for government exposure to such developments as budget allocations are possibly large and therefore constitute a significant risk to overall government budget. In the end, 'smart subsidy' may be the only means of inducing private sector participation in enhancing both the availability and quality of important infrastructure services such as power. The ongoing rural electrification program in Uganda is an example of these policy difficulties. Whilst Uganda's infrastructure needs significant increases in private investments, the available data for the region suggest that a combination of poor management and lack of political leadership, typical of the countries of the region, has resulted in poor investor response to the privatisation programs in the infrastructure sector. The imposition of donor concerns for the impact of infrastructure development on the environment in the case of Uganda may impose additional costs and risks to investors as this often requires the engagement of international experts and consultants. To some extent this process may induce local resistance to these developments as displaced communities seek a premium for the dislocation of traditional habitats and livelihoods.



## Chapter 3

### Determinants of FDI: A LDCs' perspective

#### Section 3.0

##### Introduction

This chapter discusses the determinants of FDI from a developing country perspective and with reference to a number of empirical studies of FDI inflows and its determinants for a number of mostly developing countries. Torris's (1973) empirical study of host country determinants: from a demand side perspective for FDI in non-oil producing least developed country (LDCs) is our starting point. The author formulated and developed a number of hypotheses. These were tested using multiple regression analysis of single equation demand models of foreign direct investment (FDI). A number of single equations demand models for direct foreign investment were constructed. These equations contain variables drawn from the major hypotheses considered in the theoretical literature. Statistical analysis of these equations allowed for the determination of the 'best' equations as well as the identification of those variables, which have a significant influence on foreign investment. The author justifies the use of multiple regression analysis on the basis that the study of the country made use of aggregate time's series data to estimate DFI demand models. The authors recognised certain limitations in respect of the quality and availability of data: reporting changes and redefinition of data entries. The latter was considered particularly relevant to the measurement of FDI. The rationale for the choice of Colombia is the fact that it was at the time of the investigation, a well-known LDC and because of its membership of the ANCOM, the Andean Common Market. Furthermore, the theoretical perspective is that membership of regional trade bodies have a positive impact on FDI inflow. Available evidence at the time of the empirical study (Torrissi, 1973) was that Colombia's trade flows had increased substantially over the period of its membership. The hypotheses tested were:

- Market-size hypothesis, which state that market size as measured by real gross domestic product (GDP), is a major determinant of FDI.

- A market growth hypothesis that the absolute or annual growth real rate of the economy positively influences FDI.
- A trade balance hypothesis, which argues that a country's overall trade performance (Exports-imports) has a lagged effect on FDI in LCD's that selectively enforce foreign investment regulations. This is particularly important when trade balance may influence FDI in small LDC's that typically apply criteria for the approval of FDI projects which emphasizes the net effect of investment on the country's balance of payments.
- A common market hypothesis that the creation of a regional trade bloc (the Andean Common Market, effective in 1969) will have an immediate and positive impact and/or a long-term continual positive effect on FDI in a particular member country. This study is similar to Schneider and Frey's (1985) four model approach with the exception that:
  - 1) the focus is only on economic, not politico-economic determinants;
  - 2) the number of hypotheses is limited to four, not the eleven theoretically derived hypotheses.

Both studies emphasize the theoretical justification for the variables used. However, Torrissi, unlike Schneider and Frey discounted socio-political factors. In fact Torrissi conceded that risk factors influence decision and extend this to cover political stability or instability. He asserts that the complex relationship between political stability and FDI is difficult to quantify and test empirically. The following independent variables were included in the variants of foreign investment demand equation estimated a trend variable where 1958 is equal to one, gross domestic product (GDP), the annual size of the economy, annual real growth rate of GDP (%) for Colombia. A trade balance, variable lagged for one year, plus a dummy, intercept-shifting variable, which introduced the impact of Colombia's membership of ANCOMM on the level FDI inflows. High level of government intervention in the case of Colombia, i.e. export substitution initiatives (Torrissi, 1973) export subsidies and tariffs suggested the prospect of a negative relationship between trade balance and direct foreign investment. The market variable as represented by GDP produced a positive and significant coefficient. From this the authors concluded that the market-size hypothesis is valid for

DFI in small LDC's. However, the market growth rate justified by theoretical literature and introduced as annual changes in GDP had an insignificant positive coefficient.

The results obtained with respect to the influence of trade balance on FDI indicate that a decline in trade balance is associated with an increase in FDI inflows, in the case of Colombia. However, improvement in the trade balance suggested a lagged negative impact on FDI. Again these observations are attributed to government intervention: export substitution and tariff initiatives calculated to promote the output performance of the economy with respect to the trade in manufactured goods. Singh and Jun's empirical study (1992) attempted to answer a number of questions on the determinants of foreign direct investment (FDI) to developing countries. In fact the authors sought to examine the empirical validity of a number of theoretically derived hypotheses.

These were:

- What types of socio-political/instability are detrimental to FDI flows? Are there structural differences between countries with high or low FDI flows?
- Does the perception of favourable business operating conditions positively affect FDI flows?
- Do taxes or international transactions impede FDI?
- What type of exports: (primary or manufacturing) are related to FDI?
- Do exports oriented economies attract FDI (exports precede FDI) or;
- Do inflows of FDI tend to increase exports (FDI precede exports)?

The authors argue that determination of these questions is justified on the basis that FDI is now recognised as a "viable alternative for financing development." Further justification is made on the grounds that FDI flows have in recent times dominated cross border capital movement as the largest source of non-debt investments. This much was confirmed by the figures provided by the World Bank's report on the flow of private capital to developing countries: "Private capital flows to developing countries" (1997). Singh and Jun calculated that the flow of FDI to developing countries over the periods 1987 to 1989 and 1990 to 1993 respectively had grown by some two hundred per cent. The final justification for their research is the risk sharing advantages inherent in FDI promoted development: export orientation, market discipline, and the transfer of technology and

human capital. The research focused on macroeconomic and socio-political determinants that exercise some degree of influence on the geographic distribution of FDI inflows. It is also argued that there is an absence of theoretical guidance for empirical studies of this kind. Notwithstanding, these observations, the study made use of earlier investigations (see Table 4). Listed in Table 4 are a number of studies based on either a single or multiple approaches for individual countries and or clusters of developing countries. These include countries from different geographical locations. The multiple-approach is argued to provide a basis for a more robust means of checking similar issues via a variety of “methodological filters.” The approach used by the authors is centered on country level characteristics with made use of macroeconomic variables/ factors as the important variables. The authors identified the absence of a clear consensus on the major determinants of FDI, a major difficulty for empirical studies. This failure is attributed to the reliability of available data on FDI. This difficulty is compounded by methodological over simplification. This occurs primarily at the level of analyses of FDI determinants, which have made use of clustering techniques based on countries which have significant structural diversity. This resulted in major variations in the variables used to explain changes in the state of the economy. Furthermore, the quantification of policy issues e.g. incentives as an explanatory variable was recognised as a major difficulty. This problem is accounted for by the authors through the use of qualitative indices from expert field based judgments.

Hypothesis 11 was derived from reflection on the theoretical literature on FDI as it relates to the possible impact of tariff barriers. These barriers to trade are related to economic and development policies based on the protection of native industries i.e. import-substitution FDI, the so-called “tariff hopping” investment. The hypothesis is formulated from theoretical speculation about the relationship between the direction of causality between exports and FDI. That is whether increased inflows of direct foreign investment are positively influenced by rising levels of export. The following variables were employed by Singh and Jun (1992): market size, wage costs, the exchange

rate, home country characteristics, debt swaps and private restructuring, export orientation, interregional characteristics, and past FDI. The dependent variable used by Singh and Jun was relative FDI, relative to gross domestic product, GDP. Other GDP related variables included per capita GDP, the growth rate of GDP (GDP %). These were introduced to control potential and actual market size.

**Table 33 Summary of Five aggregate studies**

Author/year dependent variable	Sample years: number of countries	Significant Variables	General comments
Root and Ahmed (1977):average per capita FDI	58,developing countries, 1966-70	Per capita GDP,GDP growth rate, economic integration, urbanization	Employed discriminant analysis
Nigh (1984 ): US manuf investment	24 countries; 1954-1975	Indicators of Int conflict and cooperation, internal conflict, GDP change	Did not control for other economic factors, political, data detailed and comprehensive
Schneider and Frey (1985): net per capita FDI	54 developing countries,1976,1979, 1980	Real per capita GNP,inflation, balance of payment deficit, wage cost,credit rating, political instability	Incorporate both economic and political variables
Lucas ( 1993 ); real net FDI	7 Southeast Asian countries 1961-87	Realwages, industrial dispute	Model based on production function with few controls
Wheeler and Mody (1992):capital exports of US Cos	42 countries 1982-88	Labour cost, market size, level of FDI, infrastructure	Employed qualitative data for stability of results

Source: H Singh and K.W. Jun: Some new evidence on determinants of foreign direct investment in developing countries (1997)

Yang, Groenewold and Tcha study (2000) of the determinants of FDI in Australia, a country known for its abundant natural resources endowment is an example of the inconsistencies and variation in the variables employed to capture environmental conditions. The authors employed some 15 variables to capture the impact of a wide range of factors on FDI inflow into the Australian economy. However, what is important here is the explanation by the authors that changes made to the definition of FDI by the Australian Bureau of Statistics June 1985 resulted in the qualification of equity stake being reduced from 25% ownership to 10%, i.e. the level of foreign equity holding

which qualifies as FDI. This was reduced from a quarter to ten per cent. This resulted in non-compatibility of data before and after these changes, thus making it necessary for the authors to restrict their sample period. Effort to capture the impact of macroeconomic stability through the use of interest rates was compromised by the lack of detailed time series and sector-specific interest rates. In the case of the latter, the authors reverted to the alternative use of the net difference between the 30 -day bill rate and the actual consumer price index (CPI) inflation rate. This approach was recognised as second best to sector-specific interest rates and rates which prevailed in sectors typified by large inflows of FDI. The rate of return variable INF was also used to capture the stability of the macroeconomic environment and computed as changes in the consumer price index (CPI). The authors' review of the theoretical literature supported the choice of variables. These were, explained above, primarily concerned with the inflow of FDI to the Australian economy in the mid-1980 to mid-1990s. The following factors were captured by the use of macro and micro variables:

- A rate of return (BB30)
- The wage rate (WAGES)
- Measure of openness (OPEN), measured by the aggregate of imports and exports as a percentage of gross domestic product (GDP)
- The level of tariff by divided by host country's exchange rate, TWI (Trade Weighted Index)
- SINDUS, Industrial dispute (Number of working days lost due to industrial dispute).

Seasonal adjustment of data was not undertaken as it was recognised that this could result in 'spurious' properties being introduced into the data. However, the authors tested for seasonal unit roots and co-Integration followed by appropriate transformation in line with the outcome of the aforementioned procedures.

The significant seasonal component of working days lost due to industrial dispute was removed by regression using as set of seasonal dummy variables and making use of the residual from this operation: SINDUS as the regressor in the equation for estimating FDI. The authors reported that

GDP, WAGES, exports and imports were available in seasonally adjusted form, whereas the following variables had no seasonal pattern: FDI, BB30, TWI and INF.

Yang et al (2000) formulate the following static equation for FDI inflow:

$$FDI_t = \beta_0 + \beta_1 \text{ change of BB30} + \beta_2 \text{ change of TWI}_t + \beta_3 \text{ change of GAP}_x + \beta_4 \text{ change of WAGES}_t + \beta_5 \text{ OPEN}_t + \beta_6 \text{ SINDUS}_t + \beta_7 \text{ INF}_t.$$

The equation was first estimated by the authors in the general dynamic form. It incorporated lagged and current values of all variables, including the dependent variable. The use of quarterly data made it necessary for the authors to express a preference for four lags on all the variables used as FDI may have responded slowly to its determinants. This preferred approach was excluded by the small size of the available sample. The outcome of the dynamic form of the equation using once-lagged and current values of the variables produced satisfactory  $R^2$ . However, the low  $R^2$  and relatively low F statistics were accounted for by the large number of regressors' (Yang et al, 2000). The F statistics was determined to be significant at the 10% level but not at the 5% level. The LM statistics for first-to-fourth-order auto-correlation was found to be significant at the 5% level whilst the Durbin-Watson (DW) was located in the uncertain region.

The outcome of these operations is the identification of only 3 explanatory variables as significant at the 5% level. Elimination of the insignificant variables, whilst maintaining current or lagged value of the regressors,' resulted in lower  $R^2$  but improved  $R^2$  and significant F statistics. The Durbin-Watson statistics declines from 2.5794 in equation 1 to 2.3153 for equation 3, although it is still confined to the indeterminate region even though the lag range multiplier statistics (LM), does not indicate auto correlation. Further elimination of insignificant variables: change of TWI and change of GDP to produce equation 3 and improved  $R^2$  and F and with no indication of auto correlation. At this level IMF and SINDUS are insignificant and their removal resulted in equation 3. Elimination of SINDUS generated equation 4 in which all variables incorporating were found to be insignificant at the 10% level. Retention of SINDUS and the elimination of INF generated the final equation, equation 5. This final equation produced results in which all the incorporated

variables were significant at the 5 per cent level. The overall outcome of Yang et al empirical study is in line with theoretical explanation of the determinant of FDI. The authors observed that the coefficients were generally in line with theoretical predictions and in all cases the interest rate variable change of BB30 had the expected sign, with higher domestic interest rates being associated with increased FDI inflows. In the case of domestic inflation rate, these variables, in equation 3 and 5, also had the correct sign.

**Table 34 The determinants of FDI in Australia**

Constant	Equation 1	Equation 2	Equation 3	Equation 4	Equation 5
Constant	100.150 (2.42)	106.7900 (3.78)	93.8010 (3.59)	109.1300 (4.22)	59.6940 (3.82)
R2	0.6740	0.6236	0.5961	0.5417	0.5547
R2	0.3684	0.4927	0.4992	0.4536	0.4690
F	2.2052	4.7632	6.1502	6.1461	6.4764
DW	2.5794	2.3153	2.3249	2.3140	2.4337
LM	10.4475	2.9507	2.8059	5.3153	3.8158

Source: Yang, Groenewold and Tcha: The Determinants of Foreign Investment in Australia, Economic Record, March 2000.

This was in line with the theoretical perspective on the determinant of FDI inflow, i.e. high domestic interest rates as indicative of an unstable macro-environment, a result of policy failure and a deterrent to foreign inflows. The authors offered two possible explanations for the observed universal +ve sign of wage variables in the 5 equations, that it may indicate factor substitution as advocated by Lucas (1993). The second is based on methodological errors or failing in the use of an incorrect wage variable. This latter point serves to underline the difficulties inherent in the use of variables to capture accurately the impact of economic and non-economic factors on FDI flows.

The Yang et al attempt to resolve this difficulty resulted in speculation that their real wage measure captured real wages as income and not as real wage cost. This distinction was considered important as foreign investment is argued to be more a function of the latter than real wages as income. Substitution of average weekly earnings (AWE) by wages, salaries and supplements per person employed (RWSS) deflated for producer prices. Incorporation of this new variable resulted in



inferior statistical results to those produced by AWE/CPI. Furthermore, incorporation of RWSS variable was insignificant in both lagged and current value as well as resulting in significantly lower R<sup>2</sup>. This manipulation by Yang et al (2000) did not resolve the difficulty, as RWSS was positive in the event of average weekly earnings deflated by the consumer price index (AWE/CPI). The alternative formulation offered by Yang et al was made on the basis that AWE/CPI was invalid, as it failed to account for productivity gains, i.e. improved GDP per employee over the period. It is reasoned by the authors that although AWE/CPI may have improved over the sample period, real wage costs may have declined significantly as a result of productivity gains. The authors adjusted average weekly earnings deflated by consumer price index (AWE/CPI) by dividing by an index of average labour productivity – GDP per person employed.

The unexpected positive sign of the real wage variable was accounted for by reference to the impact of rising wages: a substitution of capital for labour (Lucas, 1993) thus encouraging capital inflows. The authors found a strong positive correlation between the OPEN variables and FDI inflow: supporting the theoretical proposition which links FDI inflow with trade. And accordingly, FDI inflows are viewed as substitutes for trade. It follows from this that a fall in trade, evidenced by a decline in ‘open’ is accompanied by a corresponding rise in FDI inflow– the substitution phenomena. The author observed that the results obtained with respect to the impact of industrial dispute on FDI inflows did not support the theory, i.e. a positive correlation was obtained, not the expected negative, which would demonstrate the ‘scaring-off’ effect. Yang et al offers the explanation that the variables employed may have captured some of the wage variable impact.

Further investigation of the models resulted in the use of equation 4 which avoided this perverse correlation sign for number of days lost due to industrial action, SINDUS. The outcome of this latter operation is improved forecast of FDI inflows. However, the authors reported that the new equation performed better in the first half of the sample period than the second half. The decline in the predictive performance of the model in the second half of the sample period was attributed to significant changes in the composition of FDI inflow into the Australian economy as a result of a

number of privatisations which, in turn produced sizeable changes in the normal pattern of FDI inflows: the result of foreign participation in the privatisation process. Yang et al concluded that only GDP and exchange rate as measured by trade-weighted index (TWI) were not significant, whilst all the estimated coefficient signs obtained were plausible.

### **Section 3.1**

#### **The Politico-economic Dimension of FDI**

Drawing on a number of empirical studies, this section of the chapter critically discusses the politico-economic determinants of FDI. Schneider and Frey (1985) attempted to present an integrated perspective on the determinant of foreign direct investment. The politico-economic perspective offered here made use of four models and considered data on some 80 less developed countries. Schneider and Frey (1985) applied an econometric analysis of FDI inflows estimated and compared to ex-post forecasts. The approach taken is posited on the basis that this dual perspective, the politico-economic, offers a basis to explain and forecast foreign direct investment flows. The authors develop a theory of the cyclical in and outward investment flows linked into the four stages with the objective of explaining Dunning's electric theory of international direct investment: operating conditions, ownership-specific advantages, and the tendency to internalise advantages from foreign location. Furthermore, Schneider and Frey's cyclical theory also sought to explain how Dunning's three factors/determinants are related to the level of economic development and the host country characteristic, namely the extent of industrialization.

The above study involved some 67 countries over a decade starting from 1967. The 67 countries were divided into three clusters on the basis of GNP per capita followed by multiple regression analysis. From this the following were determined: the most important organization, internalization and locational variables: outward, inward and net outward investment flows. The organization variables consist of human capital by skill levels and R&D expenditure. The internationalization variables is accounted for by the proxies, royalties and fee incomes remitted by un-associated firms

as a percentage of total funds from subsidiary operations: Locational variables include the rate of growth of output, an infrastructure index, tax burden, hourly wage rates and the Business Environmental Risk index (BERI). This index is based on pooled data from some 100 experts and various sub-indices in which political stability is given a weighting of 12%, attitude to foreign investors and profits (6%), threat of nationalization (6%) and quality of bureaucracy (4%). Whilst the authors recognized no clear generalized pattern, it is acknowledged that the variables have significant influence, for particular country cluster and the direction of the investment flow.

The locational factors were found to be statistically significant in a large number of cases; however the Environmental Risk Index also includes political risk. However, Dunning's statistical analysis concluded that political factors do not influence international investment flows. However, the author found a weak correlation between political stability and the threat of nationalization in volume of foreign direct investment.

Root and Ahmed's (1979) empirical investigation of non-extractive direct investment using data for 70 developing countries between 1966-70 and discriminant analysis that test whether sixteen economic, five social (degree of education, size of middle class, degree of modernization of outlook, strength of labour movements, extent of urbanization) and seven political (frequency of government changes, number of terrorist attacks, degree of administrative efficiencies, degree of nationalism, per capita foreign and colonial affiliation and role of government in economy) variables have significant influence. Root and Ahmed's study make use of a wide range of political influences than earlier studies. However, the emphasis is decidedly more economic than political. Some six variables were selected as essential proxies with significance at 5% level, the four economic factors were per capita GDP, GDP, GDP growth rate, economic integration, importance of commerce and the importance of transport and communication, one social (degree of urbanisation) and only one political (the number of constitutional changes in governments over the period 1956-67). The relationship between the latter and foreign direct investment was contradicted by Green (1972). The author found no significant positive correlation between political instability and

US foreign investment. Levis (1979) tested two hypotheses: 1) that economic factors are the prime determinants of foreign investment flows and, 2) that political variables are only of secondary importance. The variables considered were political instability, a political competition index (the higher the value on this index, the greater the credibility of the political system and the more FDI inflow is expected).

The relationship of the 25 developing countries from 3 continents, Africa, Asia and Latin America, and the then centralised economies of the Eastern European trading bloc used as a proxy of political risks. The models derived from these variables were tested by a step-by-step regression for the period 1965-67. As expected, the economic factors were more influential than the political ones. These were indicated by quality of life (GDP per capita), the balance of payments, government capabilities, (measured by the level of taxes) and by the proportion of GNP devoted to social services. Economic condition factors as determined in Levis' (1979) study, is indicated by per capita energy consumption, investment and export shares, GNP growth and inflation. The authors recognised that these factors have a 'positive' sign with analysis on this basis producing a positive correlation between improving host country economic conditions with declining foreign investment. The only statistically significant political variable, the index of political competition, is preceded by the four economic variables mentioned above. Taken together, the five factors account for 55% of the variance. However, the time period used had a significant impact on the outcome, i.e. it produced significant changes in the ranking of the variables.

In Schneider and Frey's approach, the four models: the political component was confined to the assessment of political instability on FDI; whilst economic performance was indicated only by per capita GNP. This model was associated with two hypotheses, No. 7 and 1. Hypothesis 1 and 7 like 2 & 3, referred to domestic economic conditions in the host country. According to hypothesis number 1 a positive relationship exist between higher GNP per capita, improved national economic well-being, and positive prospects for FDI returns, i.e. profits.

This outcome is expected to have a further positive influence on FDI. Hypothesis number 7 associates political instability with reduced FDI. According to this hypothesis, domestic political problems may be unstable (8b) and create difficulties for FDI inflows. Model (b) 'Economic' model contains the economic determinants of model (d), i.e. hypotheses (1)-(6), see table below. Model (c) 'Amalgamated' model consisted of a combination of economic and political variables. The Institutional Credit Rating indicator was composed of both economic and political factors. The researchers therefore decided not to introduce any other determinants to avoid repeated measurement of the same influence. The only variable controlled for in this model is the per capita level of GNP, see hypothesis 1. The 'politico-economic' model (d) incorporates hypotheses (1) – (11) again see Table 35. The four models were subjected to econometric test by multiple regressions of over 54 developing countries incorporating the full set of available data. The stability of the estimated parameters was tested for the years 1976, 1979 and 1980. The results are listed in Table 3. The authors derived some eleven testable hypotheses from the theory underlying economic determinants.

These are as follows:

- The higher the GNP per capita, the better the nation's economic health and the better the prospects for profitable direct investment. A positive influence on direct investment is expected.
- A higher rate of growth of GNP is an indication of good development potential in the future. This suggests a positive influence on direct investment from abroad.
- A high rate of inflation is a sign of internal economic tension and the inability or unwillingness of the government and the central bank to balance the budget and to restrict money supply. As a rule, the higher the rate of inflation, the less foreign direct investment decision-makers are inclined to engage in the country. A negative relationship is hypothesised.
- This hypothesis relates to the external economic conditions of the host country: a large deficit in the balance of payments indicates that the country lives beyond its means.
- The lower the wage costs are, the more profitable it is to directly invest in the country concerned. A negative relationship to foreign direct investment flow is hypothesised.

- For direct investment to be worthwhile, a skilled work force is needed. It is hypothesised that the larger the share of an age group with secondary education, the more direct investment will ceteris paribus flow in a positive relationship.

Political instability may disrupt the economic process and affect in particular foreign investment. Internal political difficulties may be projected outwards and create additional difficulties for foreign owned firms, including the threat of partial or total nationalisation. This danger exists quite irrespective of whether the government is of left-wing or right-wing persuasion, because both types may resort to nationalism to strengthen their position. It is hypothesised that increased political instability induces marginal decision-makers to undertake less direct investment; a negative relationship is expected. The more left-wing the host government's ideology is, the more likely it will be that the foreign direct investor runs into trouble, ceteris paribus. The international investment community is likely to perceive these dangers to be lower in countries with a more right-wing orientation, especially as its rhetoric is friendly to foreign investors. The authors assigned dummy variables: 1 for right-wing and 0 for left-wing governments, a positive relationship to foreign direct investment is expected.

The larger the percentage of aid originating by countries from the communist bloc, the less will foreign direct investors be inclined to invest in the country. A negative relationship is hypothesised. Conversely, a large amount of aid from Western countries is conducive to more foreign direct investment. A positive relationship is expected. The host country's economic and political position may be eased by multinational aid. Such aid serves to release some of the balance of payment pressure. It is given on the basis of often quite stringent restrictions by the international institutions (especially, the World Bank). The international direct investors may therefore expect from the host country a more friendly political posture, and have to fear less nationalisation and curtailment of the movement of capital. A positive relationship between the amount of multilateral aid and foreign direct investment is expected. Again the points made in support of this hypothesis would find some measure of credibility from recent IMF and World Bank intervention in the aftermath of the 'Asian

Crisis' 1997/98. However, the post-Soviet and post-communist international environment challenges the general credibility of this hypothesis. The authors take on the importance of socialist and Soviet influence as formulated in the 1970/80s. Hence the complexities associated with western versus eastern/communist geopolitical aid giving and political re-alignment. These developments have been matched by rapid economic integration and reduced barriers to trade and investment flows. The major lenders and donors have focused on market-based forces as the basis for structural reforms and long-term economic development. At the same time, governments have been encouraged to put in place prudent systems of regulation and good governance. The authors readily admit that the theories advocating a link between political factors and FDI flow have very little agreement in the relevant economic literature. However, they advanced four testable and theoretically supported hypotheses.

Schneider and Frey (1985) were unable to estimate the 'amalgamated model (c) due to lack of institutional investor's credit rating (IICR) for periods prior to 1979. Political factors, as incorporated in politico-economic model, (d) was found to provide statistical explanation for seventy five per cent of the variance. The 'political' model accounted for forty per cent whilst the 'economic' model accounted for fifty one per cent of the variance. The majority of the coefficients of the three models were found to be statistically significant at ninety-five per cent level of security. The fact the coefficients were all positive, allowed the authors to conclude that the hypotheses were valid. Furthermore, as the size of these coefficients was uniform across the four models, it was concluded that the addition of 'economic' determinants to the 'political' model (a), and the addition of political determinants to the 'economic' model(b), adds an independent new dimension to the estimator. It was also concluded by Schneider and Frey that joint simultaneous consideration of economic and political determinants, as attempted in model (d) to be justified by the results achieved, see earlier section for list of determinants. The authors also concluded from the standardised regression coefficients ( $\beta$ -coefficients) that GNP per capita is the dominant influence on foreign direct investment flows. This result was achieved for all three models.

The results obtained – $\beta$ -coefficient supported the hypothesis that bilateral aid from Western donors (in model d) is of significant positive influence on foreign direct investment inflows. Models b and d, which were concerned with the balance of payment deficit, had a higher  $\beta$ -coefficient than the above. The analysis of the data supported model c as statistically significant good-country risk ratings have a positive influence on foreign direct investment at constant per capita GNP. The empirical evidence strongly supported ten out of the eleven hypotheses. However, the impact of left-wing ideology, was not supported i.e. was not statistically significant. The authors concluded that all four models are statistically satisfactory for explaining ‘politico-economic’ FDI flow. Comparisons of the forecasting capacity of the four models by the authors identified the ‘politico-economic’ model as far as goodness of fit with  $R^2$  and with respect to the periods 1976, 1979 and 1980 respectively. The results for the economic and amalgamated models produced predictions, which overestimated the actual value of FDI for 25 countries, whilst under estimating it for 26 countries. For the politico-economic model, over predictions were produced for 24 countries and under predictions in the case of 27 countries.

**Table 35 Politico-Economic Determinant of FDI**

Average absolute residual(\$)	Model a 28.8	Model b 17.9	Model c 34.4	Model d 11.6
% deviation from true value	56.9	35.4	48.2	23.0

Source: Frey and Schneider (1985)

It can be seen from the above table that model d produced the best results in terms of average absolute residual in US dollars and percent deviation from true FDI inflow value. The overall empirical results support the argument made by Schneider and Frey (1985), namely: a simultaneous consideration of politico-economic factors provide a better/superior analysis of the determinants of foreign direct investment in less developed countries. Furthermore, the authors challenge the orthodox approach of FDI analysis in which determinants are either political or economic and their



influence considered separately. The development of testable hypotheses from theoretical literature is another departure from the common practice of those times.

Lucas empirical study of the determinants FDI made use of a model of derived demand for capital by a multiple product monopolist for seven East Asian countries. Whilst the decline of FDI to developing countries was identified, it was recognised that a number of Asian economies were exception to this general decline. According to Lucas, their share of the global inflow of FDI grew from 8% (annual average) over the period 1972-87 i.e. 29% of FDI to developing countries, and that this figure had risen to 50% of aggregate flows to these economies. The study is predicated on these observations and the suggestion that the determinants of these flows are of some importance for investors and the economies and governments of the region. Furthermore, Lucas argues that the rapid growth of the Asian economies is due, in large measure to the export-orientation strategies of policy makers and the use of FDI inflows across the region to support export platform.

The author takes a critical view of previous empirical studies of the determinants of FDI. He asserts that up to the point of his study much of prior empirical work avoided any derivation from theoretical perspectives of firm behaviour. The results according to Lucas, is that the literature has developed independently of contemporary perspective on derived demand for domestic capital. The final outcome of these failures (Lucas, 1993) is the absence of a clear consensus on the determinants of FDI. This latter point is reinforced by the observed lack of coincidence on the relative importance and impact of labour costs on FDI flows. However, the authors work on a number of newly industrialised economies, East Asian economies, identified increasing wage costs as a major deterrent of foreign investment. It is evident from the above account that Lucas' approach is guided by reference to earlier empirical studies, although he makes the point that his is not a 'generalised approach' now applied to Asia. The methodology is also embedded in the theoretical literature.

Lucas' derived demand model for foreign capital for a profit maximising multiple product monopolist was extended to include/accommodate the following:

- Interdependence in location decisions (inter-country effects, e.g. costs.)
- A potential role for market size
- Expectations formation (anticipated time paths of future costs and returns)
- And consideration of political risk and the regulatory environment.

These models were estimated using annual time series data for 1960-87, supported by reference to the progression from capital stock demand to the investment decision. Foreign capital inflow (FDI) is measured as net investment deflated by country specific deflation for fixed capital but not net of FDI outflow from the host country. Lucas recognised that his attempt to determine a rental equivalent cost for capital services in the case of foreign capital (FDI) is at best controversial. The author offered the following equation for the calculation of this cost:

$$R = pk \times ir / (1 - tx)$$

Where  $pk$  = fixed capital formation deflation

$ir$  = measure of real interest rate

$tx$  = indicate corporate profit tax rate

The study also recognised the difficulty of identifying an appropriate cost of capital measure of foreign investors and the recognition that the source of funds is a major factor in determining the interest rates charged. In the case of Western investors i.e. providers of FDI, the authors made use of average lending rates of interest in the three provider nations, the United States, Japan and the United Kingdom. This calculated lending rate is adjusted for the rate of inflation in the host country's cost of labour to produce the mean of real interest rate,  $ir$ . Similar complication in calculating corporate tax rates resulted in the decision to use a proxy for this variable. This was constructed as the ratio of corporate tax revenue collected relative to the value added in manufacturing. This maneuver exposes the question/problem of comparability of corporate tax rates across countries with incompatible regimes and regulations.

The rental equivalent cost of capital across the seven East Asian economies were found to vary from +ve to negative. This fact has, according to the authors, justified the uniform treatment of  $r/w$

in a linear form. The justification for measuring wage rate ( $r$ ) by average monthly earnings in manufacturing was made on the basis that FDI inflows to the region was export related. Product price ( $P$ ) was measured by export price index. Failure to determine a measure of the value of domestic capital stock in joint ventures with foreign partners resulted in the use of  $K$  as the rate of fix capital formation deflated for rate of FDI inflow. Testing for location advantages was reduced to two alternatives as the available data would not support a multiple location choice. The two alternatives were represented by a weighted average of the six host countries and a weighted average of the home countries of the investing firms (parent companies of the subsidiaries). The authors made allowance for the fact that whilst GDP is conventionally used as an indicator of domestic market size and its growth as in earlier studies by Lucas (1993) and Kindleberger (1961), this study made use of capital formation as the indicator of market size and growth of the economy. In keeping with this approach, capital formation i.e. aggregate of private plus government consumption spending, was deflated for consumer retail price index (CPI). The size of the export market is measured by the weighted average of GDP in all the major export markets for the relevant countries. The result obtained indicated that output deterrent effect of higher wages outweighed the movement to greater capital intensity; thus suggesting a combined negative impact, of higher wages on FDI inflows. However, the deterrent effect of industrial disputes on inflows was less demonstrable, as the evidence suggested the negative effect is only partial. From a policy perspective (Lucas, 1993); the impact of legislation, which restrains union activity and consequently limit the demand for higher wages, and its ability to induce foreign investment inflows is a major area of uncertainty. These inflows were empirically estimated to be less elastic with respect to cost of capital (including taxes) than labour costs. The relationship between FDI and domestic capital was unresolved, that is, whether the two flows were complementary. The findings here were unambiguous. However, the author noted that a positive relationship between the two is more usually the case where the host country has maintained foreign capital restraints. The results for individual countries indicated an association between increased domestic costs and enhanced FDI

inflows, higher costs in neighbouring countries were not associated with increase inflows. It is reasoned from the above that domestic investment policies, which have as their center the attraction of FDI are ill conceived if lower labour cost is a significant component of the strategy. Earlier studies by (Lucas 1983) have concluded the same relationship between labour cost and foreign capital inflows. The present study is an exception to this generalised observation, see section on FDI impact.

The use of aggregate private and public consumption data as a substitute for market size produced weak, but positive association between the said and the rate of FDI inflows. Similar relationships were found for the level export earnings (foreign exchange inflows) and foreign currency deposits in the host countries respectively. The Lucas study also differed from a number of previous studies in that it looked at export earnings. This failure is significant in that an accounting for export earnings will indicate the nature of the inflow; market seeking or efficiency seeking. This allows for the evaluation of the differential impact of determinants. It is possible that marketing seeking FDI may respond more to domestic market size than efficiency seeking FDI. In the case of export-oriented FDI, (Breit, 1976) regional factors such as trade relationship and membership of a regional trade body e.g. trade bloc, as well as host country characteristic may be more important determinant of inflow than purely domestic issues.

Understanding of the determinants of FDI must be viewed in this context and in accordance with typologies and the particular development policies championed by the host country. The results obtained also support the conclusion that competition between the economies of the region for FDI based on labour and non-capital inputs costs would be ineffectual as the evidence demonstrated of a link between competitor nation relative costs and the volume of capital inflows. However, Lall (1978) concluded from his empirical studies that the greater portion of FDI went to LDCs with inward-orientation export-substitution policies and practices. Macroeconomic stability as represented by foreign currency reserve, produce positive but weak correlation with respect to FDI inflows. This observation was complemented by a positive association between exports earnings

from major markets and FDI inflows, a point already remarked on. For the East Asian markets, the Lucas study highlighted the possibility that FDI may be more responsive to demand in the exports markets of the host countries (among East Asian countries) than in the domestic market of the host country. Furthermore, these studies indicated that three of the seven countries examined produced results that indicated that non-economic i.e. domestic and sub-regional political factors had no impact on the inflow of FDI into these countries (Malaysia, Singapore and Taiwan). However, for the remaining four countries, the authors concluded that the exclusive consideration of economic costs would be inappropriate in explaining the pattern of FDI inflows to this sub-cluster of countries. Furthermore, political uncertainty was attributed with higher influence on inflows than purely economic factors.

Earlier studies by Riedel (1975) of the determinant of FDI inflow to the Taiwanese economy identified manufacturing for exports as the “new orthodoxy of development economies.” The author explored the empirical literature on the impact of FDI on growth and development: a developing country perspective is maintained throughout. The study is based at two levels: macroeconomic and microeconomic. At the macro level, the study attempted to determine the impact of policy initiatives on the inflow of FDI into the Taiwanese economy. The providers of FDI were limited to the United States, Japan and Hong Kong for a period starting 1955 to 1972. The import of the study was supported by reference to the emerging consensus that FDI will play an increasingly vital role in expanding the export manufacturing base of least developed countries, LDCs. From this two important questions were derived:

- “What is the nature of export-oriented FDI and how does it affect factor proportions problems, balance of payment constraints, employment and income distribution”?
- What are the factors, which determine the inflow of foreign capital, and how effective are alternative policy measures in influencing this process?

In partial response to question number two, the theoretical literature suggest four significant determinants of export-oriented foreign investment inflows into developing countries: labour costs,

adjusted for productivity; distance costs (in the main these are transport related ); government influence ( these are often taken to be political and trade policies) and political stability and security. Taiwan was chosen for its openness to foreign investors and the fact that the country has pursued policies calculated to encourage foreign direct investment (FDI). Furthermore, the other three countries are major trade partners and its significant trade and investment activities in the region.

Riedel estimated a multivariate discriminant function to determine which characteristics as well as factor-intensity differential, sector-by-sector, foreign investors from their domestic counterparts. The study made use of a survey of some 400 Taiwanese based manufacturing firms. Some 30 per cent of these had foreign capital participation. The analyses made use of a number of linear regression equations to test a variety of theoretically derived hypotheses. These formulations generated a number of hypothesised relationships between macro and micro variables. In the case of micro variables such as labour costs, the rate of FDI inflow were tempered by macroeconomic policy in an effort to isolate and delineate the relative significance of other factors which may determine the rate of FDI accumulation. The author recognised that the costs associated with manufacturing by the subsidiaries of manufactured exports, cannot be attributed to production factors other than local labour as multinationals may incur the bulk of its input costs outside the host country i.e. not in the Taiwanese market. The labour costs variable employed in the study was calculated using absolute nominal manufacturing wage differences divided by relative labour productivity index. For Taiwan this represented changes in “efficiency wage” between the host country and the three investing countries.

The impact of government influence i.e. domestic policy and incentives offered to foreign investors could not be easily captured by a single variable. Furthermore, it was acknowledged that incentives were very difficult to evaluate for their impact on foreign inflows, however, a dummy variable was employed to account for this influence. Changes in the tax regime in respect of its application to

corporate profits and commercial transactions, investment activities, on reserves against foreign exchange; and the treatment of imported plant and machinery, was considered potentially important to the study. This complex area of inquiry was complemented by similar difficulties of the impact of government policy and specifically the transition from export-substitution to outward orientation and investor friendly policies. These included the relaxation of exchange rate control and the passing of the 1960 “statute for the encouragement of investment.” This comprehensive overhauling of corporate taxation policy was primarily focused on encouraging the inflow of foreign direct investment. Further liberalisation on trade and investment included the 1966 establishment of export processing zones. According to Reidel (1977), the impact of these developments was demonstrated by a significant rise in FDI over the period associated with these changes in policy i.e. 1960 to 1973. The following regression equations were employed to both estimate and distinguish between the impact of changes in efficiency wages and economic policy on FDI inflows:

The wage variable was found to be significant for all cases with the exception of the US. In the case of the latter, the linear function demonstrated a superior performance over the log-linear function. The author concluded that in the case of the United States, investors that responded to changes in efficiency wage differences were marginal. The offered explanation for this outcome is the virtuous cycle of successful US investments in Taiwan on US investor confidence with respect to further investment in the country. Furthermore, policy reforms in 1960 were positively associated with increased inflows from Japan and Hong Kong. However, outflows from the US were not significantly influenced by these changes.

The 1966 policy dummy indicated that the period was not associated with any meaningful changes in FDI inflow. Riedel suggested that the establishment of export processing zones compensated for the decline of labour costs as an incentive for Japanese and Hong Kong FDI inflows post 1967. For the US this decline in appeal in terms of wage costs and tax concessions, were explained as a consequent of the relatively large differential between US labour costs relative to Taiwan. The

study speculated that government influence might be particularly significant in the area of general liberalisation of economic policy and the creation of an investor friendly environment. However, it is also argued that the flow of FDI to LDCs is normally motivated by the existence of protected markets. The investigation of the relative capital intensity between Taiwan and the three investing countries found no significant differences. However, every labour per unit capital varied across a number of sectors: textiles, plastics and metal products.

Domestic firms dominated all three sectors. Factor intensity (at constant import-dependence) did not distinguish between foreign and domestic firms in textiles and metal products. Thus suggesting, according to Riedel, that MNCs may provide labour intensive technologies to LDCs. Import-dependence was determined to be a major distinguishing factor between domestic companies and their foreign counter parts. The implication of the above empirical findings is that FDI may actually result in further economic deterioration in host countries where linkages to intermediate goods and services are either very poor and/or non-existent. The counter argument is that vertical linkages don't in themselves guarantee improved external performance of the host country.

## **Section 3.2**

### **FDI and Growth in LDCs**

Interest in the impact of FDI on economic growth in LDCs coincided with the emergence in the 1950s and 60s of a number of newly independent states from a long period of colonial rule by European powers such as the United Kingdom, Spain and Belgium and later from Portugal in the 1970s. The focus on the growth promoting influence of FDI was made in the context of the need of these poor states for technology and jobs. The fact of their rich natural resource endowment made them a target for Western companies seeking cheap sources of raw materials and natural resources. Many of the newly independent states had little or no pre-colonial industrial activity and the politics of national self-determination and its association with modernisation and economic progress.

According to Mundell (1957) the differences between the newly independent developing states and their factor endowment, relative factor costs and their need for technology and jobs, created



incentives for the inflow of capital. Another important consideration was the presence of significant trade barriers resulting in the establishment of foreign affiliates in overseas markets as a means of overcoming restrictive tariffs and non-tariff barriers. The augmentation of multinational activities over the last six decades suggested that FDI had become an important ingredient of economic growth and development as it was associated with a combination of technology, marketing, capital, human resources management and entrepreneurial capability (Romer, 1993). For Romer, FDI is the vector in the diffusion and dissemination of knowledge as well as transfer of technology and ideas to local partners. According to this view, FDI is associated with the flow of capital from parent company to its overseas affiliate. This process was associated with the following:

- 1) The transfer of technical factors between regions
- 2) The exchange of capital movement with labour mobility in the host regions and
- 3) Removing or reducing market imperfection through the capitalization of host domestic markets.

Many of the theoretical approaches to the study of the relationship between FDI and economic growth have focused on the preconditions required for FDI to enhance the growth of recipient economies and the determination of the process through which economic expansion occurs (Solow, 1956). The neoclassical growth theory was the first attempt to explain the working of the FDI-growth process.

The Solow model employed a number of 'key' variables in a production function to explain steady state growth. In contrast, the Endogenous growth model theory, the effect of FDI on growth is viewed as either direct or indirect. This is explained in Wang's (1990) differentiation in which direct positive host country impact is experienced through improvement in productivity and the channeling of knowledge and expertise to local partners and indirectly by upgrading the productivity and skills of employed labour. According to Feenstra and Markusen (1994) FDI affects recipient economies through the introduction of new inputs such as new technologies and the spillover of the knowledge (de Mello and Sinclair, 1995) and expertise embodied or associated with these cross-border flows to domestic firms (Krugman, 1979). The development of the endogenous

growth theory (Romer, 1990, Barro and Sala-i-Martin, 1995) provided a wide range of possible avenues through which FDI can influence long-term growth in recipient economies. This variety of potential and actual influences is discussed in this sections of the present chapter. Foreign Direct Investment (FDI) is widely credited with rapid rates of growth in recipient economies. In recent times the growth of countries such as China and India has been explained by large volumes of inflow of FDI. Earlier observations of the so-called tiger economies of South-East Asia: Singapore, South Korea and Malaysia also identified high levels of FDI inflows and high rates of domestic investment with rapid expansion of aggregate output and development in these economies.

Although the precise mechanism through which this growth and development occurs is not fully understood, the literature on FDI is voluminous with some authors focused on the nature of economic policy and its orientation for the explanation of FDI growth enhancement effects. Bhagwati (1994) for instance argues that economies which follow an outward orientation i.e. export-push as opposed to an inward-orientation and import-substitution strategy (IS) is less effective in its appeal to foreign investors as well as being less efficacious in its ability to enhance economic activity. Pearce (2006) assessment of the impact of FDI on LDCs is divided into four major areas of enquiry: efficiency, distribution, sovereignty, growth and development. This approach is, according to Pearce, one of reformulation of earlier debates and structured around the modes of analysis of transnational corporations as the agents and vector of FDI. Here Transnational Corporations (TNCs) are viewed as exploiting the freedoms explicit in the process of globalization to leverage competitive advantage from the differences between countries or sovereign units. Responses to differences is analysed as representing a number of strategic motivations: market seeking, efficiency seeking and knowledge seeking. Recent controversy about the relationship between capital, labour and technology and their respective contribution to economic growth and development is illustrated by reference to the experience of a number of South-East Asian economies. What is clear from this analysis is that the arguments will continue as the achievement

of these economies defies definitive prescription. The rapid and sustained growth of the Asian tiger economies is accounted for by capital accumulation (Jong-11 and Lawrence (1993), not technological progress as in the case of the industrialised economies of Western Europe. The contribution of capital and labour to economic growth for a number of East-Asian economies is compared to a number of European countries.

**Table 36 Job creation in the Developing World: Private firms as a source of job creation (selected developing countries, 1987-98)**

Country	Period	Private jobs 000s	Public Jobs 000s	Ratio of private to public jobs
Mexico	1989-98	12,431.0	143.0	87:1
Costa Rica	1994-98	238.0	12.0	20:1
Turkey	1987-92	1,490.0	91.0	16:1
Kenya	1993-98	173.0	13.0	13:1
Guatemala	1994-98	47.0	4.0	12:1
Boliva	1994-97	181.0	18.0	10:1
Uruguay	1987-92	127.0	27.0	4.7:1
Gabon	1992-96	4.7	1.3	3.6:1

Source: Agosin, M.R and Mayer, R (2000): Foreign Investment in Developing Countries: Does it crowd in Domestic Investment. IMF, Recent Economic Developments (Various years, for each country)

Japan is included to complete the picture. The figures in Table 37 indicate that whilst capital and labour combined accounted for 56 per cent of Japan's growth, it was responsible for 76 to 89 per cent of the growth in four East-Asian economies included in the study. Technical progress accounted for 43 (in the case of Japan) to 66 per cent of the growth in the advanced industrialised economies. The contribution of this factor for the NICs was rated at zero whilst the importance of Human Capital for these countries ranged from eleven per cent for Taiwan to 14 per cent for South Korea. The impact of FDI on LDCs will consider the following issues: addition to the real resource of the economy; the impact on output, market structure, and prices; the shift in resource use and factor rewards, the potential rise in GNP and real income; and changes in the balance of trade and

payments (Behrman, 1962). For LDCs the contribution of FDI is of particular importance in improving the three vital ingredients: personnel, technological capability and capital resources.

**Table 37 The source of economic growth for selected countries (%)**

	Capital	Labour	Human Capital	Technical progress
Hong Kong	66	22	11	0
Singapore	63	25	13	0
S Korea	67	19	14	0
Taiwan	75	14	11	0
France	33	-1	4	63
W Germany	36	-7	5	66
Japan	48	6	3	43
UK	35	4	6	55
US	23	30	4	43

Source: The competitive Advantages of the Far Eastern Business (Robert Fitzgerald 1994)

The scarcity of adequately developed local managerial skills and the poor technical ability of the local labour force is argued to be a major restraint on the capacity of these countries to derive maximum benefits from foreign direct inflows (Helleiner, 1994) as well as constituting a major disincentive to inflows of foreign and domestic capital. Foreign direct investment allows for the transfer and/or training of local personnel.

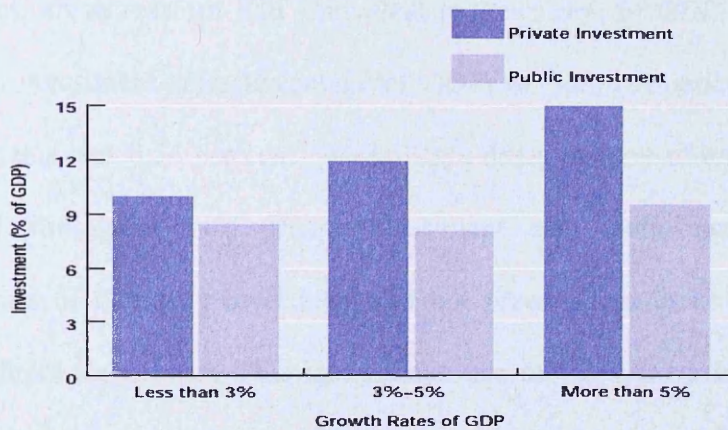
Either way, addition to the stock of managers and technicians is accompanied by a re-orientation of local corporate culture to support greater enterprise and involvement of workers and managers (Blomstrom et al 1993). In short, these developments are calculated to bring about a more enterprising culture within the individual subsidiary and throughout the local business sector. The expected outcome of this development is efficiency gains in local operations in addition to the expansion of technical and managerial resources. Furthermore, where transferred personnel maintain close contact with parent firm, updating of technical and managerial resources can be readily made. The long-term benefits for the host country, according to Behrman (1962), is a

diversification of employment opportunities and a wider variety of skilled personnel. These include advanced processes and research and development.

FIGURE 1.2

## PRIVATE INVESTMENT IS STRONGLY ASSOCIATED WITH ECONOMIC GROWTH.

Investment and Economic Growth in Selected Developing Countries, 1970–98



Source: Bouton and Sumlinski (2000).

The latter is associated with new product development, growth and increases in productivity. Behrman make reference to US direct investment in EU countries as an example of the impact of US-foreign firm collaboration in research and development and the spill-over impact on host countries. This perspective is reinforced by Dunning's (1970) earlier studies of the impact of US technology and investment on the growth of a number of European Economic Community (EEC), (now EU) countries. The author concluded that this transfer of US technology has resulted in higher levels of growth in the recipient countries than would have otherwise occurred. The inflow of new capital good associated with US investment produced, according to, Dunning, rapid increase in real per capita income and a general convergence of the European economies with the US pattern of production through technology and changes in factor proportions. These benefits to the host country included: low cost access to the outcome of advance R&D; new product development, and process technologies. At this point, Behrman links the 'idea' of progress and the process by which it is

obtained as the initiator of economic growth. Accordingly, progress is synonymous with new techniques; and it is realised through the employment of new techniques.

MacMillan (1998) study of the impact of FDI inflows on domestic investment capital formation for some 86 countries concluded that a lagged FDI has a significant effect on the aggregate level of domestic investment. This was determined to be strongest for developing countries. In the latter economies, an increase in FDI equivalent to 1 per cent of GDP, produce a 1.17 increase in host country's investment as a percentage of GDP; for Latin American economies but for developed countries this was 0.54 per cent. McMillan's desegregation of total domestic investment revealed that FDI stimulated local private investment, not public investment. Further study of the components of domestic investment did not reveal them to be accurate determinants of future foreign direct investment. This study made use of five year averages to determine the long-run relationship between FDI and domestic investment. The results obtained indicated that FDI had a strong positive impact on the level of domestic investment in all developing regions. The impact of these inflows on domestic investment of recipients were determined for a number of developing countries (Hufbauer et al, 1994); they are present in Table 3. The figures indicate that for a number of developing countries, for example: Australia, Malaysia and Venezuela, FDI accounted for up to 20 per cent of gross domestic investment.

A departure from this positive correlation between FDI and increase domestic investment was observed in OECD countries for which a negative relationship between FDI and private domestic investment was empirically determined. This outcome was taken by the author to suggest some kind of specialisation. Four important conclusions were derived from the above observations:

1. A strong dichotomy between the behaviour of FDI and domestic investment;
2. A differentiation between public and private investment and associated behavioral differences between the two types of investors;

3. The distinction between developed and developing countries, allowed the author to demonstrate that the relationship between FDI and private domestic investment is particularly positive in developing countries;
4. The above points contradict hypothesised negative link between FDI and domestic investment.

### **Section 3.3**

#### **The Trade Impact of FDI**

Explanation of the impact of FDI on host economies requires the construction of a link between FDI and the production of beneficial external economic effects, the so-called, spillover effects. Behrman (1962) and McMillan (1998) respectively, argue that this effect is especially prominent in developing countries where the potential for technological and managerial upgrading is greatest. Alternatively, this may be explained by reference to the fact that FDI is primarily associated with multinational firms, which have superior market knowledge, better endowment of financial resources and management skills. These foreign firms and their subsidiaries are, therefore, better equipped to make good commercial opportunities in the host country than local firms. Foreign direct investment is theoretically argued to stimulate private and public domestic investment by two mechanisms: through its impact on the profitability of domestic investment. Example of this mechanism may relate to the addition of local infrastructure, roads, communication and the enhancement of local supplier network. This may also be complemented by FDI spill-over effects of technology and processes across industries. This inflow of FDI may have negative consequences for domestic firms as an increase in number of companies operating in a limited market will result in a redistribution of market share in favour of foreign firms. The second explanation, highlights the possible negative consequence of FDI on the level of domestic investment. This occurs through a change in the ownership structure of total investment in the recipient economy by providing a wider pool of investment capital for domestic investment. The latter resulted from the sale of state owned firms through the privatisation process to foreign firms thus establishing a clear link between

foreign inflows and domestic investment. Harrison and Haddad (1993) study of the link between foreign direct investment and spillover effects found evidence for this link.

The majority of the studies have concluded a positive relationship between FDI outflows and host country exports by 7 to 3. In the case of the three negative correlation {(Blomstrom, et al, (1998), Braunerhjelm (1991), and Svensson (1993)}, the authors found a negative relationship between FDI outflow and host country exports. Here it is argued that outflows reduce output and employment in export competing industries: with FDI substitute for domestic investment and output. Foreign production is expected to generate cheap imports for the home country and thus displace employment in import competing industries at home. From the recipient point of view, the negative aspect of FDI manifest its-self in the introduction of inappropriate capital-intensive technologies in inherently capital-intensive sectors; neither of which will promote employment in labour rich and capital poor developing countries. Furthermore, FDI inflow may exert inflationary pressure on domestic wage rates. Additionally, where the size of the inflow and related commercial activity is large relative to the host economies GDP, the dumping of weak host currency (MacDougall, 1960), the repatriation of profits and royalties may combine to cause severe balance of payment problem for already vulnerable economies. The fact that foreign firms pay higher wages may also encourage domestic firms to respond to the competition of the limited pool of skilled labour through higher wages and the move towards more intensive technology. The outcome of this process is the displacement of cheap labour (Balasubramanyam and Sapford, 1994) and the displacement of income towards capital.

The relationship between trade and FDI is long established in the theoretical literature. Mundell (1957) hypothesised that they were substitute i.e. barriers to trade would result in FDI to the protected market. However, recent revision of this view suggests that the two complement each other and are not necessarily substitutes (Greenaway and Milner, 1988). FDI is prized by developing countries for its association with a bundle of intangible assets not generally possessed



by host economies. These include international channels for marketing and distribution of products, advance technology, management skills, brands, R&D, and links to international knowledge networks.

Whilst earlier sections have focused on the determinants of FDI, its growth impact, its relationship to R&D and a review of the related theoretical and empirical literature, this section will critically discuss the trade effects of FDI from a Developing Country Perspective.

Trade not only improves the foreign capital earnings potential of exporting Developing Countries but it may also make a vital contribution to countries experiencing the decline of traditional industries and a consequent deterioration of foreign currency earnings and a fall in the employment contribution of established pillars of the economy. FDI also brings with a significant contribution to the structural transformation of the economy [(Balasubramanyam, 2005, (UNCTAD, WIR and WTO, 2002)] where this is associated with the creation of new industries and/or more technology intensive enterprises. Whilst the taxes and duties on trade have declined as a consequent of multilateral trade agreement which have sought to reduce barriers to the flow of trade and investments between countries, inflows of FDI help to stabilise or expand the tax-base of the host country (UNCTAD, 2005). This section will discuss these issues in details for their policy implications. However, the caveat is that policy makers in developing countries are increasingly including the non-economic impact of FDI, not the traditional focus on: growth, capital formation and technology impact. This change of focus has made it increasingly difficult for academics to apply simple econometric models to determine the economic impact of this inflow on recipient economies as non-quantitative performance objectives are included in host government objectives and policy measures. TNCs and their affiliates may increase the skills-base of the local workforce through (Balasubramanyam, 2005) their training and employment practice. Another important potential outcome of TNC investment activities in LDCs is the establishment of international linkages with major markets for their goods and services. These linkages are associated with

additional inflows of technology, financial and technical resources (Balasubramanyam, 2005). As the level of competition in international markets are generally more intense than that in the markets of Developing countries, only those companies with the requisite skills and resources are capable of competing (Blomstrom and Kokko, 2001) at this level.

This is particularly true of companies based in developing countries i.e. they are generally less able to compete on international markets than companies based in developed economies. TNCs with their network on international contacts or affiliates are best placed to compete at this level. However, close proximity of local companies to TNCs as suppliers or strategic partners i.e. distributor or component/raw material providers (Gorg and Greenaway, 2001) will allow them to gain access to both knowledge and experience of international distribution networks and market opportunity.

As TNCs are generally much larger than local firms, they can better manage the fixed costs associated with transport, communications and the services integral to the development and maintenance of export markets.

According to Helleiner (1973) assessment of the impact of FDI on the host countries trade performance necessitates a differentiation between direct and indirect effects on the export activities into its principal aspects:

- 1) Local raw material processing
- 2) Conversion of import-substituting industry to exporting
- 3) New labour-intensive final product exports, and
- 4) Labour-intensive process and components specialisation within vertically integrated international industries.

In the case of raw material processing, the superior endowment of TNC i.e. technology, capital, management resources, markets and marketing links mean they are generally better placed to influence both the quantity and quality of the host country's exports. Where host countries are seeking more valued added production away from the exports of unprocessed commodities as part

of an industrialisation program or import-substitution industrialisations (Bhagwati, 1988), (ISI) in line with the Perish-Singer (1950) thesis. The focus of TNCs on exports when host markets are not the major consideration in their production location, may contribute to the emergence of free trade as their pattern of trade means that they are dependent on open markets for their production and therefore willing to advance their own objectives by convincing host governments of developing countries of the benefits of open markets and reciprocal trade between nations, Dunning (1993) and (UNCTAD, 2005). However, where TNCs are motivated by higher rates of return available in protected markets i.e. markets isolated from foreign competition by high tariffs on imports, tariff hopping investment activities of this type may have a vested interest in the maintenance of these barriers to trade. However, agreements in the World Trade organization have reduced the ability of governments to pursue such policies.

TNCs may be the principal advocates of trade liberalisation in their domestic market given the tendency of policy makers in many developed countries to introduce initiatives which hinders or restricts the inflow of manufactured goods such as textiles and agricultural produce as in the case of the European Union under its Common Agricultural Policy (CAP). However, as many of the producers, growers, distributors and processors of agricultural produced are affiliates of TNCs, policy makers in developed countries are often subjected to lobbying by these companies or by their trade association. For instance retailers and super markets may be major importers/distributors of these goods and are therefore inclined to use the benefits of cheap prices to customers as a major argument for the free inflow of these goods. TNCs may also agitate for the free flow of raw material from developing countries to support value-adding activities which are important sources of employment in developed economies.

The empirical evidence in support of TNCs as advocates of free trade is inconclusive (Lavergne (1983) and Helleiner (1973), Bhagwati (1988) argues that whilst the case is not empirically supported, TNCs are expected to promote or advocate free trade in their domestic market to avoid protectionisms generally, not just in their overseas markets. Whilst it is possible for developing

country firms to achieve significant export markets for labour-intensive products such as textiles and agricultural produce, the help of foreign firms with advance technologies, branding, packaging and distribution expertise, will significantly improve the export performance of developing country firms operation in these sectors.

This has been the case for developing country firms and their export of light consumer goods to developed countries. Intermediary firms in developed economies may help to ensure the success of these goods by providing inputs in branding, marketing, packaging and distribution as well as employing their established direct contacts with customers to secure a good position in the market, capturing customer feedback to improve the function and competitiveness of the product.

Although local suppliers may not have any direct contact with overseas markets, their relationship with TNCs and or their affiliates may provide them with large markets for their products, encouraging them to improve both the quality and quantity manufactured. The resulting economies of scale and efficiency gains may further the competitive position of the company in international markets and allow it to spend more of R&D, the use of more advanced manufacturing technologies, branding and marketing. In the process of time, the company is able to serve a more diverse market and customer base as it differentiates products and increases its product range (Keesing and Lall, 1992), and widen the tax base of the host economy.

TNCs operating in vertically integrated industries are responsible for the export of labour-intensive components. Whilst these exports are traditionally viewed as intra-firm trade, Kobba (1986) suggest that, in reality they may result from the arms-length trade between TNCs and LDC firms. Although high import requirement and marginal profitability is often a feature of such trade relationship, they encourage skills development, generate employment. Local firms imitate the activities and technologies of their TNC partners and are therefore able to acquire positive externalities such as techniques, technologies as well as benefiting from policies resulting from the lobbying activities of

TNCs: of their home government and host government. These may result in more open markets and or policies which are supportive of the private sector of domestic firms in developing countries and those in particular which are seeking to develop overseas markets. As TNCs may make significant investments in skills training, improving the pool of technical skills of the workers available to local firms, they also contribute to productivity and competitiveness of local firms. Furthermore, knowledge of foreign markets opportunities and the means of exploiting these may be acquired by local firms from their close proximity to TNC affiliates or through local trade association.

Aitkin and Harrison and Hanson (1994) empirical analysis of the export performance of a large number of Uruguayan firms concluded with the hypothesis that close proximity to exporting TNCs reduced the costs associated with exporting and local firms were therefore more inclined to initiate export activities. The authors also concluded that foreign affiliates were vectors of exporting spreading knowledge of the technical requirement for exporting as well as providing channels for the distribution of the goods produced by developing country firms. Foreign firms provided direct or in direct facilitation of domestic exporters through the provision of information and distribution support.

The Aitkin, Harrison and Hanson (1994) hypothesis was subsequently supported by Kokko, Tansini and Zejan (1996) in that they too found that interaction between a local firm and a TNC improve the exports propensity of the former. Whilst this was observed for exports to world markets, exports to Uruguay's neighbours, Argentina and Brazil was unaffected by the presence of TNCs. Kokko et al (1996) established empirically that this influence of TNCs was restricted to a period associated with a relatively out-ward oriented trade and investment environment in the 1970s.

### **Section 3.4**

#### **Configuring Aid Policy for Enhancing FDI Inflows**

This section reflects on the recent history of development in LDCs and specifically the experience of SSA economies post-independence to achieve long-term growth and development based initially

on inflows of aid and in subsequent period on private capital, principally FDI from developed countries. We begin with a brief account of the performance of the regions post-independence as context for later exploration of Aid policy and its employment to increase private inflows principally FDI.

The disappointing two decades of structural adjustment in Sub-Saharan Africa have served to motivated donors to attach political strings to aid as a means of achieving economic and political reforms and the acceptance of IMF and World Bank macroeconomic policy prescriptions. These political reforms and the adoption of good governance, in contrast to earlier orthodoxy, which advocated stern authoritarian rule as the only means of bringing about credible economic development, were undermined by the new development agenda. Notwithstanding the high level of consensus between donors on the desirability of this link between aid and political reform, there are some challenges (Robinson, 1995). The new development paradigm is now focused on reducing the role of the state to create opportunity for private sector actors. This is accompanied by a focus on growth policies and away from maintaining aid flows. However, donors now focus on selectivity i.e. aid to countries pursuing pro-poor development policies according to Mosley, Hudson and Verschoor (2004). However, there is growing skepticism about the effectiveness of aid as the agent of growth and development for LDCs (Hudson and Mosley, 1994/95); even though this has long been the focus of donor policies in channeling aid to poor countries. This skepticism is due in large measure to the poor rate of returns to aid flow to LDCs, contrary to the expectation that returns to capital should be higher in capital-poor than in capital-rich countries (Lucas, 1990). The evolution of a consensus on the poor growth performance of the developing world identified lack of access to investment capital, low domestic savings and declining foreign earnings, served only to highlight the need for external inflows of private capital. This perspective coincided with the revision of American Foreign Policy and its new focus on economic growth and development as a major contribution to long-term economic progress and a means of supporting the development of democratic state institutions against contradictory internal foreign forces. Security and

historical relationships with former colonies resulted in French and UK expanding aid and technical assistance. Helleiner (1994) noted that although a number of Sub-Saharan economies, namely, Franc Zone countries, had achieved a level of success in overcoming poverty and general economic decline, the limited nature of these achievements have not dispelled “universal disappointment” with the economies of the region. The 1980s were designated a period of economic reversal, not unlike the crisis of the 1930s (Helleiner, 1994). For Kirkpatrick (1995) it marked the beginning of the decade of trade liberalisation; with the World Bank initiating its program of structural adjustment lending as a supplement to traditional forms of project investment and sector specific lending.

Competition for FDI is made on the premise that it is associated with a bundle of goods generally in short supply in LDCs such as our case-study country Uganda. FDI is valued for its association with the international diffusion of technology, product innovation, and modern production and management methods. Policy makers also associate FDI with the process of economic integration and linkages to international markets. For LDCs inflows of FDI also provides a basis for the development of a modern industrial base i.e. structural transformation and the opportunity to upgrade its technological and human resource base (Kirkpatrick, 1995). As reductions to barriers to trade in manufactured goods is more significant than for traditional industries such as agriculture and textiles, LDCs have sought to promote industries less constrained by distortions in international trade either through producer or export subsidies. In the case of the latter reforms of the Multi-Fiber Agreement (MFA) was not achieved until the late 1990s. Recent policy initiatives such as the WTO Aid-for Trade has formalised the link between public inflows and private sector development with a focus on trade capacity (Table 2). The generally small domestic markets poor infrastructure endowment LDCs and especially those in SSA means they attract small amount of global FDI flow. This low absorptive capacity suggest a need to seek foreign inflows of private capital, however, as FDI is linked to the trade and investment activities of Transnational Corporation (TNCs) and these are based in large markets or in countries with a ready supply of productive labour, the prospects of

significant inflows to poor developing countries such as Uganda are limited. It is therefore necessary for policy makers in these countries to address the needs of international investors with a range of attractive economic policies and efforts to improve the quality and availability of their physical infrastructure and the skill base of the local workforce. Members of the international community have engaged with these issues and have sought to improve the competitiveness of these countries in the global competition for FDI with a number of initiatives ranging from Structural programs in the 1980s to recent initiatives such as the WTO's Aid-for-trade facility (Table 2). The explicit linking of Aid to the development of the trade capacity of poor states is linked to the SAL of the 1980s which focused on the removal of state monopolies and reforms of trade and investment policies: liberalization and privatization as a means of stimulating the development of the private sector through the establishment of an appropriate policy environment (Kirkpatrick, 1995).

The fact that external capital would be increasingly private in origin focused the attention on the role of government and in particular, domestic macroeconomic policy. This has resulted in the development of investor friendly policies. However, the poor response of foreign investors to ongoing policy initiatives such as the privatization and liberalization, with the opening up of many sectors of the economy in SSA states, amount to a failure of sector-led economic transformation (Moss and Ramachandrain, 2005). However, the utility sectors: telecommunications, transport and power are largely now open to foreign investors. The privatization of state-owned companies has provided opportunities for inflows of equity, new technologies and modern management practices. Efforts to increase inflows of FDI are reflected in a variety of policy incentives: devaluation of national currency and a rise in the number of multilateral and bilateral trade and investment agreements, see Table 9 P52. Aid has sustained the reform process and provided technical assistance for the development of regulatory regimes in the infrastructure sectors especially in the power and telecommunications sectors. It has provided co-financing of private sector investment in the infrastructure and agricultural sectors in Uganda - see chapters 4 and 5 for details of these.



## Section 3.5

### Conclusions

It is clear from the above that the efforts of LDCs to increase their international competitiveness with respect to increasing their share of global FDI inflows are constrained by a number of factors. These range from poor endowment of physical capital i.e. the low skill base of the local work force infrastructure bottlenecks such as inadequate utility power, poor road and rail links to port facilities in neighbouring countries in the case of landlocked Uganda. These are compounded in many instances by inappropriate policy environment, weak state institutions and lack of property rights. Aid however, may be employed to improve policy/investment climate, skills base of the workforce, education, vocational training as well as co-financing improvements in the physical infrastructure. Beyond this, aid may also support significant policy innovations via technical assistance and budgetary support to mitigate reforms of trade based-taxes and long-term structural changes in the pattern of economic activity. As the empirical elements of the above suggests, the policy orientation of recipient countries has a significant bearing on the effectiveness of public inflows i.e. aid and the productivity of private capital, reforms of state institutions and greater efficiency of the major ministries will, over time, reduced the risk to government budget and aid dependency. Whilst the FDI/Growth relationship is complex, proxies are employed with varying degree of agreement between researchers, the precise mechanism through which FDI influences growth and development in recipient countries is multi-dimensional and this is difficult to capture in econometric analysis (see Figures 1 Pages ). Furthermore, it may be argued that the determinants of FDI and its impact are qualitative in nature. For instance, the policy preference of domestic policy makers and the incentive structure to domestic and foreign investors will determine the productivity of foreign inflows. As LDCs are seeking significant FDI inflows to their infrastructure sector, it may be some while before these investments impact on aggregate production, again making analysis based on increases in short-term aggregate production challenging.

The evolution of macroeconomic policy over the period of the 1970s to the present is characterised by marked changes of policy towards FDI by LDCs and DCs. For instance inward investment promotion is linked to out-ward orientation and export oriented policies in former highly regulated and protected economies of Latin America and African economies and donor sponsorship of policy reforms has been important to these countries and regions. Aid-for trade under the WTO has grown in significance for these countries and so too trade financed economic infrastructure.

Formulating an aid policy for enhanced inflows of FDI would constitute a basis both for long-term donor commitment and increase aid effectiveness. This also provides a basis for long term economic growth in line with the orthodox justification and purpose of aid: facilitating the take-off to self-sustaining growth and development. This approach will also reinforce the importance of private sector and market mechanism in the allocation of public inflows. At the policy level convergence between aid& FDI will suggest a greater level of pragmatism on the part of policy makers in LDCs as investor friendly policies will be required to facilitate the convergence of aid and FDI determinants. Whilst we have explored the link between Aid and FDI in the financing of infrastructure in LDCs with some specific reference to Uganda, the issues identified above have significant implications for policy makers in LDCs and especially for similar countries endowed with poor infrastructure and an economy dominated by a low income traditional sector which is concentrated in the rural areas and constrained in its efforts to modernise and expand internationally. Restricted access to important domestic and international markets reduces the attractiveness of the sector to investors: domestic and international.

## **Chapter 4**

### **Qualitative Assessment of the AID-FDI Link**

#### **Section 4.0**

##### **Introduction**

This chapter begins with the identification of aspects of the philosophical and technical issues that have influenced the choice of methodology. Bryman's assertion of a convergence between the qualitative and quantitative is, in this context, very influential as the authors also suggest that the adoption of a multiple approach is commonplace in sociological research. Gill and Johnson argue that a single approach is incapable of meeting the many challenges encountered in data gathering although some methodologies have particular strengths in some well-defined areas of data gathering. Based on these observations, the author has decided to employ a multiple approach using both qualitative and quantitative methodologies. Reference to earlier studies such as those by (Papenek, 1973) (Mosley, 1980) suggest that a purely quantitative approach is likely to be undermined by the quality and availability of macro aggregate data for the case study economies. This has been identified in a number of earlier studies on SSA LDCs.

#### **Section 4.1**

##### **Research Design: Justification**

Bryman (1991) and Miles and Huberman (1994) support the rationale for the case base qualitative approach as a precursor and complement to a qualitative natural science approach. These authors are supported by the fact that data varies in its nature and classification as qualitative or quantitative, sensitive or not, formal or informal, widely distributed or rare, easy or difficult to measure. As information is generated across many different sectors, it is often very different and conditioned by its origins and methods of generation. It is therefore necessary to employ methods of investigation, which will account for the differences. For example, information about the wholesale price of cocoa beans is quantitative, objective, macro and it is not particularly sensitive and therefore readily measured. On the other hand, information about investors' risk aversion may be at

the opposite end of the spectrum on almost all accounts. Furthermore, information on the price of cocoa beans may be recorded and to some extent already in the public domain, whereas information about the risk aversion of investors is neither recorded or in the public domain. It is therefore understandable that a common research tool is incapable of investigating the two phenomena. Maxwell (1984) identified a number of research tools which may be employed to address this variation between types of data – more specifically the need to employ methods of data gathering that take full account of their different natures and origins.

## **Section 4.2**

### **Research Process Design**

Five main classes of tools are distinguished: secondary sources; surveys-both singles and multiple case study and experiment. Because these vary in cost, coverage, accuracy, time and statistical validity, a trade-off is inevitable. This pragmatic approach is therefore a necessary evil as the two main constraints dictate that the chosen method should provide the greatest speed and the lowest cost, subject to achieving the required minimum levels of accuracy, coverage and statistical validity. So a study of private and public inflows to a selected number of SSA economies and their respective impact on the growth and development process in LDCs could be determined by reference to published, i.e. secondary sources. The author will use the World Bank and ESDS online World Development database for all macro variables. However, the behaviour of international-cross border investors might entail detailed fieldwork of an anthropological or sociological nature (Maxwell, 1984). As the data required would fall into a number of categories, dual research methods will be required. The use of qualitative in-depth interviews in which participants are given the opportunity to explain their perspective on the phenomena of interest to the researcher is a critical aspect of the employed methodology.

The justification for the case study approach is based on epistemological concerns and the need to understand behavioral and attitudinal factors – the investment preferences and behaviour of senior decision makers in 1) a purely political environment/context and 2) in a purely commercial

environment. The need to investigate causality and the related need to account for the interrelationships between economic and political actors, to determine and/or explain the current attitudes and beliefs of donors, domestic and foreign investors is critical to the determination of why certain behaviour occurs. This present study will build on these explanations in order to identify policy initiatives, which may influence the investment behaviour of private investors – domestic and international. Maxwell (1984) advanced two supporting propositions for the use of the case studies. These are 1) there are some subjects for investigation or piece of data where intensive study of a few cases provides the only practical approach: quite simply, nothing else will work. 2) There are many other subjects where alternatives exist but where case studies provide an optimal combination of time, cost, and accuracy and coverage characteristics.

The author argues that under these circumstances case study research is an appropriate substitute for, or complement to other methods.

### **Section 4.3**

#### **Specifying the Model**

The methodological shortcoming of a single approach is discussed at some length in earlier sections, namely the decision to employ a dual approach: qualitatively case based approach, which is complemented by quantitative econometric and statistical methods. In the case of the latter, time series macro-variables pooled panel data for 23 Sub-Saharan economies are employed. Econometric evaluation will attempt to identify the respective contribution of aid and FDI to the growth process. This is accompanied by the assessment of the FDI-Aid interaction function. Here we are concerned with the joint impact of the two flows on the growth of recipients. This interface is also determined qualitatively using a number of case studies. Here we specify the case studies. These are micro-projects, which demonstrate the hypothesised FDI-AID interface/interaction. We are focused on projects which have by virtue of their size and nature, a potential impact on the growth and or development of the recipient economy. This impact is determined econometrically and qualitatively. Survey of Uganda's principal development partners will determine whether these

organizations recognize potential complementarities between aid and FDI i.e. our interaction term: Aid-FDI. We also seek examples of this interaction where two types of inflows have jointly financed projects.

The general application of these findings for Sub-Saharan economies in term of macroeconomic policy is another significant and intended outcome of this research. Whilst the aid-FDI may address concerns for effective utilization and enhanced allocative efficiency, it may also catalyse the finance of infrastructure. Although Infrastructure projects have come to occupy a position of importance in developing countries; its provision has traditionally been the exclusive concern of governments. For poor states such as those common to SSA, their generally inadequate state of public infrastructure is now recognised to be a major impediment to the growth and development process in these countries. With limited technical and financial resources, this group of economies have recognised the need to increase private sector participation in the financing and operating physical infrastructure. This development has stimulated critical studies of the beneficial impact of public goods on the welfare of recipient economies. In the main these studies such as that by Canning and Bennathan (2001) have attempted to answer a number of questions, not explicitly stated but inferred by the suggested policy: is infrastructure led development strategy a credible macroeconomic strategy for poor developing countries such as those in SSA? We make a necessary interruption at this point. It is understood by advocates and critics that infrastructure plays a critical role in development. However, aid critics such as Bauer (1971) argue that claims that a ready-made infrastructure is a precursor for development is challenged by the experience of the developed economies and former colonies such as United States and Australia. According to Bauer, social capital i.e. infrastructure is the result of economic development, not its cause, Hernandez-Cata (2000) and World Bank (1997, 1998), respectively, however, argue in favour of the primacy of infrastructure led development. This view is supported by Brenathan et al (2001) in their identification of a number of infrastructures generated positive outcomes: improved domestic

opportunity for foreign investment, and;Facilitating potential gains in the productivity and profitability of these investments.

Inadequate transport links and unreliable power supply impose extra risks principally in the form of higher costs on commercial operators. Brenathan and Canning recognised the basis for this pragmatism i.e. the appeal to private sector provision and/or participation in infrastructure provision. This is summed up in the following statement by the authors:“If the takeoff in developing countries relies on a co-coordinated bout of investment, the public provision is risky, large scale infrastructure projects may provide a trigger for private sector investment and escape from a poverty trap.”

The critical issue here is the relative contribution of public and private providers of infrastructure i.e. public goods. The efficiency with which these services are delivered and their potential to positively influence the growth and development process in poor countries is critical to the current study and the body of literature on development economics. However, the principal focus of this thesis is the empirical evaluation of the Aid-FDI interaction as a means of enhancing the impact of these inflows on the growth process in recipient countries. Whilst earlier studies have been controversial and generally inconclusive as far as the direct impact of aid on the growth of recipient economies, the present work seeks to address this issue by the Aid-FDI interaction term as a possible mechanism for assessing the impact of such inflows on recipient’s economic growth.

The present study is concerned with the testing of the hypothesized Aid-FDI link through the qualitative and quantitative investigation of incidents of this interface in the provision of public goods such as infrastructure and private investments generally. A further aspect of this study is the impact of this convergence on recipient economies, specifically, its influence on the growth and development process in recipient countries. A detailed investigation of the policy environment that facilitates this convergence will provide a basis for the identification of the policy implication for LDC: specifically macroeconomic strategies for enhancing the effective utilisation of declining aid and improving the attractiveness of FDI inflows.The determination of Aid, FDI and Aid-FDI impact

is undertaken at two levels: micro level qualitative case based and the macroeconomic level using a quantitative methodology. This final approach will be guided by the methodology employed by Brenathan and Canning to calculate social rate of return and returns to capital for infrastructure projects in developing countries.

Here we argue from a policy perspective that a necessary convergence between the two types of inflows must occur if private investors are to obtain adequate rates of returns and thus become significant providers of public goods. However, the authors recognised that quantitative assessment of rates of return will fail to capture full impact on recipient economies where significant externalities exist. This is argued to be a function of the level of market competition and costs. Here the authors anticipate that a positive correlation between infrastructure stock and aggregate output may be due to a rise in demand and not the outcome of supply side productivity effects. This outcome is avoided by the use of co-integration analysis of panel data. A further consequence of this approach is the productivity of human and physical capital which approximated those obtained from microeconomic studies of their private rates of return. This was accepted as confirmation of the biases resulting from reverse causality. In the present study we test for these biases using statistical methods to identify significant levels of reverse causality. The Brenathan and Canning study discounted the use of Cobb-Douglas production function in favor of a translog specification.

In this research I have decided to use a multiple approach. This will involve the use of both qualitative and quantitative methodologies. The choice of approach is supported by reference to the literature on research methods for example: Maxwell (1984), Easterby-Smith (1991) Bryman (1984) and Miles and Huberman (1994) have all recognised that the complex nature of the data associated with quantitative and/or qualitative research defies a single research methodology and epistemology. I have therefore decided to acknowledge this difficulty and employ a dual perspective. We expect the qualitative component to provide context for the interpretation and meanings attached to the quantitative aspects of the present research. We begin the process by specifying a production function, which allows us to determine the impact of a number of macro



variables such as aid and FDI, respectively on the rate of growth of recipient countries, see chapter 5 for details of these and the qualitative assessment based on an econometric estimation of the hypothesised Aid-FDI interaction.

#### **Section 4.4**

##### **Research Instrument**

The questionnaire consisted of 20 questions and is divided into two sections with the first focused on macroeconomic environment i.e. policy context and its impact on the performance and future investment intentions of the firms and investors. Some questions on the importance of infrastructure: power, telecommunications and transport were included as again these have been highlighted in a number of World Bank and academic studies as significant determinants of FDI and corporate performance. The questionnaire was distributed by email and fax to a list of companies identified as significant investors in Uganda. The list was constructed from a data base of companies obtained from DFID, the Ugandan High Commission and the Commercial Attaché at the British High Commission in Kampala. From the data bases a total of 20 companies were identified as appropriate i.e. were connected to the internet with reliable connection. Of these 12 agreed to participate in the research i.e. agreed to complete the questionnaire and return it within a relatively short period. In reality the majority of these took two or more months to return the completed questionnaire after numerous reminders. A cross section of companies representing: manufacturing, services (banking/finance and consultancy), infrastructure and the power sectors were surveyed. A number of these were also interviewed over the telephone after receiving the completed questionnaire. This was done to clarify some outstanding issues and correct a number of ambiguous responses to specific questions.

#### **Section 4.5**

##### **Analysis of Private Sector Response to Questionnaires**

As generally observed by other researchers, private sector companies and large voluntary organisations are somewhat bureaucratic and can take long periods to respond to outside

researchers. Whilst it may reflect company concerns for possible over exposure to negative outcomes, it is clear that private sector participation in the ownership and/or delivery of public goods still has the power to evoke strong feelings amongst the general public, politicians and policy makers.

### Q1]

**In your company's view, what are the main factors influencing FDI in Uganda? List these in order of importance, with the most important first i.e. at the top.**

- |        |         |
|--------|---------|
| 1----- | 2-----  |
| 3----- | 4-----  |
| 5----- | 6-----  |
| 7----- | 8-----  |
| 9----- | 10----- |

Q1] The fact of Uganda's geographical location and weather is highlighted as a significant positive factor in the investment decision of a number of respondents, see Tables 38 and 39. Although respondents indicated that the legal or regulatory framework, the poor state of the country's physical infrastructure; principally, the lack of reliable power supply are major constraint on their operations. The investment in alternative sources of power is said to be expensive and has a negative impact on the price competitiveness of their products.

According to one respondent: *"Alternative sources of power have been a major investment component and the timing has been accelerated by recent deterioration in the utility power availability. Investment has been focused on diesel generators and on biogas generation, with further projects planned."*

The problems with diesel generation are as many as the benefits, and again according to one respondent, *"Diesel generators ensure the ability of our factory to continue processing during period of power load-shedding. However, the unit cost of power is over three times the cost using*

*diesel compared to utility power. Result: no loss of production volume, but at higher cost of production.*”

Corruption and the small size of the domestic market are also listed as important dis-incentives to higher levels of investment. Privatisation of existing assets; probably a reference to state owned companies, is for some a major influence on the inflow of FDI. For more on this latter point see section of privatisation and FDI inflow to the Ugandan economy. Land availability and the incidence of corrupt practices and fraud are also sighted as having a negative impact on the level of investment made by existing investors. Respondents have identified corrupt practice in the procurement process as having had a significant impact on a number of proposed hydropower schemes with a number of international financiers either withdrawing or reducing their commitment.

## Question 2

**In your company’s view, rank in order of attraction as investment location the following countries:**

**Ghana, Kenya, Mauritius, Nigeria and Uganda,**

1) ----- 2)----- 3)----- 4)----- 5)-----

Q2] In comparison to a number of other economies: Ghana, Kenya, Mauritius, and Nigeria, Uganda and Mauritius were cited as joint top of the list of five countries as the most attractive location for FDI. Overall Uganda achieved better scored with more second and third ranking than Mauritius (see Table 38) an attractive destination for FDI.

## Question 3a

**Table 38 Investor’s assessment of Uganda’s location ranking relative to competitor countries**

Ranking	Country
Ghana	1
Kenya	2
Mauritius	3
Uganda	4
Nigeria	5

Source: Taylor, L. Survey of Ugandan Investors, 2007/8

## What are the main obstacles to doing business in Uganda?

Q3a] Overall lack of reliable electricity supply is the principal concern of manufactures and power and distribution companies. In fact, one respondent stated that *“delays in investment in electricity generation have caused significant difficulties in making our decision whether to invest in distribution.”* This respondent also claims that these delays have had a negative effect on the quality and efficiency of their operations. However, investment in alternative sources, according to the respondent has helped performance not to get worse in the case of a major retail bank. For examples of the problems associated with the financing of infrastructure in the SAA region see Tables: 30 (P110), Table 31 (P111) and Table 32 (P 112).

Other respondents (a company involved in the tea production and processing) have stated for example that *“our operating costs are rising and this makes additional investment a hard sell.”* For another conglomerate involved in the tea, sugar and steel production, the state of the utility supplier has provided it with the opportunity to establish a cogeneration plant using the waste produced from the sugar extraction process as fuel for its power production process. In fact, this project been so successful that the company has negotiated the sale of its surplus electricity to the national grid.

When asked what influence, if any, have these infrastructures (power, transport and telecoms) services had on the timing and size of their investment, respondents have for example stated that:

*“they have a significant influence on the investment decision.”* In response to the impact of these difficulties: *unreliable power supply and the generally high cost of alternatives such as diesel generation, respondents have stated that “margins have become thinner due to a combination of high production cost and competition.”* This suggests the Ugandan government needs to better management investments in the power sector to increase reliability and reduce costs. The fiscal burden of the government may ruleout meaningful short-term response; in fact the removal of the tax rebate on diesel generators supports this view i.e. the government does not have the resources to reduce tariff on alternatives to utility power.

Respondents are without exception agreed that the telecoms sector has improved significantly and their concerns are directed at the power and transportation sector. The combination of higher production costs associated with diesel generation and high transport cost has resulted in a decline in quality, competitiveness which according to some companies especially those in manufacturing and exports is made worse by the poor state of road and rail links and the consequent slow speed of transport and its high cost.

**Table 39 Relative Ranking of Investment Location**

Ranking	1st	2nd	3rd	4th	5th
Country					
Ghana	1	2	2	1	0
Kenya	1	1	2	4	0
Mauritius	2	1	2	0	2
Nigeria	1	2	0	0	4
Uganda	3	2	2	1	1

Source: author Survey of Private sector investors in Uganda 2006/07

Question 3b

**Has the quality and reliability of Uganda’s physical infrastructure (power supply, telecommunications and transportation services) influenced your investment decisions and/ or operations?**

Q3b] Respondents identified a number of obstacles to doing business in Uganda. These are listed below. The factor most commonly identified is the lack of reliable power supply. Poor transportation links is of particular concern for the agricultural sector and horticulture (Cut flower and fisheries sector). The fact that manufacturers are unable to source a significant amount of inputs locally means that they import large quantities of raw material and consumables .Poor transport has made this dependence on imported goods time consuming and expensive. Whilst the appreciation of the Ugandan Shilling in the late 1980s and 1990s may had a positive impact on companies dependent on imported inputs, this would also add to the lack of price competitiveness in export markets in line with the comments of some respondents-see section 5.6 (P226) for account of the

REER movements for the Ugandan Shilling and the policy implications of a high REER for exports and the overall international competitiveness of the economy. Other important issues identified by respondents included the following: the cost of doing business, corruption, lack of security (especially around the Great Lakes region). The high incident of fraud and the scarcity of well trained workers-see tables 40 and 41 (P173). On the other hand, other respondents were much more positive, identifying the availability of cheap labour, government support, and the central location of Uganda for the region, a competitive exchange rate and the availability of agro raw material.

**Q3d]What influence, if any, have these infrastructure services had on the timing and size of your investment?**

**Table 40Principal factors/determinants of inflow of FDI to Uganda**

<p>These were listed in order:</p> <p>Location i.e. central location of Uganda to significant markets</p> <p>Positive approach of government</p> <p>Cheap Labour</p> <p>Availability of agro raw material</p> <p>A competitive Currency (Ugandan Shilling)</p> <p><b>Negative factors/deterrents of FDI:</b></p> <p>Lack of price competitiveness of manufactured exports</p> <p>Legal and regulatory factors</p> <p>Poor physical infrastructure e.g. lack of reliable utility power</p> <p>--requiring expensive diesel power which is 300%&gt; expensive than utility</p> <p>Poorly trained and developed workforce</p> <p>Corruption and small scale of domestic market</p> <p>Poor land availability for commercial purposes</p> <p>Poor quality of local inputs-raw materials, &amp;consumables</p> <p>Inadequate procurement procedures and project tendering</p> <p>Lack of security especially around the Great Lakes region</p> <p>Withdrawal of 10-year tax holiday and tax break for diesel generator and fuel to compensate for inadequate utility power</p>
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Source: author Survey of Private sector investors in Uganda 2006/07

Q3d] Overall respondents state that their investment decision will be negatively influenced by poor provision of infrastructure, the fact that many have linked poor provision to reduced profits and

declining profit margins is evidence of a clear link between the quality of infrastructure and the investment decision, volume of the said as well as the viability of local investment.

The poor state of the electricity supply was of particular concern for manufacturers and power distributors. These range from: tea estates, sugar producers to steel production. One sugar producer invested some \$US20 million in a co-generation plant but it has also deferred investment in increasing capacity in steel production and glass bottle production facility. Overall the high cost of diesel generator has according to some respondents resulted in increases in capital cost of investment projects. The scaling back of these investments mean reduced employment and lower levels of domestic investment. For the government this is a major setback as development strategy is based on private sector expansion which in turn will grow the tax base of the economy as well as adding to the level of employment in the economy.

#### **Question 3e]**

**Has the quality of these infrastructure services had any impact on the profitability and competitiveness of your operations?**

Q3e] Respondents reported a negative impact of unreliable power supply on profits, profit margin and its impact exaggerated by the severity of local competition: an intensification of competition in the local market.

#### **Question 3f**

**Has your company invested in alternative sources of these infrastructure services? This should include for example stand-by generators and independent communication infrastructure.**

Q3F] The majority of respondents (80 per cent) had invested in alternative source of power: diesel generator, but as already reported above, for many of these this is not sustainable in the long run as it up to 200 more expensive than normal power supply.

#### **Question 3g**

**To what extent have alternative sources of these infrastructure services removed the infrastructure constraint on your business's performance?**

**Table 41 Impact of infrastructure on operations and investor intentions**

Infrastructure	power	Road transport (road, rail, and access ports)	Skills-base of local workforce
Impact	Reduced service quality to customers Negative impact on Profits, size and timing of further investments also increase capital cost of investment	Reduce competitiveness in export markets,  increase cost of production as well as increase time taken to obtain inputs— overall increase in costs	Limited supply of skilled workers means more investment in training  Shortage of middle-managers & technical personnel
Industry/sector	Service sector & Retail banking	Manufacturers, agro sector, exporters & firms dependent on imports of inputs	All sectors & firms

Source: author Survey of Private sector investors in Uganda 2006/07

Q3g] For the majority of respondent the use of standby generators was only a short term fix and a poor substitute for reliable mainstream supply.

**Q 3h]**

**Has investment in alternatives infrastructure services improved the performance of your operations?**

Q3h] For a major international financial institution with a retail branch network “It has eased our ability to deliver services but the costs cannot be fully recovered in the price.” Investment in alternative has for this respondent not improved performance *“but it has removed some of the negative services issues.”*

Overall the response of respondents is summed up in the answer to Q3i] however, the sugar producer is now a net contributor to the National Grid, as surplus electrical power from Bagasse i.e. the fibrous remains from sugar production is sold to the state owned distributor. Investment in cogeneration has according to one sugar producer improved the performance of the company.

**Q 3i]**

**In the opinion of your company, what actions or policy should the government put in place to improve the current situation?**



Q3I] According to one respondent *“Government needs to take a long-term approach in resolving infrastructure problems, as short-term solutions are inferior in quality and considerably more expensive.”* A number of respondents suggested that the Ugandan government should build the much talked about Bujagali hydro power facility. For one respondent *“The government needs to adopt a long term strategic plan in which the vision for Uganda’s future is clearly articulated. Then a real partnership between the public and private sectors in the achievement of shared milestones should be codified.”* For another respondent *“The real need is speedy implementation of policies taking a practical approach, seeing the national “big picture” and moving ahead instead of seeking to reach “theoretically perfect” decisions without appreciating the value of time lost in the process.”* The withdrawal of the previous 10 years tax-holiday which was offered in the mid-1990s to attract FDI, was viewed by one investor is a negative development as a number of competing counties in the region have maintained this policy and not its replacement: the accelerate depreciation.

**Table 42 Suggest policy response for Ugandan Government**

<p><b>Suggested action Ugandan Government Should take:</b></p> <p>Government should take specific measures to remove barriers to the proposed Bujagali hydro-power facility—now under construction</p> <p>Establish long-term strategic plan with infrastructure as clear priority for long-term development.</p> <p>Facilitate partnership between Ugandan Government and the private sector</p> <p>Avoid seeking the perfect solution—need for pragmatic not ideal solutions—speeding up the process &amp; response to the issues.</p> <p>Withdrawal of 10-year tax-holiday with accelerated depreciation for diesel generator viewed as in appropriate response.</p>
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Source: Taylor, L Survey of investors in Uganda 2007/8

**4QJ]What specific supports, if any, have been provided to your company by the central government (directly) or via ministries and /or agencies?**

Q4] The majority of respondents stated that they had enjoyed a good relationship with the government. And according to these reduction in load-shedding i.e. reduction electricity interruption and /or the granting of tax credit for the purchase of standby generators and or subsidies on diesel. Whilst the latter would be welcomed, some respondents have maintained that the use of

standby generators would still be too expensive being up to 300 per cent more expensive than hydro power. Whilst the relationship between respondents and the Ugandan government is said to be good, actual support is not considered meaningful. For example, replacement of the ten-year tax holiday with the accelerated depreciation is viewed as a negative development by respondent firms, see Table 43.

**Table 43 Central Government Support for the Private sector**

- Tax-credit for purchase of standby generators
- Generally good relationship with Central government
- NRM Government credited with return/restoration of confiscated properties
- Help with land acquisition for investors in agro-based industries or for crop cultivation—expansion of existing operations or new investments
- Government has for example assisted firms to obtain World Bank grants & Carbon- credit for cogeneration power plant using renewable energy source/fuel to generate power.

Source: Taylor, L Survey of investors in Uganda 2007/8

The NRM government was credited with the policy of handing back properties expropriated during the Amin Regime to their original owners. For companies involved in the agricultural sector and activities based on large plantations, the government has helped with the process of land acquisition for new projects or the expansion of established operations (Table 43). In the case of the company operating the bagasse co-generation project, the Ugandan government (The Ministry of Energy) assisted the company to obtain a World Bank GEF Grant as the project is based on the use of a renewable bio-mass resource to produce electricity. The company also stated that the government is assisting it to apply for carbon for another co-generation project which also makes use of renewable energy/fuel.

**Q 5]In your company’s view, how helpful have these supports been to your operations in Uganda?**

Q5] Whilst subsidies for diesel generation are welcomed by all respondents, it is universally viewed as a second best to utility power and an expensive one at that. For others, subsidies to diesel

generation would lift the cost burden as well as contributing to a lower tariff than would otherwise be the case. Still others argue for the expansion of biogas generation initiative for the tea industry. One respondent reflected the sentiment of many companies as obtained in telephone conversation: *“There is a feeling that the power crisis may have been avoided through better forward planning by Central Government and could have been mitigated by better control of the water resources in Lake Victoria.”* For companies involved in the agricultural sector, tea, cut flower, and co-generation, government help is assessed as having had a significant positive impact on their activities. This suggest some frustration with the slow pace of new power generation capacity and the need to simplify and reduce the over specification, contractual and procurement process for new infrastructure construction. We have noted some concerns for the level of corruption and political interference in the procurement process associated with a number of major infrastructure projects and the fact that some contractors have resigned from some of these and increasing the risks to private sector partners. The fact that the Ugandan government has entered into off-take agreement with the generators and these are linked to the REER of the Shilling means the government budget is at risk and this is likely to increase with time and delays, see Tables: 17 (P87), 22 (P96), 26 (P108) for the various financial instrument employed in infrastructure finance and related issues such as those listed in Table 44.

#### **Q6a]**

**Has your company’s operations achieved its expected performance? If not, why not?**

Q6] The principal concerns of respondents and explanation for failure and/or delays in meeting projected/expected performance was linked to the unreliability of power supply and its impact on production volume, quality and especially higher cost and reduced output. Others have stated that lack of skill shortage for technical personnel and middle managers especially in the tea sector, and corrupt practices amongst government officials and inadequacies in the procurement process and in the judicial system account for their underperformance, a significant delay in the projects such as the 10 year delay in the Bujagali hydropower project.

**Q7] What actions and/or policies, if any, could and should be taken by the Uganda authorities to improve the business environment for your business?**

**Table 44 Actions required by Government to improve business environment**

Actions	Expected outcomes
Further investment in Government capacity building—e.g. Anti-corruption	Strengthening the judicial system
Greater transparency in government procurement	Better incentives for FDI
Donor and multilateral agencies to institute adequate checks and balances	Improve procurement with better quality & timely implementation
Reduce inappropriate exchange rate of Ugandan Shilling (FOREX)	Reduce over-dependence of government budget spending on aid.

Source: Taylor, L Survey of investors in Uganda 2007/8

Q7] The response of one investor in the tea sector reflected the sentiments respondents of all across all the sectors. This response is reproduced in-full: “Anti-corruption measure; strengthening the judicial system; greater transparency in government procurement, better incentives for FDI”. For one conglomerate involved with a wide range of industries ranging from tea plantation, tea processing, steel and sugar manufacturing, tourism and financial services, the Ugandan government should provide better financial incentives for investors especially for FDI. Respondents have voiced their concern for the procurement process (Table 45). One such concern is expressed thus: “Where there is donor/multi-lateral agency funding for projects, the financiers should institute adequate checks and balances to ensure (i) clean and quick procurement, (ii) progress monitoring for quality and timely implementation.

**Table 45 Foreign Investors experience of Aid-FDI interaction**

Participants	Sector	Project
WB, MGA, IFC, Aid-FDI	Power sector: generation and distribution	project-Bujagali hydro-power
DFID	Agricultural sector	Stimulating input market/factor market
USAID	Agro-sector	Supporting/guaranteeing commercial loans to small-scale farmers
USAID	Facilitate HIV/AIDS (50-60% of budget allocation) program and technical training of local work force	Especially in the agro- & manufacturing sectors
Netherlands	Technical assistance	horticultural sector@ co-generation power project
USAID/FMO/BTA	Power sector	Private sector firms receive technical assistance and feasibility studies: bio-fuel and horticultural projects

Source: Taylor, L Survey of investors in Uganda 2007/8

For others the inappropriate exchange rate of the Ugandan shilling suggested a need to reduce reliance on donor support for Government budgetary expenditure, which artificially strengthens the local currency exchange rate. Infrastructure improvements (power and roads); resolve the internal war in the north; ongoing investment in government and government competency and depth so that policy and reality are more closely matched.

**Q8] In which sector of the Ugandan economy has your company invested in and why?**

Q8] Respondents represented a wide range of activities ranging from: the tea plantation sector, power distribution, steel production, tourism/hotels, power generation, manufacturing, business consultancy, horticulture, agriculture, banking, commercial property development and financial services, respectively.

**Table 46 Ranking of sectors attracting FDI**

Service sector	Sector: manufacturing, agro and power
Business consulting	Power distribution
Banking & finance	Power generation
Tourism/hotel and construction	Agriculture & horticulture
	manufacturing
	Steel production

Source: Taylor, L Survey of investors in Uganda 2007/8

**Q9] Do you have a domestic i.e. Ugandan partner?**

Yes (explain its importance to your company)

**No (Is this a policy decision, or the result of a lack of suitable partners?)**

Q9] Only two respondents had local partners one of these being a minority shareholding by the Ugandan Government from the privatisation process in which the foreign investor acquired a majority holding from an initial involvement as a technical partner with the Commonwealth Development Corporation (CDC) at the point of privatisation of the company. Whilst three respondents indicated that the lack of suitable local partners (Table 47) accounted for the lack of local ownership, one had plans to offer shares to local investors and one had 10 per cent of its shares in local public ownership. The typical structure of UK subsidiaries is local management with a number of indigenous directors and in one company a native Chairman.

## Table 47 Local partnerships

Only two of the participant firms had local partners  
Partnerships are usually with the central government or overseas investors  
Where partnership exist between private sector companies they are principally the result of a privatisation process  
UK subsidiaries are locally managed but larger firms are listed with or planning to list with shares being offered to local investors via the local Stock Exchange

Source: Taylor, L Survey of investors in Uganda 2007/8

However, a number of respondents have stated the intention to secure a listing on the local Stock Exchange and offer shares to the general public and local institutional investors.

## Table 48 Respondent Additional comments: Additional comments by Company B

### Please make additional comments/suggestions in the space below

#### Additional comments by company B

As an exporter, the strength of the local currency has a significant impact on the performance of the business. Tea is sold in US\$, so this currency determines the business revenue base. Over the last 3 years, the UShilling has strengthened by approx 10% against the US\$, reducing the local currency receipts per US\$ of revenue. In the same 3 year period, input costs have been increasing. In particular, labour rates have been increasing by approximately 20-25% over the 3 year horizon. Other costs, such as energy and transport costs, have also increased over the period. Gains in productivity and yield have been outstripped by these increases in costs. The net result is a squeeze on profitability.

If the exchange rate had shown a slow but steady depreciation during the period, this would have mitigated the cost increase and sustained profitability and competitiveness. The feeling is that the actual strength of the UShilling has arisen not from any underlying fundamentals or strength of the economy, but rather from donor contributions in the way of budgetary support to the Government. The strong currency that results tends to penalise both exporters and local manufacturers substituting for imports, which sectors are arguably the real engine for sustainable economic development. This raises the question of whether donor support is now at a level which is detrimental to the development of a sound productive base for the economy.

There is considerable disparity in the roles of the state and the company with respect to the traditional plantation model for the tea in tea producing countries. In Sri Lanka, the government has taken back responsibility for health and education in East Africa governments have tended to encourage unions to press for plantation companies to increase the levels of social and medical provision so that the state is absolved of the costs. This is understandable in poor countries but puts the entire economic enterprise at competitive risk. In Sri Lanka the government has been very effective at attracting and coordinating aid such that housing schemes for workers are funded with AID driven soft loans and neither the govt nor the enterprise are saddled with costs that they cannot afford and the industry is not imperiled. I believe there is real scope for the successful coordination of large scale aid in such a manner.

Source: Author Survey of private investors and FDI in Uganda, 2007/8

## Section 4.6

### Analysis and Discussion

What we conclude from the aforementioned responses is that private sector investors (overseas investors, FDI) are generally dissatisfied with the poor state of Uganda's utility power sector: unreliability and the consequent need to have expensive diesel generators in place. Even with the benefit of government subsidies for diesel generators, the costs of this alternative source of electrical power (200 per cent higher than utility power), means it is not a viable long-term substitute as it contributes to a decline in price competitiveness and greater inefficiency for manufacturing and agro-processors. Whilst Uganda's domestic market is relatively small, her geographic location, and her close proximity to relatively well developed and significant trading partners such as Kenya, Tanzania and South Africa, is viewed as a major attraction for investors—for ranking of locational advantage see Tables 38 (P165) and 39 (P167). However, investors are exercised by the inadequacy of legal and regulatory framework and in particular the lengthy bureaucratic processes. The combination of relatively small domestic market and corrupt practices is having a negative influence on the size of their investment. However, the withdrawal of the 10 year tax-holiday is viewed as much more significant as a number of countries in the region have maintained this incentive: this means that competitor countries have gained an advantage over Uganda. In the main respondents did not view the accelerated depreciation imitative as a suitable replacement for the 10 year tax-holiday.

Whilst, the privatisation of former state-owned assets has had a positive influence on the level of FDI inflows into the Ugandan economy, the difficulties experienced by many investors in finding suitable land combined with corrupt practices in the procurement process are important constraint on FDI inflows. The latter was identified as the principal cause of the withdrawal/collapse of private sector participation in a number of infrastructure projects, namely in the power sector. For a number of respondents, this factor explains slow progress in increasing private sector participation in a number of hydropower schemes. Manufacturing and agro-processors and firms involved in power

distributors, have experienced the impact of poor utility power. The fact that they depend on expensive diesel generators put them at competitive disadvantage in important overseas markets. Overseas investors agro-processing, tea production and power distribution have planned investments. For one local conglomerate, poor state of utility power resulted in investment in co-generation plant generating power from the waste produced from its sugar extraction process with the sale of surplus electrical to the state owned national grid. The experience of this company in negotiating the sale of its surplus power to the state-owned distributor, suggest a need to reduce the complexity of the process and a review of the tariff system. It is clear that this has significant implications for the expansion of the national grid and rural electrification: low income of consumers especially those in rural areas will require significant subsidies to reduce tariffs to an affordable level for these communities. With this in mind it is hard to see a case for more commercial/private sector involvement in the power sector.

Overall, manufacturing companies have experienced rising costs of productive factors: labour, power and transport. Combined these have resulted in declining profit margins, quality and competitiveness. Poor road links and the slow speed of transport have also resulted in investor apathy as summed up in the following assertion by one investor—**“our operating costs are rising and this makes additional investment a hard sell.”** Whilst the majority of respondents have invested in alternative power supply (diesel generation), but at 200 per cent more expensive than utility power, it is not viable in the long-term; notwithstanding the reduction in load-shedding, Tax-credits and grants for diesel generators. The view of respondents is that the government needs to take a long-term approach to resolving infrastructure problems, as short-term solutions have proved ineffective, inferior and expensive for both the government and firms. Respondents are clear that the government needs to **“adopt a long term strategic plan in which the vision for Uganda’s future is clearly articulated. Then a real partnership between the public and private sectors in the achievement of the shared milestones should be codified.”** Respondents argued for a “big-picture” i.e. national perspective and the need to implement well considered and practical solutions,



rather than a search for “**theoretically perfect**” solutions which fail to account for the value of time lost in the quest for ideal solutions.

The fact that the country is landlocked means that transport costs for exports both for input and exports is vital and the high cost and time associated with this aspect of their business is another major issue: roads are in generally poor state and transport to port of shipping is time consuming and expensive. For agro-processors and the cut-flower sector this is a major constraint of the expansion of the industry. This is also true of the tea industry as improvements of the roads to allow greater access to higher altitude would improve the capacity of the industry to increase acreage and high altitude cultivation. For respondents the Ugandan government has failed to take a long-term strategic approach to the improvements of basic infrastructure such as power and transport.

#### **Section 4.7**

##### **Policy Response: Manufacturing and Agro-processing Industries**

Here the analysis of respondent views and opinion is used as a basis for suggesting policy initiatives by the Uganda government to resolve/reduce or eliminate constraint on specific industries. It is clear that International Development Assistance i.e. Aid inflow could be directed at addressing the welfare needs of employees in the agro-processing: tea and cut-flower industries as these have experienced a combination of significant rises in input costs: for example a 20-25 percent increase in labour costs over a three year period according to one significant tea cultivator. According to this firm, the state must carry more if not all the health, housing and educational needs of the workers except for those training and development needs that are job-related. For the respondent this will reduce the overall burden on the sector and specifically the negative impact these have on the competitiveness of the industry on world markets. The argument here is that AID inflow should be co-ordinated around the provision of social housing and education for workers. Clearly firms operating in the tea sector are experiencing some element of risk to their operation from transfer of fiscal burden from the government to their firms introducing additional costs and with this lowering their capacity to compete on price in important export markets. This burden is compounded by the

appreciation of the Ugandan Shilling, high transport cost to ports in neighbouring countries, and rising labour costs in the industry.

## **Section 4.8**

### **Foreign Investors Experience of Aid-FDI link**

The objective of this section of the questionnaire was to determine whether private sector companies had participated in projects jointly i.e. examples of the Aid-FDI interface or investments made exclusively by aid. Examples of infrastructure projects financed by a mix of aid and FDI would provide opportunity to investigate the policy implications as well as the direction of causation whether aid was responsible for increasing the prospect of private sector participation and whether private sector participation resulted in better aid allocation and enhanced effective utilisation. Both of these would address concerns in the academic literature and amongst policy makers in donor countries as well as in recipient economies for aid effectiveness in its indirect impact on poverty and economic growth.

The section below asks a number of questions about your experience of Aid funded projects in Uganda.

#### **Q10a]**

#### **Have you invested in projects involving foreign aid and/ or technical assistance?**

Q10a] Three respondents have knowledge of projects partly aid funded. For company “A” the investment project involved government and World Bank guarantees to equipment procurement at the start of private sector power project. The World Bank allocation/commitment of \$11US Million was made under the World Bank’s Power for Loan, 10 per cent of the initial budget. According to the respondent this facility was important in the early stage of the network extension as it allowed the electricity tariff to be kept low. However, the company regretted the involvement of the World Bank due to the level of complexity involved in meeting the bank’s terms and conditions and the consequent delays to the procurement process. Although the assessment is that even at this level of contribution, the company would still have made the investment without this contribution from the

World Bank. The effectiveness of World Bank participation was reduced, according to the investor by delays in the procurement process due to complex nature of WB participation. Current investment by this power company stood at \$US10-50 millions in 2005/6 and was expected to grow to \$US50-100 millions by 2010-2012 as further investment in the distribution network is made by this power company.

**Q10b]**

**Please give a brief description of the project and the names of the major donors of the aid and/or technical assistance.**

Q10 (a & b)] Company “B” operates in the financial sector and it is a large international bank with a tradition of providing trade finance across the SSA region. It has participated in projects partly financed by aid from USAID. The latter acted as guarantor of loans made to farmers by the bank.

**Q10c]**

**How important was the involvement of aid/technical assistance to your decision to invest in the project?**

Q10c] USAID participation was said by the bank to be very important in managing the high risk of lending to small farmers. Q10] Company C-The provision of assistance allowed the investor to accelerate its HIV/Aids program. The respondent had already made long-term commitment to the technical training and development of its local staff. For one overseas retail and trade financing bank, some 12 per cent of its loan portfolio is made up of agricultural projects and support help form the bank to manage their risk profile in lending to small farmers.

**Q11]**

**What percentage of the projects’ overall budget was supported by aid and or technical assistance?**

Q11] According to the bank “principle and interest on these loans is available for claim after defunct and collection efforts are exhausted.”

For the bagasse co-generation project, USAID provided technical feasibility studies for the project, GEF/World Bank grant for the facility, and FMO/IBTA of the Netherlands provided technical assistance for the sugar plant effluent treatment whilst the PSOM of the Netherlands assisted with the establishment of a pilot plant to produce bio-fuel from bagasse. This investor was also assisted by the Netherlands to establish a pilot project to cultivate chrysanthemums. Whilst the HIV/Aids program received 50-60 per cent budget support for three years, technical training received less than 10 per cent of its budget.

### **Q12a]**

**In the opinion of your company, would this project have taken place without the contribution of aid and/ or technical assistance?**

Q12a These projects would have taken place without the assistance according to the respondent, albeit at a lower scale. In the case of the co-generation project, the grant+ technical assistance was 20 per cent of the original project cost, whilst the technical assistance from the Netherlands amounted to 50 per cent of the specific costs. According the respondent not all of these projects would have taken place without this assistance.

The need for commercial viability is summed up in the following statement by the respondent:

“Whilst aid and/or technical assistance can reduce the initial project costs, the long-term viability of a project must be based on intrinsic project parameters and market factors.” Q12 a] Some 12 per cent of loan portfolio of the bank is made up of agricultural projects and aid support helps the bank to manage their risk profile in lending to small farmers.Q12b]

**Please explain your response to 12a.**

Q12b] In the absence of these guarantee, the level of activity in this sector i.e. micro-credit to small farmers would be significantly reduced according to the bank “as support has helped us to mitigate the risk of losses”.

### **Q12c]**

**How important was the contribution of aid and/ or technical assistance to the long-term viability of the project?**

**Q12c]** According to the respondent: “In this case of loans to small farmers, if we did not have the comfort of support it would be difficult to justify taking the risk.”

**Q12]** Contribution to technical training was relatively small and so its absence would not have mattered so much in contrast to the 50-60 per cent contribution to HIV/Aids program, but even this program, according to the respondent would still have been developed.

**Q12b]** As the company did not respond to this question, it is quite obvious that the wide spread nature of HIV/Aids would require employers to participate in Aids awareness campaign.

**Q12c]** Again according to this company aid and/or technical assistance was “useful, but not vital”. Under additional comments section of the questionnaire, the respondent stated that: “Uganda is a country which has great opportunities and potential. Its future success will depend on purposeful leadership, good governance, strategic partnership between the public and private sectors with a common vision. It is also important that the full potential of the East African Union is realised.”

## **Section 4.9**

### **Empirical Identification of the Aid-FDI Link**

This section of the research is critical as it seeks to further test the hypothesis that Aid may improve the inflow of private overseas investment in infrastructure projects such as: power, telecoms and transport. The FDI-AID jointly funded projects will provide a basis for further testing of the combine impact of the twotypes of inflows on economic growth using a production function for regression analysis. As the theoretical and empirical literature have generally failed to establish a direct link between AID inflow and economic growth host economies as measure in GDP growth, indirect transmission via interaction with FDI is expected. This positive outcome would also allow

policy makers to address issues concerning aid effectiveness and allocative efficiency. Clearly a positive outcome would also suggest that policy should seek ways and means of linking donor and private sector investors' motivation to converge the determinants of these inflows as well as seeking equal rates of return for Aid and FDI and thus meeting donor concerns for Aid effectiveness.

From the response of the surveyed investors, we have identified a number of instances in which Aid was used to support projects in which FDI or profits generated by established foreign owned companies financed a number of investments. These include for examples: 1) World Bank guarantees for equipment procurement in a cogeneration power project. The facility was provided under the World Bank Power for Loan. Whilst the investor was pleased with the fact that World Bank participation and the fact that the assistance accounted for 10 per cent of the initial project budget and allowed for a significant reduction in the tariff; the delays associated with meeting the bank's complex requirements significantly reduced the usefulness of the assistance. Further assistance was provided for this project in the form of Technical Assistance by USAID (feasibility studies of the bagasse co-generation power project) and further technical assistance by FMO/IBTA of the Netherlands and the establishment of a sugar affluent plant (pilot plant) by PSOM of the Netherlands to produce bio-fuel. Total grant and technical assistance amounted to 20 per cent of the original project costs and Dutch support accounted for 50 per cent of the specific costs. The Netherlands' development agency has also provided assistance to another UK based firm to expand its cut flower business. Whilst development agencies have provided significant support for company-based HIV/AIDS program with contributions of 50-60 of the total budget, contribution to workforce training have been much lower and of the order of 10 per cent or less.

The 2) example of partial aid funding was that of a large international commercial bank with retail operations in Uganda and provision of credit to small scale farmers. In this case USAID guaranteed loans made to farmers. For the lender, USAID was considered vital in mitigating the risks associated with lending to farmers as some 12 per cent of its loans portfolio was made up of

agricultural projects. According to the bank, micro-credit to small farmers would be significantly reduced as USAID “support has helped to mitigate the risk of losses”. However, investors are concerned that aid must be used in such a way that it does not compromise the long-term viability of the investment. The need for commercial viability is summed up in the following statement by the project director of a foreign owned company which had received some USAID and World Bank project finance for a power generation scheme: “Whilst aid and/or technical assistance can reduce the initial project costs, the long-term viability of a project must be based on intrinsic project parameters and market factors.”

Another instance of AID participation in commercial organization was that in which a major retail bank was able to accelerate its HIV/Aids program to complement commitment to technical training and development of local employees. Overall investors believe that the success of the Ugandan economy will depend on purposeful leadership, good governance, strategic partnership between the public and private sectors and the development of a common vision. Investors also stated that this success is also linked to the realisation of “full potential of the East African Union”.

#### **Section 4.9.1**

##### **Survey of Ugandan Policy Makers**

The purpose of this section is a determination of the policy context in which an interaction of FDI-Aid may occur. Clearly the focus is one of determining whether policy makers are cognisant of the potential and actual gains from this interaction. Both the Ugandan Investment Authority (UIA) and the Privatisation unit and the Ministry of Planning and Finance were surveyed. Again the effort is one of identifying whether policy in these departments assumes positive benefits from the alignment and interaction between FDI & Aid. As highlighted in the introductory chapter of this thesis, the problem for poor developing countries such as Uganda is the low absorptive capacity and over dependence on public inflows. The related issue is how these inflows may be used to improve the capacity of the economy to attract higher inflows of private capital. As the economy has a

relatively industrial sector, significant increases in foreign capital is likely to be attracted to the infrastructure sector as the availability of local capital: both private and public is insufficient to meet the need to significantly improve the quality, and availability of utilities such as power, transportation and the telecommunications sectors. Wide-scale privatisation of state owned enterprises including companies providing these services has provided opportunity for significant private sector participation. The improvement of these services may also provide the basis for enhanced inflows of foreign investment. The inflow of Aid may therefore be employed to co-finance the privatisation process i.e. from the engagement of consultants, the establishment of regulatory bodies for the post-privatisation environment and pre-privatisation and feasibility studies.

## **Section 4.9.2**

### **The Structure of the Questionnaire**

Section 1 of the questionnaire is concerned with Exchange Rate Policy, economic reform, donor objectives, and the nature, extent of external financing, institutional reforms and the establishment of bodies relating to the liberalisation and privatisation process. Subsequent sections cover the management of Government budgets and the reform of the trade and investment policies. The final section is focused on policies to improve FDI to the infrastructure sectors: power generation and distribution, telecommunications, and transportation. Related to this is the prospect for Aid induced inflows of FDI to the sector.

## **Section 4.9.3**

### **Responses to Sections 2**

**Q1] Over the period 1986-to the present, what role has foreign aid (bilateral and multilateral) played in the following areas:**



Q1] The respondent stated that AID inflows have allowed the Ugandan shilling to trade freely on the open market. This has according to the respondent, “allowed businesses to flourish, and investors to invest in Uganda.”

**Q2] Reform of the economy?**

Q2] The respondents have argued that prior to reforms of the exchange rate policy, companies were at the mercy of ‘Black market money changers’ as it was the only means of obtaining foreign currency. The consequence for many companies is that they were unable to operate or operated at a significantly lower level. Foreign Aid, has for some respondents removed this constraint by allowing the Uganda shilling to free float i.e. ‘market driven value’.

**Q3] Establishment of new institutions associated with the implementation of new policies?**

Q3] The response here is that “Foreign Investment brought relative stability to Uganda, and will help Uganda to recover from years of Government mismanagement. Institutional, economic and structural planning, will allow Uganda to start to improve the population’s welfare and living standards.

**Q4] Reform and/or privatisation of state-owned industries?**

Q4] Respondents have stated that a large number of state own companies were poorly managed and that privatisation and their subsequent return to the private sector will benefit the nation and improve the welfare of the nation as new products become available to the market. Injection of capital, knowledge and technology has removed the burden of having to support these companies from public sources.

**Q5] The establishment of regulatory and/or competition authorities?**

Q5] No response to this question which covered donor assistance: level and nature of support.

**Q6] Please identify the nature of the assistance: Technical, Monetary (US\$), financial aid and the combined values of these or Secondment.**

Q6] No response to this question which covered donor assistance: level and nature of support.

**Q7] What were/are the principal objectives of donor assistance? Please list these in order of priority:**

Q7] Security and development in the region

**Q8] Which, if any, of these were achieved?**

Q8] Of the two stated objectives, security was listed by this respondent as the objective achieved.

**Q9] How are realisation and non-realisation assessed?**

Q9] The principal objectives of donors were identified as: Security in the region and development. The link between the two is summed up by the assertion by the donor that: “Without security, there can be no development.”

**Q10] In your opinion, what impact has these achievements had on the investment climate?**

Q10] The achievement of a greater measure of security is expected to provide a reassuring environment and consequently, result in enhanced level of domestic & foreign investment. The policies stance of the government was identified as the program was recognised as exemplary setting Uganda up as a “shining example to Africa.” Donors also expressed some concern for the level of Uganda’s external debt and for its impact on the welfare of the population and its potential to impede the recovery of the region. Uganda has the notable distinction as the first SSA country to qualify for the HIPC initiative-indebt cancellation to highly indebted poor country initiative.

#### **Section 4.9.4**

##### **Conclusions (Based on response to section 2 of Questionnaire)**

Respondents have asserted that the Ugandan government cannot meet all the basic needs of the population: health, education. Respondent stated that Aid was important in the financing trade and investment policy reforms. These changes were associated with improvement in the investment climate/environment. Although a number of donors stated that they have not seen the tangible impact of trade reforms. They have, however, agreed that World Bank assistance has resulted in

improvements to the infrastructure sector: power, telecoms and transport. Whilst significant improvements in the telecommunications sector and public roads/transport were significant and tangible, private sector i.e. foreign investors have responded to changes in these sectors but the level has been generally poor and improvements less than is required. Telecommunications to major towns has improved, according to respondents, but service and access by rural communities continue to be poor. The sector noted for its deterioration is the power sector where manufacturing companies in particular have experienced significant shortages of power resulting in the need to invest in alternatives such as expensive diesel generation, resulting in higher costs and reduced margins and competitiveness in world markets for agro-processors and exports generally.

#### **Section 4.9.5**

##### **The Ugandan Investment Authority (UIA)**

The purpose of this section is to determine whether the policy pursued and the objectives of the authority would suggest a link between Aid & FDI. As the principal function of the body is one of raising the profile of Uganda as a favoured destination for foreign investors, it is clearly a body which has some influence on the level of inward investment. The questionnaire was developed after a number of telephone conversation and email correspondence with the chief executive and a number of colleagues. The first 6 questions (in section 1) focus on the establishment and financing of the UIA. Section identified the policy context in which the organization was first established and in section 3, the performance of the organization is assessed.

#### **Section 4.9.6**

##### **UIA Response to the Survey**

**The questions in this section concerns the establishment of the UIA**

**Q1]**

**When was the authority established?**

Years-----

Q1] The Uganda Investment Authority (UIA) was established in 1991.

Q2]

**What were the major reasons for the establishment of the UIA? List these in order of importance in the space provided-increase spacing as required.**

Q2] The principal objectives of the organization as reported by its chief executive are to: Promote, facilitate and supervise investment in Uganda. This entail the award of investment Licenses for investors intending to establish businesses in Uganda under the 1991 Code. This is linked to the granting of licenses, authorisations and permits to ensure all approvals granted by UIA have “full effect.” The UIA is also actively promoting investment opportunities to potential overseas investors and at the policy level act as policy advocacy: reviewing potential investors in identifying and establishing investment projects in Uganda.

**Q3] Were donor countries involved in the establishment of the UIA?**

Q3] Donors were involved as sponsors of the UIA and its financing.

**Q4] If the answer to Question No.3 is yes, name the donors.**

Q4] The donors were identified as: USAID, ODA now DFID, the EU and the Austrian Bureau.

**Q5] Identify the significance of donor contribution/support and where possible in terms of percentage contribution to establishment costs/budget) and nature (i.e. was it technical assistance, finance et cetera).**

Q5] UIA state that: “Finance and technical assistance by USAID was over 80 per cent but the system altered so that funding by Donors go to the Government of Uganda, in a single basket, from which it is given as Government funding. In this manner donors need not interface with local recipients. There was no explanation for this change of policy i.e. donor funds to government not ultimate recipient.

**Q6] Who are the major providers of recurrent i.e. ongoing funding for the UIA? Again, list these donors in order of importance.**

Q6] Although USAID was identified as the principal donor, the UIA stated that “Once donor funding is given, money is distributed through the budget support and we don’t bother with who

contributed. At Ministry level, it is possible to analyse donor contribution, but not at the level of the institution that is a beneficiary.”

#### **Section 4.9.7**

##### **Discussion of UIA Response**

With its primary focus on the Promotion, facilitation and supervision of investment in Uganda, it is clear that the present level of funding of the UIA is inadequate for its needs and the mechanism through which financial support is provided by donors is indirect and via central government budget support. Donor influence is therefore indirect. It is evident from this that donor priorities are not capable of full expression as it must be transmitted through several tiers of government from the Ministry of Finance & Planning to sub-ministries. Issues of accountability are foremost ministerial and internal. The lack of direct donor interaction with UIA and its dependence on donors (USAID, ODA now DFID, the EU and the Austrian Bureau) support for the majority of its funding may reduce the motivation of the latter and destroy the incentive structure for UIA to produce outputs in line with donor preference and by this means undermine the long-term commitment of donors.

The current pattern of funding is cause for concern as UIA obtains some 80 per cent of its financial and technical support from USAID. This over dependence on a single donor for the bulk of its finances although indirect, combined with varying degree of pressure on central government budget, means that it is inevitable that the organisation will experience significant variation in the level of resources provided to it: “Finance and technical assistance by USAID was over 80 per cent but the system altered so that funding by Donors goes to Government of Uganda, in a single basket, from which it is given as Government funding.”

#### **Section 4.9.8**

##### **UIA Response to Survey Questionnaire**

The questions included in this section are concerned with policy issues. Despondence preface: “Since 1986, the economy went through rehabilitation; partnership between public and private

sectors was encouraged. The economy was liberalised. There was privatisation of monopolistic institutions and opening up for private sector and FDI flows.”

**Q7]**

**What aspects of economic policy were supportive of the establishment of the UIA? List these in order of importance.**

**Q7]** Policy adopted by the Ugandan government as supportive of the UIA establishment was listed as: Financial liberalization, adopting market determined interest rate and exchange rate, introduction of foreign exchange bureaus, end of ‘black market’. The principal objectives of the UIA are: Trade liberalisation, especially removal of monopoly for traded goods and flow of foreign exchange, removal of foreign exchange control and setting the environment for attraction of FDI as well as enabling domestic investment. Higher economic growth rate of about 6 per cent was a result of a mix of economic and financial policies.

**Q8]**

**What aspects of the UIA’s work have focused on these policy issues and objectives?**

**Q8]** What aspects of UIA’s work have focused on these policy issues and objectives? These include: promotion, facilitation and aftercare of private investment (foreign and local). UIA response to this question is stated here in-full: “ Outward and inward missions to target trade and investment priority countries; providing published materials as sector profiles and guides to investment; private and public sector reforms; sensitise business community; country established annual international trade show led by Uganda’s Manufacturers’ Association. Agricultural trade show has also become a growing annual industrial and commercial agricultural development. UIA has established District Focal Point Officers to assist with upcountry investment promotion and facilitation. There is the team Uganda approach as well as the Linkage program for big companies and SMEs in the process of investment.”

**Q9]**

**In your opinion, how successful has the UIA been in achieving the above objectives?**

Q9] The UIA response is that it has been quite successful in accomplishment of its stated objectives: promotion, facilitation and aftercare of foreign investors and improvement to the inflow of FDI. Whilst the UIA assert that a success rate of 60-70 per cent would be acceptable, however, the actual performance of the organization is not stated in percentage terms.

**Q10] What were the main constraints on the performance of the UIA in this area? List these in order of importance.**

Q10] The main constraints on the performance of the UIA were listed in order as:

- Insufficient financial support
- provision of infrastructure for investors
- insufficient land for industry and commercial agriculture;
- administrative barriers

The respondent stated that “UIA is not yet a “one stop center” for investors; it is more of a “facilitator”.

#### **Section 4.9.9**

##### **Discussion of UIA response to section 3)**

Macroeconomic policy focused on the contribution of the private sector was the context in which the UIA was established to facilitate the achievement of enhanced foreign inflows and provide some input in the development of trade and investment policy. “Since 1986, the economy went through rehabilitation; partnership between public and private sectors was encouraged. The economy was liberalised. There was privatisation of monopolistic institutions and opening up for private sector and FDI flows.” UIA provides a range of sector specific support. These include for instance: international trade show led by Uganda’s Manufacturers’ Association. Agricultural trade show has also become a growing annual industrial and commercial agricultural development.

Notwithstanding the above, according to UIA its performance has been compromised by the inadequate level of funding and specifically, its effort to improve the inflow of FDI (see Tables No

67& 68) undermined by the poor provision of infrastructure for investors, insufficient land for industry and commercial agriculture and administrative barriers. Clearly government must address these issues as they frustrated the work of UIA and may give donors the wrong view of the organization and its performance. Failure to provide a good level of service to potential and actual investors may result in the reduction of the size and number of investment projects. The survey of foreign investors identified a scarcity of appropriate land for agro-projects and manufacturing. The government has the lead role in making suitable land available to foreign investors. This therefore calls for a review of policy in this area. Closer links between the appropriate planning and land registry is required to support the aspiration of UIA to be a “one stop center” for investors as well as removing or reducing the complexity and timescale for new investments. In this section the performance of the UIA is assessed using a number of questions relating to quantitative indicators as well as the determination of the principal strategic and operational objectives of the organization.

**Q11] What are the main strategic and operational objectives of the UIA?**Q11]. The response of the respondent to this question: “strategic vision to make Uganda a leading investment location in the world, through application of best practice investment models and streamlined investment procedures. At the operational level, the mission was one of enhancing Uganda’s development by promoting private sector investment”.

**Q12] In your assessment, which of these have been achieved? List these in order of attainment i.e. the best are of achievement first.**

Q12] Of the stated objectives, the respondent highlighted the following achievements:

- Creation of one a one-stop facilitator moving towards a one-stop centre concept: promote, facilitate and supervising investment in the country;
- Provide information on matters relating to investment in the country
- Enhance public-private sector partnership
- Formation of linkages between Foreign and Local SME’s



**Q13] What impact, if any, has the UIA had on the level of foreign direct investment inflows? State this in terms of increases in number of foreign investors/recorded investments and in US\$ (Millions) on an annualised basis. Please give figure for the previous 5 years.**

Q13] The following inflows of FDI was ascribed to the activities of the UIA

**Table 49 UIA FDI Inflow Uganda Recorded**

Year	FDI (Millions US \$)
2000	275
2001	229
2002	203
2003	211
2004	237

Source: UIA Uganda and Taylor, L (2006)

**Q14] What proportion of the resources and efforts of the UIA is devoted to increasing FDI inflows?**

Q14] The respondent stated that some 70 per cent of its effort is devoted to increasing the inflow of FDI to the Ugandan economy.

**Q15] How does the effort made by the UIA to increase domestic investment levels compare to that made for FDI?**

Q15] The response provided here gives the corresponding figures for the level of domestic investment compared to that obtained for FDI. The corresponding expected employment in terms of the number of jobs created are also listed Table 50.

**Table 50 UIA Annual Summary of Local Licensed Projects**

Year	Number of investments	Value of investment Millions US\$	Expected Employment
2000	18	65	1309
2001	21	29	1765
2002	51	110	6181
2003	59	96	6846
2004	64	103	5184
2005	107	304	12317

Source: UIA Uganda and Taylor, L (2006)

**Q16] How does the rate of growth of domestic investments compare to that for FDI for the past 5 years?** Q16] Comparison of FDI and level of domestic investment for the previous five

years- see above tables. **Q17] What accounts for differences, if any, in the rate of growth of the**

**two sources of investments? List these in order of importance.**

Q17] Differences in the relative volumes of FDI and domestic investment were accounted for by the following in order of importance:

- access to financial resources
- exposure to technology
- level of experience and development

**Q18] In the opinion of the UIA, what are the major impediments to the growth of FDI inflows? Again, list these in order of importance.**

Q18a] Impediments to the growth of FDI inflows are listed as:

- Infrastructure including energy
- exposure to mergers and acquisition
- access to financial resources
- exposure to technology
- low level of FDI flow to the African region

**Q18b] To what extent are these constraints also common to domestic investments? Again, list these in order of importance.**

Q18b] Constraints which are common to FDI and domestic investment were listed in order of importance as:

- infrastructure including energy
- limited exposure to financial resources
- low level of FDI to the African region
- political instability
- support for private sector led growth

**Q19] What actions and/or strategies have been put in place to remove these constraints?**

Q19] Actions/strategies taken to remove the constraints on domestic and foreign investments were listed as:

“A concerted effort is put on improving the investment climate and governance, and removal of administrative barriers as well as to support growth of the private sector”.

**Q20] Which, if any, of these have been successful in the case of FDI?**

Q20] Acquisition and mergers are identified as having contributed more to FDI inflows than other factors.

**Q21] Which, if any, of these have been successful in the case of domestic investment?**

Q21] The response given here is: “increasing the role of private sector led development through partnership with the public sector.”

**Section 4.9.9.1**

**Discussion of the-UIA (Based on UIA response to section 3b)**

The UIA claimed that the figures presented in Tables 49 and 50. The figures in Table 49 are the direct outcomes of its investment promotion activities; it is hard to determine the veracity of these claims. Other than stating the range of activities engaged in by the UIA, there is little explicit link between the inflows and even with the level of domestic investment and the activities of the organization. FDI inflows are the evidence for a link between the activity of the organization and the recent pattern of foreign and domestic investments. The actual level of FDI inflow over the period 2000-2004 declined from US\$275 to US\$237million by the end of 2004. Furthermore, no comparative assessment of the performance of the organization was produced to show how the figures in respect of FDI compared to those achieved by its equivalent in neighbouring countries and especially in competitor economies such as Kenya and Tanzania for example. This assessment could for example compare and contrast the share of FDI acquired by each country as a percentage of total inflows to the region or in terms of GDP. It is therefore difficult to determine the performance of UIA on this important indicator which serves well as an indicator of its principal objectives of “making Uganda a leading investment location in the world”.It is clear from the above that performance of the UIA, and specifically its claimed performance in respect of FDI and the level of domestic investment, must be formally assessed on a quantitative basis in order to address donor concerns generally for aid effectiveness and to establish a better case for enhanced

level of funding from the Government. This could take the form of a funding formula that links the performance of the UIA on: annual FDI inflow and the level of domestic investment to its level of resources. If seventy per cent of the organisation's activities are directly related to investment and specifically that of enhancing the level of FDI, its performance against targets set in the context of historic performance could and should be the basis for future funding formula. Whatever the approach taken, donors, the government and the management of the UIA should develop a basis for future funding which links directly to the agreed aims, objectives and performance of the organization. Where external factors such as the availability of suitable land or infrastructure are principal constraint on the performance of the organization in respect of its ability to improve the level of FDI and domestic investment, government must take responsibility for these; recognising their negative impact on FDI and domestic investment. It must also recognise how these limit the organisation's ability to achieve its objectives of becoming a one-stop shop.

It is clear that differences between the level of domestic and foreign investment is largely explained by the lack of access to financial resources, exposure (lack of) and the level of experience and development; as stated in the UIA survey. On the other had the major obstacles to improving FDI (see Q18) suggest the following actions by policy makers: improvement to utility power supply, privatisation of state-owned assets should be used to maximise opportunity for foreign and domestic acquisition and mergers, improving access to financial and equity capital, facilitating greater access to technology. At a macro level, the relative low volume of FDI to the region is acknowledged as a major issue and should therefore be the context in which present and future efforts to improve the percentage captured by Uganda is determined.

In addition to the latter, it clear that improvements to the investment climate is vital if Uganda is to enhance its share of regional FDI inflows. This entails improvement to the investment climate through the removal of administrative barriers and actions to further support the growth of the private sector through public-private sector partnership in the public sector.

## **Section 4.9.9.2**

### **Survey of Uganda's International Development partners**

#### **Introduction**

Here the approach is one of soliciting the views, opinions and experience of Uganda's development partners. These organisations include: The World Bank (country rep), the UK Department for International Development (DFID), the EU Development Department, USAID, Irish Aid, The Netherlands International Agency, and the majority of the Development Association Corporation members (OECD DAC): top ten donors to Uganda. In addition to these the following bilateral donors: Sweden, Denmark, Ireland and the Netherlands International Development Agency were contacted via their national ministry, UK embassy or via their embassy or country offices in the Ugandan capital, Kampala. In keeping with the survey of private sector investors, the approach taken here was a distribution of a questionnaire following a number of telephone conversations to identify the appropriate person. The actual distribution was made after a formal identification of the responsible person and agreement obtained that he or she would be willing to participate in the study. In achieving this respondents were given a brief account of the aims and objectives of the research and an assurance that the response would be used for purely academic purposes. This latter undertaking was considered significant by a number of respondents as this area of activity is politically sensitive and the willingness to participate rested on the assurance that the material will be circulated amongst academics and not to the general public. Issues relating to aid effectiveness and the relationship between Aid and FDI is an area fraught with controversy. This is especially true for aid to SSA countries as many activists and campaigners have focused on the plight of poor people in this region and the level of aid and development assistance provided by the West and individual donor countries. The disparity between what is promised and what is actually received by poor developing countries has become a major campaign issue for activists and NGOs. It is

therefore necessary to assure recipients that no political and/or negative use will be constructed from the use of the responses obtained.

The questionnaire consists of some 24 questions ranging from the date of engagement with Uganda, to their experience of Aid and FDI co-financing of infrastructure projects. Also included are questions on economic, trade and investment policy. However, the principal focus of the questionnaire is on the relationship between Aid and FDI and whether the donor has knowledge of a formal or informal relationship between the two types of capital and if so, whether this has influenced their development assistance and aid policy especially in the area of infrastructure development.

### **Section 4.9.9.3**

#### **Results: Response to Questionnaire**

In this section of the questionnaire donors are asked a number of questions about the assistance they provide to the Ugandan government and the specific projects and programmes. This also includes the financing of policy and capacity building institutions (Tables: 42 (P171), 43 (P172), and 45- (P174)). **For the sake of completion and to make good gaps in the response of individual respondents, the answers obtained given by the surveyed organisations below have been aggregated to give a fuller picture of donor response.**

#### **General Donor policy and objectives**

**Q3a] When did your assistance to Uganda start?**

Q3a] The Dutch development agency started its activities in Uganda in 1990, The EU Development Debated started in 1976, DFID (1962), and the USAID in 1968.

**Q3b] Has there been a break in your support during this period? If so, please explain the factors which have resulted in the resumption of assistance?**

Q3b] The period coinciding with the Idi Amin regime was associated with a reduction in donor support partly as a result of poor security in the case of the Netherlands's development agency and the EU Development Department. However, USAID discontinued its activities in the country during this period.

**Q3c] Has the nature and level and composition (i.e. the ratio of technical to financial assistance) changed over the past 10 years?**

Q3c] Respondents indicated that significant changes have been made in both the quantity and nature of assistance provided: in the case of the Netherlands these elaborated as "from only project support to programmatic approach (SWAP's) to sectorial and now general budget support." In the case of USAID, the level of assistance and the priorities are determined by and based on an annual approval of the foreign relations appropriations bill with the domestic context of the country determining priorities in "the amount and mix in funds going to various countries, including Uganda." The EU Development Department asserted that Uganda had obtained under LomeIV (8th EDF) 1996-2000 an allocation of Euro295,800,104 (inclusive of transfers from structural Adjustment Facility) and under Cotonou (9th EDF) 2000-2006 Euro 268,713,914 (includes transfers from previous, closed EDFs). A further additional assistance was made for humanitarian/emergency needs.

**Q3d] Please explain the reason for these changes? (list the most important factors first).**

Q3d]

In the case of USAID, the changes in the volume and priorities over the last ten years were driven by the deterioration in HIV/AIDS which went from \$12.9million in 2001 to \$US 74 million in 2005. Funding for agriculture related to initiatives to address poverty in Africa also resulted in increases in funding to agricultural programs. For the EU Dev Department, changes to the quantity and nature of the assistance provided is determined by negotiation with the partner government "based on shared priorities, other donor activities, lessons learnt from past cooperation." In the case of Uganda the level of assistance was based on the evaluation of the earlier EDF (8th) programme. For the Netherland's International Development Agency, the signing of the Paris Declaration, and

the Uganda Joint Assistance Strategy plus greater effectiveness as demonstrated by the recipient in earlier programmes. DFID's development assistance is determined by the "country's preferred form of development assistance as set out in the partnership principles", as agreed by the two countries.

**Q3e] Has the overall level of support provided changed since the present government first came to office in 1986?**

Q3e] According to the USAID, the type and volume of assistance offered to Uganda is based on stakeholder involvement, the situation in northern Uganda (reference to military campaign against rebels) and the resulting impact on communities: social and economic decline/disintegration. For USAID, "Uganda is seen as a good performer with strong leadership and good potential for success, so has received high levels of support from USAID" (USAID office Uganda, 2006). The EU Dev Department stated that under the 6th EDF (1986-1990) Uganda was allocated Euro 129,121,793 and this rose under the 7th EDF (1990-1995) to Euro 207,594,840.

DFID stated that the level of assistance it had provided to Uganda has increased from £50 million in 2002/03 to £70 million in 2004/05. The Netherland's development agency stated that since 1986 its assistance to Uganda had gradually increased from Euro 5 Million to the present Euro 45 Million per annum now (2007). Irish Aid started in 1994 and current support is around £25 million annually with education, health, poverty reduction, HIV/AIDS and governance being the main principal distribution priorities. Agriculture received less than £1million annually.

**Q3f] List the major determinants of continued support in order of importance?**



**Table 51 Determinant of continued support by major donors**

USAID	Netherland Dev	DFID	Irish Aid	EU Dev Dept
Performance	Successful poverty reduction	Reduction of poverty	Sustainable development and democracy	Provision of Cotonou Agreement
Funding availability	Macroeconomic development	MDG goals		Trade
Needs of the country	Governance	As agreed in multinational agreements for the country and the region	PEAP and anti-poverty	With strong regional focus
Presidential initiatives	Economic development With focus on private sector development	Inline with WB and international-education, social sector, agriculture	inline with WB poverty reduction support credit (PRSC)	Trade preference

Source: Taylor, L (2005/07) Survey of Uganda's Development Partners

**Q3h] Have your priorities changed, and if so, explain the factors or issues which have resulted in these changes?**

Q3h] DFID stated that its priorities had not changed. However, Netherland's development agency stated that: in "the last two years there has been an increased focus on Northern Uganda. First humanitarian because of the conflict and now more development because of the peace process." For USAID, "changing country context (conflict, pluralism, corruption) and performance in each sector, funding availability and Presidential initiatives" has resulted in changes in the level of funding as well as distribution priorities. For the EU Dev Department, overall priorities have not changed but some adjustment has been made to reflect recent developments. These include project support (road infrastructure, rehabilitation in Northern Uganda), EU and Uganda agreement to support reform in the road sector, recovery in the North of the country and the reintegration of displaced people. The lack of specialisation and harmonisation of donor support is evident from the respondents, see Table

**Table 52 Distribution Priorities of Donors (Bilateral and Multilateral)**

USAID	Netherland's Dev	DFID	Irish Aid	EU Dev Dept
Human capacity	Education	Budget support	Anti-poverty programs	Inline with EU Consensus and allied to country Poverty Eradication Action Plan
HIV/AIDS	Justice & Law Order	Humanitarian assistance	Health,	Trade
Education/Health	Local Governance/Decentralisation	Project aid	Governance & Democracy	Infrastructure

Economic growth (Agriculture)	Horticulture	Agriculture	Education and economic development	Health, HIV/AIDs
Democracy, Governance and conflict team	Private sector expansion	HIV/AIDS		Humanitarian assistance

Source: Taylor, L (2005/07) Survey of Uganda's Development Partners

**Q3i] Have you provided technical or financial assistance to support policy changes?**Q3i] The EU Dev Department indicated that it had provided assistance to the Road Sector (support to the Road Agency Formation Unit, now known as the Uganda National Road Authority) and in the Public Finance Management sector. Although DFID asserted that it had provided some assistance in this area, it made no specific claim although it cited financial sector development, modernisation of agriculture and economic stability as sectors which it had supported. USAID supported “various policy developments in education, policy on Orphans and vulnerable children”. The Netherland’s development agency provided technical support to the Ugandan Revenue Authority to increase tax collection and supported changes to Uganda Procurement Agency (PPDA) as part of an anti-corruption drive.

**Q3j] If the answer to Q3i] is yes, provide examples of policy changes that have resulted in donor intervention/collaboration with domestic policy makers?**

Q3j] The responses provided to this question i.e. examples of policy specific support is listed in the response to Q3i].

**Q3k] Were you involved in sector specific reforms such as privatisation programs in, for instance, telecommunications, power generation or transport?**

Q3k] Respondents acknowledged that they had some private sector activities but none of these were directly involved in the privatisation of the power, telecommunications or transport sectors. However, DFID acknowledged that it had support policy associated with privatisation in the telecommunications, power and transport sectors.

**Q3l] What were the objectives of these reforms and to what extent were they realised?**

Q31] For DFID the objectives of their support were improved efficiency, productivity and total output.

#### **Section 4.9.9.4**

##### **Discussion and Analysis**

Donor engagement started in the early 1960s shortly after the country achieved its independence from the UK. The 1970s were associated with the rule of the dictator Idi Amin and with its economic and social decline. The confiscation of the business and personal assets of the Asian community resulted in donors scaling back their support and programs due to the poor security, an account of the recent economic and political history of Uganda is discussed in chapter 1. However, re-engagement with donors was associated with a change in both the quantity and nature of the assistance provided by Uganda's major development partners. This is particularly true of the last two decades and started with the first term of office of the present government in the late 1980s. For instance the pattern of development assistance reflects the general tendency to move from project, sector, and/or program support to general budget support, in accordance with national priorities and bilateral agreements. Donor engagement has gone through a major philosophical change and reflects general concerns for local ownership and the pre-eminence of domestic circumstances in determining national priorities.

Donor commitment is determined by the international political environment and national objectives. Whilst the domestic circumstance of the recipient is a factor in determining the final amount of assistance that is provided as well as its composition: the relative proportion of technical assistance to financial support, donors such as the USAID support is determined by the annual appropriation of the Foreign Relations Appropriation Bill and the domestic context of the recipient country. The development of country Poverty Reduction Strategy Papers (PRSP) is the basis for donor-recipient bilateral and multilateral agreements. This survey identifies national objectives: strategies to reduce poverty, stimulate socio-political and development objectives. In its development, it incorporates feedback from a wide range of civic organisations: NGOs, Community groups and Trade Unions.

Coupled with the intensification of debt forgiveness campaigns in the period running up to the Millennium, Uganda was the first SSA country to qualify for the enhanced Highly Indebted Poor Country debt forgiveness initiative (HIPIC).

A combination of domestic and donor initiative to tackle the incidence of HIV/AIDs resulted in significant increases in the level of donor support for this area and related projects. In the case of the Dutch International Development Agency from Euro 5Millions to a current level of Euro 45Million per annum (as of 2007), corresponding figures for USAID are US\$12Millions in 2001 to US\$74Millions in 2005. For the UK International Development AgencyDFID, the level of commitment provided increased from£50 Million in 2002/03 to £70 Million in 2004/05. The EU Dev Department sated that under the 6th EDF (1986-1990) Uganda was allocated Euro 129,121,793 and this rose under the 7th EDF (1990-1995) to Euro 207,594,840. These figures were obtained directly from the aforementioned organization by Taylor,L (2005/06) 'survey of Uganda's Development Partners'.

Donor commitment both in terms of distribution priorities, the relative mix of technical assistance and capital is linked to performance principally in the area of poverty reduction. The critical issue is whether this allows for long-term poverty reduction measures linked to development over the long-term or whether appraisal on an annual or relatively short period undermine measures which may take longer to produce quantitative outcomes but have a more significant, cost-effective and permanent influence on the causes of HIV/AIDS i.e. behavioural and attitudinal than just shallow head-count of reduction in numbers over a relatively short performance/assessment period. Whilst, the principal performance indicator is poverty reduction, there is an obvious lack of congruence amongst donors, see Tables 69 and 70 for instance, the determinant of continued support as well as principal and subsidiary objectives varies between donors. So whilst the distribution priority of the Netherlands is education, decentralisation, Law & Justice; over the last two years it has increasingly focused on the conflict in Northern Uganda and support for the peace process, and with the latter greater priority for development aid. The Netherlands'assistance to Uganda is based on earlier

performance on the EDF (8<sup>th</sup>) program, the signing of the Paris Declaration and the Uganda Joint Assistance Strategy. Achievement of the MDGs is a principal focus of the UK's DFID, budget support, Humanitarian assistance, and project aid. The nature of the DFID's support is determined by or set out in the Uganda-UK bilateral 'partnership principles.' USAID priorities are Human Capacity, health, economic growth, Democracy, Governance and conflict resolution. For USAID the present context is characterised by: conflict, pluralism and corruption. For the EU Development Department, its objectives are stated to be in line with EU consensus and allied to Uganda's PRSP. It is clear from the above that there is significant scope for greater congruence between donors allowing for a 'big bang' approach to agreed objectives by donors and recipient governments. The capacity of poor states such as Uganda to address the many and varied objectives of individual donors is universally recognised to be a major constraints on the effective utilisation of external assistance. The lack of capacity also account for a many of the failures associated with the debates on aid efficiency/ inefficiency and donor apathy: failure to achieve measurable improvements in the socio-economic and development profile of recipient countries.

This lack of donor congruence may impose extra costs and add to the administrative burden of states which are characterised by significant capacity deficits in terms of personnel and the ability to both develop and implement appropriate policies at departmental and ministerial levels to coordinate operational and strategic objectives within and across ministries for better resource allocation, and the achievement of domestic objectives and donor performance targets especially where these are linked to the continuation of external support both in terms of volume and composition.

#### **Section 4.9.9.5**

##### **Enhancing private sector participation**

**Q3m] Were any specific policy implemented to improve the investment climate for domestic and foreign investors?**

Q3m] Whilst DFID has supported the development of a domestic climate supportive of enhanced foreign inflow of private investment through assistance provided to improve economic stability and infrastructure development, USAID has supported arbitration and dispute resolution with support for the micro and medium finance sectors. The latter has also focused on anti-corruption. The Netherland's Development Agency had no involvement in stimulating private sector development.

**Q3n] Does your organisation have a view on how the private sector can or should contribute to the growth and development of the Ugandan economy?**

Q3n] According to DFID the role of the private sector is linked to efforts to reduce the incidence of poverty. However, the view of the Netherland's development agency is that the private sector should be focused on export promotion and the reduction of barriers to trade. The views of the EU Dev Department was much more strategic in that it as it argues that "the private sector has a key role to play in the economic growth of Uganda both domestically (employment creation, value added etc) but also regionally and internationally in trade with its partners". The EU Dev also stated that the EU Commission was currently negotiating a series of Economic Partnerships Agreements with six regional African and Pacific Countries (ACP) grouping in anticipation of the end of the expiry of the Cotonou trading arrangement in 2007.

**Q3o] What specific contributions have you already made and/or are willing to make to development in this area?**

Q3o] DFID is trying to improve the productivity and efficiency of the private sector with 50 per cent of its aid budget going to the Ugandan government's own poverty eradication plan whilst the Dutch have supported horticulture and the export of cut flower. USAID did not provide an answer to this question: suggesting that this question is too involved to provide an easy answer in a questionnaire format.

**Q3p] In relation to Q3o, What level of success has been achieved in this area?**

Q3p] As the USAID has not given a response to Q3o, it also did not produce a response to this question as well. However, both DFID and The Dutch have acknowledged improvements in

performance. In the case of the latter, assistance provided to the cut flower industry is associated with the fact that “80 per cent of some of the ‘Dutch’ flowers comes from Uganda and its Private sector development programme.” Respondents all agree that potential complementarities between aid and FDI exist. The EU DEV cited as example of their experience of infrastructure improvement and specifically their assistance to the development of the road network: linking landlocked Uganda with its trading partners and in the process encouraging investment. Other general examples include “the potential benefits from aid for trade packages where assistance can be provided to tackle obstacles to investment (legal framework, customs procedures, etc)”.

**Q3q] In your assistance policy, do you recognise any potential complementarities between aid and foreign direct investment?**

Q3q] These complementarities will, according to DFID, provide increased inflow of resources, expanding capacity and improving economic stability. The Dutch state that “Dutch companies doing good flower business is good for private sector development in Uganda as well. One strengthens the other.” Whilst the USAID recognised the assistance of potential complementarities between aid and FDI, it did not provide examples of these in its development assistance to Uganda.

Q3r]

# Chapter 5

## Major Themes and Policy Implications

### Section 5.0

#### Introduction

With a focus on the aid effectiveness debate, this chapter critically discusses the policy implications of the principal themes identified in our empirical survey of Uganda's development partners and foreign investors. Whilst our hypothesised Aid-FDI interaction is central to our research, the context is characterised as one in which markets are given a larger share in the process of development and efforts to reduce poverty in LDCs. This is universally acknowledged as a positive development amongst policy makers and members of the international development community.

This volte-face and pragmatism overlooks the traditional ideological friction between state and market-driven approach to development in poor countries such as Uganda. Evidence of this about turn is the Aid-for-Trade stance of the international development community and the World Trade Organisation (WTO). The latter is the chief advocate of this new thinking and its Task Force established the terms and condition necessary for Aid to be recognised as aid-for-trade. This development is linked to and is the result of a focus on private sector development as an important pillar of aid policy driven by the poor history of donor intervention and concerns for the disappointing returns to aid inflows to LDCs, especially those in SSA. The initial focus of aid policy was on meeting domestic shortfall in savings and investment in low wage economies of mostly former colonies and foreign dependencies. However, failure to achieve significant improvements in the economic and development performance of recipients resulted in efforts to link Aid inflows directly to the growth of recipient economies. Again, these produced poor results and from this it was concluded that deficiencies in the domestic policy environment were responsible for earlier poor returns to Aid inflows. So the new approach linked inflows to changes in domestic macroeconomic policy. The development of policies supportive of Private sector development is a vital component and central to donor engagement. This is the context of this chapter and its



discussion of the policy implications of our empirical findings. The WTO 2005 Ministerial meeting in Hong Kong concluded with a call for expansion of Aid for Trade to assist development in poor countries especially in LDCs through local ownership, alignment with national systems and strategies, harmonising donor efforts in line with the Paris Declaration of aid effectiveness as the qualifying condition for the provision of Aid-for-trade. This development complements earlier efforts by the World Bank's Private sector Development initiatives in poor developing countries and especially in LDCs. However, as these countries generally have a small modern industrial sector, these policies have focused on the traditional sectors such as agriculture and mineral extraction sectors. What is clear to observers is that both sectors and agriculture, in particular, requires significantly more inflows of investment capital beyond what is available from purely domestic sources; and this is especially true of Sub-Saharan Countries such as Uganda.

The chapter begins with a discussion of environmental issues and the related issue of landlockedness and its implications for countries such as Uganda. This discussion is based on the survey of foreign investors in Uganda especially those in the Agricultural, power generation, distribution and horticultural sector with some comments of donor support of a number of specific projects in these sectors. In section 5.1 we discuss recent trade environment and their importance in Market Access for Uganda exports and investor confidence. Section 5.2 is focused on the bilateral market access complementing a subsequent section, 5.3 on the internationalisation of domestic production. The principal focus here is one of identifying the domestic and international barriers to the international integration of Uganda's agricultural sector. This is followed by section 5.4 in which we discuss the complementarities between program and project Aid. Section 5.5 discusses the financing of infrastructure projects. In section 5.6 we discuss the changes in the REER of the Ugandan Shilling and its impact on the trade and competitiveness of the country's export sector. This is linked to our empirical survey of investors in Uganda and the identification of the appreciation of the Shilling in the late 1980s and 1990s as a major factor for exporters.

In section 5.7 we report our conclusions and policy recommendations suggesting the available options for countries similarly endowed with poor infrastructure as Uganda and those in particular which are landlocked but are actively seeking ways and means of accessing export markets by the lowest cost routes and at the same time addressing concerns for trade-related carbon emission associated with the mode of transshipment of goods to major export markets.

## **Section 5.1**

### **Trade and the Environment**

This section of the chapter will explore the policy implications of efforts to overcome Uganda's documented poor physical infrastructure endowment and examples of these deficiencies identified in this thesis. Whilst donors are seeking ways and means to improve physical infrastructure as a means of both enhancing the productivity of local factors of production and connecting rural agricultural production to domestic and international markets, landlocked countries such as Uganda have experienced some difficulties in accessing international markets due to the high cost of road and rail transport. This imposes extra cost and therefore increased risk to investors. Landlocked Uganda depends on the shipment of exports from port facilities in neighbouring countries such as Kenya. Both road and rail network to neighbouring facilities are poorly maintained so costs are high and a significant cause of exports price escalation and thus reduced price competitiveness in important overseas markets. However, airfreight is a popular and viable alternative to other modes of trans-shipment to major export markets. Significant improvement to rail and road infrastructure would require significant investment and the bulk of this would come from donors. This would also require regional agreement with neighbouring countries as Uganda is a landlocked country. In their present state, transport infrastructure pose a risk for existing investors and a major deterrent to further FDI inflows to the agricultural sector, see Tables 58 and 59 which list both the importance of the sector to GDP and economic growth, respectively.

Road and rail are associated with slow transit and this has particular negative implications for fresh fruit and vegetable produce which have a limited shelf life and require refrigeration and appropriate storage and packaging which are difficult to provide for road-based transport. The latter are known for their inefficiencies and high cost, so airfreight has evolved as the quickest and most efficient routes to major import markets for the country's principal exports: agricultural produce. Whilst Uganda has obtained EU funding for road construction, respondents have indicated that access to major port facilities in neighbouring countries by road remains costly and unreliable. Furthermore the cut flower sector also expressed a need for better access to higher altitude to increase the variety of cut flower production and poor road access has not made investment possible. It is clear from this that although funding has been obtained for the road building, more is needed to provide better access for the industrial sector and this is also true of greater access to suitable agricultural land as scarcity of land for agricultural production is also an important issue for investors in the agricultural sector.

However, recent concerns for the impact of international trade on the phenomena of global warming have focused on the contribution of the aviation industry and in particular the air freighting of fresh agricultural produce from producer countries to markets in developed countries. This unfortunate conjunction occurs/comes at a time when development bodies such as the IMF, World Bank and donor countries have converged on the importance of trade as a vehicle of economic growth and poverty reduction in poor developing countries. For many of these poor countries expansion of international trade is focused on increased exports of agricultural produce to meet growing demand in overseas markets especially in the developed markets of the rich western economies. However, concerns for the impact of international trade on the environment i.e. the emission of CO<sub>2</sub> linked to global warming has invoked particular concerns for the long-term sustainability and development of the agricultural sector in LDCs.

As agriculture accounts for the lion's share of employment and export earnings, this has a particular negative potential implication for countries such as Uganda. Some possible consequences of this debate on investor sentiment are reduced investment in agricultural production and capacity expansion. Furthermore, these developments may result in rural decline and a collapse in export earnings and fiscal tightening. This has consequences for efforts to reduce the level of poverty in rural communities and especially those dependent on agricultural employment. Another possible consequence of these developments is a reduction in the number of potential private sector partner in infrastructure investments and/or direct involvement in the agricultural sector.

Conditions attached to the financing of the infrastructure projects by the World Bank and the European Investment Bank (EIB) support this concern for the impact of infrastructure projects such as the Bujagali hydropower project on the environment. Furthermore, these conditions often translate into additional costs and time delays, reducing the overall commercial viability of the investment. Increased costs and delays to initiation and completion of projects includes for example: Environmental and Social Impact Assessment (ESIP) which have resulted in resettlement programs for affected communities and compensation for displaced households. The imposition of World Bank and EIB environmental standards has provided the banks and donors with a critical veto even when the project meets local environmental standards. Furthermore, the fact that the environmental impact study were prepared by international environmental and social experts with monitoring by another group of experts employed by the participating financial institutions with inputs from local community groups and NGOs, suggest little scope for radical solutions to Uganda's power problem as the government must accommodate a wide range of stakeholders and many of these have close links to the World Bank, IMF and principal aid donors.

In the end compliance with international environmental standards could mean social rates are high, but private rates are low, suggesting low profitability and the need for long-term public support (recurrent funding) i.e. private sector partners are given subsidies to reduce tariff levels to household consumers. On the other hand, commercial and industrial consumers would effectively

subsidies the public through higher prices tariffs with implications for industries already operating with high transport, labour and other costs. Combined, this may result in a further reduction in competitiveness on international commodities markets. Add to these concerns, the appreciation of the Ugandan shilling in the late 1990s, a point confirmed by the IMF and World Bank Independent Evaluation Group(2002)- “Liquidity injections into the economy by donor funded poverty reduction spending posed threat to price stability”. The report also acknowledged that the first two years of program aid inflows combined with high levels of remittances resulted in currency appreciation in 1997.

Uganda is dependent on agriculture: coffee, tobacco, cotton and fish products, animal products and cut flowers for the bulk of her foreign earnings. Therefore, domestic constraints on productivity and external demand are important determinants of future growth and development of the sector. Note also that the greater portion of the employed workforce (68% according to ACTADE, 2007) is employed in this sector. It also accounts for some 38.5% of GDP; generating some 85% of exports.

**Table 53 Key Indicators of ‘food miles’ on CO<sub>2</sub> Emission**

Indicator	Notes
Urban food km in the UK, split by car, LGV,HGV	Urban food km account for most of the accident and congestion costs. The impact of air pollution is also much higher in urban areas. At present, this indicator relies on the assumption that the urban/rural travel ratio is the same for food transport as for all other transport. An alternative proxy for congestion and accident costs would be car food km.
HGV food km	This covers HGV transport both in the UK and overseas. HGV transport is responsible for the majority of infrastructure, noise and air pollution costs.
Air food km	Air freight of food is rapidly growing and has a higher environmental impact than any other transport mode.
Total Co2 emissions from food transport	Emissions of co2 from the transport sector are highly significant and are growing. This indicator includes estimated co2 from transport fuel use both in the UK and other countries. Currently excludes co2 and other greenhouse gas emissions from refrigeration during transport, although it would be desirable to include this in future.

Source: The Validity of Food Miles as an Indicator of Sustainable Development: Final Report of DEFRA (2005)

So even with establishment of investor friendly policies, access to major export markets in North America and the European Union (EU) for agricultural products is vital for investor confidence and hence for the long-term growth of the Ugandan economy and central to efforts to reduce rural

poverty. Therefore, any tendency amongst western consumers to exercise preference in line with concerns for ‘global warming’/ and/or ‘food miles’ (Table 53) and environmental sustainability may have a significant negative effect on the long-term prospect for export-oriented agricultural investments and jobs in this sector and related industries.

## **Section 5.2**

### **Bilateral Market Access Agreements**

The tragedy is that whilst opportunities to invest in agricultural production may have improved significantly due to escalating prices and a shortage of supply of many staples in recent times, the identification or linking of the industry to rising carbon emission may serve only to nullify any gains from the revision of international trade protocol and the removal or reduction of trade distorting producer and/or export subsidies by the EU and USA authorities, respectively. However, the continued existence of domestic distortions in domestic factor markets, trade distorting producer and exporter subsidies, adds to the barriers LDCs must negotiate if they are to successfully expand agricultural exports. We are therefore keen to explore the efforts made by the international community to address the issue of market access for LDCs agricultural exports and the recent linking of concerns for the ‘carbon foot print’ as potentially new determinant of market access. Expansion of agriculture into the pattern of trade between developing and developing country is widely recognised by policy makers (Table 54) and the international development community as potential means of addressing rural poverty in LDCs and this is particularly true for countries such as Uganda in which the majority of the working population are employed in the sector. Growing recognition of the importance of agricultural exports to poverty eradication and development in poor countries, especially those in SSA, is reflected in a number of bilateral and multilateral market access agreements between a number of developing countries and USA and the EU (see Table 56), respectively. This includes initiatives such as the United States African Growth Opportunity Act (AGOA) and the European initiative: Anything But Arms (ABAs). These are expected to be complemented by a number of specific trade and development assistance expected to emerge from

the Doha development round for developing countries. This round is expected to focus on further reforms of international trade in agriculture with reductions in subsidies by the EU and US governments, respectively. However these negotiations are now stalled and are likely to continue in its present static state for some while; the prospect of significant reforms in this area is far from being realised.

It follows that the prospect of raising income and the general welfare of agricultural communities has a particular attraction for policy makers in countries such as Uganda. Furthermore the importance of agricultural production and employment is reflected in donor investment in related infrastructure; developing the market for agricultural inputs: seeds and fertiliser, joint financing of physical infrastructure such as cold storage for cut flowers and other temperature sensitive agricultural produce. However, the cut flower industry is limited by the poor state of rural road and lack of access to appropriate agricultural land notwithstanding EU provision of road sector finance.

This research also identified examples of industry and sector specific intervention by the Dutch International Development Agency and the UK's Department for International Development (DFID) respectively. They are actively involved in the agricultural and horticultural sector.

However this does not suggest specialisation or division of labour amongst donors even though current Aid-for-Trade programs are largely based on efforts to improve aid effectiveness in areas such as infrastructure to enhance agricultural productivity, capacity enhancement and connecting the industry with international value chain in developed markets. Whilst the direction of travel in international trade reform especially the trade in agriculture is greater market access and the reduction of barriers to trade with tariffication and the removal of administrative hurdles, focus on the environmental impact of trade evokes Lal's (2005) concerns for new impediments in trade: "eco-protectionism" of foreign trade in developed economies and eco-fundamentalism.

Enhanced investment in physical infrastructure such as transport, power and telecommunications and greater access to port facilities are central to growth and international expansion of the agricultural sectors, however, these developments are likely to impede this development as

investors are likely to conclude that rates of returns to investments will be compromised by these concerns. This also calls into question donor policy and specifically differentiation between project and program aid.

### Section 5.3

#### Internationalisation of Domestic Production

SSA economics are largely dominated by agriculture (Tables 54 and 55) and the sector account for the lion's share of Uganda's exports and domestic employment. Increasing the capacity of these countries to trade requires higher level of investment in productive capacity and the necessary infrastructure to boost agricultural production. However, our survey of landlocked Uganda suggests that this geography i.e. landlockedness is a major issue for the agricultural sector as fresh products: cut flowers, vegetables and food products generally have a limited shelf life and therefore require timely processing and dispatch to major export markets. However, the fact that shipping ports are in neighbouring countries, in the case of Uganda, sea born cargo must first traverse rail and road infrastructure to ports and these are generally poorly managed, unreliable, expensive and time consuming.

**Table 54 Agriculture Share in GDP**

	2002	2003	2004	2005	2006
North Africa	15.8	16.3	15.1	13.4	13.6
West Africa	29.6	27.1	21.0	31.6	32.6
Central Africa	26.7	27.2	27.3	20.8	22.1
East Africa	32.6	32.4	32.9	26.7	26.7
Southern Africa	8.3	8.0	7.8	8.9	8.7
Total Africa	16.4	16.3	14.9	14.0	13.8

Source: WDI, 2007 Economic Report on Africa 2008 Africa and the Monterrey Consensus: Tracking Performance and progress.

For Ugandan exporters the principal port of lading is Mombasa. However, it is poorly connected with long delay due to the poor state of the roads and rail, inadequate customs procedures and lack



of appropriate storage facilities, which means that exporters are driven to seek solutions which provides better access and low risk mode of transport to major markets. Poor road infrastructure has also constrained the capacity of the horticultural producers to extend the range of and variety of cut flower cultivated. Whilst we have examples of investment in Uganda's road network such as from the EU, feeder road to higher altitude is still lacking and the overall view of investors especially those in the agricultural sector is that road transport is expensive and unreliable and adds significantly to their cost and time to important markets. The solution to landlockedness and poor road, rail and port facilities is Airfreight. However, growing concerns in major markets for the impact on this mode of transport on CO<sub>2</sub> emission and its link to global warming has the potential of reduce demand in important markets as consumers are made aware of the potential, if not actual, environmental issues of the industry. Air freight is popularly employed for the transport of season and non-seasonal fresh agricultural produce and cut flowers. The industry has come under sustained pressure by pressure groups representing the farmers in EU and US, anti-globalisers and environmentalist. Furthermore positioning on global warming has become an important political marketing strategy for mainstream political parties in the EU and increasingly so in the USA.

**Table 55 Agricultural sector growth rate**

	2002	2003	2004	2005	2006
North Africa	2.2	8.1	-2.5	0.5	6.9
West Africa	1.8	-1.8	-18.7	4.1	4.6
Central Africa	4.4	5.0	3.9	4.8	4.9
East Africa	-5.9	1.4	8.1	2.3	3.5
Southern Africa	9.8	0.3	1.6	2.3	0.8
Total Africa	2.3	3.3	-3.9	3.4	5.0

Source: WDI, 2007 Economic Report on Africa 2008 Africa and the Monterrey Consensus: Tracking Performance and progress.

The imposition of environmental standards on agricultural imports from poor countries is likely to constitute a barrier to their exports and additional costs reducing their comparative advantage.

Concerns for global warming is increasingly reflected in the activist trade policy in major export markets as governments of importing countries are pressurised by environmentalist and climate scientists to reduce the impact of international trade and aviation on global warming via CO<sub>2</sub> emissions.

At the retail end, leading supermarkets are also now differentiating their offerings on the basis of sustainable production and low 'carbon foot-print' and/or reduced "Food Miles". The potential negativity for producers in SSA is a permanent and significant change in consumer preference for locally sourced produce away from imported and especially air freighted fresh produce. For producers and exporters, the fact of rapid transit to major markets offer a potential premium to producers in countries such as Uganda and its neighbour Kenya as it is possible for higher levels of value adding as fresh produce may be partly or completely processed for direct entry into the retail supply chain. This could improve returns to investments in seasonal agricultural produce to the major EU and US markets.

These developments have the potential to decouple established value chain through higher costs and reduced demand in these important export markets. Respondents have noted the potential of these developments to reduce market access and thus undermine the viability of further investments in horticulture and agriculture. Faced with high transport and production costs, some producers are even concerned for the long prospect of the industry. Furthermore these developments will aggravate significant increases in the price of inputs and the fact that road transport account for some 40 per cent of FOB prices and with recent increase in the price of oil and hence in road and other mode of transport, costs are likely to increase further. Partial processing allows for greater valued adding and the ability of producers and processors to extract a premium and this is only possible for air freighted fresh produce so concerns for food miles and the development of marketing campaigns based on locally sourced produce by some of the UK's leading supermarkets may have a negative impact on investments and the profitability of the sector. Another important consideration is the fact that processing may drive up the level of investment and employment in the

sector. It is quite possible that this may also facilitate innovation and the diffusion of new technology throughout the sector. This may spill over into wider economy and thus increase the productivity of local factors.

## **Section 5.4**

### **Complementarity between Programs and Project Aid**

This section attempts to identify convergence between program and project aid in terms of the associated level of donor control/intervention and potential complementarities between the two types of aid. Traditionally program aid is associated with efforts with sector specific initiatives and macroeconomic reforms whilst project aid is associated with higher level of donor intervention at project level. However, project aid like FDI is generally more stable than program aid and whilst donors may make commitment through annual allocation, projects may require multiple-year commitment to support projects of the type discussed in chapter 3 such as power and projects and investments in the agricultural sector.

However, whilst the aid strategy of major donors is characterised as either promoting an enabling environment for bilaterally agreed social and economic outcomes, project aid is focused on specific projects i.e. not on policy or sector initiatives. So aid supportive of recipient budget may finance sector wide programs including policy changes, whilst project aid is associated with a high levels of donor intervention. Programs aid is associated with and country specific issues and with aims and objectives locally determined. From our empirical determination donors are likely to assert a higher level of control over this type of assistance and will therefore be better placed to determine its effectiveness and allocative efficiency. Furthermore, the linking of these inflows to private inflows would apriory suggest a greater prospect for enhanced effectiveness. With the ongoing debate on aid effectiveness and on the volume of public inflows to poor developing countries such as Uganda, there is growing awareness of the potential contribution of private sector in realising economic and social indicators such as those included in the MDGs. So Aid-FDI co-financing what are largely

private sector investments with donor aid budgets could potentially address not just issues relating to aid effectiveness but also the inability of donor and recipient government to leverage private finance to support the large investments required in public and market infrastructure of poor states. This type of aid would allow donors to be more commercially minded as the determinants of aid are converged with private inflows such as FDI.

It clear that whilst program aid may finance the changes in macroeconomic policy and thus the establishment of a recipient state's capacity both to formulate and implement pro-poor development and enhancement of economic growth, financing government budgets means that assessment of aid effectiveness is complex and less amenable to detailed evaluation. On the other hand, Aid employed in commercial investments is more transparent and may provide greater scope for donor participation and effective evaluation of outcomes and performance. This is important as the emerging consensus amongst recipient is a reduction in donor direct intervention and local ownership. The policy implications are clear; donors are likely to obtain higher rates of return on project aid than for program aid as the latter allows for higher levels of donor intervention and the imposition of performance targets and their assessment. With the opportunity for private sector efficiencies through the convergence of Aid and FDI, the determinants of donor contributions are converged with those of private inflows.

**Table 56 African Growth and opportunity Act**

Date	ACT	Focus
2001 AGOA (1)	May 2000 Title 1 of Trade & Development Act	Market reforms and opening up to trade
AGOA (11)	April 2002	Expansion of preferential access for beneficiary SSA countries' exports
AGOGA (111)	July 2004 to 2015 Extends system of preferential access for imports from to 2015	Extends third country fabric provision for three years from 2004 to 2007
AGOA (1V)	2006 Expansion of AGOA (111) with addition of African Investment Incentive Act	Further extension of third country fabric provision for 5 yrs from 2007. Allowing beneficiary SSA LDCs exports of

Source: USA International Trade Commission

Whilst public transfers from donors to poor countries such as Uganda has been the principal form of development assistance as discussed above, recent efforts have focused on the need to expand market access for the exports of poor developing countries. Evidence of this focus on trade expansion is reflected in recent bilateral market access treaties between SSA countries the EU and the USA, respectively. These agreements are focused on the expansion of the range of LDCs exports which are allowed duty and quota free access. Critical to this are complementary actions by donors to enhance the capacity of qualifying countries to improve their export intensity and competitiveness in international markets. A major focus of these initiatives is the opportunity for increased access for LDCs agricultural exports to regional developing countries and the markets of developed countries such as the USA and the EU member countries. Uganda is evidence of these developments as economic policy is focused on trade liberalisation and the development of export side of the economy. However, this effort is constrained by a range of domestic and international factors: poor market infrastructure, capacity and quality constraints. These are compounded by failure in international trade talks such as that those in the WTO and Doha to agree new trade rules for agricultural trade. Whilst donor budget support have finance gaps in government revenues it has in the view of at least one significant investor resulted in an unwelcomed appreciation of the Ugandan shilling; adding to the challenge of price competitiveness in international markets for low value added agricultural exports which constitutes the bulk of Uganda's international trade.

Again, this development suggests switching more program and budget aid to project financeto co-finance commercial investments and improve inflows to the infrastructure sector. However, the concerns here is that this may effectively constitute a subsidy to private investors as projects co-financed by donor contribution may results in higher rates of return to commercial investors to the detriment of the wider society and especially the poor: reduced social rates of return. The danger is

that aid employed in this capacity may be wasteful and provide a subsidy to private investors likely to be politically controversial and bad in donor countries.

## **Section 5.5**

### **Financing Infrastructure**

This study identified examples of AID-FDI interaction i.e. projects jointly financed by a mix of two types of capital, our Aid-FDI interaction. In the first instance, we found examples of agriculture-related investments by bilateral donors such as DFID focused on improving access to inputs i.e. stimulating the market for inputs such as seeds and fertilizers and assisting the development storage and refrigeration facilities for fresh fruits and vegetables. The Dutch development agency has provided technical assistance and funds for the cut flower sector and co-generation power plants using bag gas waste to generate electrical power with surplus being sold to the national utility company. Clearly the dangers for Uganda and other LDCs is that poor infrastructure endowment may impede the exploitation of comparative advantage in labour intensive industries such as agriculture and this may occur through disincentive to foreign investment as this deficiency reduces returns on investments whilst on the other hand, risks are perceived as high and unmitigated. In this context aid may reduce investment risks and improve returns to interments. The Bujagali hydropower project is one example of this kind of public funded project with significant private sector participation. Here aid is employed to finance public sector obligations in a private public-partnership agreement, thus aid is also opening the opportunity for higher levels of private sector investment in line with our Aid-FDI hypothesis. The aid component may increase in importance as investors may have reduced access to investment funds aggravated by the need to reduce debt and focus on established markets. Aid also plays a vital role in the resettlement of displaced populations and efforts to maintain the livelihood of affected communities.

The AID-FDI funding of PPP infrastructure projects also evoke concerns for the allocation of risk between partners as well as the relative rates of return i.e. private versus social/public rates of

return. It may be argued that public subsidies may inflate returns to private investors whilst those to the public sector are inferior. However, in the case of investments such as that above, aid may reduce tariff charge as incomes are low so affordability is a major issue for the government and the private sector investors. Budget support is vital for public participation as the state owned Uganda Electricity Transmission Company Ltd (UETCL) is expected to finance the Bujagali Interconnection Project, a high voltage transmission system to connect the proposed Bujagali Hydropower project to the national grid.

The Ugandan Government has also contracted a Power Purchase Agreement with the private sector consortium. The provision of some \$US130Million by the European Investment Bank (EIB) was contingent on environmental and social analysis in line with the expectation of the Bank. This financial support was derived from EU Development Fund managed by EIB under an EU African and Caribbean Pacific states and linked to co-financing contribution by the World Bank's International Finance Corporation and International Development Association (IDA) - see chapter 4 for a discussion of infrastructure finance and sources of the said and a list of providers of project finance and private sector participants for the Bujagali hydropower Project. What is clear is that the financing is complicated by the large number of international public bodies and the consortium of private sector investors. A major consideration for participants such as the World Bank and EIB is the assessment that the Bujagali Hydroelectric Project would "use indigenous and renewable resources with a consequently low CO<sub>2</sub> emission".

## **Section 5.6**

### **ODA inflows to Uganda and Exchange Rate Appreciation**

While it is clear that Uganda requires significant foreign inflows of public and private capital to support economic transformation and efforts to sustain long-term growth, Nkusu (2004) highlights the possible negative as well as positive consequences of inflows such as ODA on the real exchange rate (REER) of the shilling. This latter point was highlighted in our empirical survey of private

sector investors in the agro processing and exporting sector, and reported in recent IMF review papers (2005 and 2010) on the Ugandan economy.

Significant increases in both public and private inflows are associated with the period of economic reform and subsequent to the coming to office of the NRM movement in the late 1980s. The surge in inflows coincided with Uganda's early qualification for debt reduction under the Heavily Indebted Poor Country (HIPC) Initiative to support her Poverty Eradication Action Plan (PEAP). However, this has provoked concerns for the impact of these large inflows on macroeconomic management; specifically on monetary stability and the possibility of "Dutch disease." However, large inflows of aid to the Ugandan government in recent times have expanded the fiscal space for more robust government policy intervention. Whilst public inflows account for a large segment of government spending, they are also associated potentially with negative macroeconomic consequences. Appreciation of the shilling and high interest rates (when used to curb associated domestic inflationary pressures) can have implications for the tradable side of the economy.

The change in the REER of the shilling as illustrated in Figure 16 is the principal focus of this concern. Uganda is, as is commonly the case for the region's economies, characterised by high trade intensity (measured by trade shares in GDP). A decline in export earnings from a high REER of the shilling or, conversely, depreciation resulting in higher import costs can each constitute a major policy dilemma and potential deterioration in the country's terms of trade. Appreciation of the shilling also poses risks to established firms and the profitability and viability of current and planned investments. These observations gain further relevance when linked to the fact that Ugandan exports generally face significant market access costs due to landlockedness and the poor quality of road and rail links to ports in a neighbouring jurisdiction, namely Kenya. These are expensive and often unreliable. Studies by Morrissey and Rudaheranwa (1998) estimate that transport costs are equivalent to some 40 per cent of Uganda's FOB exports. The authors conclude that the poor state of the country's transport infrastructure is a major barrier to efforts to both



diversify and improve the international competitiveness of the economy. The policy dilemma is clear: whilst an appreciation of the Ugandan shilling could reduce the cost of imported intermediate goods, components and equipment, an increase in the REER of the shilling could have serious implications for Uganda's relatively small export sector and its competitiveness (Table 48, P179). Furthermore, Ugandan firms already operate under significant constraints of poor power supply and transport infrastructure and the fact that their exports are largely price sensitive commodities means appreciation of the shilling poses risk to profitability, margins and to market share in highly contested international markets.

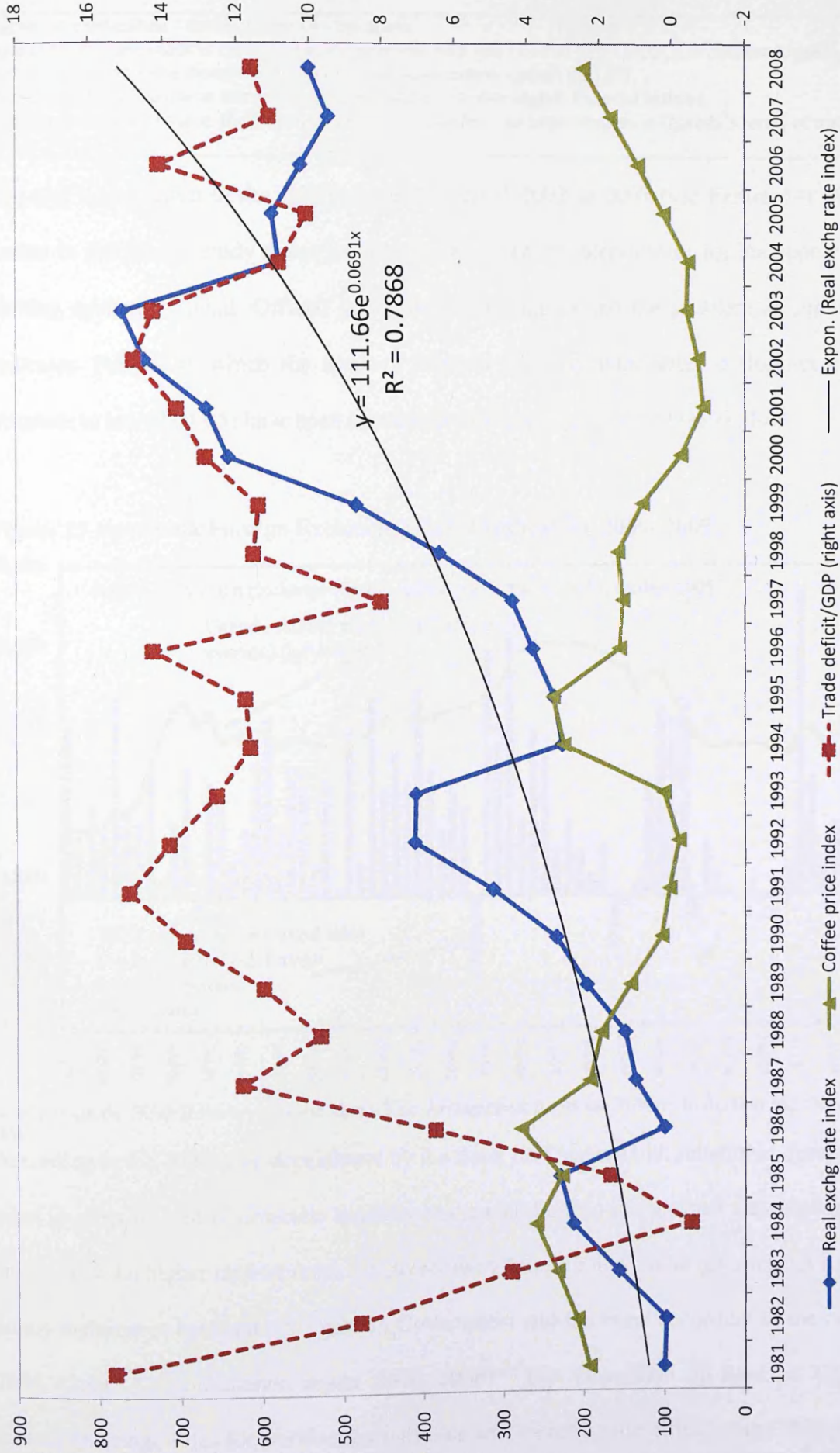
Nkusu (2004) argues that Uganda's monthly real effective exchange rate (REER) had experienced an upward trend (signifying real appreciation) since early 1999, although the economy had experienced a significant deterioration in terms of trade from the mid-1990s and sizeable current account deficits were also evident (see Figure 5 Page 27 for the trend in external balances). Whereas Nkusu's REER series is based on a trade-weighted basket of currencies, Figure 14 below shows the equivalent rate against the \$US alone (an upward movement in this case implies a real depreciation). Over the period covered by Figure 14, the trend annual rate of real depreciation against the \$ appears to have been close to seven per cent (0.0691), so that experience after 1999 should be seen in this light. The relative international strength of the \$US in the years just before the dot-com crisis converts Nkusu's finding of real appreciation after 1999 into one merely of reduced bilateral real depreciation against the \$ between 1999 and 2002. Such comparative real strengthening of the shilling over this period was perhaps linked to increased inflows of aid (proxied by the trade deficit ratio in Figure 14), but it may not be considered the principal driver. The figure also illustrates a 'negative' relationship between the real exchange rate index and the coffee price index; with stronger coffee prices linked to real appreciation of the shilling. As Nkusu also argued, it is not clear that capital inflows were the dominant factor in the strengthening of the shilling after 1999.

Similarly, an article in the Independent newspaper (Kampala, 13<sup>th</sup> April, 2010) argued that three factors accounted for the more recent appreciation of the shilling that is evident in Figure 14. These include: 1) the Ugandan Bond market, 2) high interest rates on Government bonds which peaked at 14 per cent in 2009, 3) inflows of investment related to oil exploration, the power sector, property development and construction, banking, telecoms as well as remittances from Ugandans living abroad. Factors 1 and 2 are also identified in recent IMF reports (2006 and 2010, respectively) as important contributors to shilling real appreciation. The newspaper article claims, plausibly, that overseas and offshore portfolio investors were largely responsible for the recent appreciation as government bonds were upgraded by a number of rating agencies.

Following the 2007-08 global financial crisis, by contrast, the Ugandan authorities acted to stimulate economic activity and a significant reduction in interest rates was a central plank of this intervention. Rates fell from a peak of 12 per cent in June 2009 to a low of 5 per cent for 12-month treasury bills and from 14 per cent in June to a recent level of 8 per cent for the three-year bond. These developments have been reflected in a decline in the REER for the shilling from the final observation in figure 14(2008) to early 2010. Even if it has not been a central factor, experience from 1999 to date therefore suggests that variations in the volume of international capital flows, whether or not aid-derived, are likely to have implications for the real exchange rate. The use to which the inflows are put will therefore have an important bearing on the consequences for the country's traded goods sectors.

Figure 14 Uganda external trends 1981-2008

## Uganda external trends 1981-2008



Source: Constructed from IMF International Financial Statistics (IFS) data for Uganda

Technical explanation - data in figure 14 - see above

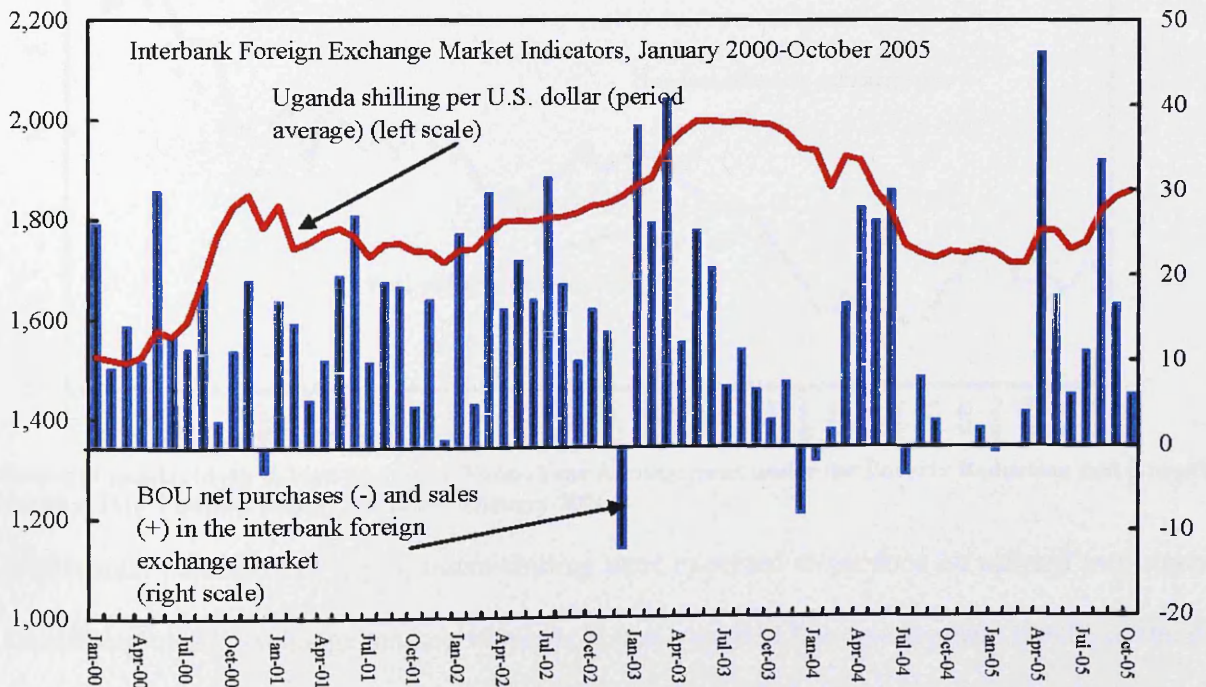
Real exchange rate index is calculated as the principal Sh/\$ rate ( end of year) x USGDP deflator/Uganda GDP deflator. A rise in value therefore represents a real depreciation against the US\$.

Trade deficit/GDP: a rise in this resource balance deficit implies higher financial inflows

Coffee price index; a rise in the index implies, *ceteris paribus*, an improvement in Uganda's terms of trade.

The real appreciation of the shilling over the period 2002 to 2007 (see Figure 14) was identified earlier in the present study through concerns expressed by interviewees for the appreciation of the shilling against its trend. Official policy may have aggravated the problem as Figure 15 below indicates. Periods in which the Bank of Uganda has suspended sales of foreign currency (for instance, in late 2004-05) have been associated with a strengthening of the shilling.

**Figure 15 Interbank Foreign Exchange Market Indicators, 2000- 2005**

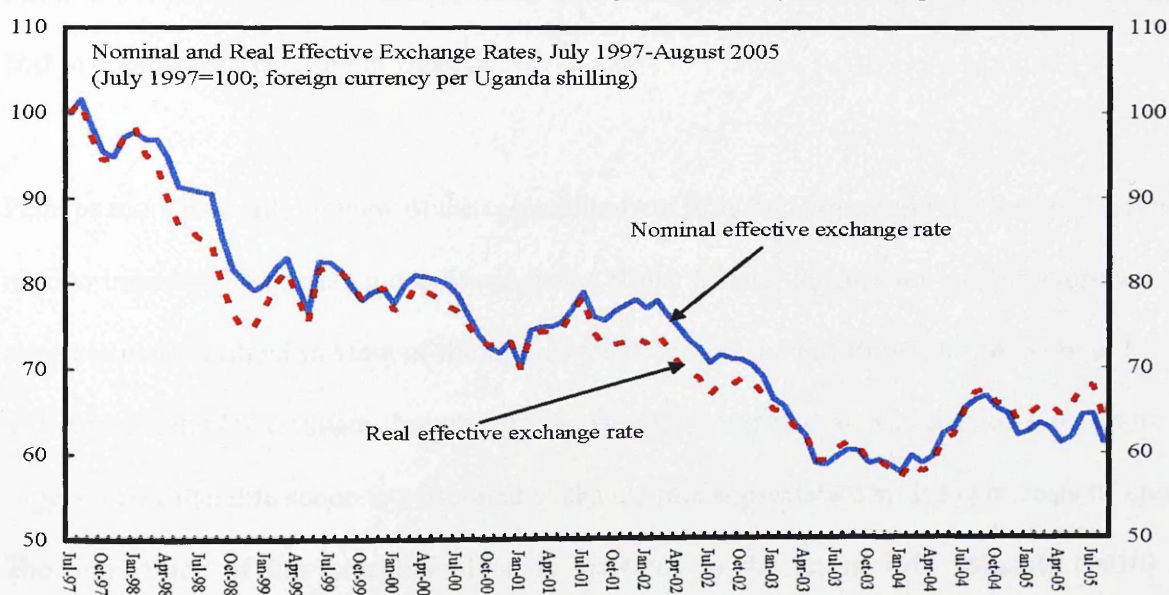


Source: Uganda: Sixth Review under the Three-Year Arrangement under the Poverty Reduction and Growth Facility' IMF

According to the IMF, over-dependence by the Bank on Treasury bill, rather than foreign exchange, sales in order to control domestic liquidity has tended both to put upward pressure on the shilling and to provoke higher interest rates. The trend away from foreign exchange sales has revealed some policy differences between the Ugandan Government and the Fund according to the organisations' 2004 Article 1V consultation report (IMF, 2006). The suspension of Bank of Uganda (BoU) foreign exchange sales for sterilisation purposes was therefore identified by the IMF as a negative

development as prevailing conditions in the foreign exchange markets meant that it was unable to absorb additional sales without further significant increases (appreciation tendencies) of the exchange rate. The suggested approach of the Fund was more effective sterilisation, principally through better management of foreign exchange sales as a means of relieving pressure on real interest rates. In response to these developments the BoU recommenced the sale of foreign currency in 2005 i.e. the purchase of Ugandan shillings with international reserves as a means of managing increased liquidity resulting from public inflows.

**Figure 16 Nominal and Real Effective Exchange Rates, July-1997-August 2005**



Source: Uganda: Sixth Review under the Three-Year Arrangement under the Poverty Reduction and Growth Facility' IMF Country Report No.06/43 February 2006

Whilst such purchases of the Ugandan shilling were expected to produce an upward movement of the shilling on the exchange market, however, it was expected this development would, at the same time, allow the government to reduce the sale of treasury bills, thereby easing pressure on market interest rates (IMF Country Report No.06/43 February 2006). It is clear from Figure 16 that the appreciation of the Ugandan shilling started in early 2004 and the intervention by the BoU to sterilise inflows effectively maintained the position of the shilling at this higher level and may account for the concerns by surveyed enterprises for the impact of the shilling's appreciation on the export sector.

While the issuance of treasury bills resulted in an increase of domestic interest rates and a consequent increased appreciation pressure on the shilling, inflows related to energy and the commercial exploitation of oil are potentially more significant future sources of monetary instability. This is likely to amplify the policy dilemma raised by the interview findings of the present research and which are reported in this thesis. One possible solution to the dilemma is timely intervention by the BoU with higher reliance on the sale of foreign exchange, rather than Treasury Bills and government bonds to manage domestic liquidity (IMF, 2010). The development of the bond market over the medium term would complemented this operation and thus reduce the cost to companies operating in Uganda.

Perhaps more critically in view of the capital likely to flow into Uganda in the future, aid funds will need to improve the operating conditions facing firms. Greater inflows for infrastructure investment are particularly critical in view of the figures mentioned at the beginning of this section. Morrissey and Rudaheranwa's estimate that transport costs can amount to 40 per cent of fob export values suggests considerable scope to offset real exchange rate appreciation with lower costs of operation. The importance of this potential offset is indicated in the recent IMF estimate (2010) that a resurgence of capital inflows resulted in an appreciation of 19 per cent of the shilling between June and November 2009. Nkusu's relatively sanguine conclusions concerning the impact of real exchange rate appreciation on the traded goods sector have, further, been open to contradiction. According to Selassie (2005) "The performance of the tradable sector in Uganda has until very recently been weak, and this reflects the more appreciated real exchange rate that aid has engendered." This was a comment on the earlier period of overvaluation through the late 1980s and the more limited overvaluation during the mid-1990s.

The key requirement that the supply side benefits of aid inflows should offset their consequences for the currency can be related to a longer-standing concern over the country's growth trajectory. It

has been suggested that an over-emphasis on growth driven by factor accumulation (capital and labour) has developed. Mikkelesen (2005) argues that growth in Uganda during the late 1980s was driven by factor accumulation, with capital accounting for 85 per cent and labour for the balance. By contrast, the contribution from productivity improvement was estimated as negligible. This rather suggests that over the long-run, growth in productivity may (with the help of well-directed aid) have a more significant influence on the competitiveness of the tradable sector than the exchange rate of the Ugandan shilling. However, as Uganda will continue to depend on substantial inflows of aid to finance improvements in trade-related infrastructure, especially in the transport and power sector; efforts to improve productivity in the export sector and structural transformation will require more intensive use of physical infrastructure. The impact of inflows to the oil, power and the tradable side of the economy will continue to occupy policy makers and investors. In the larger scheme of things, Uganda's transformation from a supply constrained economy (African Centre for Trade and Development—ACTADE, 2005) to one that is competitive will require a combination of sound monetary policy combined with improvements in its innovative capacity and an appropriate business and macroeconomic environment. Critical to this is the growth and enhancement of her physical and human infrastructure.

## **Section 5.7**

### **Policy Implications of REER of the Ugandan Shilling**

It is clear from the above that appreciation of the Ugandan Shilling is a source of risk to exports as these are primarily commodity based goods with little value added and are therefore price sensitive. The cut flower industry is known for its relative low profit margins and intense competition in international markets. The fact that the operating environment is characterized by poor infrastructure: transport and power for Ugandan producers, mean that airfreight is the only appropriate alternative for landlocked Uganda as road and rail transport to ports in neighbouring countries such as in Kenya are unreliable, expensive and time consuming.

The fact that agricultural exports which are well known for their price sensitivity constitute the bulk of Uganda's export earnings and account for the lion's share of domestic employment and GDP helped only to further consideration of these issues i.e. ODA induced Dutch disease and REER appreciation of the Ugandan shilling. Clearly any significant appreciation of the Ugandan Shilling may have long-term negative consequence for a vitally important sector of the economy and efforts to improve productivity and modernise the agricultural sector through enhanced inflows of FDI in this context is significantly more urgent and challenging.

Expansion of the country's agriculture is based primarily on increased international trade linked to efforts to reduce rural poverty and low income. So any decline in trade resulting from a high REER for the Ugandan shilling would compromise efforts in this direction. Conversely, a low REER for the Shilling would mean higher cost for local manufacturers and even for the agricultural sector which imports a large amount of inputs. The policy dilemma is clear, the Ugandan shilling is likely to appreciate from increased inflows of capital to the power and energy sector as Uganda begins the transition to oil based economy. It is therefore important that aid inflows reduce cost to producers and exports through investments in infrastructure such as transport and power generation and thus remove two of the principal impediment to the further expansion of the agricultural sector. This assumes no neglect of traditional sectors such as agriculture in the new oil based economy and prudent management of monetary policy to maintain a competitively priced shilling and appropriate interest rates for the private sector.

## **Section 5.8**

### **Policy Recommendations**

From the above discussion it is clear that Uganda's policy makers have a policy dilemma: a low REER for the Shilling would imply price competitiveness for her relatively small but vitally important export sector, however, her high import intensity, means this would also restrict her trade capacity as producers must import a large range of intermediate goods and components not readily available locally. Furthermore, a weak Shilling would also reduce the value of receivables i.e.



exports would generate lower returns for exporting firms and thus undermine the profitability of investments especially in the agricultural sector.

For policy makers the response suggested by this development is a commitment to macroeconomic stability principally the stability of monetary policy; however the ability of the Bank of Uganda to maintain a competitive Shilling depends on the inflows of foreign capital and an appropriate level of foreign currency reserves to enhance its ability to make timely and effective intervention i.e. buying or selling Shillings. Uganda is an Aid dependent economy with a large segment of government total expenditure supported from foreign inflows of Aid /ODA so fiscal policy is rigid and the capacity for effective intervention and sterilisation of inflows suspect. So a long-term commitment to wean the economy off its Aid/ODA dependence and address the need of the private sector is vital.

With the expected growth inflows linked to the power sector and significant revenues from the commercial development of the oil sector, a significant increase in the ability of the BoU to sterilise these inflows would suggest the need to develop a large domestic bond market as a means of achieving monetary stability and appropriate REER for the shilling and interest rates at a level consistent with the focus on private sector development and the competitiveness of the export sector. This should be linked to strategies to both grow and to reduce risk the profile of the agricultural sector, improving market access through investments in road and rail links to port facilities in neighbouring countries such as Kenya as well as improving access to higher altitude to allow the cut flower industry to introduce new varieties of flowers and thus improve its ability to command a market share of those types that are not currently produced in Uganda.

Improvement in the power sector to produce competitively priced utility power would improve the productivity of local investments especially in the agro-processing sector as well as providing incentives for further inward investments to a sector of the economy considered important to Uganda's Poverty Eradication Action Plan (PEAP).

The above evokes our hypothesised Aid-FDI link i.e. configuring Aid development policy to induce enhanced inflows of private capital to the infrastructure sector. Aid in this instance could finance necessary reforms of the sector as program aid and project aid could provide investors with an initial subsidy to reduce the risk profile of their investment and tariffs to domestic and possibly commercial consumers. In the case of the rural electrification program, Aid project could also support uptake as rural income are low and affordability is a major constraint on the viability of private sector investment in power distribution.

The eventual transition to an oil based economy and inflows to the power sector may have a long-term and possibly a permanent upward movement of the REER of the Shilling. This could have a greater impact on the non-oil sector as in countries such as Nigeria. However, the oil industry may grow domestic incomes and consumption and thus reduce the relative importance of traditional sectors such as agriculture as it becomes a significant and eventually the major source of foreign earning and the lion's share of the domestic economy. In the end oil could also reduce the importance of public inflows as these are displaced by private inflows either as investments or returns to the export of oil. Oil or gas based generation of electricity could quickly add significant generation capacity reducing or removing a major constraint on the productive sector.

Expansion of the domestic capital base could also provide greater access to local firms allowing expanding their investment in technology and foreign market operations and the ability to compete internationally. This may stimulate the labour market by creating demand for highly skilled workers as well as financing investments in training of local workers thereby reducing the burden on the government and donors.

## **Section 5.9**

### **Conclusions**

A major challenge for policy makers in respect of private sector participation in poor countries such as Uganda have few domestic private sector firms that are of appropriate size and ability to provide foreign investors partnership potential so these partnerships are normally ones in which the state or

state agencies or state owned firms are co-investors and joint venture partners. As above this implies risks to the national budget as in some cases such as the off-take agreement governments are required to provide guarantees relating to the value of the national currency to protect investor's profits and margins when translated into dollars or other foreign exchange. In the case of Uganda, the ability of the government to maintain the REER of the Uganda Shilling suggest that such currency guarantees are risky and frustrates the overall policy of transferring operations of these facilities to the private sector. Clearly these contractual guarantees removes the incentives for private sector partners to exercise higher levels of commercial judgment in their investment activities and may result in lack of strategic and operational efficiency at great costs to poor countries such as Uganda.

For Uganda, markets access problems due to inadequate infrastructure are compounded by the imposition of climate-trade and carbon emission linked to air cargo; this has particular implications for landlocked countries such as Uganda. The fact that agricultural policy is a major plank of development policy in non-oil developing countries heightens the risk to the development of the sector with consequences for the reduction of rural poverty and jeopardising the pro-poor growth agenda of the Ugandan government.

# Chapter 6

## Quantitative Assessment of the AID-FDI Link

### Section 6.0

#### Introduction

This chapter provides a detailed analysis of the quantitative section of the research. In truth this section complements the qualitative analysis with its focus on capturing factors which may provide context and links to causal and explanatory factors which are not captured by a purely qualitative method. The approach taken here is explored, discussed and justified in the detailed account of the methodology, see chapters 9 and 10. The epistemological and technical aspects are teased out for their influence on the approach taken in this instance. From this critical overview of the theoretical and empirical literature it is recognised that a single method is incapable of reflecting the complexities inherent in empirical research: some important determinants are complex and are not amenable to quantitative evaluation.

As the overall focus of the present research is one of identifying the policy implications of the hypothesised link between AID and FDI, the FDI-AID interface, the views and opinions of Uganda's development partners and the experience of private sector investors especially those providers of FDI are taken into account when policy lessons are being identified and discussed as is the case here. The quantitative approach taken in this section should be seen in the context of the overall dual approach, with the results as well as the approach taken in the earlier qualitative section providing a basis for comparative analysis of outcomes. This also allows for some critical discussion of the level of agreement or divergence of the results obtained and the conclusions and policy lessons derived from the said analysis.

## Section 6.1

### Context and Issues in Data Gathering and Analysis

With an anticipated relationship between aid and FDI, the primary data for this research was gathered through interviewing a selected sample of government ministries: the Ugandan Investment Authorities (UIA), the Ministry of Energy and authorities in Uganda for their views and experience with the Aid-FDI interface i.e. public-private sector linking as proposed earlier. This was accompanied by a survey of foreign investors. These were obtained from DFID, the Ugandan Embassy (London) and from the commercial attaché at the British High Commission in Kampala, Uganda. The respondents in these companies were individuals involved in investment and/or project management. Overall they could be described as senior decision-makers of transnational corporations (TNCs).

Donor agencies such as the UK's Department for International Development (DFID), The Irish Development Agency, The Netherlands, EU Development Department, and the World Bank, and managers of aid financed projects. See below for design of research process. The final stage of the research study will attempt to identify potential complementarities such as from aid and FDI funded growth and development enhancing projects. The choice of Uganda is dictated by the need to generalise the findings across SSA LDCs. In many ways Uganda is typical of the groups of countries classified as LDCs due to her history of unstable politics and poor record on growth, development and the managed reduction of poverty. The performance of the economy over the period of the NRM government from 1986 to the present has been associated with improvements in macroeconomic aggregates and some reduction in the level of poverty and the incidence of AIDS/HIV infection. These improvements have resulted in IMF and World Bank elevation of the country as an example of successful structural adjustment.

The fact that Uganda was first to qualify for the debt reduction HIPC initiatives is also important as this provides academic economist and policy makers to learn lessons from her performance which may be relevant for other poor developing debt laden countries.

## Section 6.2

### **Econometric Estimation of the Aid-FDI interaction Term**

Before describing the issues relating to the analysis, the objective of this thesis is twofold: 1) a determination of a mechanism through which aid may create the conditions for enhanced inflow of FDI i.e. enhanced inflows through the co-financing of private investments and 2) the aid-FDI convergence or interaction term may have a greater impact on the economic growth performance of recipient countries i.e. effective utilisation. In this case we are focused on our case study country, Uganda. The quantitative assessment of the impact of Aid-FDI interaction term on the rate of economic growth for 23 SSA economies was undertaken.

This interaction was also evaluated qualitatively using questions to survey a number of Uganda's principal development partners and a second questionnaire of a number of private sector investors in the economy, see chapter 4 for details of this estimation. The data used in this analysis was obtained from the World Bank World Development Report which is hosted on the ESDS website at Manchester University and accessed via the Middlesex subscription. Initially, the analysis was limited to three comparator countries: Ghana, Kenya, and Zambia. However, as the numbers of observations for these countries were 19, for the period 1986- 2005, it was decided to increase the number of countries and use a panel data approach to compensate for this paucity of data . The choice of the period 1986-2005 was dictated by the availability of data for the period. This is the only period that provides us with the relevant macro data for the 23 countries included in this study.

A major aspect of this analysis is the determination of the policy implications for the Ugandan government and the implications for policy makers in poor developing countries such as they seek to compete in the global market for foreign investment. The accepted wisdom is that countries such as Uganda do not have the necessary infrastructure and absorptive capacity to significantly improve their attractiveness to foreign investors. This accounts for their failure to increase economic growth to the level required to increase the long-term welfare of their population.

## Section 6.3

### Specifying the Model

We begin the process by specifying a production function, which allows us to determine the impact of aid and FDI, respectively on the rate of growth of real GDP per capita in the recipient countries. This single equation estimates represent a reduced form of the two linked hypotheses: aid facilitating enhanced inflows of FDI and combined these are expected to have a greater impact on the growth of recipient economies. It follows that the dependent variable is growth and the explanatory variables are aid-linked.

#### Production Function

$$G = \alpha + \beta_1 L + \beta_2 K + \beta_3 FDI + \beta_4 AID + \beta_5 (FDI * AID)/K + \beta_6 XGS/GDP + \beta_7 K/GDP$$

Where G = Growth rate of real GDP/ per capita

L = Labour Force as Growth rate of real labour force replaced by Labour force participation rate

K = Gross Fixed Capital Formation –Constant GFCC as (GFC/GDP)

FDI = Real FDI (FDI/GFCC)

AID = Aid as Aid/GFCC

Exports = as XGS/GDP

$(FDI.AID)/K =$  Interaction term between FDI and AID which captures joint effects of the two types of inflows on economic growth, G.

Papernek's (1973) use of the growth equation was criticised by Mosley (1980) for its use of a single equation model by least square. This operation was argued to be inappropriate as aid (occurring on the right hand side of the equation) is endogenous i.e. it both influences and is influenced by the recipient country's level of income. The resulting two-way causation:

(1) Level of GDP ← savings, aid, and other financial flows

And level of GDP → aid (2).

Mosley offers the two-stage least squares as the most appropriate means of estimating equation (1). However, for poor developing countries such as Uganda and for the SSA regionally, Aid is not empirically shown to have a direct impact of economic growth. Furthermore, the controversy is that returns on aid is historically disappointing in that original proponents argued that aid would, in Harrod-Domar inspired model, under the Dual/two Gap model remove the constrain of low domestic savings and investment and the paucity of foreign exchange and thus finance long-term growth. The empirical evidence does not support this proposition or its theoretical justification. The employment of a dual approach in which Uganda's principal international development partners and a sample of foreign investors are surveyed using questionnaires and the regression analysis of a number of variables commonly used in Cobb-Douglas production function, suggest that the direction of causality is from Aid to FDI. Aid is identifying as contributing to trade and investment policy initiatives such as the reform of the power, and telecommunications sectors in Uganda. This is now associated with significant inflows of private investment to both sectors. Discussion of endogeneity are also discussed in Table 57

**Table 57 Description of data and data source**

Variable Name	Variable transformation	Source
Foreign Direct Investment ( FDI)	Real annual % growth in FDI in US \$	World bank development indicators Finance Online ESDS
Gross Domestic Product (GDP)	Real annual % growth in GDP	World bank development indicators Finance Online ESDS
Aid International Development Assistance (ODA)	Real ODA annual % growth in US\$	World bank development indicators Finance Online ESDS
Exports (Total exports)	Real annual % growth in US\$ (Xgs)	World bank development indicators Finance Online ESDS
Domestic credit at commercial banks	Annual % growth rate (Dcb)	World bank development indicators Finance Online ESDS
Labour force participation Rate (Lfpr)	Real annual % growth	World bank development indicators Finance Online ESDS
Gross fixed capital formation (Gfcc)	Constant /Real in US\$?	World bank development indicators Finance Online ESDS
Interaction term (Inter)	Gfcc-Aid/Aid.FDI	World bank development indicators Finance Online ESDS

Source: author



Whilst the level of human capital development is positively correlated with GDP growth, accurate data for these countries is poor. The problems with regression analysis are well known and in this section of the thesis we outline these and the approach taken in this thesis to resolve them. The objectives of the thesis were explained and detailed in earlier chapters and specifically the quantitative component: the approach taken and the data gathering. Here we give a detailed account of the challenges associated with the many and varied issues: technical and philosophical. The challenges associated with the interpretation placed on the results of regression and correlation often suggests a more critical analysis to resolve apparent and actual flaws. Certainly the use of non-stationary time series in OLS regression may produce spurious results.

The review of the theoretical and empirical literature allowed us to specify a production function in which we introduce our hypothesised interaction term i.e. Aid-FDI. This is accompanied by a number of empirically and theoretically relevant variables. We have used the variables in percentage terms both to remove complications for their specification and also to reduce addition of further complications to our production function. As the labour force aggregate value will vary with the size of the national population, it was decided to use the alternative: labour force participation rate as a percentage of total labour force.

The Aid-FDI interaction term is treated in line with our hypothesis i.e. the combine impact of the two type of capital may have a greater impact on economic growth as the linking of aid to FDI allows for enhanced effective utilisation of the former as well as higher allocative efficiency. In truth aid inflow may be employed in this scenario to improve the absorptive capacity of the country with respect to FDI. Combined, the two are expected to complement domestic investment. FDI is also expected from the theoretical literature to introduce new technology and capital into what is generally capital poor countries such as Uganda and SSA LDCs generally, removing the 'dual gaps' characteristic of these countries. The deflator was used to adjust all the relevant variables. The first regression was made without lags but with the introduction of country dummies to pick up structural differences over-time between the 23 countries employed in this study. The fact that we

have used time-series pool data means dummies acknowledge cross-country heterogeneity. Year dummies account for factors which may occur over time such as policy changes over a set period or significant changes in terms of trade.

The second regression was made with the removal of the country dummies and the introduction of a three period lag to account for the delay in application of inflows on the economy. FDI and Aid would generally be expected to be in productive use in the first or second period. Poor absorptive capacity and low technological and administrative capacity suggest that a lag period is necessary for the effect of these inflows.

## Section 6.4

### Regression analysis: Discussion and Conclusions

Econometric estimating using multivariate analysis in fixed and random estimation failed to establish a significant relationship between the Aid-FDI interaction term and economic performance as measured in percentage increases in GDP growth rate, see Tables 58 and 59.

**Table 58 Quantitative Assessment of Aid/FDI on GDP Growth**

<b>Equations:</b>							
Model 1)xi: xtreg gdp_g L4.IntoverKβ <sub>1</sub> L4.aidoverKβ <sub>2</sub> L4.fdi_rβ <sub>3</sub> L4.Kgdpβ <sub>4</sub> Xgdpβ <sub>5</sub> Cbgdpβ <sub>6</sub> Lfpβ <sub>7</sub> i.year, fe robust							
Model 2) xi: xtreg gdp_g L2.IntoverKβ <sub>1</sub> L2.aidoverKβ <sub>2</sub> L2.fdi_rβ <sub>3</sub> L2.Kgdpβ <sub>4</sub> Xgdpβ <sub>5</sub> Cbgdpβ <sub>6</sub> Lfpβ <sub>7</sub> I. year, fe robust							
Model 3 xi: xtreg gdp_g L4.IntoverKβ <sub>1</sub> L4.aidoverKβ <sub>2</sub> L4.fdi_rβ <sub>3</sub> L4.Kgdpβ <sub>4</sub> Xgdpβ <sub>5</sub> Cbgdpβ <sub>6</sub> Lfpβ <sub>7</sub> I. year, re robust							
Variables	Model 1		Model 2		Model 3		
	Cof & SE	T-stats	Cof & SE	T-stats		Z-stats	
IntoverK	-6.15e-08 (2.46e-08)	-2.5	3.86e-09 (1.39e-08)	0.28	-3.38e-08 (2.53e-08)	-1.34	
aidoverK)	0.6212 (1.085)	0.57	2.343 (1.111)	2.11	-1.507 (1.826)	-0.83	
Fdi_r	0.2515 (0.0415)	6.05	0.727 (0.631)	1.15	0.0831 (0.048)	1.71	
Kgdp	0.337 (0.195)	1.72	0.501 (0.182)	2.75	0.223 (0.169)	1.32	
Xgdp	0.487 (0.166)	2.92	0.388 (0.154)	2.53	0.889 (0.088)	1.01	
Cbgdp	0.0005 (0.0005)	1.0	0.0001117 (0.0004661)	0.24	-0.00019 (0.0004)	-0.47	
Lfp	2.215 (0.800)	2.77	2.37 (0.727)	3.26	0.289 (0.213)	0.14	
R <sup>2</sup>	49%		44%		40%		

Note: Coefficients with Standard error in brackets variables\*, IntoverK is Interaction term Aid\*.FDI/GFCC, Aid/K (Overseas aidoverK is Development Assistance, ODA)/GFCC (GFCC is Gross Capital Formation Constant minus Aid), kgdp is GFCC/GDP, FDI (deflated)/GDP, Fdi\_r is FDI/GDP, Xgdp is Exports (annual total of goods and services)/GDP, Cbgdp (Domestic Credit at Banks)/GDP, Lfp is Labour Force Participation rate. Keys: SE\* standard Error in brackets, Fixed effects (fe), and Z statistics for random effects (re) estimations

However, both the exports of goods and services and labour force participation rate were positive and significant at 5 per cent. Aid, bank credits were negative and insignificant whilst FDI, gross fixed capitals were both positive but insignificant.

**Table 59** Quantitative Assessment of Aid/FDI on GDP Growth

<b>Equations:</b>							
Model 4 xi: xtreg gdp_g L2.IntoverK $\beta_1$ L2.aidoverK $\beta_2$ L2.fdi_r $\beta_3$ L2.Kgdp $\beta_4$ Xgdp $\beta_5$ Cbgdp $\beta_6$ Lfp $\beta_7$ I. year, re robust							
Model 5 xi: xtreg gdp_g IntoverK $\beta_1$ aidoverK $\beta_2$ fdi_r $\beta_3$ Kgdp $\beta_4$ Xgdp $\beta_5$ Cbgdp $\beta_6$ Lfp $\beta_7$ I. year, re robust							
Model 6 xi: xtreg gdp_g IntoverK $\beta_1$ aidoverK $\beta_2$ fdi_r $\beta_3$ L4.Kgdp $\beta_4$ Xgdp $\beta_5$ Cbgdp $\beta_6$ Lfp $\beta_7$ I. year, fe robust							
Variables	Model 4		Model 5		Model 6		
	Cof & SE	Z-stats	Cof & SE	Z-stats		T-stats	
IntoverK(t-2)	1.14e-08 (1.13e-08)	1.02	2.13e-08 (9.06e-09)	2.35	3.09e-08 (9.83e-09)	3.14	
aidoverK(t-2)	-0.582 (1.803)	-0.32	-3.063 (1.627)	-1.88	-0.437 (1.213)	-0.36	
Fdi_r(t-2)	-0.565 (0.0723)	-0.78	-0.236 (0.374)	-6.31	-0.0701 (0.0266)	-2.64	
Kgdp (t-2)	0.324 (0.151)	2.14	-	-			
Xgdp	0.098 (0.0843)	1.17	0.0065 (0.062)	0.10	0.341(0.132)	2.58	
Cbgdp	-0.0002 (0.0003)	-0.59	-0.0002 (0.003)	-0.54	-0.0002 (0.0004)	-0.53	
Lfp	-0.097 (0.205)	-0.47	-0.405 (0.141)	-2.86	1.13 (0.551)	2.05	
R <sup>2</sup>	36%		26%		37%		

Note: Coefficients with Standard error in brackets variables\*, IntoverK is Interaction term Aid\*.FDI/GFCC, Aid/K (Overseas aidoverK is Development Assistance, ODA)/GFCC (GFCC is Gross Capital Formation Constant minus Aid), kgdp is GFCC/GDP, FDI (deflated)/GDP, Fdi\_r is FDI/GDP, Xgdp is Exports (annual total of goods and services)/GDP, Cbgdp (Domestic Credit at Banks)/GDP, Lfp is Labour Force Participation rate. Keys: SE\* standard Error in brackets, Fixed effects (fe), and Z statistics for random effects (re) estimations.

The introduction of a two period lag for FDI produced a significant but negative t value for the interaction term; the coefficient for this variable in all regression is very small with value ranging from  $-8.6 \times 10^{-8}$  to  $1.9 \times 10^{-9}$  indicative of some possible misspecification of the variable, these are explored in the conclusions and discussion of future studies. The 2 period lag produces a significant but negative t value for FDI, however, the p value is zero. Lag values for Aid also produced positive and significant values for exports and labour force participation but again, the interaction term is negative and insignificant whilst Aid and bank credit were also negative, FDI and gross fixed

capital were both positive but as in the previous estimation insignificant. With a four period lag on Aid, labour force participation and exports are still positive and significant; the other variables are insignificant positive (gross fixed capital, FDI, bank credit) with aid and the interaction term both having negative coefficients and t values.

The random effect estimation also produced large negative coefficients for the interaction term with the exception of the case in which a four period lag was attached to FDI. In this case the positive but insignificant z value was still associated with a large coefficient of 2.83E-12; however, gross fixed capital formation is positive and significant at 5 per cent.

The labour force participation rate has a negative coefficient and insignificant z value, and exports are positive but insignificant. OLS estimation with 2 and 4 period lags on Aid, respectively generated large and negative coefficients for the interaction term but significant t values, significant and positive t values for gross fixed capital and large positive t values for FDI (at 2 and 4 period lags) producing t values for the interaction of -2.44 and -2.54 and 2 and 4 period lags, respectively, on FDI producing small positive coefficients for the interaction term and insignificant t values. Coefficients for bank credit, Aid, and labour force participation rate were negative and insignificant whilst that for FDI, exports, were also insignificant and the coefficient for gross fixed capital positive with a significant t value. Finally, the methodological shortcomings of this thesis are discussed in the discussions and conclusions with the identification of alternative approaches to resolve them as well as the identification of their implications for future empirical investigations.

# Chapter 7

## Summary and Conclusions

### Section 7.0

#### Introduction

This final chapter assembles the various aspects of the present study and in so doing it identifies the issues, major themes, concepts and findings of chapters 1 to 6. The contents of these chapters are linked to the present body of knowledge thus allowing the generation of conclusions based on the relationship between Aid and FDI as hypothesised in chapter 1. This chapter also outlines methodological issues: qualitative and quantitative as well as the general and specific limitations of the study. These are accompanied by suggestions for possible future studies.

In brief, this thesis discusses the relationship between Aid and FDI, in line with our hypothesised Aid-FDI convergence as a possible mechanism for addressing concerns for Aid effectiveness through linking the two types of cross boarder inflows. An important aspect of this convergence is its impact on economic growth as donors and recipients harmonise their Aid policy with efforts to increase the absorptive capacity to private inflows of capital. The combination of the two could finance infrastructure projects in recipient countries such as Uganda which are well known for the poor state of their physical infrastructure. Poor infrastructure endowment is linked to the low absorptive capacity of LDCs such as Uganda to FDI. Poor infrastructure also constitutes a major risk to private investors. The desire for FDI is associated with this type of capital and international diffusion of technological, product innovation and economic integration. Poor countries such as Uganda traditionally exhibit limited capacity to capture these positive externalities associated with FDI inflows and their growth facilitating potential. It is clear from this that LDCs are keen to improve their capacity to compete for more FDI both as a means of facilitating what is often a slow and complex transition from economies dominated by low wage and low tech industries such as agriculture and commodity based industries to the development of a modern industrial economy.

This study has sought to establish examples of this convergence/link between Aid and FDI in relation to foreign commercial investments in Uganda as well as the policy implications for the trade and investment policies of poor developing countries such as Uganda. This was linked to both donor and recipient Aid policy through questionnaire survey of Uganda's principal DAC international donors, the Uganda Investment Authority (UIA) and a number of significant UK based investors in the country. In short, the focus here was one of identifying examples of commercial projects and especially those in the infrastructure sector co-financed with a mix of Aid and FDI. This would provide empirical evidence of our AID-FDI link. Quantitatively, this Aid-FDI link was also assessed using a simplified single equation production function. The policy implications of the resulting findings are the principal concern of this chapter.

## **Section 7.1**

### **Summary and Conclusions: Qualitative Assessment of the Aid- FDI Link**

Whilst donors have willingly conceded potential complementarities between aid and FDI, the working relationship between donors and Private sector investors is at best marginal and at worse frustratingly cumbersome for private investors. Donors have supported micro-credit i.e. commercial loans to small farmers. In this case the participating lender claimed that as some 12 per cent of its total portfolio is to small scale farmers, the provision of USAID guarantees helped to mitigate the risk of losses and thus allows it to provide credit to an important sector of the economy and one universally associated with initiatives to reduce the level of rural poverty and the overall performance of the economy.

Generally, the activities of donors do not fully accord with their acknowledgement of the AID-FDI interface as in many of these interactions the private sector partner has regretted taking aid funding as it was associated with a complicated procurement process, resulting in considerable delays, additional work-load in meeting complicated requirement of the donor. The net result in some cases is that planned investments have not taken place in line with the schedule of the investor in terms of timing and the scale of the project reduced or staggered. This suggest that donors processes are too

onerous for private sector partners and must therefore be modified to meet the needs of private sector organization with a certain aversion to bureaucracy and the consequent constraint on their ability to make/take decisions and implement them in good time. This signifies a need for donors to fully recognise the importance of facilitating the growth of the private sector and tailoring their policies and practices to meet the needs of private sector partners. However, as donors are the subject of political control and shifting overseas political and policy objectives, opportunity for closer convergence between profit seeking entities and donors which have a non-profit and humanitarian focus is problematic. It may be concluded from this that unless and until donors and recipients have both recognised the potential contribution of private sector companies and overseas investors, in particular to generate the sort of public good that the latter are keen to achieve, economic growth and via this mean expanding the financial and technical resources available to recipient countries as the basis for sustained poverty reduction, will be a challenging one.

Donors are overall agreed that the co-ordinated management of Uganda's external debt through the HIPC mechanism has resulted in an improvement in the investment climate and built investor confidence. However, whilst significant inflows of aid has also resulted in the free-float of the Ugandan Shilling; removing the 'black market' premium from money changers and thus providing better access to foreign currency, the private sector and donors are still occupied with concerns for the level of Uganda's external debt and its welfare impact on the population. For some respondent the major concern is the need for security, especially in the north of the country.

The state of the infrastructure sector and power sector: unreliability and high price of alternatives such as diesel generation are cause for concern in the private sector especially amongst agro-processors, exporters and power distributors. Three major areas were identified as providing opportunities for projects jointly financed by a mix of AID and FDI. These included: agro-processing, power generation and distribution and storage facilities for the agricultural sector and especially cold-storage facilities at port and air cargo terminals for perishable goods.

## Section 7.2

### **Summary and Conclusions: Donor Policies and Priorities**

It is clear from the proceeding discussion that donors are largely focused on the social sector including efforts to finance the attainment of the MDG quantitative targets and this has implications for the development of the private sector. The danger faced by the private sector is crowding out sectors such as agriculture which has a leading role in the domestic economy and accounts for the lion's share of exports, receive a relatively small amount of public and private inflows. Aid policy could be employed to improve this situation by co-financing and leveraging private investment in the sector. In the final analysis a growing and private sector will provide the future tax base for government fiscal policies. Aid will at some point in the future come to an end so it is therefore necessary for recipients to develop alternative sources of finance to support government budgets. This is particularly urgent for SSA economies as the commitment of western donors is less than unanimous. Furthermore policy initiatives such as those of the WTO: Aid for Trade and the World Bank's Private sector Development Programs (PSDP) initiatives, amount to a significant shift to private sector led growth and development. This signals a departure from long established state model. Donors show little division of labour i.e. specialization, and are therefore offering a large range of goods and this is associated with cost and capacity constraint for recipients. Priorities have been what could be labeled as humanitarian intervention; with a significant proportion of aid inflows going to the social sector (see Tables 12a and 12b page 75) such as health care and specifically the anti-HIV/AIDS campaign and efforts to support displaced people from the conflict in the north of the country, we have identified efforts on the part of donors such as USAID, and DFID to support the expansion of the private sector with the co-financing of investment projects in the agricultural sector both at production and distribution level. However, donor priorities are still far from unified. Some donors have maintained almost exclusive concerns for capacity building and social and community out-reach, whilst others are concerned for economic development and growth as the principal means of poverty reduction. With a substantial amount of recent inflows of aid to the



social sector partly to achieve development targets such as those in the MDGs and national Poverty Reduction Strategy Papers (PRSP); the real danger here for those countries which are seeking to implement private sector development program (PSDP) such as is generally supported by the World Bank, is the crowding out of the private sector by the social sector which commands the lion's share of donor contributions. The fact that donors are operating at local level with many small scale projects means that they are less likely in the short-term to impact on the national economy as many of these projects whether private or public are small scale and the principal benefits are locally contained with little prospect of spill-over to the regional or national level.

From the above, it is clear that a 'big bang' is desirable both for its economies of scale and its ability to impact on the wider national economy. For example, co-ordinated efforts to improve access to higher altitude by upgrading rural roads would improve both the quality and variety of cut-flower and tea production, respectively and as these are important exporting activities, this could potentially improve foreign earnings and employment in the sector. Another potential benefit of improving rural feeder roads would be a reduction in transportation costs and facilitation of the rural electrification process as currently less than 10 per cent of domestic households have access to utility power. This provokes concerns for the relative amount of aid to the private sector i.e. the distribution priorities of the international development community and perceptions of the contribution of the private sector to long-term growth and poverty reduction. Finally, external promotion of social sector expansion in the recipient countries may impose an unsustainable burden on poor aid dependent countries.

### **Section 7.3**

#### **Summary and Conclusions: Quantitative Assessment of the Aid-FDI Link**

Econometric estimating using multivariate analysis in fixed and random estimation failed to establish a significant relationship between the Aid-FDI interaction term and economic performance as measured in percentage increases in GDP growth rate. However, both the exports of goods and services and labour force participation rate were positive and significant at 5 per cent. Aid and bank

credits were negative and insignificant whilst FDI, gross fixed capitals were both positive but insignificant. The introduction of a two period lag for FDI produced a significant but negative t value for the interaction term; the coefficient for this variable in all regression is very small with value ranging from  $e^{-08}$  to  $e^{-09}$  indicative of some possible misspecification of the variable, these are explored in the conclusions and discussion of future studies. The 2 period lag produces a significant but negative t value for FDI, however, the p value is zero. Lag values for Aid also produced positive and significant values for exports and labour force participation but again, the interaction term is negative and insignificant whilst Aid and bank credit were also negative, FDI and gross fixed capital were both positive but as in the previous estimation insignificant. With a four period lag on Aid, labour force participation and exports are still positive and significant; the other variables are insignificant but positive (gross fixed capital, FDI, bank credit) with aid and the interaction term both having negative coefficients and t values. The random estimation also produced large negative coefficients for the interaction term with the exception of the case in which a four period lag was attached to FDI. In this case the positive but insignificant z value was still associated with a large coefficient of  $e^{-08}$ ; (Tables: 58 and 59) however, gross fixed capital formation is positive and significant at 5 per cent. The labour force participation rate has a negative coefficient and insignificant z value, and exports are positive but insignificant. OLS estimation with 2 and 4 period lags on Aid, respectively again, generated large and negative coefficients for the interaction term but significant t values, significant and positive t values for gross fixed capital and large positive t values for FDI (at 2 and 4 period lags) producing t values for the interaction of -2.5 and 0.28 and 2 and 4 period lags, respectively (Table 58), on FDI producing small positive coefficients for the interaction term and insignificant t values. Coefficients for bank credit, Aid, and labour force participation rate were negative and insignificant whilst that for FDI, exports, were also insignificant and the coefficient for gross fixed capital positive with a significant t value. For model 1 all coefficients apart from domestic credit at bank and the interaction term, are significant and the T-statistics significant and positive with the exception of credit at bank and the interaction term. In

model 2 the coefficients for bank credit and the interaction term are again insignificant and very small. However the T-statistics are positive and significant for all variables. In model 3 we employ the fixed regression effects estimation and again the coefficients for the interaction term and bank credit are insignificant and very small-of the order  $e^{-08}$  and  $e^{-09}$ . The  $R^2$  values range from 26 per cent for model 5 to high of 49 percent in model 11.

Finally, the methodological shortcomings of this thesis are discussed in the discussions and conclusions with the identification of alternative approach to resolve them as well as the identification of their implications for future empirical investigations.

Although inflows of FDI is widely agreed to be vital to the long-term growth and development prospects of poor developing countries such as Uganda, these countries are also characterised by poor infrastructure endowment which mean that they have limited absorptive capacity with respect to FDI; our Aid-FDI is introduced as a possible means of making good this deficit by financing both infrastructure and co-financing commercial investments projects in which recipient government or state owned entities may be an active partner. In such cases state participation is financed or made possible through donor support of the national budget such as in the case of the Ugandan Government's participation in the Bujagali hydropower project. These investments are expected to improve the absorptive capacity and sector specific inflows of Aid and FDI are expected to improve the market infrastructure to support and facilitate an expansion of productive capacity. We have found examples of firm level projects financed by a combination of Aid and FDI and our Aid-FDI interaction.

## **Section 7.4**

### **Summary and Conclusions: The Policy Implications of our Findings**

Having offered the Aid-FDI interaction as a possible solution to the issue of aid effectiveness through enhanced effective utilisation and enhanced allocative efficiency, we now conclude with the policy implications of our empirical testing of this relationship. Although our survey of donors

and private investors supported our hypothesized Aid-FDI interaction term, this not verified in our quantitative estimation of the Aid-FDI interaction on GDP growth in Uganda.

It is clear from our empirical observation that differentiation between program and project aid is hard to maintain as private sector firms are increasingly investing in production and distribution of public goods and state monopolies in infrastructure provision are largely historical. Furthermore aid recipient are increasingly entrepreneurial in that they have become the investment partner in many commercial investments with private sector partners. These projects are increasingly evaluated for their commercial viability and long-term sustainability. So investment decisions are made on commercial or near commercial terms with the state as joint-shareholder.

Whilst program aid may for instance support sector specific reforms such as liberalisation of the power sector, this is effectively project aid when a state monopoly of a single large provider type exist even post liberalisation and partial privatisation. Historically project aid has a larger risk profile than program aid but the fact that private sector firms are often involved in projects partly financed by public inflows in LDCs means that firms and investors are involved in project aid, so risks are in line with returns on investments: social and private. Project aid complements program aid as the latter may improve the investment environment i.e. establishment of regulatory authorities and finance the privatisation process which removes state monopolies; creating a market environment in which prices reflect producer/supplier costs and risks.

Whilst a number of high profile PPP projects were identified, the prima facie evidence suggests that international partners: World Bank organization, bilateral donors and corporate investors may individually outweigh the Ugandan government in terms of their relative power of veto. For instance, the World Bank and its other principal financial backers have to insist on compliance to international environmental standards. The World Bank and European Investment Banks commissioned a number of impact studies varying from the environmental effect of the Bujagali hydropower project on local communities, their livelihood and the need to compensate for loss of livelihood, dwellings and relocation.

Investors have voiced concerns for the high level of bureaucracy associated with obtaining Aid co-financing. One such example is the World Bank sponsored Bagasse co-generation project in which the investors stated that the donor conditions were over onerous and this resulted in a scaling back of the project and considerable delays in the establishment of the project. It clear from our analysis that poor developing countries are vulnerable to changing pattern of consumption and the market for their agriculturally dominated exports as the major importers and retailers in their principal markets make adjustment to and/or lead the response of consumers to concerns for the impact of international trade on carbon emissions and the related issue of 'food miles'. Strategies embracing these concerns are now popularly employed by commercial rivals in the grocer retail sector and even by political parties as they seek ways and means of engaging with or leading public debate in this area. Particular concerns for the contribution of the aviation industry including tourism and cargo may undermined attempts both to exploit comparative advantage in poor countries such as Uganda and their attempt to internationalise their agricultural sector. For countries such as Uganda, efforts to diversify its economy away from over dependence on agricultural exports through the development of tourism, may well jeopardise as landlockedness already mean extra costs and risks to exporters and potential 'new barriers' to agricultural exports would constitute strong disincentives to existing and new investors in the agricultural and related sector. One possible response to these environmental concerns is coordinated approach by poor developing countries such as Uganda to fully participate in international forum on environmental issues and especially discussion of carbon emission, global warming and the contribution of air cargo trade for landlocked countries. It may well be that special dispensation should be sought by landlocked countries such as Uganda and the fact of her low per capita carbon emission factored into any regional or international agreement on trade-related carbon emission and policies and sourcing strategies relating to 'food miles'. Any reduction in the performance of the agricultural sector in countries such as Uganda would run counter to the efforts of the international development

community to stimulate private sector development as an essential element of their pro-poor growth and development strategy in such countries.

The provision of aid-for-trade by the donor community to facilitate the enhancement market infrastructure is largely supportive of the agricultural and mineral extraction sectors, suggesting that the international development community is well suited to the role of advocate for these countries; supporting the technical capacity of affected countries to both participate in and influence the outcome of multilateral discussion in this vital area and any trade-related measures based on carbon emissions as well as informing public debate in important markets for LDCs exports especially that of fresh produce. Developed countries such as the UK could for instance, demonstrate through its own enlightened trade and development policy and the sourcing policy of leading importers and retailers the benefit to producer communities of unrestricted access to their principal exports.

The fact is that inflows of FDI is widely agreed to be vital to the long-term growth and development prospects of poor developing countries such as Uganda. However, these countries are also characterised by poor infrastructure endowment which mean that they have limited absorptive capacity with respect to FDI; our Aid-FDI hypothesis is introduced as a possible means of making good this deficit by financing both infrastructure and co-financing commercial investments projects in which recipient government or state owned entities may be an active partner. In such cases state participation is financed or made possible through donor support of the national budget such as in the case of the Ugandan Government's participation in the Bujagali hydropower project. These investments are expected to improve the absorptive capacity and sector specific inflows of Aid and FDI are expected to improve the market infrastructure to support and facilitate an expansion of productive capacity. We have found examples of firm level projects financed by a combination of Aid and FDI our Aid-FDI interaction. Having offered the Aid-FDI interaction as a possible solution to the issue of aid effectiveness through enhanced effective utilisation and enhanced allocative efficiency, we now conclude with the policy implications of our empirical testing of this relationship.

It is clear from our empirical observation that differentiation between program and project aid is hard to maintain at a time when private sector firms are increasingly investing in production and distribution of public goods and state monopolies are largely historical. Furthermore aid recipient are increasingly entrepreneurial in that they have become the investment partner in many commercial investments with private sector partners. These projects are increasingly evaluated for their commercial viability and long-term sustainability. So investment decisions are made on commercial or near commercial terms with the state as joint-shareholder.

## **Section 7.5**

### **Summary and Conclusions: Enhancing Private Sector Participation**

This section addresses questions connected with the relationship between donors and private sector firms. The focus is on establishing whether donors have developed policies which formally acknowledge potential complementarities between AID and FDI. This would reflect increasing flows of aid to project and thus finance investments in the private and public sectors. The response of a number of donors demonstrates that the benefits of this interface is understood. However, it lacks a strategic overview. Where donors are involved in private sector projects such as the case of World Bank guarantees for equipment procurement in a co-generation power project, the administrative burden imposed on the private sector participant and the consequent delays to the establishment of the projects reduced the benefits of donor involvement/participation. Clearly the process needs to be simplified and made more transparent for all participants. Donor support through aid financing the risk-premium for commercial loans i.e. micro-credit to small farmers is an important aspect of the Aid-private capital relationship. In this case Aid funds are effectively employed to support bank credit to farmers lacking conventional assets. A participating lender assert that as some 12 per cent of its total portfolio is to small scale farmers, the provision of USAID guarantees helped to mitigate the risk of losses and thus allows it to provide credit to an important sector of the economy and one universally associated with initiatives to reduce the level of rural poverty and the overall performance of the economy.

The fact that the Ugandan government is unable to meet many of the medical and housing needs of the population means that private sector companies are pressured into making commitments by workers and Trade Unions in what amounts to a fiscal transfer and added cost and the prospect of these firms being unable to compete on price in important markets. The respondents believe the government and Trade Unions have supported this development. Whilst this development may suggest co-ordinated action by the Uganda government and its international development partners to maintain the competitiveness of the export sector through a reduction of these non-business costs, the danger is that this intervention may signal to other industries the possibility of obtaining subsidies. However, this should be seen by the donor community and the Ugandan government as an opportunity to better co-ordinate government and donor support to better maintain the working population and the provision of affordable social housing. Better health as in good medical and housing provision will contribute to the productivity and efficiency of the working population. Many of the respondents have in-house HIV/AIDS programs but whilst in some instances donors have contributed up to 60 per cent of the total budget, they have contributed significantly less for workforce training: of the order of 10 per cent or less.

Whilst some donors are clear about the need to encourage private sector participation in the economy; notably the USAID, DFID, EU and the Netherlands; others DANAID, Irish Aid and others are less concerned with this issue. EU cites examples of participation in infrastructure projects, assistance to the development of the road network, linking landlocked Uganda with its trading partners and in the process encouraging private sector investment. Other example includes the well-known aid-trade packages where assistance can be provided to tackle obstacles to investment (legal framework, customs procedures).

The view of these donors is that the private sector is critical to the long-term development of the Ugandan economy both in terms of growth and as a means of reducing the poverty head-count and improving regional and trans-regional economic and political linkages. The EU (Taylor, 2006) is currently negotiating a series of economic partnerships agreements with six regional African and



Pacific Countries (ACP) grouping in anticipation of the expiry of the Cotonou trading arrangement in 2007.

DFID is supporting the development of the agricultural sector with assistance to stimulate the growth of the market for agricultural inputs and improvement of the necessary infrastructure. Whilst Uganda has secured Dutch assistance for the development of its horticultural sector and the fact that the industry now accounts for up to 80 percent of some varieties of cut-flowers imported by the Netherlands, recent concerns for the 'carbon foot print' of goods imported into the EU calls into question the long-term prospects for the industry. This combined with the activity of environmentalist, and the growing awareness of consumers may result in a change in demand, investor sentiment and the consequent decline of the industry. At the strategic level, the industry needs an advocate to address concerns in important markets such as the Netherlands and the EU.

## **Section 7.6**

### **Limitations of This Study**

The two categories of research limitations encountered in this research are reported below with some explanation of what can and should be done in future studies to overcome them.

## **Section 7.7**

### **General Limitations**

Review of the empirical literature on the combined impact of aid and FDI for our hypothesised interaction term, Aid-FDI found no example of previous econometric analysis of this convergence of the two types of inflows on LDCs. Although many of the early theoretical argument for aid were made on the basis of its expected positive impact on economic growth and development in recipient countries, most studies have focused on their independent influence/impact of Aid and FDI respectively, rather than on their combined influence as is the case with our present study. However, the findings and conclusions of these studies are controversial (Burnside and Dollar, 1997 & 2000), Collier and Dollar, (2004) and Tarp (2001) largely inconclusive or contradictory. The need for further empirical studies is driven in part by the fact that donor policy is influenced by these

findings and the need to resolve the current lack of consensus amongst policy makers and academics on how and under what condition aid may exert a positive influence on economic growth in recipient countries. As the argument for more Aid is advanced, donors are increasingly looking for a 'convincing argument' to assuage tax payers concerns for poor returns to Aid and international intervention in poor developing countries. Advocates such as Chenery and Strout (1966), Rosenstein-Rodan, Bruton and Bruno argued in the 1950s and 1970s that inflows of Aid would correct low domestic savings and the presence of a foreign currency constraint on poor developing countries such as Uganda. These authors focused on the so called Dual Gap hypothesis (the low savings and foreign exchange constraint) which we have already discussed in chapter 2 and 4 of this thesis. These concerns provide the intellectual justification for the development of the aid industry in the 1950s. However, the emerging consensus is that aid provides a basis for domestic resource mobilization for social transformation, long-term development and economic growth.

As a response to the absence of an agreed explaining or transmission mechanism through which Aid impact on economic growth in LDCs, this thesis developed the Aid-FDI interaction as a potentially important transmission mechanism, allowing for a convergence of the two types of capital. Of course this convergence seeks also to address donor concerns for aid effectiveness though the use of the latter to improve the absorptive capacity of recipients i.e. when aid is used to create the infrastructure required by MNEs, the principal source of FDI for LDCs and its associated benefits. The linking of the two types of inflows would also improve or enhance both the allocative efficiency and effective utilisation of foreign aid. Given the relative paucity of research on the AID-FDI interaction term, this research provides a basis for future exploration of this convergence on recipient economies with potential implications for donor and recipient policies with respect to the vexed issue of aid effectiveness and its impact on the economic and development performance of poor developing countries.

The exploration of the policy dimension of donor-recipient interaction suggested a need to employ a multiple approach: qualitative survey of donors and private sector organisations, respectively for their experience and/or knowledge of the Aid-FDI interaction term. This would be identified in investment projects in which an aid is combined with FDI.

## **Section 7.8**

### **Limitations of Methodological Approach: The Qualitative Aspects**

We were limited to a few participants in the survey of Uganda's principal development partners: only 5 of the 10 listed on the DAC website took part in the study. It was therefore not possible to choose a representative sample both in terms of their level of contribution i.e. the level of assistance provided to the country and the policy preference and distribution priorities. Notwithstanding this shortcoming, the participants of this study represented some 54 per cent of total DAC Aid to Uganda (OECD, World Bank, 2002-2003, see Tables 12a and 12b (Page 75), and Tables 51 and 52 (Page 203/204). Clearly some donors are focused on particular sectors: social development, capacity building and others on assisting private sector development. Of particular interest to this research is the Aid-FDI interaction in infrastructure project finance. In addition to provision of infrastructure finance, the policy stance of both organisations would suggest the long-term prospect for joint financing of this type and its influence on Uganda's other development partners.

The activities of the World Bank and IMF are important for a deeper understanding of domestic policy development in LDCs such as Uganda. It follows from this that significant engagement with poor developing countries such as Uganda may have a profound influence on the development of its trade and investment policy and this would be generally true for other poor developing countries and especially highly indebted countries such as those common to the SSA region. Opportunity to engage with these two organisations would have allowed us to assess prospects for the convergence of policies between donor and between donors and foreign investors and hence prospect for our Aid-FDI interaction. However, given the finite resources limitation of this study and the time

constraint, it was not possible to continue discussion with these organisations to secure their participation. Whilst World Bank and IFC finances to the infrastructure are sufficiently large to impact on the economy; examples of Aid-FDI interaction identified in this research and survey of foreign investors are small and less likely to demonstrate impact on the aggregate economy in the short-to-medium term. This reduces the chance of the interaction term estimation in our regression analysis being either significant or positive.

A review of Uganda's experience of infrastructure finance in chapter 3, presents an example of infrastructure finance in which World Bank affiliates such as the International Finance Corporation (IFC, its private sector division and the Multilateral Investment Guarantee Agency (MIGA)) provided funding support and guarantees of some US\$300 million for the Bujagali hydro-power project. These funds will support a major foreign investor. Unfortunately, we were unable to secure the involvement of the lead private sector investor in this project.

## **Section 7.9**

### **Limitations of methodological approach: The Quantitative Aspects**

As demonstrated empirically in Swamy and Fikkert (2002) determinants of economic growth based on Cross-country growth regressions suffers from a number of problems: principally omitted variables and simultaneity. The first is produced by country specific characteristics that influence growth but are unobserved by the researcher. The second problem result from the fact that determinants of economic growth such as physical capital may be influenced by growth-bidirectional causation i.e. growth may for instance attract more FDI and FDI may also result in enhanced growth in the recipient economy. Whilst omitted variables accounted for through fix effects, simultaneity is resolved by instrumental variables as estimation employing variables that are unaffected by changes in the dependent variable. However, Caselli et al (2002) exclaim that “we wonder whether the very notion of exogenous variables is at all useful in growth framework other than the case of morphological structure and certain geography”.

The need to use time series pooled panel data resulted from the general lack of suitable data. In this case the available macro-economic data (From World Bank via ESDS online source) for Uganda had only 19 observations (1987-2005) and it was therefore concluded that with so few observations extending the number of countries and using a pooled times series would correct this problem. This required the attachment of time dummies and country identities to account for significant heterogeneity between the countries and structural factors. In the end we found that the best sample of countries was 23 for which we could obtain the required macro data. However as these countries varied in size, economic policy, culture and history any conclusions drawn from econometric analysis is tempered by these facts. With numerous earlier empirical studies establishing a direct link between human capital Lucas (1988), (Borenzstein et al (1995) and economic expansion, and inflows of FDI on economic growth, respectively, such as in empirical studies by Lall (1980), Findlay (1987), Blomstrom et al (1994), Dees (1998), and De Mello (1996), respectively, it is clear that poor human capital endowment, would suggest that inflows of private capital such as FDI would have a more limited impact on economic growth, Barro (1991), Borenzstein et al (1995), and Gemmell (1996) and development in situations characterised by poor human capital development. Furthermore, the attractiveness of poor countries generally characterised by poorly developed physical infrastructure: transport, telecommunications, and power, adds to their low absorptive capacity with respect to the attractiveness to FDI whilst adding to the cost-base of domestic firms and foreign investors: reducing their competitiveness in international markets. It follows from the above discussion that a future study should seek ways of developing useable measures of human capital development for the countries employed in the study.

Extending the list of foreign investors in Uganda to those from countries other than the UK would help to expand the number of participating firms and thus give the conclusions and policy implications derived from the analysis of the data a better level of generalisability as well as the opportunity to find more examples of projects making use of our Aid-FDI interaction term. For detailed explanation of the methodology employed in this research, the specification of the model

used in the econometric estimation of the Aid-FDI interaction term and its justification see chapters 8 and 12. However, we can say here that empirical determination of the growth promoting aspects of aid inflows to poor countries is controversial and to highlight this we only have to recall the conclusions of the Burnside and Dollar (2000) study in which the authors concluded that aid is ineffective for countries with poor policies but positive for those countries with high scores for policy indicators (Gomance, Girma and Morrissey, 2005) and when other determinants of growth are controlled for, is positive. This positive outcome is explained by aid being employed in growth-promoting initiatives rather than financing increases in government consumption.

In our econometric estimations aid is not disaggregated into productive and consumption components. Clearly, aid employed in co-financing investment projects or supporting trade and investment policy formulation and implementation in line with a number of WTO agreements (Institute for Agriculture and Trade Policy, 2006) would be expected to have some impact on the performance of the economy over time in contrast to that element which is consumed as government spending. Aid may also be employed to compensate for trade liberalisation which results in a reduction in trade related taxes to the government or increases in domestic unemployment in sectors of the economy affected by more competitive imports. This may provide opportunity to estimate the contribution of aid to policy development in international trade.

In Leeuwen's comparative empirical analysis using an approach associated with the two branches of the new growth theories in which Romer and Lucas's, respectively establish the importance of Human capital as a factor of production in the new growth theory. However, lack of useable data for human capital development, means that we were unable to introduce this important variable in our estimation of GDP-AID-FDI growthrelationship.

The generally poor availability of macro-economic data and the non-disclosure of information by a number of donor countries and private overseas investors in Uganda highlight the importance of qualitative determination of our Aid-FDI interaction term. In the present study, the qualitative

approach identified several instances of this convergence in the financing of a number of investments in the agricultural, power generation and agro-processing industries. In the main these were relatively small investments and their impact on the overall economy limited to the investor and employees and possibly the community in which the investment is based. One important and significant exception to this is the recently announced Bujagali hydro power project, a US\$700million investment in which the World Bank Group has contributed some US\$300 million of loans and guarantees through its private sector division, the International Financial Corporation (IFC) and risk insurance by the Multilateral Investment Guarantee Agency (MIGA). Discussion of this investment and its policy implications for donors and the Ugandan government is included in chapter 9 of this thesis.

Clearly investments of this size are scarce but likely to have a significant impact on the economy in the medium- to- long-run as the power sector has suffered from lack of investment, poor reliability and lack of capacity. This has been a major concern for investors as power produced by diesel generators is 300 per cent more expensive than utility power and manufacturers' costs are pricing some exports out of international markets and/or reducing the profitability and viability of future investments. Respondent firms actively involved in tea production, power distribution and the agro-processing sector expressed concerns for the impact of poor and unreliable utility power on their investment intention. However, lack of disclosure of information on the impact of poor power supply on their profitability and competitiveness in international markets made it impossible for us to determine the scale of this problem and the policy implications for the Ugandan government's efforts to increase inflows of FDI to the infrastructure and agricultural sectors, respectively.

Econometric analysis employing both fixed and random models produced the same results for our interaction term. It was therefore concluded that the fixed estimator would be employed in our regressions. This supported the use of the untransformed variables in production function. As the standard production function is the Cobb-Douglas (CD) specification is the only linearly

homogenous production function with constant elasticity of substitution. As the original form of CD is non-linear, we transformed the variables by taking natural logs and first difference of the variables. The outcome of this transformation was insignificant: the interaction term (Aid-FDI) was insignificant and negative whilst other variables had the same signs. With a significant number of missing values the transformation to natural log resulted in the removal of missing values to achieve the same number of observations for each variable. As the transmission mechanism for aid induced economic growth is not well understood, it is difficult to determine the time required for inflows of capital: private and public, and our Aid-FDI interaction term, respectively on economic performance. In the final analysis, poor countries such as Uganda may experience significant decline in economic performance even in the presence of large inflows of aid and FDI as domestic factors such as weather, rain fall patterns and civil strife, high rates of HIV/AIDS and political uncertainty may reduce the productivity of these inflows.

Developments in donor countries and the management of the political dimension of increasing or maintaining aid flows to developing countries in times when budgets are heavily committed and public support is lacking if not opposed to continued or increases in foreign aid. Prospect for the commodity exports especially of unprocessed agricultural goods and oil of LDCs and improvements in terms of trade are important determinants of the long-term growth prospects of countries such as Uganda.

### **Section 7.9.1**

#### **Suggested Avenue for Future Research**

Previous empirical studies of the impact of Aid have had limited success in establishing a direct relationship between the former and economic growth, Papanek, (1973), Mosley (1980), Burnside and Dollar (2000). Whilst the latter authors have concluded that aid has a positive influence on economic growth in countries with good policy, most other studies such as that of Tarp (2001) using the same data set as the Burnside and Dollar (2000) study, concluded the opposite even for those countries pursuing good policies. Chapters 2 and 5 of this thesis discussed the



interrelationship between FDI inflow, trade and growth from a LDC perspective. In the case of aid, the controversy is significant in that recent debate amongst LDCs is focused on increasing the volume of public inflows as a means of meeting the MDGs and social sector development. However, as tax payers in donor countries and policy makers are concerned for the generally poor outcome of these inflows on the growth and development of recipient's economies, the need to establish best policy for maximising the positive impact of these inflows on recipient countries is vital for restoring public confidence in aid giving at a time when governments are under pressure to improve both the range and quality of public goods in donor countries as well as the general decline in budget allocations.

With a focus on the combined impact of Aid-FDI, this study offers a new conceptualisation of the interrelationship between aid and economic growth, namely that the convergence of public and private inflows as the vector or transmission mechanism for aid catalysed economic growth. This mechanism comes into operation when projects/investments are financed by a mixture of aid and FDI such as is increasingly common to large infrastructure projects such as the recently agreed Bujagali hydro power projects in Uganda. With a total investment of some US\$700million and World Bank contribution of US\$300 million, this project has the potential within a relatively short while to positively impact on the growth performance of the Ugandan economy as firms in Uganda currently experience an intermittent supply with up to 100 plus days without utility supply and many of these have had to invest in costly diesel generators. UNCTAD (2005) survey of Uganda found that only 10 per cent of the population have access to utility power supply and this has made rural development difficult especially as efforts to advance agro-processing industries as the bulk of agricultural production is located in rural areas and so too the concentration of poverty head count and lack of social development.

Aid may be employed to increase the attractiveness of investment projects especially those relating to infrastructure sector. The Bujagali hydropower project is a good example of this. The privatisation program in the Uganda has benefited from significant donor support to establish a

framework for the process and to buy-in technical expertise for the tendering and specification of the project. These upfront costs associated with major infrastructure projects are unlikely to be met by private sector firms and must therefore be assumed by the government and its development partners. The obvious danger here is that public funds may artificially boost rates of return to private investors and at the same time reduce social rates of return.

Donors must be more deliberate in engaging with foreign investors to secure a balance between social and private rates of return to projects partly financed by aid: 1) This would suggest that future studies should focus on assessment of the impact of Aid-FDI financed projects on the economy and their relative rates of return i.e. social versus private,2) On the qualitative side, much more detailed study on non-UK investors in the Ugandan economy should be included as UK former colonial relationship with Uganda means that UK firms are more involved in traditional industries such as agriculture: tea plantation, sugar production and finance whilst non-UK firms may be more prominent in new sectors such as power distribution, construction, the service sector and horticulture. This would also expand the range of industries covered and the number of participating firms.

3) Disaggregation of aid inflows which allows a distinction between general government budget support and Aid employed in the financing of productive assets such as infrastructure and agricultural production would provide a basis for a more robust determination/estimation of public inflows on the economic performance of recipient such as Uganda. As the country has a high level of aid dependency (an estimated 40 per cent of government expenditure is supported by aid inflows), this would suggest that aid may also finance trade and investment policy development, education and capacity building in these sectors. From our survey of the Ugandan Investment Authority (UIA) it is clear that this organization was established by and maintained by donor contribution. In this case the USAID is the principal financial sponsor of the organization.

4) Future studies should address the efficiency of aid finance infrastructure projects and the relative rates of return achieved by these projects: social relative to private. This may provide a basis for the

development of recipient and donor policies to maximise the allocation of aid inflows with the ability to discriminate between projects with high relative social rates of return where this is the primary objects of specific investments.

5) As the paucity of macroeconomic data has suggested that the qualitative approach is likely to yield better results as our study identified the convergence of Aid and FDI but we were unable to do this using a quantitative method. Furthermore, the benefits of a qualitative approach are that it provides a deeper level of understanding of the issues and opportunity to make direct contact with senior policy makers and foreign investors. The data collected by this mean is timely and generally superior in quality.

## Section 7.9.2

### Recommendations

In this section we reflect on the policy implications of our empirical study and make specific recommendations for policy makers in Uganda. This is followed by some suggested policies for members of the international development community. In both instances we seek to address the future prospect for addressing the overall topic of aid effectiveness and the respective implications for donors, the Ugandan government and policy makers in countries with similar endowments to Uganda.

#### **Ugandan Policy makers:**

The fact is that Uganda is a country endowed with a wide variety of natural resources evident from this research, however; the ability of the government to effectively deploy these in the service of the nation is limited and frankly impossible without continued inflows of capital and technical resources. This will also require greater market access for Ugandan exports and her ability to protect her trade from policies and practices deployed by her major trading partners: principally the EU and USA. At the present time concerns for the impact of the mode of transport associated with tropical agriculture has become a major debating point amongst environmentalist and anti-globalisers and this is reflected in political strategy of major political figures and parties across the EU and in North America. As a landlocked country, Uganda must engage with these campaigners and political entities and make her case for reasonable treatment as a poor country that depends on agricultural exports for the major share of foreign earnings and domestic employment.

Overdependence on agriculture means the economy is vulnerable to external demand shocks for a narrow range of goods. In recent times improving credit rating of the government combined with high interest rates on government instruments resulted in inflows to the bond market and significant appreciation of the Ugandan Shilling. This has resulted in some concerns by the agricultural sector: that a significant outcome of a high REER for the Ugandan Shilling (late 1980s and 1990s) is

reduced price competitiveness in international markets. For many investors the appreciation of the Shilling is only one of several negative factors at play on the private sector: unreliable utility power and the need to invest in expensive diesel generators and the poor state of road and rail links to ports in neighbouring countries, principally those in Kenya. There is clearly a need for significant long-term investment in Uganda's road and rail network; however, this suggests a regional approach as important links are transnational for landlocked countries such as Uganda. The need to upgrade national and regional feeder roads is also clear as lack of access to land suited to the cultivation of a wider range of horticultural products, namely cut flowers, is restricting the effort of the industry to further expand its portfolio and differentiate for higher priced products in an industry famed for small margins and high import intensity of input. Some efforts to address the supply of inputs from local sources are in operations and one such project is sponsored by DFID. This involved stimulating the development of local supply networks for seeds and fertilizer and related goods as well as centralised storage and distribution. Whilst some effort has been made to address the poor provision of utility power, significant delays have resulted from a complicated and discredited procurement process and this has featured in the resignation of a number of contractors on power projects such as the Bujagali Hydropower facility. This has also resulted in significant delays and additional costs to contractors. The start of the project was also characterized by a very demanding set of environmental standards by participants such as the World Bank and other international financial institutions. The lack of significant local expertise in this area required the engagement of foreign experts, lack of competence effectively relegated the government to the position of observer having accepted externally imposed environmental standards. Our recommendation is that domestic policy in this area must be the principal guide and be based on wide scale national consensus, consistent with the concept of local ownership. Whatever emerges from this process will reflect national priorities and the importance of infrastructure development relative to concerns for the impact of such developments on the environment or the displacement of local communities.

The importance of the agricultural sector suggests that donors should be much more supportive of the sector as Ugandan agriculture is rural, small scale, low income and low tech. Another important challenge for the industry is the lack of progress in the Doha development round and a consequent freezing of further measures to ease restrictions on the international trade in agriculture and thus facilitate inflows of investment and technology to countries such as Uganda. It is therefore necessary that Uganda and her neighbours develop a common approach to international trade discussions and reforms likely to expand international trade in agriculture. This should be linked to initiatives such as the WTO Aid-for-Trade to further develop the capacity of qualifying states to exploit greater market access. This should be accompanied by specific provision for those qualifying countries which may require additional space and time to grow their productive and export capacity to meet any growth in demand whilst allowing them a measure of protection from foreign imports which may destroy domestic incentive structure, this is not the import substitution strategy of former times but rather giving countries such as Uganda the opportunity to meet the challenges of a more liberal international trade regime for agriculture.

Her limited technical capacity has restricted the growth of the industrial sector and this is evident from earlier studies and support by the response of participants to the present research. So improving the skill-base of the local work force should occur in tandem with reforms at the international level to meet needs of the export sector. As respondents have identified lack of technically competent personnel, the government must focus on programs that will meet this gap.

Whilst some Donors support local training programs to improve the skills-base and competitiveness of the domestic workforce through a variety of vocational training initiatives, this has not met the need of local employers who continue to experience a lack of technically competent personnel.

### **Uganda's Development Partners**

What is clear from our research and specifically the survey of Uganda's major development partners is the wide range of programs and projects being supported. However, with a few

exceptions, most projects are relatively small and therefore lack national impacts, with a regional and or local focus and so limited in its national economic and social influence/reach. These small projects range from micro-credit to rural farmers to small farm cooperatives and village-based small-scale energy/power projects. The facts are: the rural community is mostly employed in low wage subsistence agriculture and poverty is significantly a feature of rural life in Uganda and majority of developing countries including her immediate neighbours.

Efforts to improve the welfare of these communities require significant investment in agricultural expansion and this will depend on foreign inflows to the sector. For this to happen significant improvement in related infrastructure is required and as the government does not have the funds to do this, donor support is vital. However, a number of donors have provided significant funds for road and rail improvements but, again, the evidence suggests that the procurement process is the major barrier to development in this sector. Donor funds for the road and rail network are significantly undisbursed for this reason. The government must therefore address this issue and develop the technical competence and political will to resolve and reform its procurement programs.

Harmonisation of donor efforts should be linked to significant reduction in the number and variety of projects with better specialisation to focus more resources and expertise in well-defined areas of the economy for critical mass and efforts to grow the economy. This suggests a need to focus on areas in which Uganda has a sustainable comparative advantage and the prospects of profitability and employment generation especially in rural communities. The flow of resources to the social sector overshadows that to the private sector. This evokes concerns for the long-term development of the economy and continued dependence on public inflows for significant portion of central government budget.

The Ugandan Investment Authority (UIA) has performed well given its limited resources and the evident lack of integration with other important functions of the government and those in particular

which have a role in economic development. As the UIA claim some success in using aid to improve inflows of FDI, formal linking of the organization with departments and ministries with links to donors, would help to further development in this area so donors may acknowledge complementarities between public and private inflows (our Aid-FDI hypothesis). This clearly one avenue to develop policies to encourage this convergence and the use of aid inflows and donor policy to support enhance investments in economic infrastructure and financing commercial ventures and those especially in agriculture and related industries.

Better coordination of land use and land tenure is vitally important for the agricultural sectors and the management of natural resources must also create a balance between the need of local communities especially those in the rural areas so private sector commercial agriculture expansion creates opportunities for these vulnerable communities.



## **Appendix: Empirical Research Questionnaires**

**(Questionnaires are reproduced in the narrative of participant's responses)**

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