

**A COMPARATIVE STUDY OF FOREIGN DIRECT INVESTMENT  
POLICY IN EASTERN AFRICA: THE CASE OF RWANDA AND  
TANZANIA (2000-2006)**

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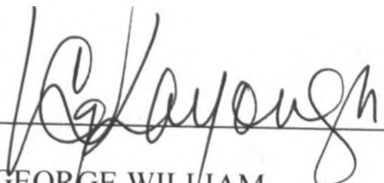
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**DECLARATION**

THIS DISSERTATION IS MY ORIGINAL WORK AND HAS NOT BEEN PRESENTED FOR A DEGREE IN ANY OTHER UNIVERSITY.

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THIS DISSERTATION HAS BEEN SUBMITTED FOR EXAMINATION WITH MY APPROVAL AS A UNIVERSITY SUPERVISOR.

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## **DEDICATION**

To the people of East Africa.

## ACKNOWLEDGEMENTS

I wish to register my gratitude to all persons who assisted me in the course of researching and writing of this project. However, I am particularly indebted to a number of people, whom I must mention here for their unreserved support.

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## LIST OF ABBREVIATIONS

AGOA	African Growth and Opportunity Act
ATC	Air Tanzania Corporation
CEPGL	Economic Community of the Great Lakes
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
COSATU	Congress of South African Trade Unions
DRC	Democratic Republic of Congo
EAC	East African Community
EBA	Everything But Arms
EPZ	Export commodity processing zone
EPZ	Export Processing Zone
FDI	Foreign Direct Investment
FTZ	Free trade zone
GDP	Gross Domestic Product
GTZ	German Technical Cooperation
HDI	Human Development Index
IMF	International Monetary Fund
IPAs	Investment Promotion Agencies
M&As	Mergers and Acquisitions
MNCs	Multinational Corporations
MNEs	Multinational Enterprises
NACC	National AIDS Control Council
NMB	National Micro-finance Bank
ODA	Official Development Aid
PCB	Prevention of Corruption Bureau
PRSP	Poverty Reduction Strategy Papers
R&D	Research and Development
RIEPA	Rwanda Investment and Export Promotion Agency
SEEPZ	Single enterprise considered as export processing zone
TANESCO	Tanzania Electric Supply Company Limited
TIC	Tanzania Investment Center
TNCs	Transnational Corporations
TRA	Tanzania Revenue Authority
TTCL	Tanzania Telecommunications Company Limited
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Program
UNIDO	United Nations Industrial Development Organization
VAT	Value-Added Tax
WAIPA	World Association of Investment Promotion Agencies
WB	World Bank
WIR	World Investment Report
ZIPA	Zanzibar Investment Promotion Agency



## ABSTRACT

This study's main objective is to explain why while Rwanda and Tanzania both have low FDI potential; Tanzania performs better than Rwanda in attracting FDI. This is done by attempting to establish the contribution of policy in increasing FDI inflow through a comparative analysis of FDI policy in the two countries. In tackling the above-mentioned problem, the study utilizes both primary and secondary sources of data. The findings established that new trends have reinforced the importance of private investment for many developing countries. As a result of the move towards neo-liberal policies, the role of the State has shifted from an active economic player with productive activities to a provider of an environment of doing business and of social risk insurance. The main factors influencing investment decisions in Rwanda and Tanzania were noted to include political risk, economic freedom, business freedom, fiscal incentives, trade freedom, government expenditure, inflation, corruption, property rights, status of financial system and labour regulations. However, the study argues that the FDI national policy framework of a country is a very important determinant of FDI in a country. In this regard, it established that the liberalization of national FDI frameworks in third world countries has been substantially successful in attracting FDIs in those countries but their benefits are debatable. Overall, it was ascertained that the policy orientation of government exhibited that Tanzania had an upper hand in attracting FDI than Rwanda.

## CHAPTER ONE

### FOREIGN DIRECT INVESTMENT POLICY IN RWANDA AND TANZANIA

#### Introduction

After gaining political independence in the 1960s, African countries—like most developing nations, were very skeptical about the virtues of free trade and investment. Consequently, in the 1970s and 1980s several countries in the region imposed trade restrictions and capital controls as part of a policy of import-substitution industrialization aimed at protecting domestic industries and conserving scarce foreign exchange reserves. There is now substantial evidence that this inward-looking development strategy discouraged trade as well as foreign direct investment (FDI) and had deleterious effects on economic growth and living conditions in the region.<sup>1</sup>

The disappointing economic performance of African countries beginning in the late 1970s up till the mid 1990s, coupled with the globalization of activities in the world economy, has led to a regime shift in favour of outward-looking development strategies. Since the mid-1990s, there has been a relative improvement in economic performance in a number of African countries as a result of the change in policy framework (Fischer et al, 1998). Available data for Sub-Saharan Africa indicate that the average annual growth rate of real Gross Domestic Product (GDP) per capita which was -0.9% over the period 1975-84 rose to 0.7% in the period 1995-2002.<sup>2</sup> However, the progress made so far is not enough for sustained growth and development in the region.

The role of the private sector in assuring economic growth in African countries is now a fundamental part of national and donor development strategies. But entrepreneurs in

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<sup>1</sup> Dani Rodrik, *Trade Policy and Economic Performance in Sub-Saharan Africa* (USA: National Bureau of Economic Research Inc., 1998) p. 53

<sup>2</sup> Fischer S., Hernandez-Cata E. and Khan M. S., 'Africa: is this the turning point?' International Monetary Fund Paper on Policy Analysis and Assessment, 1998, PPPAA/98/6 p. 11

Africa face severe constraints: their business climate is less predictable, their markets are smaller, the supporting infrastructure is weaker, and the regulatory and legal environment more restrictive than elsewhere.<sup>3</sup>

The further decline of world FDI flows in 2003 by more than a quarter after the decline by more than half in 2001 meant that more investment promotion agencies chased fewer FDI dollars. That made it more important for countries to assess how they are doing in terms of their success in attracting FDI and in terms of their potential to do so. The United Nations Conference on Trade and Development's (UNCTAD) introduced a tool to examine this; the new Inward FDI Performance and Potential Indices. UNCTAD's Inward FDI Performance Index scores ranks countries by comparing each country's FDI and GDP. The index is the ratio of a country's share in global FDI flows to its share in global GDP.<sup>4</sup> Therefore, if a country's share in global FDI flows matches its relative share in global GDP the country's Inward FDI Performance Index would be one. A score greater than one indicates a larger share of FDI relative to GDP and a score less than one indicates a smaller share of FDI relative to GDP.

UNCTAD's Inward FDI Potential Index assesses each country's attractiveness for FDI inflows based on eight variables. The eight variables are: GDP per capita, real GDP growth for the past ten years, exports as a percentage of GDP, number of telephone lines per 1000 inhabitants, commercial energy use per capita, research and development (R&D)

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<sup>3</sup> Basu Anupam and Krishna Srinivasan, *Foreign Direct Investment in Africa: Some Case Studies* (Washington D.C.: IMF, 2002) p. 107

<sup>4</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* (Geneva: United Nations, 2006) p. 23

expenditures as a percentage of gross national income, students in tertiary education as a percentage of total population, and political risk.<sup>5</sup>

The Performance Index relates FDI inflows to market size, to standardize absolute inflow figures by the economic size of countries (GDP) while the Potential Index is based on eight structural economic variables that change only slowly. Unsurprisingly, developed countries are leading here. Performance can vary considerably from year to year, reflecting, for example, large cross-border Mergers and Acquisitions (M&As).<sup>6</sup>

The indices allow comparisons over time. And they allow comparisons between performance and potential. For example, countries that are attracting more FDI than expected (given their potential) may have to make extra efforts to maintain their performance. On the other hand, those performing below their potential should be able to attract more FDI, should they wish to do so.<sup>7</sup>

Like all indices of this kind, the new ones have their limitations. For example, the Performance Index does not distinguish between green-field FDI and M&As – with the latter being particularly important during the FDI peak period of 1999-2000. And the index does not address the quality dimension of FDI or the benefits derived from it. Still, the indices provide a rough guide to where a country stands compared with its competitors. In today's highly competitive world market for FDI, this can provide an important pointer for policy makers.

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<sup>5</sup> Ekrem Tatoglu and Keith Glaister, *Dimensions of Western Foreign Direct Investment in Turkey* (London: Quorum Books, 2000) p. 219

<sup>6</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* op. cit., p. 24

<sup>7</sup> Moosa Imad, *Foreign Direct Investment: Theory, Evidence and Practice* (New York: Palgrave Macmillan Ltd, 2002) p. 38

## **Problem Statement**

This study attempts to do a comparative analysis of FDI policy in two countries in Eastern Africa; Rwanda and Tanzania. According to this study, Eastern Africa is composed of Kenya, Uganda, Tanzania, Rwanda and Burundi. However, specifically the study does a comparative analysis of FDI policies in Rwanda and Tanzania. These two countries were selected following the 2006 World Investment Report by UNCTAD that rated Rwanda as a country with both low FDI potential and performance and Tanzania as a country with low FDI potential but high performance.<sup>8</sup> Therefore, this study seeks to explain why while both countries have low FDI potential, Tanzania has performed better than Rwanda. This it does by attempting to establish the contribution of policy in increasing FDI inflow through the comparative analysis of FDI policy in the two countries.

The indices used by UNCTAD to rate country performance were analyzed in this study. Following the above classification, it is generally taken that Rwanda has a lot to learn from Tanzania given its high FDI performance. While the study supports this fact, it also contends that there are positive elements in Rwanda's policy framework that Tanzania may have ignored. Therefore, this study focuses on how the two countries can learn from each other in order to improve the business environment for FDIs. It identifies policy issues from the other countries in the region that both Rwanda and Tanzania need to address.

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<sup>8</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* op. cit., p. 24

## **Objectives**

The main objective of this study is to carry out a comparative analysis of FDI policy in Rwanda and Tanzania. In addition, the study has the following specific objectives:

1. To evaluate the causes of success of the already instituted policies in Tanzania.
2. To evaluate the causes of the failure of the already instituted policies in Rwanda.
3. Proffer policy recommendations for conducive business environment that can effectively attract FDI.

## **Justification**

### **Academic Justification**

From the literature review section, it is apparent that there is literature dealing with issues related to FDI flows to Africa. However, the existing literature focuses on the empirical determinants of FDI to the region, with very little discussion of concrete actions or strategies that could be adopted to promote FDI flows to the region. This study attempts to overcome this limitation. It emphasizes a new approach to the promotion of investment to the region. Besides, the vast literature on foreign direct investment is suffering from a lack of comparative work based on specific case studies drawn from different regions of the world. This study therefore seeks to fill this gap by analyzing comparatively the FDI policy of two countries in Eastern Africa: Rwanda and Tanzania.

### **Policy Justification**

Improvements in economic policies are needed to enhance macroeconomic performance and attain the minimum growth rate required to meet the Millennium Development Goals set by the United Nations. An increase in investment is crucial to the attainment of sustained growth and development in the region. This requires the mobilization of both domestic and international financial resources. Given the

unpredictability of aid flows, the low share of Africa in world trade, the high volatility of short-term capital flows, and the low savings rate of African countries, the desired increase in investment has to be achieved through an increase in FDI flows, at least in the short-run. Foreign investment inflows are influenced very little by variables such as locational advantage, proximity to financial centers, total population and size of the country. Instead, they are heavily influenced by the countries' policies and institutions. This means, as is established in the literature review, that even though initial, country-inherent conditions may play a certain role, they can be overcome by sound policies and their thorough implementation.<sup>9</sup> This study seeks to do a comparative analysis of FDI policy in two countries of Eastern Africa: Tanzania and Rwanda with the objective of identifying policies that improve the business environment for FDIs.

## **Literature Review**

This section addresses two dominant themes in the debate concerning foreign direct investment. The first part examines the role of FDI in development. The debate brings to the fore works of scholars who have argued for and against this contention. However, the study as seen from one of the hypotheses supports the argument that FDI helps to spur development in Developing Countries. The second part considers the factors that necessitate the location decision of FDIs. The literature review shows that there is no ultimate consensus on these factors but they include natural resources, market size, government policies, political instability and the quality of the host country's institutions on FDI among others.

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<sup>9</sup> Yingqi Wei and Xiaming Liu, 'Foreign Direct Investment in China: Determinants and Impact' *The China Journal*, No. 48, 2002, pp. 229-230:229

## The Role of FDI in Development

This section mirrors one of the hypotheses of this study which is that FDI accelerates economic growth and spurs development in the host country. The Economic Report on Africa by the United Nations Economic Commission for Africa advocates that FDI is the key to solving Africa's economic problems. Bodies such as the IMF and the World Bank have suggested that attracting large inflows of FDI would result in economic development.

Foreign Direct Investment as a development tool has its benefits and risks, and will only lead to economic growth in the host country under certain conditions. It is the responsibility of governments to make sure that certain conditions are in place so that FDI can contribute to development goals rather than just generating profits for the foreign investor. These conditions cover broad features of the political and macroeconomic environment. The impact of FDI in a country would depend on a number of factors such as the mode of entry (greenfield or merger and acquisition), the activities undertaken, and whether these are already undertaken in the host country, sources of finance for FDI (reinvested earnings, intra-company loans or the equity capital from parent companies), and the impact on the activities of domestic companies.<sup>10</sup>

Aaron (1999) sees FDI as an important source of capital formation particularly when the capital base is low. Capital inflow is seen as a way of creating a surplus in the capital account of the balance of payments or to make up for the deficit on the current account.<sup>11</sup>

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<sup>10</sup> Consumer Unity Trust Society, *Making Investment Work for Developing Countries* (India: CUTS, 2001) p. 9

<sup>11</sup> Aaron C., *The Contribution of FDI to Poverty Alleviation* (Washington, DC: Foreign Investment Advisory Service, 1999) p. 235



On the contrary however, Yash Tandon (2002) argues that any reasonable accounting of capital flows must take into account what flows in and out of the country.<sup>12</sup> In the Investment Position Paper by Congress of South African Trade Unions (COSATU), it was pointed out that FDI flowing out of South Africa had increased rapidly, and since 1994, it has exceeded direct capital flows. COSATU has indicated that between 1994 and 2000, FDI into the country came to R45 billion, while outflows of direct investment came to R54 billion.<sup>13</sup> Therefore FDIs can contribute to the underlying fragility of an economy and make it more susceptible to balance of payments crises. When they repatriate profits and restrict exports by a subsidiary by undercutting the market of the parent company, they worsen a country's balance of payments.

On the other hand, Dunning (1994) posits that foreign exchange effects of FDI are often simplistically assumed to be positive. He argues that in actual fact, the foreign exchange effects are much more negative than what emerges from an idealized view of FDI. Positive effects arise only where new productive capacity is created in the export sector, or in very strongly import-substituting sectors. If FDI takes the form of purchase of existing capacity, even in the export sector it will have a negative foreign exchange effect even if export production goes up, unless the productivity of capital increases enough to offset the other increased foreign exchange costs. At lower levels of import substitution, the effects of FDI on new capacity are much more ambiguous, and may be negative.<sup>14</sup>

Akinlo (2003) contends that FDIs provide access to modern technological and management know-how (such as research, development, marketing, finance). They are the

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<sup>12</sup> Yash Tandon, *Fallacies about the Theory of FDI: Its Ideological and Methodological Pitfall* (Zimbabwe: SEATINI, 2002) p. 98

<sup>13</sup> COSATU, *Investment Position Paper* (South Africa: COSATU, 2001) p. 4

<sup>14</sup> Dunning John, 'Re-evaluating the Benefits of Foreign Direct Investment' in John H. Dunning (ed), *Alliance Capitalism and Global Business* (London: Routledge, 1994) p. 27

agencies through which advanced technology is transferred to the underdeveloped countries. From a developmental perspective, it is more important that technology is diffused with spill-over into the local production process, and that technology be adopted and adapted by local enterprises. For an economy to improve on quality, technological upgrading is crucial. Technical inefficiency, in developing countries, can severely hinder the quality of products produced and the ability to cope with new demands. At the moment, no studies have shown that FDI had this diffusion-effect in Southern Africa.<sup>15</sup>

The biggest hindrance to the successful technological development of enterprises according to Matkin (1990) is that the quality of manpower is low. African countries seem to have inappropriate personnel. Their educational level is low, they join the enterprises without any technical training, and whatever they learn is from the workers who have already been working there. So hardly any improvement takes place in their quality, and their absorption and analytical capacity.<sup>16</sup>

It is argued that FDI will lead to employment creation. Examining China as a case study, The Moore School looks at employment creation by Coca Cola. It observes that the number of people directly employed in the Coca-Cola system is estimated to be 14,046. This includes permanent and temporary, skilled and unskilled workers. More than 62 percent are skilled workers who usually get permanent jobs. Moreover, through Coca-Cola's supplier (upstream) linkages, total employment supported by the bottling system is about 350,000. Coca-Cola also participates in self employment via retail and wholesale trade ventures that sell Coca-Cola products. These ventures prosper and affect the economy according to the margins charged on traded goods. It is estimated that the sale of

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<sup>15</sup> Akinlo A. E., 'Foreign Direct Investment and Economic Growth in Sub-Saharan Africa' *International Review of Economics and Business* Vol. 50, 2003, pp. 569-80: 572

<sup>16</sup> Matkin G., *Technology Transfer and the Universe* (New York: ACE Macmillan, 1990) p. 81

Coca-Cola products in China supports at least 50,000 jobs in the wholesale and retail sectors.<sup>17</sup>

Nevertheless, the involvement of FDIs in employment implications has long been a source of controversy in developing countries. De Mello argues that the technology introduced by FDIs involved in import-substitution production is highly capital intensive, and therefore tends to reduce the employment potential of industrialization.<sup>18</sup> In addition Jauch (2002) notes that although FDIs employ a massive number of workers, they also contribute to a shrinking in employment in the national sector by attracting capital away from the indigenous industries. It is also alleged that FDIs pay abnormally high wages to local workers leading to further intensification of the overall capital intensity bias in industry and unequitable distribution of gains from industrialization. Jauch also presents another problem with employment through FDI as the kind of employment it creates. He uses Namibia as an example where the government claimed that the Export Processing Zone (EPZ) programme created jobs and thus reduced the unemployment rate. However, the jobs that were created are mostly characterized by poor working conditions and very low salaries. Most of the employees do not have job security and little prospects of improving their standards of living. It is thus important to examine the quantity and quality of jobs created.<sup>19</sup>

It is also argued that a country gains some wealth by way of taxes. However, Moran (2006) argues that the problem arises when FDI enterprises demand for tax concessions and subsidies. He also notes that FDIs evade taxes most of the time by

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<sup>17</sup> The Moore School, *The Economic Impact of Coca-Cola in China* (Columbia: University of South Carolina, 2000) p. 3

<sup>18</sup> De Mello L.R. Jr., 'Foreign Direct Investment in Developing Countries: A Selective Survey' *The Journal of Development Studies*, 1997, Vol. 34, No. 1, pp 1-34:29

<sup>19</sup> Jauch H., *Foreign Investment and Employment Creation: No Panacea for Southern Africa* (New Jersey: Africa World Press Inc., 2002) p. 10

overpricing inputs transferred from another subsidiary and under pricing outputs sold by the enterprise to another country.<sup>20</sup> Moreover, Hill (2005) contends that the very competition to attract more FDI by governments with over-optimistic expectations regarding such investment, means that all sorts of concessions are offered, which may turn out to be very expensive for the economy in the medium or long term. He observes that such FDI promotion tends to focus heavily on the demand side, in terms of requirements imposed on host countries which involve changing their own policies in order to make themselves more attractive. Such unilateral concessions are increasingly sought to be entrenched through international agreements.<sup>21</sup>

### **Determinants of FDI in Africa**

Although there have been a considerable number of analytical and empirical studies on FDI inflows, there has been a limited consensus on which factors play an unambiguous role in explaining their location decision. This section reviews literature on the determinants of FDI to developing countries.

In the past, investment promotion activities in the region were carried out in an environment in which domestic policies were by and large not conducive to foreign investment and so were not successful. However, Pigato (1999) argues that today, an enabling environment has to be created first before marketing investment opportunities to foreign entrepreneurs could be done effectively. The maintenance of a sustained political and macroeconomic policy environment would get the African region closer to attaining this objective. Furthermore, the realization of Africa's FDI potentials will also depend on

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<sup>20</sup> Theodore H. Moran, *Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries* (Washington: The Brookings Institutions, 2006) p. 91

<sup>21</sup> Charles W. Hill, *International Business: Competing in the Global Marketplace* (Princeton NJ: McGraw-Hill, 2005) p. 75

the ability of its leaders to improve the FDI climate and take advantage of the new global interest in the affairs of the region by implementing sound macroeconomic policies, enforcing the rule of law, reducing risks of policy reversals, and improving the provision of infrastructure.<sup>22</sup>

While supporting the contention that large markets are great determinants to location decision of FDIs, Srinivasan (1999) observes that African countries that have been able to attract most FDI have been those with large domestic markets. Following his survey, about 65 per cent of total FDI inflows to Africa concentrated in South Africa, Nigeria, and Cote d'Ivoire in 1996/1997, which also accounted for about two-third of the continent's GDP during the same period. He emphasizes that the role of market size can be further evidenced by the almost perfect positive correlation between FDI inflows and GDP for some African countries during 1996 and 1997 which he cites from the 1999 World Development Report.<sup>23</sup>

On the other hand, the 1998 UNCTAD Report underscores the role of natural resources in the location decision of FDIs. The Report holds that traditionally, about 60 per cent of FDI in Africa is allocated to oil and natural resources. This is corroborated by the coefficient correlation between FDI inflows and the total value of natural resources in each country, which appears close to unity. The African region possesses not only large reserves of oil, gold, diamonds and copper but also more than half of the world's cobalt and manganese, one third of bauxite and more than 80 per cent of chromium and platinum. The

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<sup>22</sup> Pigato Miria, *Foreign Direct Investment in Africa: Old Tales and New Evidence* (Washington D.C.: World Bank, 1999) p. 51

<sup>23</sup> Srinivasan Krishna, *Foreign Direct Investment in Africa: Some Case Studies* (Washington D.C.: International Monetary Fund, 1999) p. 79

continent is also among the main exporters of agricultural products such as cocoa, coffee and sugar.<sup>24</sup>

To analyze the aforementioned three determinants, Asiedu (2006) uses panel data for 22 countries over the period 1984–2000 to examine the impact of natural resources, market size, government policies, political instability and the quality of the host country's institutions on FDI. She also analyses the importance of natural resources and market size *vis-à-vis* government policy and the host country's institutions in directing FDI flows. Her main result is that natural resources and large markets promote FDI. However, lower inflation, good infrastructure, an educated population, openness to FDI, less corruption, political stability and a reliable legal system have a similar effect. She argues that a benchmark specification shows that a decline in the corruption from the level of Nigeria to that of South Africa has the same positive effect on FDI as increasing the share of fuels and minerals in total exports.<sup>25</sup> These results suggest that countries that are small or lack natural resources can attract FDI by improving their institutions and policy environment.

On the contrary, Onyeiwu and Shrestha (2004) dispute the fact that policy orientation of a country can determine its FDI inflow. They contend that the capacity of African countries to attract FDIs is principally determined by their natural resources and the size of their local markets. Over the years, Nigeria and Angola have been two of the most successful countries because of their comparative location advantage in oil despite their unstable political and economic environments. They justify this contention by the apparent lack of interest of transnational corporations (TNCs) in African countries that

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<sup>24</sup> UNCTAD, *World Investment Report 1998: Trends and Determinants* (New York and Geneva: United Nations, 1998) p. 13

<sup>25</sup> Asiedu Elizabeth, 'Foreign Direct Investment in Africa: The Role of Natural Resources, Market Size, Government Policy, Institutions and Political Instability' *The World Economy* 2006, vol. 29 issue no. 1, pp. 63–77: 68

have attempted to implement policy reforms.<sup>26</sup> In the same vein Bhinda (1999) and others contends that in several African countries it is often difficult to tell what specific aspects of government policies are. This is due in part to the high frequency of government as well as policy changes in the region and the lack of transparency in macroeconomic policy. The lack of transparency in economic policy is of concern because it increases transaction costs thereby reducing the incentives for foreign investment.<sup>27</sup>

Morrisset (2000) posits that FDIs may lack interest in African countries that have attempted to implement policy reforms because it has been argued that policy reforms in many African countries have been incomplete and thus have not fully convinced foreign investors to develop activities that are not dependent on natural resources and aimed at regional and global markets. He however notes that it takes time for a country to modify its image, especially when the State has a long tradition of policy intervention, and when the reforms have been mostly symbolic with the adoption of new texts that have not yet been translated into actions. Although Morrisset seems to support Onyeiwu and Shrestha's contention, he still holds that African countries can also be successful in attracting FDI that is not based on natural resources or aimed at the local market, but rather at regional and global markets, by implementing policy reforms.<sup>28</sup>

### **FDI in Rwanda and Tanzania**

The Governments of Rwanda and Tanzania, like all others in Africa, have taken significant steps to encourage foreign investment. In Tanzania, the Tanzania Investment

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<sup>26</sup> Onyeiwu S & Shrestha H., 'Determinants of Foreign Direct Investment in Africa' *Journal of Developing Societies* 2004, vol. 20 pp. 89-106:93

<sup>27</sup> Bhinda et al, *Private Capital Flows to Africa: Perception and Reality* (The Hague: Forum on Debt and Development, 1999) p. 41

<sup>28</sup> Morrisset Jacques, 'Foreign Direct Investment to Africa: Policies also Matter' *Transnational Corporation* 2000, vol. 9 pp. 107-25: 118

Center (TIC), established by the country's Investment Act of 1997, is a focal point for all investors and performs all liaison work such as answering inquiries and facilitating project start-up. It provides certificates of incentives on approved projects that have a minimum investment of US \$300,000 if foreign owned and US \$100,000 if locally owned.<sup>29</sup> Similar work is done by the Rwanda Investment and Export Promotion Agency (RIEPA) that was established in Rwanda in 1998 to encourage investment. Registered investors obtain certificates that bring benefits, including exemption from value-added tax and duties when importing machinery, equipment, and raw materials. RIEPA also assists with the issuance of expatriate work permits, securing all the required government permits, and assisting with land acquisition if required.<sup>30</sup>

In Tanzania, the priority sectors for investment, as identified by TIC, are: mining, petroleum and gas, tourism, infrastructure development, aviation, agriculture, construction, financial services, and manufacturing. Investment in other sectors is not restricted. On the other hand, the agricultural sector in Rwanda presents great investment opportunities especially in its primary exports coffee and tea, horticulture, floriculture and herbal products. In tourism, Rwanda's best known asset is the mountain gorillas. Although tourist numbers are low - mainly on account of the country's misleading image as an unsafe place - opportunities for investors are many and varied: hotels and lodges, entertainment facilities, restaurants, tour operations, and training services. The ICT sector also needs more investment.<sup>31</sup>

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<sup>29</sup> Ngowi Honest, "The Inadequacies of FDI's Determinants in Tanzania: Some Evidence" *Economics and Development Papers*, 2001, Vol. 1 No. 1, pp. 104-118:107

<sup>30</sup> RWANDA: Record Investment *Africa Research Bulletin: Economic, Financial and Technical Series* 44, Issue 1, pp. 17254A-17254C

<sup>31</sup>



UNCTAD's world investment report (WIR) 2006, observes that Africa received a record high FDI inflows in 2005 of US\$31 billion, but this was mostly concentrated in a few countries and industries. FDI inflow in Rwanda and Tanzania has been very fluctuative and unpredictable. Table 1 shows that the volume of FDI into Tanzania is huge compared to the inflow into Rwanda. This study looks into the probable factors that encourage as well as discourage FDI inflow into these two countries.

**Table 1: Inflows into Rwanda and Tanzania (USD Million)**

Year	Tanzania	Rwanda
1999	541.7	2
2000	282.0	9
2001	467.2	9
2002	429.8	7
2003	526.8	5
2004	469.9	11
2005	473	8

The UNCTAD report '*Foreign Direct Investment in Africa: Performance and Potential*', argued that although external investment in Africa has been increasing in recent years, it still lags far behind the flows to other developing regions partly because of the generally negative image of the continent portrayed in the international media. To rectify these misconceptions, UNCTAD sought to reveal the situation as is in Africa. The study, as it focused on the FDI inflow into Africa, revealed as shown in table 2, that Rwanda is a country with both low FDI potential and performance while Tanzania was rated as one

with low FDI potential but high performance.<sup>32</sup> This dissertation attempts to examine the other specific factors that contribute to the difference in performance of the two countries away from the ones provided for in the UNCTAD indices of both potential and performance.

**Table 2: Matrix of inward FDI performance and potential, 2001-2004**

	<b>High FDI performance</b> Front-runners	<b>Low FDI performance</b> Below-potential
<b>High FDI Potential</b>	Bahamas, Bahrain, Belgium and Luxembourg, Botswana, Brazil, Brunei Darussalam, Bulgaria, Chile, China, Costa Rica, Croatia, Cyprus, Czech Republic, Denmark, Dominican Republic, Estonia, Finland, France, Hong Kong (China), Norway, Hungary, Ireland, Israel, Kazakhstan, Latvia, Lithuania, Mexico, Netherlands, Panama, Portugal, Qatar, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, Trinidad and Tobago, Tunisia and Viet Nam.	Argentina, Australia, Austria, Belarus, Iceland, Iran, Islamic rep, Italy, Japan, Jordan, Canada, Germany, Greece, Kuwait, Lebanon, Malaysia, Malta, New Zealand, FDI, Oman, Philippines, Poland, Libyan Arab Jamahiriya, Russian Federation, Thailand, Ukraine, United Arab Emirates, Saudi Arabia, Taiwan Province of China, United Kingdom, United States, Republic of Korea,
<b>Low FDI Potential</b>	<b>Above-potential</b> Albania, Angola, Armenia, Azerbaijan, Bolivia, Colombia, Congo (Republic), Ecuador, Ethiopia, Gambia, Georgia, Guyana, Honduras, Mali, Mongolia, Morocco, Mozambique, Namibia, Nicaragua, Nigeria, Peru, Republic of Moldova, Romania, Sudan, Syrian Arab Republic, Macedonia, Togo, Uganda, Jamaica, Kyrgyzstan, Madagascar, India, Myanmar, Malawi, <b>United Republic of Tanzania</b> and Zambia.	<b>Under-performers</b> Algeria, Bangladesh, Benin, Burkina Faso, Cameroon, Congo Democratic Republic, Kenya, Venezuela, Yemen, Cote d'Ivoire, Egypt, El Salvador, Gabon, South Africa, Zimbabwe, Malawi, Indonesia, Ghana, Guatemala, Guinea, Haiti, Kyrgyzstan, Madagascar, India, Pakistan, Papua New Guinea, Paraguay, <b>Rwanda</b> , Senegal, Sri Lanka, Turkey

Source: World Investment Report 2002, United Conference for Trade and Development

<sup>32</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* op. cit., p. 24

## Theoretical Framework

This study adopts a theory that tries to address the various dimensions of the problem under investigation. The main theory employed is liberalism and its offshoot neo-liberalism. Economic liberalism can be traced back to Adam Smith in his '*The Wealth of Nations*' in 1776 which has become a classic manifesto against mercantilism. On the other hand, neo-liberalism refers to a historically-specific reemergence of economic liberalism's influence among economic scholars and policy-makers during the 1970s and through at least the late-1990s, and possibly into the present (its continuity is a matter of dispute). It is associated with Friedrich Hayek and the Austrian School of economics, economics departments such as that at the University of Chicago (and such professors as Milton Friedman and Arnold Harberger), and international organizations such as the International Monetary Fund and The World Bank.<sup>33</sup>

Smith claims that self-interest in a free society would result in a rapid progress and economic growth. It can therefore lead to socially beneficial results.<sup>34</sup> Every individual possesses a complex set of contradictory qualities such as selfishness and altruism, in varying proportions. Capitalists are neither more egocentric nor more generous than workers, and liberals are no less concerned than socialists with the disadvantaged strata of society. According to this liberal approach, capital is a source of power that should be used by capitalists, just as political power should be used by politicians, for the benefit of society. No politician is completely devoid of personal ambition, and most capitalists act with some degree of idealism.

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<sup>33</sup> Harvey David, *A Brief History of Neo-liberalism* (Oxford: Oxford University Press, 2005) p. 45

<sup>34</sup> Hollander Samuel, *The Economics of Adam Smith* (Toronto & Buffalo: University of Toronto Press, 1973) p. 207

Consequently he argues that the free market, while appearing chaotic and unrestrained, is actually guided to produce the right amount and variety of goods by a so-called 'invisible hand'.<sup>35</sup> Therefore for example, the presence of factories with varied relative efficiency in a competitive market causes a continuous decline in prices, and forces the least efficient enterprises to either improve their efficiency or disappear from the market. Thus, relative efficiency leads to a continuous searching for new methods and products, with the consequent reduction of costs and prices, improvement of salary/prices ratio, and a raise in workers' standard of living.

Besides, the surplus value that remains after income tax is deducted, generates new capital, which attempts to find lucrative investments. Part of it is invested in construction of new factories in industrial branches with good prospects of profits, that is, branches in which there are enterprises marketing with high surplus values. This results in increased supply and consequent reduction of price, marginal cost, and surplus value.<sup>36</sup>

In sum, in a free-market economy, relative efficiency and surplus value together raise the living standard of the masses, by lowering costs and prices, and by developing medicines, tools, and commodities.

This school of thought holds that government intervention as a forced partner in administration of gains but not in losses is a strong deterrent against investment. Furthermore, the wealthier the taxpayers, the less their standard of living is affected by taxes. Hence, the demagogic justification of income tax as taking from the rich and giving to the poor, is incorrect. Instead, such antiquated government restrictions not only hinder industrial expansion but also most forms of government interference in the economic

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<sup>35</sup> Muller Jerry, *Adam Smith in his Time and Ours: Designing the Decent Society* (Princeton: Princeton University Press, 1995) p. 38

<sup>36</sup> Prasad Monica, *The Politics of Free Markets: The Rise of Neo-liberal economic Policies in Britain, France, Germany, & The United States* (Chicago: University of Chicago Press, 2006) p. 29

process, including tariffs create inefficiency and high prices in the long run.<sup>37</sup> However, this theory advocates that a Government should be active in sectors other than the economy such as public education of poor adults; institutional systems that were not profitable for private industries; a judiciary; and a standing army.

Lastly, economic liberalism holds that states are not the only actors on the international plane but non-governmental organizations and individuals also influence the operations in the international sphere.<sup>38</sup> This assumption is in line with this study since it incorporates the major focus of the study, foreign direct investment in terms of multinational corporations, trans-national corporations and other forms of FDI.

Other theories that could be used to study FDI include functionalism and neo-realism. Functionalism could suit this study since it recognizes non-state actors in global relations. Neo-realism on the other hand holds that countries decide to cooperate or do business in others for their own benefit. Despite these assumptions, liberalism is best suited to guide this study due to its assertion on the role of government in FDI operations. It holds that government interference in administration of gains is a deterrent to FDI flow. However, it proposes that government should be active in other sectors that facilitate getting these gains. This refers to government policy.

### **Hypotheses**

This dissertation sought to test the validity of the following three hypotheses;

1. A good business environment in Rwanda and Tanzania will increase and maintain FDI in flow.

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<sup>37</sup> Hollander Samuel, *The Economics of Adam Smith* op. cit., p. 206

<sup>38</sup> Goldstein Joshua, *International Relations* 4th ed (New York: Longman, 2000) p. 65

2. Business environment in Rwanda and Tanzania can be improved by government policy orientation towards FDI.
3. Tanzania and Rwanda need more investment in terms of FDI in order to fill the investment gap for purposes of economic growth.

### **Definitions**

*Investment Climate:* The general economic conditions affecting the financial markets. A favorable investment climate encourages businesses to improve efficiency and productivity in order to increase revenues and capital available for investment. It also gives investors confidence in the market and encourages them to invest more capital.<sup>39</sup>

*Foreign Direct Investment:* Foreign direct investment (FDI) is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. Thus it is distinct from portfolio investment which may cross borders, but does not offer such control. Firms which source FDIs are known as 'multinational enterprises' (MNEs).<sup>40</sup>

### **Methodology**

The study relied on both primary and secondary sources of data. External secondary sources of data entailed the analysis and review of published books, journals, papers, periodicals, and unpublished works; Government documents from the two countries including both policy documents and sessional papers, media sources and the internet. Although secondary data saves time and cost given for instance that longitudinal studies have already been completed and documented, it needs a lot of fine-tuning and adjusting for it to fit the objectives of the study.

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<sup>39</sup> Consumer Unity Trust Society, *Making Investment Work for Developing Countries* (India: CUTS, 2001) p. 8

<sup>40</sup> Charles W. Hill, *International Business: Competing in the Global Marketplace* (Princeton NJ: McGraw-Hill, 2005) p. 74

The study also depended on primary sources of data since they are tailored to address its objectives. The primary sources will include direct interviews.

The study sought generally to examine FDI policies in Eastern Africa that, according to the study, is composed of Kenya, Uganda, Tanzania, Rwanda and Burundi. However, specifically the study does a comparative analysis of FDI policies in Rwanda and Tanzania. These two countries were selected following the 2006 World Investment Report by UNCTAD that rated Rwanda as a country with both low FDI potential and performance and Tanzania as a country with low FDI potential but high performance.<sup>41</sup>

Personal interviews were used because they allow the interviewer to control over the type of data and information to be collected. Probing/open-ended questions that can only be asked via this mode facilitated the collection of a lot of data. This type of data collection allows for clarification of ambiguous questions through getting feedback from the respondent. The interviews were directed to civil servants in various ministries of the two countries that deal with the following issues; starting and closing a business, business registration and licensing, tax remittances, worker's welfare, investors' protection, trading across borders and enforcing contracts. Cluster sampling was used to select these ministries. Then stratified sampling was used to select two officers in managerial positions who will analyze each one of the above issues in depth but speak on the rest. Five foreign direct investment institutions were selected from each country using convenience sampling.

After a satisfactory theoretical identification of the FDI policy stance of each country, the interviews that were conducted with respondents from relevant ministries and

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<sup>41</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* (Geneva: United Nations, 2006) p. 24

the foreign investors sought to find out the policies that have been implemented in the respective countries. The foreign investors provided information on their view of the existing policy frameworks and suggestions on the improvements that need to be done.

## **Chapter Outline**

### **Chapter One: Foreign Direct Investment In Africa: Potential And Performance**

This chapter provides an insight into the structure of the dissertation. It lays the background in which the introduction, statement of the problem, objectives, hypotheses, justification, literature review, theoretical framework, research methodology and chapter outline are discussed.

### **Chapter Two: Foreign Direct Investment: Conceptual Debates**

This chapter reviews the FDI conceptual debates which include the meaning of FDI taking into consideration its definitional impact on Africa, its contribution to development, and whether it is supply or demand driven.

### **Chapter Three: Foreign Direct Investment Policy in Rwanda and Tanzania**

This chapter uses government documents, sessional papers and policy documents of the two countries to identify FDI policies that are exhorted in these countries. These include starting and closing a business, business registration and licensing, tax remittances, worker's welfare, investors' protection, trading across borders and enforcing contracts.

### **Chapter Four: A Comparative Analysis of Regional FDI Policies in Eastern Africa**

First, this chapter analyses the impact of each identified policy issue on in and outflow of FDIs. It then compares the policy orientations of the two countries as outlined in the previous chapter and analyzes the implications of their differences.



## **Chapter Five: Conclusions and Recommendations**

Following the findings in the previous chapter, this chapter offers a conclusion. After assessing the findings, it also proffers recommendations on a credible FDI policy framework in African countries that will serve to attract FDIs.

## CHAPTER TWO

### FOREIGN DIRECT INVESTMENT: CONCEPTUAL DEBATES

#### Introduction

For many developing countries, attracting FDI has been a key aspect of their outward-oriented development strategy, as investment is considered a crucial element for output growth and employment generation. New trends have reinforced the importance of private investment. As a result of the move towards neo-liberal policies, the role of the State shifted from an active economic player with productive activities to a provider of an environment of doing business and of social risk insurance. Private investment, both domestic and foreign, is viewed as the driving force of the economy

This chapter reviews the FDI conceptual debates which include the meaning of FDI taking into consideration its definitional impact on Africa and the various projections of different theories of FDI. The other sections in this chapter focus on the development impact of FDI in third world countries by examining FDI roles in employment, security, economic growth, technology transfer and environment, corporate social responsibility, Training, Research and Development and the strength of host country.

#### Foreign Direct Investment: Definition and Reasons for Inflow

FDI is the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. Thus it is distinct from portfolio investment which may cross borders, but does not offer such control. Firms which source FDIs are known as 'multinational enterprises' (MNEs).<sup>42</sup>

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<sup>42</sup> Charles W. Hill, *International Business: Competing in the Global Marketplace* (Princeton NJ: McGraw-Hill, 2005) p. 74

FDI can also be categorized based on the motive behind the investment from the perspective of the investing firm. The economic determinants of FDI have been classified by standard FDI theories as market-, resource- and efficiency-seeking.

The main considerations of market-seeking investors are market size and per capita income, market growth potential, including access to regional and global markets, country-specific consumer preferences; and the structure of the markets. Generally, market seeking investment is *horizontal*. It means that a large part of the production chains is based within the country implying important backward and forward linkages and technological spillovers. The local plant only delivers its products to the local market.

Resource Seeking FDI's are Investments which seek to acquire factors of production that are more efficient than those obtainable in the home economy of the firm. In some cases, these resources may not be available in the home economy at all like cheap labor and natural resources. This typifies FDI into developing countries, for example seeking natural resources in the Middle East and Africa, or cheap labor in Southeast Asia and Eastern Europe. On the other hand, market seeking FDI's are Investments which aim at either penetrating new markets or maintaining existing ones. FDI's of this kind may also be employed as defensive strategy.<sup>43</sup> It is argued that businesses are more likely to be pushed towards this type of investment out of fear of losing a market rather than discovering a new one.<sup>44</sup> This type of FDI can be characterized by the foreign mergers and acquisitions in the 1980's by Accounting, Advertising and Law firms

Efficiency seeking FDI's are investments that hope to increase their efficiency by exploiting the benefits of economies of scale and scope, and also those of common

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<sup>43</sup> Knickerbocker F. T., *Oligopolistic Reaction and Multinational Enterprise* (Boston: Division of Research Graduate School of Business Administration Harvard University, 1973) p. 27

<sup>44</sup> Dunning J. H., *Multinational Enterprises and the Global Economy* (England: Addison-Wesley, 1993) p. 59

ownership. It is suggested that this type of FDI comes after either resource or market seeking investments have been realized, with the expectation that it further increases the profitability of the firm.<sup>45</sup> Typically, this type of FDI is mostly widely practiced between developed economies; especially those within closely integrated markets such as in the European Union.

### Theories of FDI

Theories of FDI can essentially be divided into two categories: micro (industrial organization) theories and macro (cost of capital) theories. The early literature that explains FDI in microeconomic terms focuses on market imperfections, and the desire of multinational enterprises to expand their monopolistic power.<sup>46</sup> Subsequent literature centered more on firm-specific advantages owing to product superiority or cost advantages, stemming from economies of scale, multi-plants economies and advanced technology, or superior marketing and distribution.<sup>47</sup>

According to this view, multinationals find it cheaper to expand directly in a foreign country rather than through trade in cases where the advantages associated with cost or product are based on internal, indivisible assets based on knowledge and technology. Alternative explanations for FDI have focused on regulatory restrictions, including tariffs and quotas that either encourage or discourage cross-border acquisitions, depending on whether one considers horizontal or vertical integrations.

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<sup>45</sup> Ibid, p. 60

<sup>46</sup> Caves, Richard E., 'International Corporations: The Industrial Economics of Foreign Investment' *Economica* February 1971, Vol. 38 pp. 1-27:6

<sup>47</sup> Helpman Elhanan, 'A Simple Theory of International Trade with Multinational Corporations' *The Journal of Political Economy* June 1984, Vol 92, pp. 451-471:453

Studies examining the macroeconomic effects of exchange rate on FDI center on the positive effects of an exchange rate depreciation of the host country on FDI inflows, because it lowers the cost of production and investment in the host countries, raising the profitability of foreign direct investment. The wealth effect is another channel through which a depreciation of the real exchange rate could raise FDI. By raising the relative wealth of foreign firms, a depreciation of the real exchange rate could make it easier for those firms to use retained profits to finance investment abroad and to post a collateral in borrowing from domestic lenders in the host country capital market.<sup>48</sup>

Management under portfolio equity ownership may be plagued by a free-rider problem under disperse ownership if an individual shareholder does something to improve the quality of management, the benefits will accrue also to all other shareholders. In contrast, FDI investor, who gains control of the firm and is endowed with management skills, has proper incentives to pursue proper monitoring of management. Furthermore, based on possession of “intangible capital” in the source country, the FDI investor can apply more efficient management standards in the host country compared to sender country. The unique advantage to FDI, that has only recently been explored, is its potential for superior micro-management, based on the specialization in niches of industry in the operation in the source country.

Razin and Sadka developed a stylized model of FDI in the presence of imperfect information with respect to the firm’s productivity.<sup>49</sup> In an integrated capital market, with full information, all forms of capital flows (FDI, loans, Portfolio equity and debt) are indistinguishable. In the presence of incomplete information, these flows are significantly

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<sup>48</sup> Buckley P.J. and M.C. Casson, *The Future of Multinational Enterprise* (London: Macmillan, 1976) p. 3

<sup>49</sup> Razin Assaf and Efraim Sadka, *Labor, Capital and Finance: International Flows* (Cambridge: Cambridge University Press, 2002) p. 15

different from one another. The disadvantage of portfolio investments relative to FDI is rooted in the following problem. The management of firms owned by portfolio investors is plagued by a “free-rider” problem. Oliver Hart, in a related context put it like this. “If the shareholder does something to improve the quality of management, then the benefits will be enjoyed by all shareholders. Unless the shareholder is altruistic, she will ignore this beneficial impact on other shareholders and so will under-invest in the activity of monitoring or improving management.”<sup>50</sup> In contrast, shareholders, such as FDI investors, which take control of the firm, and are equipped with managerial know-how, can obtain the full benefits of their actions for themselves and therefore do not face the same free-rider problem.

This unique advantage of FDI investment is formalized over other types of investment in a stylized model. According to Haque<sup>51</sup> if initially all firms are still owned by original (domestic) uninformed owners, and if the productivity shock is purely idiosyncratic, then at the beginning of the first period, when investment decisions are made, firms are uninformed about the productivity shock. It will be revealed only in the second period, when output from new capital is already materialized. In order to make new investment the firm must incur first a fixed setup cost. As the firms are all ex-ante identical if they have to make the investment decision at this level of information, they will all invest the same, based on the expected level of the productivity factor. Assume now that at this stage, before the productivity factor is known, foreign direct investors step in. Once acquiring and effectively managing the firm, the FDI investor can better monitor the productivity of the firm than her domestic investor counterpart. She can thus fine tune the

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<sup>50</sup> Hymer S.H., *The International Operations of National Firms: A Study of Direct Foreign Investment* (Cambridge: MIT Press, 1976) p. 73

<sup>51</sup> Irfan ul Haque et al, *Trade Technology and International Competitiveness* (Washington DC.: Economic Development Institute of the World Bank, 1995) p. 135

level of capital stock more closely to the value of the productivity factor. Anticipating this fine-tuned investment schedule, the value of the firm to the potential FDI investor is larger than the reservation value to the original owner, and the corresponding value to potential domestic investors.<sup>52</sup> Therefore, FDI investors will outbid domestic investors for the firms in the domestic industry. Competition among potential FDI investors, will drive up the price close to the price which reflect the upgraded micromanagement of the firm. The initial domestic owners will gain the rent, which is equal to difference between the FDI investor's shadow price and the initial owner's reservation price.

If the competition between potential FDI investors is perfect, all the benefits from the superior FDI management skills accrue to the host economy, leaving the FDI investors with a return on their investment just equaling the world rate of interest. The gains to the host economy from FDI inflows can therefore be classified into two categories. First, there are the conventional gains that stem from opening the economy to the new flow of capital, thereby allowing a more efficient inter-temporal allocation of consumption (via consumption smoothing).

In addition, there are the intrinsic gains associated with the superior micromanagement by FDI investors. The entire gain of the FDI investors is captured by the domestic economy because of assumed perfect competition among these investors over the domestic firms. The economic gains from FDI, relative to portfolio inflows, lie only in the efficiency of investment, since in both cases there are consumption smoothing effects and the same world interest rate prevails in the host country in the two regimes. In other words, the gains from FDI, in comparison to portfolio flows, do not include the traditional gains

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<sup>52</sup> South Centre, *Liberalization and Globalization: Drawing Conclusions for Development* (Geneva: South Centre, 1996) p. 72

from opening up the domestic capital market to foreign capital inflows because these traditional gains are present also in the portfolio regime. Under some plausible conditions the size of the aggregate stock of capital is larger under FDI than under Portfolio equity flows.<sup>53</sup>

### **Security**

It is often argued that it is necessary to restrict foreign direct investment in a given industry for national security purposes. This serves as a justification for prohibitions on investment in defense industries and in other industries that are deemed essential for national security.<sup>54</sup> Most governments, for example, would be concerned if their weapons were produced by companies owned by firms in countries that might serve as future enemies. However, after the September 9/11 attack on the United States, the definition of national security widened to cover economic security and energy needs.

Telecom is an essential and key infrastructure, and the ability to control it during national emergencies cannot be debated on. For instance, its role in keeping track of terrorism and other criminal activities is huge. Its capacity to be used as an espionage device is also high. Foreign ownership and management control of the telecommunication facilities of a country therefore becomes a security issue.

### **FDI and economic Growth**

FDI has proved to be resilient during financial crises. For instance, in East Asian countries, such investment was remarkably stable during the global financial crises of 1997-98. In sharp contrast, other forms of private capital flows—portfolio equity and debt flows, and particularly short-term flows—were subject to large reversals during the same

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<sup>53</sup> Irfan ul Haque et al, *Trade Technology and International Competitiveness* op. cit., p. 135

<sup>54</sup> Bairoch P., *Globalization Myths and Realities: One Century of External Trade and Foreign Investment* (London: Routledge, 1996) p. 40



period. The resilience of FDI during financial crises was also evident during the Mexican crisis of 1994-95 and the Latin American debt crisis of the 1980s.<sup>55</sup>

Despite the strong theoretical case for the advantages of free capital flows, the conventional wisdom now seems to be that many private capital flows pose countervailing risks. Hausmann and Fernández-Arias (2000) argue that short-term lending from abroad is driven by speculative considerations based on interest rate differentials and exchange rate expectations, not on long-term considerations. Its movement is often the result of moral hazard distortions such as implicit exchange rate guarantees or the willingness of governments to bailout the banking system. It is the first to run for the exits in times of trouble and is responsible for the boom-bust cycles of the 1990s.<sup>56</sup>

In contrast, FDI is viewed as "good cholesterol" because it can confer the benefits enumerated earlier. An additional benefit is that FDI is thought to be bolted down and cannot leave so easily at the first sign of trouble. Unlike short-term debt, direct investments in a country are immediately reprised in the event of a crisis.

Buckley (1976) has also cast the evidence on the stability of FDI in a new light. Though it is true that the machines are bolted down and, hence, difficult to move out of the host country on short notice, financial transactions can sometimes accomplish a reversal of FDI. For instance, the foreign subsidiary can borrow against its collateral domestically and then lend the money back to the parent company. Likewise, because a significant portion of FDI is inter-company debt, the parent company can quickly recall it.<sup>57</sup>

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<sup>55</sup> Robert E. Lipsey, *Foreign Direct Investors in Three Financial Crises* (Cambridge, Massachusetts: National Bureau of Economic Research, 2001) p. 4

<sup>56</sup> Ricardo Hausmann and Eduardo Fernández-Arias, 'Foreign Direct Investment: Good Cholesterol?' *Inter-American Development Bank* 2000, Working Paper No. 417 (Washington)

<sup>57</sup> Buckley P.J. and M.C. Casson, *The Future of Multinational Enterprise* op. cit., p. 8

One of the requirements for economic development in a low-income economy is an increase in the nation's stock of capital. A developing nation may increase the amount of capital in the domestic economy by encouraging FDI. This is because foreign direct investment occurs when foreign firms either locate production plants in the domestic economy or acquire a substantial ownership position in a domestic firm.

Besides, foreign direct investment may encourage economic growth in the short run by increasing aggregate demand in the host economy. In the long run, the increase in the stock of capital raises the productivity of labor and leads to higher incomes then further increases in aggregate demand.

FDI has become an important developmental tool for counties. Large transnational corporations have billions of dollars to invest in countries, which can provide needed services and capabilities. Foreign direct investment once attracted is a substantially more stable form of funding than either development assistance (aid) or loans. This should lead developing countries to favor foreign direct investment over other types of capital flows. Additionally, foreign direct investment appears to facilitate a one for one increase in domestic investment.<sup>58</sup> The significance of FDI in structuring the world economy can be seen by the fact that the gross product associated with FDI investments has been rising faster than global GDP and global exports. The gross product associated with FDI related production is one tenth of global GDP in 1999 compared to one twentieth in 1982. Sales revenue from FDI related foreign affiliates were 14 trillion US dollars in 1999 compared to 3 trillion in 1980. This figure is nearly double that of all global exports.

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<sup>58</sup> Grossman Gene and Elhanan Helpman, *Innovation and Growth in the Global Economy* (Cambridge, MA: MIT Press, 1991) p. 6

## **FDI: Technology Transfer and Environment**

Another long-run impact, however, comes through technology transfer, the transfer of technological knowledge from industrial to developing economies. Many economists argue that this transfer of technology may be the primary benefit of foreign direct investment since it results in the adoption of more efficient production techniques than would have been adopted in the absence of foreign investment.

However, the biggest hindrance to the successful technological development of enterprises is the quality of manpower. Enterprises in developing countries seem to have inappropriate personnel. Their educational level is low, they join the enterprises without any technical training, and whatever they learn is from the workers who have already been working there. So hardly any improvement takes place in their quality, and their absorption and analytical capacity.<sup>59</sup>

Similarly, environmentalists are concerned that the growth of foreign direct investment in developing economies may lead to a deterioration in the global environment since investment is expanding more rapidly in countries that have relatively lax environmental standards. Therefore the absence of restrictive environmental standards is one of the reasons for the relatively high rate of return on capital investment in less developed economies.

Zarsky (1999) identifies four key aspects of the FDI-environment relationship. Regarding environmental effects of private international finance, FDI may generate both risks and opportunities for the environment, depending on the circumstances. On the one hand, FDI can generate new growth and new structural efficiencies, making larger

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<sup>59</sup> Kumar Nagesh, *Globalization, Foreign Direct Investment and Technology Transfers: Impacts on and Prospects for Developing Countries* (London and New York: Routledge, 1998) p. 81

investments in environmental protection possible. But it may also lead to increased production and consumption of polluting goods, or to expanded industrial activity (and thus, to increased emissions).<sup>60</sup>

Concerning the environmental effects of FDI-based technology development and diffusion, Blomström (1989) argues that foreign investors may bring modern technologies that represent environmental improvements over what is currently available in the country in which they are investing. Thus, FDI-based economic expansion may offer the prospect of significant technology-based environmental improvements.<sup>61</sup>

The impact of environmental standards on investment decisions by the firm is also examined. A key question here is whether or not higher environmental standards lead firms located in "high-standard"<sup>62</sup> countries to move to jurisdictions with lower environmental standards, that is to pollution havens. Plant relocations may be the result of the higher costs associated with more stringent environmental standards, or they may simply be the result of other cost/quality advantages offered by the host location.

Lastly, an assessment of the environmental effects of international competition for FDI exhibits the fear that some jurisdictions will use lower environmental standards as a way of attracting new FDI. Countries could either lower their standards intentionally, or they could resist increasing their standards, in order to gain a competitive advantage.

It is not always easy to distinguish between the separate environmental effects of domestic economic activity and the activities of foreign affiliates. The marginal environmental effects of FDI, both positive and negative, will always be significant in

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<sup>60</sup> Zarsky Lyuba, 'Havens, Halos and Spaghetti: Untangling the Relationship Between FDI and the Environment' in OECD, *Foreign Direct Investment and the Environment* (Paris: OECD, 1999)

<sup>61</sup> Blomström Magnus, *Foreign Investment and Spillovers: A Study of Technology Transfer to Mexico* (London: Routledge, 1989) p. 92

<sup>62</sup> Countries with stringent environmental standards

some countries, but not in others. The internationalization of capital markets, the internationalization of production processes through FDI, and the increasing importance of multinational corporations may each generate significant consequences for the environmental characteristics of production and for technologies. Pearson argues that FDI undertaken by multinationals will result in some standardization of technologies across countries.<sup>63</sup>

The presence of multinationals can also have positive spillover effects on the technological characteristics of national firms. Local firms may try to imitate multinationals' technological practices ("reverse engineering"), depending on the stringency of the intellectual property rights regime.<sup>64</sup> Spillovers also arise as local firms employ staff previously employed by the multinationals, thereby gaining access to expertise which may not be readily available locally, particularly if the multinationals have strong training programmes for their staff. The presence of FDIs appears to generate technological spillovers amongst supplier industries as well. By demanding particular quality standards, and then providing the technical assistance needed to meet these standards, multinationals can help upstream industries improve their technological efficiency.<sup>65</sup>

### **Employment**

Multinational enterprises create employment in the host country. For example in China, the number of people directly employed in the Coca-Cola system is estimated to be 14,046. This includes permanent and temporary, skilled and unskilled workers. More than

<sup>63</sup> Jha, Markandya & Vossenaar, *Reconciling Trade and the Environment: Lessons From Case Studies in Developing Countries* (UK: Elgar, 1999) p. 261

<sup>64</sup> Esty D.C. & Geradin D., 'Environmental Protection and International Competitiveness' 1998 Vol 32 Issue 5 *Journal of World Trade* pp. 5-46:9

<sup>65</sup> Nordström H. and S. Vaughan, *Trade and Environment: Special Studies* (Geneva: World Trade Organization, 1999) p. 58

62 percent were skilled workers who usually got permanent jobs. Moreover, through Coca-Cola's supplier (upstream) linkages, total employment supported by the bottling system was about 350,000. Coca-Cola also participates in self employment via Retail and wholesale trade ventures that sell Coca-Cola products. These ventures prosper and affect the economy according to the margins charged on traded goods. It is estimated that the sale of Coca-Cola products in China supports at least 50,000 jobs in the wholesale and retail sectors.<sup>66</sup>

Nevertheless, the involvement of FDIs in employment implications in the host country has long been a source of controversy in developing countries. A common ground for attack on FDIs involved in import-substitution production is that the technology introduced by them is highly capital intensive, and therefore tends to reduce the employment potential of industrialization.<sup>67</sup>

Besides, the FDIs' stock of knowledge-based assets function as a magnet to attract the local labor and capital to the FDIs' sector and to discourage them from seeking employment in the national sector. This has the chilling effect on the total employment of labor considering the relatively capital-intensive FDIs sector and the relatively labor-intensive national sector. That is, even if the FDIs employ a massive number of workers, they also contribute to a shrinking in employment in the national sector by attracting capital away from the indigenous industries. In tandem, the expansion of the FDIs sector and the contraction of the national sector cause the employment to plummet. It is also alleged that MNEs pay abnormally high wages to local workers leading to further

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<sup>66</sup> The Moore School, *The Economic Impact of Coca-Cola in China* (Columbia: University of South Carolina, 2000) P. 3

<sup>67</sup> De Mello L.R. Jr., 'Foreign Direct Investment in Developing Countries: A Selective Survey' *The Journal of Development Studies*, 1997, Vol. 34, No. 1, pp 1-34:29

intensification of the overall capital intensity bias in industry and unequitable distribution of gains from industrialization.

While global sourcing activities of FDIs may generate new jobs in host countries, there are some untoward effects of MNE participation in export-oriented industries which lead to unequal distribution of gains from such activities between host and home countries. One such alleged adverse effect relates to the perceived tendency of export-oriented FDIs to restrain real wage growth in a given production location compared to their import-substituting (domestic-market oriented) counterparts and indigenous firms. Export-oriented MNE affiliates in developing countries, because of their use of labour intensive production techniques, tend to be more sensitive to changes in the wage bill and expectations about relative wage cost of producing in different locations. Furthermore, they have the flexibility to transfer production facilities from one country to another in response to changing labour market conditions, in sharp contrast to the difficulties of such a move for the import-substitution MNEs which are essentially 'location bound'.<sup>68</sup> The two factors, the greater sensitivity to wage changes and the prowess in labour relations emanating from the ability to relocate production, make the demand for labour by export-oriented MNEs more elastic and more resistant to workers' wage demand. Thus, under given labour supply conditions, workers employed in these ventures are likely to experience slower real wage growth compared to their counterparts in domestic-market oriented MNE affiliates and indigenous firms.

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<sup>68</sup> Caves Richard E., *Multinational Enterprise and Economic Analysis* (Cambridge: Cambridge University Press, 1996) p. 132

## **Corporate Social Responsibility**

Corporate Social Responsibility is the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and society at large. One thing that is for sure - the pressure on business to play a role in social issues will continue to grow. Over the last ten years, those institutions which have grown in power and influence have been those which can operate effectively within a global sphere of operations. Those institutions which are predominantly tied to the nation state have been finding themselves increasingly frustrated at their lack of ability to shape and manage events. These include national governments, police, judiciary and others. There is a growing interest, therefore, in businesses taking a lead in addressing those issues in which they have an interest where national government have failed to come up with a solution. That is not to say businesses will necessarily provide the answers - but awareness is growing that they are occasionally better placed to do so than any other actors taking an interest.

Coca-Cola is conscious of its social responsibility and for many years has been supporting countless activities in the social sector. The Coca-Cola Africa Foundation was launched in February 2001 in Swaziland, to manage and fund community initiatives within Africa. It concentrates its resources on key issues affecting the well being of Africans, focusing primarily on the areas of healthcare, education and the environment. The Coca-Cola Africa Foundation is a direct result of the policies of the Coca-Cola Company to reaffirm its long-term commitment to the people of Africa and to bring decision-making about our philanthropic and corporate citizenship programmes closer to the communities



that are being helped.<sup>69</sup> A recent project in Western Kenya saw the Coca-Cola region team, bottling partners and German Technical Cooperation (GTZ), collaborate in the sourcing, transportation and placement of 'containers' converted into rural health information centers for the dissemination of information on HIV and AIDS in rural, hard-to-reach districts.<sup>70</sup>

Working in partnership with the National AIDS Control Council (NACC), Coca-Cola Africa is currently at the forefront of a nation-wide communication campaign in Kenya. The thrust of the campaign is to spread a message of hope – that individuals have a choice, and that by taking responsibility for their behaviour, they can make a difference in the lives of their loved ones. The Coca-Cola Africa Foundation has donated radio airtime, billboards and research expertise to support the campaign.<sup>71</sup>

## Revenue

The country gains some wealth by way of taxes. In 1996, the total revenues of the 500 largest companies globally (including Coca-Cola) were \$11.4 trillion, total profits were \$404 billion, total assets were \$33.3 trillion, and the total number of employees was 35,517,692. The top ten companies accounted for 11.7% of the total revenues of the top 500, 15% of profits, and 13.6% of employment, according to Fortune Magazine. These revenues and profits engender tax revenues that enhance the economic growth of the host country.

The problem however arises when such multinational enterprises demand for tax concessions and subsidies. Most of the time, such enterprises evade taxes by overpricing inputs transferred from another subsidiary and under pricing outputs sold by the enterprise to another country. Large-scale flows of FDI also have effects on other domestic economic

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<sup>69</sup> 'Coca-Cola Africa' available at [www.africa.coca-cola.com/ccacms/cca/ourBusiness/files/The\\_Coca-Cola\\_Africa\\_Story.pdf](http://www.africa.coca-cola.com/ccacms/cca/ourBusiness/files/The_Coca-Cola_Africa_Story.pdf)

<sup>70</sup> The Daily Nation, 'Coca-Cola Leads Team to Rejuvenate Health' June 20, 2006 p. 11

<sup>71</sup> The Standard, 'The Private Sector in AIDS Campaign' December 16, 2005 p. 8

policies. To begin with, reliance on such flows imposes severe constraints on domestic government policy because of the fear of withdrawal, and of course the potential impact of disinvestment increases as the FDI stock grows. Further, FDI is embodied in the presence of multinational corporations (MNCs) which tend to be large and powerful lobbies in the matter of domestic policies.<sup>72</sup>

Moreover, the very competition to attract more FDI by governments with over-optimistic expectations regarding such investment, means that all sorts of concessions are offered, which may turn out to be very expensive for the economy in the medium or long term. Some scholars suggest that such FDI promotion tends to focus heavily on the demand side, in terms of requirements imposed on host countries which involve changing their own policies in order to make themselves more attractive. Such unilateral concessions are increasingly sought to be entrenched through international agreements.<sup>73</sup>

MNEs can contribute to the underlying fragility of an economy and make it more susceptible to balance of payments crises. This can happen in several ways. First, as rapidly growing stocks of inward FDI generate similarly growing profits that form part of the foreign exchange outflow. Secondly, when FDI fuels an increase in imports, such as capital goods for investment projects and other such payments. Thirdly, because current foreign exchange costs of MNEs typically exceed the foreign exchange they tend to earn through exports of import substitution. Fourthly, through the role played by foreign affiliates, including those involved in retailing, in changing patterns of consumption through advertising and brand promotion.

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<sup>72</sup> Theodore H. Moran, *Harnessing Foreign Direct Investment for Development: Policies for Developed and Developing Countries* (Washington D.C.: Centre for Global Development, 2006) p. 91

<sup>73</sup> Charles W. Hill, *International Business: Competing in the Global Marketplace* op. cit, p. 75

Repatriation of profits to the parent company is in most cases essential in order to contribute to overhead costs incurred at headquarters (e.g. for research and development) as well as to corporate profits as repayment for financial risks. Host countries often consider this a regrettable drain on limited foreign exchange and a burden on the balance of payments. When MNEs repatriate profits and restrict exports by a subsidiary when they undercut the market of the parent company, they worsen a country's balance of payments.<sup>74</sup>

Foreign exchange effects of FDI are often simplistically assumed to be positive. In actual fact, the foreign exchange effects are much more negative than what emerges from an idealized view of FDI. Positive effects arise only where new productive capacity is created in the export sector, or in very strongly import-substituting sectors. If FDI takes the form of purchase of existing capacity, even in the export sector it will have a negative foreign exchange effect even if export production goes up, unless the productivity of capital increases enough to offset the other increased foreign exchange costs. At lower levels of import substitution, the effects of FDI on new capacity are much more ambiguous, and may be negative.<sup>75</sup>

### **Training, Research and Development**

Some training is usually necessary when FDIs hire the workforce locally. This training range from on-the-job training to seminars and more formal education locally or abroad, perhaps at the parent company. The instruction depends on the skills needed and the level of employment. Furthermore, working in an FDI affiliate might generate valuable experience for the locals. Skills vary from technological know-how to quality controls,

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<sup>74</sup> Dunning John, *The Globalization of Business* (London: Routledge, 1993) p. 38

<sup>75</sup> *Ibid.*, p. 27

marketing and management. The beneficial spillovers to the host economy take place as the employees move to other firms, or set up their own businesses. The low educational level of the persons entering the workforce makes it very difficult to train and upgrade them. They lack the necessary analytical skills to absorb and master the technology. Even when they have the educational level, the environment does not require them to continuously upgrade their skills. Therefore, recipients of FDI often gain employee training in the course of operating the new businesses, which contributes to human capital development in the host country.

For example Coca-Cola recognizes the critical importance of localizing marketing expertise in Kenya. In turn, the Company has trained tens of thousands of Kenyans in its world-renowned marketing methods. Training extends to the wholesalers and retailers of Coca-Cola products, not just the Company's own sales force. For example, in Kisumu, Coca-Cola provides sales training for pushcart vendors. Beyond the training that Coca-Cola provides to Kenyans who are associated with the production and marketing of Coca-Cola products, the Coca-Cola system contributes more broadly to the development of Kenya's workforce.<sup>76</sup>

Modern theories of economic growth starting with Romer (1990), Grossman and Helpman (1991), and Aghion and Howitt (1992, 1998) emphasize that the accumulation of knowledge through scientific research and its application to production of goods and services is the engine of long-run growth. Foreign direct investment in research and development can help countries strengthen their innovation capabilities, enabling them to perform more demanding functions, handle more advanced equipment and make more

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<sup>76</sup> Pendergrast Mark, *For God, Country and Coca-Cola* (New York: Charles Scribner's Sons, 1993) p. 46

complex products, the report suggests. But these benefits do not accrue automatically. Transnational corporations are internationalizing more than their production activities these days - they are shifting an increasing proportion of their research and development to selected developing countries.<sup>77</sup> The internationalization of R&D is opening up new opportunities for investment and jobs, but that seizing these opportunities requires appropriate policies at both the national and international levels.

In Kenya, academic institutions suffer from a lack of resources. When the resource is in short supply, the first thing that comes under the budgetary axe is research. Even the meager resources they get, they spend in “fundamental” research, which have very little connection with the actual world and spread it across a wide range of areas. We often find the so-called researchers working on projects without knowing what they are actually looking for. This kills research and development that can improve MNEs.

### **FDI and strength of Host**

Hausmann and Fernández-Arias (2000) argue that a high share of FDI in total capital inflows is a sign of a host country's weakness rather than its strength.<sup>78</sup> One striking feature of FDI flows is that their share in total inflows is higher in riskier countries, with risk measured either by countries' credit ratings for sovereign (government) debt or by other indicators of country risk. Besides, the share of FDI is higher in countries where the quality of institutions is lower.

One explanation for these paradoxical results is that FDI is more likely than other forms of capital flows to take place in countries with missing or inefficient markets. In such settings, foreign investors will prefer to operate directly instead of relying on local

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<sup>77</sup> UNCTAD, *World Investment Report 2005: Transnational Corporations and the Internationalization of Research and Development* (UK: UNCTAD, 2005) p. 305

<sup>78</sup> Ricardo Hausmann and Eduardo Fernández-Arias, 'Foreign Direct Investment: Good Cholesterol?' op. cit., p. 12

financial markets, suppliers, or legal arrangements. The policy implications of this view, according to Albuquerque (2000), are that countries trying to expand their access to international capital markets should concentrate on developing credible enforcement mechanisms instead of trying to get more FDI.<sup>79</sup>

In a similar vein, Hausmann and Fernández-Arias (2000) suggest that countries should concentrate on improving the environment for investment and the functioning of markets. They are likely to be rewarded with increasingly efficient overall investment as well as with more capital inflows. Although it is very likely that FDI is higher, as a share of capital inflows, where domestic policies and institutions are weak, this cannot be regarded as a criticism of FDI per se.<sup>80</sup> Indeed, without it, the host countries could well be much poorer. They argue that FDI is not only a transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms—that is, it is a corporate governance mechanism. The transfer of control may not always benefit the host country because of the circumstances under which it occurs, problems of adverse selection, or excessive leverage.

Sometimes the transfer of control occurs in the midst of a crisis and asks whether the transfer of control that is associated with foreign ownership appropriate under these circumstances. Even outside of such fire-sale situations, FDI may not necessarily benefit the host country. Through FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This gives them an informational advantage

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<sup>79</sup> Albuquerque Rui, 'The Composition of International Capital Flows: Risk Sharing through Foreign Direct Investment' *Bradley Policy Research Center Working Paper No. FR 00-08* (Rochester, New York: University of Rochester) p. 38

<sup>80</sup> Ricardo Hausmann and Eduardo Fernández-Arias, 'Foreign Direct Investment: Good Cholesterol?' *op. cit.*, p. 5

over "uninformed" domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high-productivity firms under their ownership and control and sell low-productivity firms to the uninformed savers. As with other adverse-selection problems of this kind, this process may lead to overinvestment by foreign direct investors.

Excessive leverage can also limit the benefits of FDI. Typically, the domestic investment undertaken by FDI establishments is heavily leveraged owing to borrowing in the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by foreign-owned firms.

### **Conclusion**

Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on developing host countries. But recent work also points to some potential risks: it can be reversed through financial transactions; it can be excessive owing to adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. Though the empirical relevance of some of these sources of risk remains to be demonstrated, the potential risks do appear to make a case for taking a nuanced view of the likely effects of FDI. Policy recommendations for developing countries should focus on improving the investment climate for all kinds of capital, domestic as well as foreign.

## CHAPTER THREE

### FOREIGN DIRECT INVESTMENT POLICY IN RWANDA AND TANZANIA

#### Introduction

The main objective of this chapter is to examine the different FDI policy orientations adopted by Rwanda and Tanzania. This will lay a basis for a comparative analysis of the policies of the two countries in the subsequent chapter. The main components of this chapter include an overview of the countries as in their geographic location, administrative and other major effects of the countries in question. Then, the economic relations of the two countries with their trading partners are established. Finally, the chapter uses government documents and their websites, sessional papers, development plans and policy documents of the two countries to identify FDI policies that are exhorted in these countries. The issues that are of interest in this section include taxation, investment incentives, laws on privatizations, legal reforms, land law, the strength of the judiciary and the state of corruption, bureaucracy and cross border issues in Tanzania and Rwanda. The chapter begins with the situation in Rwanda and then tackles the one in Tanzania.

#### Background on Rwanda

Rwanda is a small landlocked country (of approximately 27,000 km<sup>2</sup>) located in East/Central Africa. It is bordered by four countries; to the west by the Democratic Republic of the Congo, to the East by Tanzania, to the South by Burundi and to the North by Uganda. Rwanda's frontier with the DRC is dominated by Lake Kivu which is shared by both countries. Located on the Great Rift Valley system the countries physical geography is distinguished by its hilly fertile grasslands which have been settled for



agriculture and the Virunga Mountains; a chain of volcanoes including Mount Nyiragongo on the northern frontier with the Congo.<sup>81</sup>

Rwanda's administrative and economic capital is Kigali which has a population of nearly 900,000 however Rwanda remains overwhelmingly rural; up to 90% of its population lives on the land in subsistence agriculture. The major languages spoken in the country are Kinyarwanda, English and French and the legal system is based on Belgian law and the constitution of 2003. As of 1<sup>st</sup> January 2006 the country is divided into five administrative provinces and thirty districts.

By African standards, Rwanda is relatively homogenous. Although the Hutu, Twa and Tutsi share a common language and culture, the pivotal event of the last two decades of Rwandese history was the 1994 genocide, an unprecedented one hundred day ethnic massacre (of Rwanda's Tutsis and moderate Hutus), which decimated much of its human and physical capital.<sup>82</sup> Much progress has been made in terms of reconstruction and reconciliation but the country continues to grapple with the after effects of the genocide and the mass displacements of the population both within and outside Rwanda's borders that were its direct consequence.

The 1994 Genocide was brought to an end by the overthrow of the Rwandese government of the time by the Rwandese Patriotic Front led by Paul Kagame. Following the Genocide, Rwanda was governed until 2003 based on the 1991 constitution and the Arusha accords. A coalition consisting of the signatories to the Arusha accords, governed the 'Transitional Government'.

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<sup>81</sup> Central Intelligence Agency, *Press Release: CIA World Factbook 2007* (USA: CIA, 2007) p. 11

<sup>82</sup> Gérard Prunier, *The Rwanda Crisis: History of a Genocide* (London, C. Hurst & Co. Ltd, 1995) p. 329

## The Economy and Economic Relations of Rwanda

Rwanda is an LDC ranked as 158 on the UNDP's human development index.<sup>83</sup> Moreover Rwanda is a post-conflict landlocked state. Thus it cumulates three major economic handicaps which together with its low levels of human development and its relative distance from the sea have proved to be strong constraints on growth, development and to participation in international trade as is the case with many other low income countries. Rwanda is also relatively resource poor; not having significant reserves of exploitable minerals with the exception of coltan.<sup>84</sup> Its economy is small and undiversified depending for foreign exchange on two major cash crops; tea and coffee. Finally until the late 1980's Rwanda operated a relatively closed *dirigiste*<sup>85</sup> economy; much of the small secondary sector of the economy was in state control, land was difficult to acquire and the laws governing such transactions were unclear and outside investment was not actively encouraged.

As a consequence Rwanda has historically been much less open to trade than other neighboring countries. The economic disorganization that ensued in the wake of the genocide created opportunities for far reaching reform to the structure of the Rwandese economy. Market oriented reforms began in earnest with the RPF governments, in particular after the initial phase of economic stabilization and reconstruction subsequent to the Civil War. The Rwandese government has pursued a range of legal and institutional reforms, such as Land reforms, aimed at improving the investment climate.<sup>86</sup>

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<sup>83</sup> United Nations Development Program, *Tanzania Human Development Report - 2006* (Kigali: United Nations Development Program, 2005) p. 6

<sup>84</sup> The World Bank, *Rwanda Country Assistance Strategy 2002-2005* (Washington D.C. World Bank Africa Region, 2001) p. 43

<sup>85</sup> State controlled

<sup>86</sup> Corporate Author, *Rwanda Business Law Handbook 3<sup>rd</sup> ed.* (USA: USA International Business, 2007) p. 54

As a landlocked country, Rwanda's competitiveness is to an important extent dependent on the quality of the management of the infrastructure of neighboring countries. Rwandese trade outside Africa transits through the Northern Corridor (Kigali-Kampala-Mombasa) and the Central Corridor (Kigali-Dar-es-Salaam). Although in theory offering comparable and competing rail and road connectivity the Northern Corridor has led in terms of market share as not all portions of the Kigali to Dar-es-Salaam road have been tarmacked. However this is expected to change as this highway is being upgraded in 2007/8. Up to 57% of Rwandese trade transits through Mombasa which implies a trip from source to ship of 1800km.<sup>87</sup>

Given the high costs and delays associated with transiting goods via Kenya and Uganda, Rwanda's ability to trade is determined to a large extent by factors out of its control. The recent accession of Rwanda to the East African Community (EAC) reflects the strategic importance Rwandan policy-makers have placed on regional integration. Rwanda is also a member of the Common Market for Eastern and Southern Africa (COMESA), and the Economic Community of the Great Lakes (CEPGL). As a member of the African Caribbean and Pacific Group, Rwanda enjoys preferential access of its exports to the EU. However as an LDC Rwanda should be able to export to Europe under the Everything But Arms (EBA) provision, duty free for most of its exports. The EBA Initiative is based on the generalized system of preferences and therefore is compliant with the WTO rulings which have led to the phase out of the preferential system of trading that ACP countries 'enjoyed'. In addition Rwanda qualifies for duty free access for its exports to the United States under the African Growth and Opportunity Act (AGOA).

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<sup>87</sup> Ibid., p. 61

## Trade and Investment Policies in Rwanda

### *Investment Climate*

In general Rwanda has received praise for the quality of its economic management. Rwanda has been undertaking extensive policy and structural reforms; in particular these reforms have aimed at liberalizing the economy. Overall economic policy in the period under consideration has been guided by two Poverty Reduction Strategy Papers (PRSP), including the 1997 Interim PRSP which set targets for annual growth at 7-8% while quickening the pace of economic and social development over the medium term in line with Rwanda's 2020 Vision. The PRSPs identify private sector development and trade diversification and expansion as top priorities for Rwanda and to this effect six priority areas in which Rwanda has or could have a comparative advantage have been identified.

- Agro-processing
- Manufacture of garments
- Tourism
- Information and Communications Technology Services
- Mining
- Human Resources<sup>88</sup>

In addition the Rwandese authorities established a one stop shop investment authority 'the Rwanda Investment and Export Promotion Agency' in 1998 to promote and facilitate investment from overseas. A National Privatization Commission has been created to coordinate divestitures. Like many of its neighbors the Rwandese government has also established a joint private sector/ government forum, the Private Sector Federation. Reforms in the financial sector have also been undertaken since Rwanda's financial system was in a crisis after the Genocide.<sup>89</sup>

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<sup>88</sup> Republic of Rwanda, *Poverty Reduction Strategy Paper: National Poverty Reduction Programme* (Kigali: Ministry of Finance, 2002) p. 71

<sup>89</sup> United Nations Conference on Trade and Development & International Chamber of Commerce, *Investment Guide to Rwanda – 2006* (Geneva: United Nations, 2006) p. 25

Other reforms include the establishment of a Commercial Court system which hitherto did not exist in Rwanda, however this court is still in the process of creation along with other reforms to the Rwandese Judicial System.

### *Taxation*

Rwanda's taxation authority is the Rwanda Revenue Authority which was established in 1997 as an autonomous and unified revenue authority structured along the lines of other revenue authorities in the other East African countries. The two main categories of taxation for which it is responsible are direct and indirect taxation<sup>90</sup>. The direct taxes consist of;

- Corporation taxes: for which the taxable profits of registered companies are liable at 35%
- A tax on self employed persons based on turnover/income.
- For any individual or firm with an income above RFr 36 million a turnover tax of 4% is also charged.
- A pay as you earn income tax (PAYE) exists for salaried persons.
- A withholding tax on loans and a tax on the profit ( including interest) of loans made to non-residents by firms based in Rwanda at 20%

The major indirect taxes are

- VAT which is in the middle range of the EAC (15%(Uganda)-20%(Tanzania) at 18%
- A number of excises which are as high as 70% on spirits
- Import duties:<sup>91</sup>

**Table 3: Rwanda's Tariff Structure**

<b>Goods</b>	<b>Rates</b>
Finished Goods	30%
Semi-Finished Goods	15%
Raw Materials	5%
Capital Goods	0%

Sources: Rwanda Revenue Authority

<sup>90</sup> Rwandan Revenue Authority available online at <http://www.rra.gov.rw/>

<sup>91</sup> Ibid.

For goods qualifying under the COMESA/FTA Rules of Origin in theory as of 1<sup>st</sup> January 2004 all categories of goods from COMESA/FTA countries are zero rated.

Rwanda has been moving to bring its trade taxes in line with those of neighboring states in the COMESA and East African Community. To this effect it adopted a four band tariff structure consistent with the COMESA Common External Tariff (CET) in 2002/2003 which at present consists of an upper band on finished goods of 30% an upper intermediate band of 15% on semi-finished goods, a lower intermediate band of 5% on raw materials and 0% on capital goods. It is expected that as Rwanda enters the EAC/ Customs Union it will have to align its trade tariffs structure to the EAC CET which has three bands and with the top band at 25%. The burden of taxation in Rwanda is however perceived to be high, according to a survey by the International Finance Corporation, investors view the effective tax burden (which comprises the rates, the costs of administration and exemptions) as being heavy and uncompetitive. The tax burden may be encouraging comparatively high levels of informality and tax evasion and discouraging investment.<sup>92</sup>

#### *Investment Incentives*

The Rwanda Investment and Export Promotion Agency was established pursuant to the Investment Promotion Law of 1998, the stated goals of the RIEPA are to promote the investment opportunities of Rwanda, to act as a one stop shop for prospective investors and to facilitate business development i.e. through the Free Economic Export Zones.<sup>93</sup>

An Investment Code was promulgated in 2005, regulating investment incentives. The RIEPA has responsibility for coordinating the investor incentive scheme under this law. The Code provides for such inducements to investors as taxation allowances on

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<sup>92</sup> World Bank, *Rwanda Mini Diagnostic of the Investment Climate* (Washington D.C.: World Bank, 2005) p. 209

<sup>93</sup> USIB, *Rwanda Investment & Business Guide* (USA: USA International Business Publications, 2005) p. 3

business assets of up to fifty percent for qualifying firms. Training and research expenditures are tax deductible and qualifying investors can also benefit from the zero rating of corporation tax on profits. The Investment Code also provides for the repatriation of profits tax free. Moreover profit taxes are discounted on the basis of the level of employment of Rwandese nationals. Exporters also receive significant tax concessions e.g. if an exporter exports goods worth more than 3 million USD that exporter qualifies for a discount of 3% on all taxes. In addition exporters (defined as manufacturers or traders exporting at least 80% of their stock) benefit from the incentives and facilities associated with the Free Enterprise Zones which are defined in the Act. Specifically the law recognizes three types of FEZ's as follows from this excerpt of the Rwandan Investment Code (Law No. 26/2005) of 17/3/2005;

*“Free economic zone” means an area designated by the competent authority where goods and services are imported free of duties. Free international economic zone consists the following activities:*

*“Export commodity processing zone or EPZ” means a clearly geographically demarcated industrial zone where imported or locally produced machinery, equipment, goods and services are imported free of duty and utilized in producing new goods with at least eighty percent (80%) of those goods exported and twenty percent (20%) sold locally after paying the necessary duties and taxes;*

*“Free trade zone or FTZ” means a geographically demarcated area into which goods and services are imported free of duties and taxes with at least eighty percent (80%) of those goods and services sold for re-export while twenty percent (20%) are sold locally after paying all the necessary duties and taxes;*

*“Single enterprise considered as export processing zone or SEEPZ” means an industry because of its nature or production factors located outside a geographically demarcated zone, where imported and locally produced machinery, equipment, goods and services are imported free of duties and utilized in producing new goods of which eighty (80%) of those goods and services are exported while twenty (20%) are sold locally after paying all the necessary duties and taxes;”<sup>94</sup>*

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<sup>94</sup> Rwandan Investment Code (Law No. 26/2005) of 17/3/2005

**Table 4: Summary of Fiscal Incentives for Investors in Free Zones**

Corporate Tax	FZ companies pay 0% + up to 7% tax rebate based on local employment + export subsidy of up to 5% based on export value
Other Taxes	FZ companies are VAT exempt
Accelerated Depreciation	40% investment on 1 years investment
R&D Training and Incentives	100% tax write off
Imports	0% duty + VAT exemption
Sales to Domestic Market	FZ firms can sell a maximum of 20% of output domestically
Other	Exemption of withholding tax and full repatriation of profits

Source: Investment Guide for Rwanda, International Chamber of Commerce

The RIEPA has developed plans for the creation of a Free Economic Zone in Kigali. In general the Investment Code provides for tax exemptions and liberalizes the import of equipment and skilled personnel by potential investors as is now common practice with other such investment promotion systems in Africa. It also provides special incentives to investors seeking to use Rwanda as a base for exports or re-exports.<sup>95</sup>

#### *Privatizations*

Since the adoption of the Privatization Law in 1996 the Rwandan government has liquidated or fully divested itself from many previously fully or partly publically owned companies particularly in the Agro-industrial sector. By December 2005, thirty six companies of various sizes had been fully or partially divested most notably the former state owned utility Rwandatel (2005), and the Rwandese Commercial Bank (2004).

These privatizations represent a significant chunk of the state holdings of productive assets and reflect the overall liberalization of the Rwandese economy since 1994. In particular the government has reduced the scope of its intervention in the key sectors of the economy by privatizing the tea and coffee estates and factories and

<sup>95</sup> USIB, *Rwanda Investment & Business Guide* op. cit., p. 3



restructuring (Office du Thé) OCIR-Thé and the (Office du Café) OCIR-Café the former state controlled commodities boards for tea and coffee into regulatory agencies for these sectors.<sup>96</sup>

### *Other Legal Reforms*

Basic labour relations are governed by the Labour Code of 2001 and the Ministerial Orders No.05/19 and 13/19 of March 2003 on overtime rates and conditions of employment of expatriates, other aspects of labour relations are governed by various amendments to prior legislation. Other legal reforms that are under consideration include reforms to the Income Tax and Customs Laws. A Business Law Reform Commission was established with the mandate to consider laws and regulations affecting business operations in Rwanda and to make recommendations. Already it is expected that substantial amendments to the Trade Marks and Companies Acts which are regarded as obsolete will be underway.<sup>97</sup>

### *Land Law*

Land disputes have been common and a source of disorder in Rwanda. This in part stems from the historical lack of clarity of land tenure and the applicable laws governing tenure. Moreover land is a scarce resource in Rwanda. The land laws of Rwanda establish a single system of land tenure in Rwanda while vesting ownership of land in the State. The right to use and dispose of land is granted to the occupant of the land who acquired that land through legal channels.<sup>98</sup> In theory land can be traded freely or used as collateral but many of the supporting institutions are not in place, given the recentness of the law. Foreign investors can obtain land by applying through the RIEPA. The ease of obtaining

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<sup>96</sup> Hirschey M., *Privatization: Financial Perspectives* (USA: University of Kansas School of Business, 2005) p. 40

<sup>98</sup> Land Law No. 08/2005 of 14/07/2005

title for land is generally viewed as a point in favour of Rwanda as an investment destination especially in comparison to its neighbors.

### *Judiciary*

The Rwandan judicial system is seen as transparent but inefficient. The Judiciary still lacks the capacity to administer commercial law and as has been pointed out the body of commercial laws in force in Rwanda is often obsolete to modern requirements. However Rwanda gets relatively high marks for the time of contract enforcement as well as the ease of starting a business by comparison with its neighbors. Its legal protection for borrowers and lenders is rated particularly poorly even by comparison with its neighbors perhaps because the commercial court system is not yet in place. This combination of factors, that is, weak judicial capacity, obsolete laws and poor legal protection for financial transactions may be undermining the development of the financial system. The government has reacted by reorganizing the judiciary creating new courts with specialists commercial chambers at the First Instance and a Commercial Division in the High Court and moving to reform and reduce administrative and legal procedures associated with starting up and running businesses as well as authorizing new notaries.

### *Corruption, Bureaucracy & Cross Border Issues*

Corruption has not generally been reported as a major constraint on business operations. Corruption does not appear to be endemic in Rwanda's Public Services in contrast to the situation in many neighboring states. However individual reports of corruption are frequently reported in the World Bank's '*Doing Business in Africa*' surveys. According to this report, Rwanda is particularly disadvantaged in terms of its prospects for overseas trade. The bureaucratic burdens of both importing into and exporting from Rwanda are considerably higher than the regional averages. Moreover the

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costs in terms of time and money are far higher. This makes Rwanda relatively closed to trade and uncompetitive in terms of manufactured exports. Moreover Rwanda is highly import-dependent, paradoxically this may signal scope for opportunities in import substitution especially for consumer goods.<sup>99</sup>

**Table 5: Costs of Cross Border Trade**

Indicator	Rwanda	Region	OECD
Documents for Export (number)	14	8.2	4.8
Time for Export (Days)	60	40	10.5
Cost to Export (US\$ per container)	3,840	1,561	811
Documents for Import (Number)	20	12.2	5.9
Time for Imports (Days)	95	51.5	12.2
Cost to Import (US\$ per container)	4,080	1,947	883

### **Background to Tanzania**

Tanzania is the largest and most populous country in East Africa. It shares borders with Kenya and Uganda to the North, Mozambique, Malawi and Zambia to the South, Burundi, Rwanda and the Democratic Republic of Congo (DRC) to the East. It also enjoys one of the longest coastlines in Africa with the Indian Ocean and a diverse and rich natural resource base. Mt Kilimanjaro which is Africa's highest peak, the Ngorongoro Crater, the Serengeti and Selous Game Reserves are just a few examples of its exceptional endowments. Moreover its large size and low population densities have encouraged the State to protect these resources and nearly a quarter of its land, some 945,000 km<sup>2</sup> is under

<sup>99</sup> World Bank, *Doing Business in Africa* (Washington D.C.: World Bank, 2007) p. 207

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<sup>99</sup> World Bank, *Doing Business in Africa* (Washington D.C.: World Bank, 2007) p. 207

some form of protection such as a Nature Reserve or a National Park. Tanzania also has considerable mineral wealth which it is only just beginning to exploit for development.<sup>100</sup>

The United Republic of Tanzania is the union of the formerly independent sovereign states of Tanganyika which forms the Mainland of Tanzania and Zanzibar. The Union was established in 1964 shortly after a 'revolution' on Zanzibar against the Sultanate. Despite forming a union with Tanganyika, Zanzibar has retained an independent identity with distinct institutions including its own constitution. The official capital of the Union is Dodoma. However in practice the seat of Government and foreign representation remains in Dar-es-Salaam. Tanzania is divided into 27 Regions, 21 of these Regions are on the Mainland and the remaining 6 are in Zanzibar.<sup>101</sup>

Tanzania has immense ethnic diversity, with more than 130 ethnic groups as well as diverse faith groups including Christian denominations, Muslims and indigenous faiths living side by side. Despite its cultural diversity, Tanzania seems to have succeeded in creating an exemplary sense of national cohesion. This cohesion is underpinned by the national language and lingua franca Kiswahili, and a history of shared collectivist ideology during the Ujamaa (Socialist) period in the 1960's and 1970's. As a Commonwealth country English is also widely spoken particularly amongst the elites.

### **Tanzania's Economy**

The Tanzanian economy has experienced profound changes since the mid 1980's. In the first decades after independence from the UK, Tanzania was a socialist country.

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<sup>100</sup> Central Intelligence Agency, *Press Release: CIA World Factbook 2007* (USA: CIA, 2007) p. 50

<sup>101</sup> McHenry E., *Limited Choices: The Political Struggle for Socialism in Tanzania* (Boulder, Colo.: Lynne Rienner, 1994) p. 41

Agriculture was collectivised and the modern economy progressively nationalized. An acute economic crisis in the 1980's led to a comprehensive program of market reforms including privatizations beginning in 1986. These reforms gained pace during the latter part of the 1990's during the Presidency of Benjamin Mkapa.<sup>102</sup>

The implementation of Tanzania's economic reforms has received high praise from donors and foreign investors alike, the result has been a strong recovery in donor support (Tanzania is now one of the leading recipients of ODA in Africa) as well as a surge in foreign investment which has averaged US\$ 250 million annually since the 1990's.<sup>103</sup> Current economic policy is guided by the Poverty Reduction Strategy Paper (PRSP) called the MKUKUTA in its Kiswahili acronym. Economic growth has averaged over 6% since 2000, well above the African average and in particular above that of Kenya and Uganda its neighbors in the East African Community. It is expected that the growth rate will strengthen further to 7-8% range in the years to 2010.<sup>104</sup>

The Tanzanian economy is essentially agricultural, over 80% of the population is employed in agricultural activities and of these the overwhelming majority in subsistence agriculture. Agriculture accounts for over 40% of GDP and moreover agricultural products have historically accounted for the larger part of its exports. However mineral exports (especially gold) have experienced very rapid growth over the past decade and now dominate Tanzania's exports. The contribution of the mining sector to total GDP has grown

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<sup>102</sup> Ibid., p. 96

<sup>103</sup> Nyoni, Timothy, *Foreign Aid and Economic Performance in Tanzania* (Nairobi: African Economic Research Consortium, 1997) p. 7

<sup>104</sup> Organization for Economic Co-operation & Development & African Development Bank, *African Economic Outlook-Tanzania Country Report* (Tunis: OECD/AfDB, 2007) p. 31

rapidly as a number of large mining projects have come on stream but its contribution remains below its potential.

Tanzania's access to the sea through the port of Dar-es-Salaam is an important strategic asset, in addition Tanzania possesses the most comprehensive railway network in East Africa. However in general its transport infrastructure is judged to be inadequate (ref). Tanzania is a member of the East African Community and its Customs Union, it is also a member of the Southern African Development Community. There appears to be some conflict over the country's competing commitments to these two regional integration schemes. Outside Africa, Tanzania is a beneficiary of the Everything But Arms (EBA) Initiative of the European Union which grants duty free access to all exports (except arms) of LDC's to the European Union. It also qualifies for duty free exports of up to 6,000 goods to the United States under the African Growth and Opportunity Act (AGOA).<sup>105</sup>

Tanzania is an LDC, ranked no. 162 on the HDI(2006)<sup>106</sup>, as such despite the rapid growth it has experienced recently it remains very poor; for instance by most measures of well-being it ranks well below its neighbors and the African average. Still, the countries medium term prospects look promising (IMF/WB); Tanzania has recently benefited from substantial debt relief under the multilateral debt relief initiative. Moreover the latest socioeconomic data show encouraging improvements in some measures of well-being.

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<sup>105</sup> United Nations Conference on Trade and Development & International Chamber of Commerce, *Investment Guide for Tanzania- 2006* (Geneva: United Nations, 2006) p. 72

<sup>106</sup> United Nations Development Program, *Tanzania Human Development Report - 2000* (Dar-es-Salaam: United Nations Development Program, 1999) p. 68



## Trade and Investment Policies in Tanzania

### *Investment Climate*

Tanzania is now recognized as one of the most investor friendly destinations in Africa.<sup>107</sup> It consistently performs in the top five amongst non-oil exporters. This wasn't always the case however and is the result of a long period of economic reforms (and changing mentalities) beginning in 1986. At present the government's development goals are embodied in its Vision 2025;

- Increasing growth to 10% on average by 2010
- Raising per capita GDP to \$3,000 by 2025<sup>108</sup>

Although no explicit goals regarding trade and investment are articulated it is understood that this Vision can only be achieved with significant foreign investment flows and structural transformation, that is, diversification of the economy. Moreover despite its recent good performance, FDI remains dominated by mining which points to continuing difficulties in attracting interest to other sectors. However manufacturing and tourism have also received significant inflows.

Tanzania has established a one stop centre for investor services; the Tanzania Investment Centre, like other investment promotion agencies its mandate is to facilitate overseas investment into Tanzania. The TIC helps to obtain permits, visas, land among others and grant certificates for investors qualifying to receive incentives. Zanzibar has

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<sup>107</sup> Investment Guide to Tanzania (2006) quoted in The World Bank, *Tanzania Investment Climate Assessment* (Washington D.C: World Bank, 2006) p. 9

<sup>108</sup> Republic of Tanzania, The Tanzania Development Vision 2025 available online at [www.tnbctz.com/docs/national\\_vision.pdf](http://www.tnbctz.com/docs/national_vision.pdf)

also established its own separate investment incentive scheme co-ordinated by the Zanzibar Investment Promotion Agency (ZIPA).

For the purposes of prioritizing incentives Tanzania's Government has identified a list of so-called lead and priority sectors for investment promotion and incentives. The sectors are defined in the Customs Tariff Act of 1976 and the Tanzania Investment Act of 1997. The initial system was viewed as too broad<sup>109</sup> and has since been refined to include agriculture and agro-industries, mining, tourism and economic infrastructure.

### *Taxation*

Tanzania's taxation authority is the Tanzania Revenue Authority (TRA) established in 1995. It is the unified revenue authority for the central government and it is responsible for collecting direct and indirect taxes as well as trade taxes. Major income taxes include; Corporate taxes at 30% and a 10% tax on repatriated profits, withholding taxes on dividends (10% unless the company is listed on the Dar-es-Salaam Stock Exchange in which case it is 5%), royalties 15% and taxes on technical services for mining of 15%. There is also an individual income tax of between 15 and 30%.<sup>110</sup>

The major indirect taxes are VAT and Excises. The current VAT rate is 20% unless the goods are zero rated which is the highest in East Africa. Imports are also VAT taxable. For external trade Tanzania applies the EAC/CU Common External Tariff which has three bands; 25 % for final consumer goods and other finished goods, 15% for intermediate goods and 0% for raw materials and capital goods. In addition, the Tanzania Investment

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<sup>109</sup> Investment Guide to Tanzania (2006) quoted in The World Bank, *Tanzania Investment Climate Assessment* op. cit., p. 9

<sup>110</sup> United States Agency for International Development, *Tanzania Economic Performance Assessment* (Washington D.C.: USAID, 2005) p. 74

Act provides for an extensive system of tax exemptions and incentives for foreign investors as follows;

**With respect to import duty:**

*All importers of raw materials, computers, electronic cash registers, capital goods, replacement parts, inputs for agriculture, animal husbandry and fishing do not pay customs duty on importation of these goods. i.e. they are levied 0% import duty. Import duty charged on imported inputs used for producing goods for export and goods sold to foreign institutions like UN and its agencies operating in Tanzania, is refunded under the duty drawback scheme.*

**With respect to the Export Processing Zones (EPZ):**

*Under the Export Processing Zone Act, all inputs like raw materials and machinery which are imported and used to process or manufacture goods in the designated areas as EPZ are exempted from import duty and other taxes.*

**Manufacturing under Bond**

*All factories registered to manufacture goods under bond for export purpose are exempted from import duty and other taxes on inputs used to manufacture such goods.<sup>111</sup>*

The Tanzania Investment Act provides for a number of other such exemptions and incentives from VAT and withholding taxes as well for qualifying foreign investors. These incentives are primarily aimed at exporters operating in EPZ's.

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<sup>111</sup> Tanzania Investment Act quoted in The World Bank, *Tanzania Investment Climate Assessment* op. cit., p. 47

**Table 6: Summary of Fiscal Incentives to Exporters**

Corporation Tax	i) 30% for Investors under the Mining Act 1998 ii) Exemption for firms operating under the EPZ Act
VAT	i) VAT exemptions for capital goods for firms under the 1997 Investment Act ii) Exemption for firms operating under the EPZ Act
Import Duty	i) Exemption for capital goods under the Mining Act and the Investment Act ii) Exemptions for firms under the EPZ Act
Strategic Investor Status	For firms investing more than US\$20,000,000, the possibility
Import Duty Draw Back	For firms operating under the Investment Act to negotiate special incentives with the Government
Capital Allowances	Capital depreciation tax deductible (at a diminishing rate) for the first five years for firms under the Mining Act

Source: Tanzania Revenue Authority

### *Investment Incentives*

The legislative framework for Tanzania's investment promotion system was largely in place by the late 1990's, however because of the number of overlapping incentives the investment promotion system is seen as unclear and complex; this has spurred further attempts at clarifying and categorizing incentives under new legislation. The incentive schemes are also distinguished by their sectoral basis; thus investment in mining is governed by the Mining Act (1998), investment in petroleum is governed by the Petroleum Act (1980) investment in tourism is governed by the Hotels Act (1963) and the Tourism Agency Act (1969) although these last two laws may have been superseded by the Investment Act (1997).

The principle law regulating foreign investment in Tanzania is the Tanzania Investment Act of 1997. Although in principle foreign and domestic investors receive equal treatment under the Act the main provisions of this act were to put all investment incentive scheme's including fiscal and non-fiscal incentives in a single law as well as eliminating practically all restrictions on foreign investment on the Mainland (the exception being petroleum where there is still a statutory requirement for government participation in the capital).<sup>112</sup> Moreover the TIA created an import duty drawback scheme and a Strategic Investor Status. The TIA also streamlined the process of requesting for incentives by creating investment certificates. The TIA however does not apply to mining and petroleum exploration or to foreign firms investing less than US\$300,000. Other applicable laws include the, the Companies Act of 2002, the Business Licensing Act of 1972 and the various double taxation and investment guarantee treaties that Tanzania has concluded with foreign governments. In addition the Government has passed the Export Processing Zones Act (2002) and the Special Economic Zones Act (2005). These investment incentive schemes have sought to create additional incentives for manufacturers for export.

Of particular interest given its resource endowments are the Mining Act of 1998. The Mining Act has won praise from foreign investors and is seen as having been the single most important reform of the 1990's improving the attractiveness of Tanzania to foreign investors. The Act embodies the government's commitment to private sector led mineral development, the government now conceives of its role as a regulator and facilitator of investment specifically the benefits of the Act according to the TIC are;

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<sup>112</sup> United Nations Conference on Trade and Development & International Chamber of Commerce, *Investment Guide for Tanzania- 2006* op. cit., p. 73

- Streamlined procedures
- Clarity and Transparency
- Right to trade mineral rights
- Environmental management<sup>113</sup>

The Tanzanian government launched the Business Environment Strengthening for Tanzania (BEST) programmes in 2003 with the aim of reducing the cost and complexity of the business operating environment over the next five years by rationalizing the business regulatory system including abolishing procedural barriers to setting up and running businesses, modernizing and simplifying the commercial dispute settlement and arbitration system, introduction of a more service oriented culture into the Public Services and enhancing public/private sector dialogue.<sup>114</sup>

The BEST programme is specifically aimed at reviewing legislation affecting business operations, that is, Labour laws, land laws and so on. Thus a new Business Activities Registration Act (2007) has been passed and an in depth review of the Labour Laws is under way. Moreover high level Investor Roundtables for both local and foreign investors have been instituted. These forums are chaired by the President and are inputs into the government's policy process.

### *Privatizations*

At the beginning of the reform process some 400 parastatal corporations in all economic sectors dominated the economy. As with other privatization programmes the rationale for their divestiture was their poor financial performance and the consequent

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<sup>113</sup> Tanzania Investment Centre website at [www.tic.co.tz](http://www.tic.co.tz)

<sup>114</sup> The World Bank, *Joint Assistance Strategy for Tanzania 2007-2010* (Washington D.C: World Bank, 2007) p. 105

burden of these firms on the Treasury at a time of scarce resources. The divestiture programme was launched in 1992 with the Presidential Parastatal Reform Commission. By 2000 some 333 parastatals had been privatized. Because the government has placed no strategic limitations on the level of ownership by foreigners of privatized firms the privatization programme has been one of the main routes foreign investors into Tanzania. Of the divestitures concluded nearly 60% have been to foreign investors or consortia involving foreigners.

The privatization programme may also have yielded important economic benefits by improving the quality of management and technology of these firms. This is particularly significant with respect to utilities which have been a problem area in Tanzania. The privatization programme has included the divestiture/leasing or the signing of management contracts for key components of the national infrastructure such as the railways and the national energy company, the Tanzania Electric Supply Company Limited (TANESCO).

#### *Land Law*

The laws on land were consolidated under the Land Act (1999) this Act regulates tenure and access to land. There is no limit on foreign ownership or control, though land ownership remains restricted. Under Tanzanian law, non-citizens or foreign companies cannot own land, which continues to be a significant barrier to foreign investment. Land in Tanzania is government property and can only be leased from the government for 33, 66, or 99 years, depending on its use. Occupation of land by non-citizens is restricted to lands for investment purposes, as approved by the TIC. Under this arrangement, known as Derivative Title, Tanzanian tenants sub-lease their land to a TIC-approved foreign

investor. The TIC has designated specific plots of land (a land bank) to be made available to foreign investors. Foreign investors may also enter into joint ventures with Tanzanians, in which case the Tanzanian provides the use of the land (but retains ownership, i.e. the leasehold).

### *Corruption, Bureaucracy and Cross Border Issues*

Corruption and red tape are seen to be major problems however there is seen to be political will to rectify these issues. Corruption is one of the major difficulties encountered by foreign investors (including U.S. firms) in Tanzania. Former President Mkapa elevated the elimination of corruption to a major priority of his administration, creating the cabinet position of Minister of State for Governance in the President's Office, charged with, among other responsibilities, fighting corruption. Mkapa's administration undertook a number of other important steps to combat corruption, including the formation of a presidential commission of inquiry against corruption, the requirement for all top political leaders to declare their assets, the firing of public servants for corrupt activity, and the strengthening of the Prevention of Corruption Bureau (PCB).

In 2004, the Government initiated reforms in the PCB, giving it increased investigative and prosecution powers, expanding its operations to the regional and district level and allotting additional budget resources to the bureau (a budget increase of US \$3 million from 2004 to 2005). The National Anti-Corruption Strategy to root out systemic corruption was developed, released and distributed countrywide for implementation by the PCB. Also in 2004, the Government of Tanzania passed the Public Procurement Act,



aiming to increase the transparency of Tanzania's Public Procurement Regulatory Authority (PPRA); implementation of this Act took effect in May 2005.

While giving or accepting a bribe (including bribes to a foreign official) is a criminal offense in Tanzania, the enforcement of laws, regulations and penalties to combat corruption, is largely ineffective. Areas in which corruption persists include government procurement, privatization, taxation, ports, and customs clearance. Transparency International has consistently rated Tanzania as one of the worst countries in the world for corrupt business practices, although its rating has improved considerably over the past seven years.

## CHAPTER FOUR

### A COMPARATIVE ANALYSIS OF REGIONAL FDI POLICIES IN EASTERN AFRICA

#### Introduction

FDI has grown dramatically and is now the largest and most stable source of private capital for developing countries and economies in transition. Due to this fact, there is keen competition among developed and developing countries to attract FDI by resorting to policies that influence the location of the value added activities of MNCs.

This drive to lure investment often extends to the sub-national level, with different regional authorities pursuing their own strategies and assembling their own baskets of incentives to attract new investments. Various reforms and strategies have been implemented, with mixed results. Some, like Braunerhjelm and Ekholm, are critical of the high costs of many of these initiatives, arguing that it would be more rewarding to improve a country's general business environment.<sup>115</sup>

Tanzania is now recognized as one of the most investor friendly destinations in Africa<sup>116</sup> and has high performance in attracting FDI. At the same time, Rwanda still has shortfalls in encouraging an adequate volume of FDI into the country. Given the exploration in the previous chapter of the different policies related to FDIs in Tanzania and Rwanda, this chapter seeks to find out why there exists a difference in the two countries' FDI performance by analyzing the impact of each identified policy issue on FDI inflow. It then compares the policy orientations of the two countries as outlined in the previous chapter and analyzes the implications of their differences.

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<sup>115</sup> Braunerhjelm P. and Ekholm K., *The Geography of Multinational Firms* (Dordrecht: Kluwer Academic Publishers, 1998) p. 77

<sup>116</sup> UNCTAD, *Investment Guide to Tanzania* (Geneva: UNCTAD, 2006) p. 91

## **FDI Inflow to Rwanda and Tanzania**

This section gives a broader picture of FDI inflow to the two countries, Rwanda and Tanzania, with the aim of justifying their performance on the various policies the respective governments have instituted. Both Governments, like all others in Africa, have taken significant steps to encourage foreign investment.

Due to the economic policies implemented by Nyerere (which mirrored the socialist leanings of so many other African nations at independence) Tanzania is a relatively late economic bloomer.<sup>117</sup> Despite its early struggles, a look at the current economic environment is very encouraging for investors. Being a late comer to FDI, Tanzania has seen great increases in FDI over the past ten years. From 1986-1991 the country only received about \$2 million in FDI, while from 1995-2000 it received \$1 billion. By 1992 annual inflows had increased to \$12 million, and accelerated at a rapid rate each subsequent year, reaching a sustainable \$150 million by 1996, and \$282 million in 2000. Considering that the country had no inflows only a few years ago, the rapid growth is impressive. The mid to late 1990's positioned Tanzania to be considered a serious player in the arena of foreign investment, as it began to encompass more of the share of the regional and continental pie. From 1991-1995 its share of FDI inflows in least developed countries was 2.7 percent, but doubled to 5.3 percent from 1996-1999. Its share of Sub Saharan inflows increased to 3.3 percent from 1.5 percent in the same time period. Since 2000 to 2005 its FDI inflow has substantially doubled at over \$400 million.<sup>118</sup>

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<sup>117</sup> Barkan Joel, *Beyond Capitalism Vs. Socialism in Kenya and Tanzania* (Boulder & London: Lynne Rienner Publishers, 1994) p. 81

<sup>118</sup> UNCTAD, *Investment Policy Review: the United Republic of Tanzania* (Geneva: UNCTAD, 2002) p. 71

Rwanda today bears very little resemblance to the country that emerged from the genocide 12 years ago, and it deserves a new look by investors. It has made remarkable socio-political progress and implemented wide-ranging structural reforms in its economy. It has established a stable government and political structure under a new Constitution, secured peace and safety, and made strong progress towards national reconciliation. Rwanda has also begun restoring and reforming its economy, and the Government has articulated an inspiring vision of the country's future - Vision 2020 - that will increase per capita GDP.<sup>119</sup> Private investment is placed at the centre of this strategy, and the government is strongly committed to providing a favourable and enabling environment for investors. According to the figures of the Rwanda Investment and Export Promotion Agency (RIEPA), registered FDI doubled in 2005 over 2004, and went mainly into manufacturing, retail trade, mining and construction. The principal sources of this investment were some European countries (Belgium and France being prominent), some African countries (Kenya and South Africa) and India. The FDI trend is now positive and, given a number of Government measures, including the setting up of RIEPA, significant growth is possible.

**Table 7: Inflows into Rwanda and Tanzania (USD Million)**

<b>Year</b>	<b>Tanzania</b>	<b>Rwanda</b>
1999	541.7	2
2000	282.0	9
2001	467.2	9
2002	429.8	7
2003	526.8	11
2004	469.9	17
2005	473	22

<sup>119</sup> Rwanda Investment & Business Guide (US: International Business Publications Inc, 2005) p. 40

The table above indicates that both countries are adding a substantial volume of FDI every year. Nevertheless, the disparity in volume of FDI between the countries is stunning.

### **Comparing the Policy Framework for FDI in Rwanda and Tanzania**

Globalization is an inevitable and irreversible process, and dealing with the imperatives of globalization capitalizing on its positive aspects and mitigating the negative ones is perhaps the most important challenge today. FDI has been one of the core features of globalization and the world economy. Nowadays, virtually all countries are actively seeking to attract FDI, because of the expected favourable effect on income generation from capital inflows, advanced technology, management skills and market know-how. Three key determinants and factors associated with the extent and pattern of FDI in developing host countries are the attractiveness of the economic conditions in host countries; the policy framework towards the private sector, trade and industry, and FDI and its implementation by host governments; and the investment strategies of MNCs.<sup>120</sup>

According to AT Kearney's recent survey of multinational executives, overseas investors now consider political risk as the third biggest factor influencing investment decisions behind macroeconomic growth and the development of countries' domestic markets.<sup>121</sup> These therefore are major drivers of investment decisions.

Africa is politically unstable because of the high incidence of wars, frequent military interventions in politics, and religious and ethnic conflicts. There is some evidence that the probability of war—a measure of instability—is very high in the region. In a recent study, Rogoff and Reinhart computed regional susceptibility to war indices for the period

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<sup>120</sup> Dunning John, *Multinational Enterprises and the Global Economy* (New York: Addison-Wesley, 1993) p. 42

<sup>121</sup> AT Kearney, *2005 Survey of Multinational Firms* (Chicago: AT Kearney, 2005) also available at [www.atkearney.com](http://www.atkearney.com))

1960- 2002. They found that wars are more likely to occur in Africa than in other regions.<sup>122</sup> The study also showed that there is a statistically significant negative correlation between FDI and conflicts in Africa. Sachs and Sievers have also argued that political stability is one of the most important determinants of FDI in Africa.<sup>123</sup>

Tanzania is one of the most politically stable countries in Africa and the prospects for serious and sustained violence are extremely low. Since gaining independence, Tanzania has enjoyed a remarkable degree of peace and stability and in 1992, the constitution was amended to allow for multiple political parties. In 1995, the first multi-party election took place. As the country makes the transition from a socialist to a democratic entity, occasional conflict is possible, particularly during election campaigns. In 2001, demonstrators clashed with police officials on Pemba (Zanzibar) during a protest against the official outcome of the October 2000 elections.<sup>124</sup> The 2005 elections, however, were primarily peaceful and marked by an absence of major violence. Most political observers believe further clashes on Zanzibar are unlikely and the chance for conflict on the mainland remains remote.

Political instability in Rwanda endured since 1959. However, today stability is based on reconciliation which seeks to bring together the people of Rwanda. The country has also embarked on a democratization process which has taken grand strides starting with elections at the grassroots. These governance reforms, together with the reconciliation process, have laid the foundation for stability in Rwanda. On the basis of the political and social stability achieved so far, the economy has been rebuilt based on the productive

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<sup>122</sup> Rogoff K. and Reinhart C., *FDI to Africa: the Role of Price Stability and Currency Instability* (Washington D.C.: International Monetary Fund, 2003) p. 7

<sup>123</sup> Sachs J. and Sievers S., *FDI in Africa: Africa Competitiveness Report 1998* (Geneva: World Economic Forum, 1998) p. 96

<sup>124</sup> Mtaki C.K. and Okama M., *Constitutional Reforms and Democratic Governance in Tanzania* (Dar es Salaam: Friedrich Naumann Stiftung, 2000) p. 62

capacity of the Rwandan people. Major sectors of the economy have been restored to the pre-1990 productive levels. It is worth noting that host country policies and policy pronouncements affect the perception of “political risk” by MNCs and thereby the amount of investment of these companies.

In their research, Nwabuzor and others found out that, on a per capita basis, there was a higher inflow of foreign direct investment into those countries that allow greater relative economic freedom. They therefore suggested that in order to attract larger volumes of FDI in the future, African nations need to accelerate progress towards more open economies and greater economic freedom.<sup>125</sup> In fact MNEs are more likely to export to countries with less economic freedom than to establish distribution subsidiaries in those countries. Rwanda's economy is 52.1 percent free, according to the Heritage Foundation 2007 assessment, which makes it the world's 136th freest economy. The country is ranked 31st out of 40 countries in the sub-Saharan Africa region, and its overall score is slightly lower than the regional average. On the other hand, Tanzania's economy is 56.4 percent free, according to the same assessment, which makes it the world's 103rd freest economy. Tanzania is ranked 15th out of 40 countries in the sub-Saharan Africa region, and its overall score is slightly higher than the regional average.<sup>126</sup> This gives Tanzania an upper hand in attracting FDI over Rwanda.

Basu, in a study of 71 developing countries, concludes that fiscal incentives are the most popular form of incentive; accounting for 19 out of 29 most frequently used incentives. These incentives are based on tax holidays and other instruments designed to

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<sup>125</sup> Augustine M. Nwabuzor and Dennis O. Anyamele, 'Foreign Direct Investment Into African Nations (1970-2000)' also available online at <http://www.jsda-africa.com/Jsda/sping2002/articlespdf>

<sup>126</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007) also available at [www.heritage.org/index](http://www.heritage.org/index)

reduce the effective rate of corporation tax.<sup>127</sup> While Rwanda enjoys relatively high levels of fiscal freedom and freedom from government, Tanzania's fiscal freedom and freedom from government has been rated strong. In both countries, personal and corporate income tax rates are moderately high, but overall tax revenue is relatively low as a percentage of GDP. In Tanzania, government expenditures are fairly low, and state-owned businesses produce only a small portion of overall tax revenue while in Rwanda total government expenditures are moderate, equaling slightly more than 25 percent of national GDP, and state-owned businesses do not constitute a large source of revenue. Recent government efforts to liberalize foreign trade in Rwanda include reducing some of its non-tariff barriers.<sup>128</sup>

Rwanda has moderately higher tax rates than Tanzania. This is evident in the top income tax rate and the top corporate tax rate which are 35 percent in Rwanda and 30 percent in Tanzania. Both countries have a value-added tax (VAT) but while Rwanda has a property transfer tax Tanzania has a tax on interest. The overall tax revenue as a percentage of GDP was 12.8 percent and 11.7 percent in Rwanda and Tanzania respectively in 2005.<sup>129</sup>

Trade barriers and overvalued exchange rates impede growth in part by restricting domestic expansion into potential export areas and in part by constraining the inward flow of knowledge embodied in new products and services. However, they are not the only such impediments. The process of growth via trade expansion involves a phase of investment supply response that is influenced by a broad range of considerations that are sometimes

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<sup>127</sup> Basu A. and Srinivasan K.. *Foreign direct investment in Africa: Some case studies* (Washington D.C.: International Monetary Fund, 2002) p. 25

<sup>128</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* op. cit.

<sup>129</sup> Ibid.



grouped together under the label of “investment climate.” They include the transaction costs encountered in trade-related business activities such as clearing goods from customs and shipping goods overseas, the expenses involved in routine business operations for telecommunications and electricity, and the burden of regulations involved in starting a business, hiring and firing labor, and closing down a business. They can also refer to aspects of governance, such as corruption, the strength of property rights and adherence to the rule of law.<sup>130</sup>

Rwanda's weighted average tariff rate was 9.7 percent in 2005 and 8.2 percent in the same year for Tanzania. This implies trade freedom in Tanzania is wider than that in Rwanda. Although the Rwandan government has made progress in liberalizing the trade regime, import bans, prohibitive tariffs, and lack of transparency in trade regulations and government procurement add to the cost of trade. Consequently, an additional 20 percent is deducted from Rwanda's trade freedom score to account for these non-tariff barriers. On the other hand, inefficient and corrupt customs implementation, import taxes, some prohibitive tariffs, and weak enforcement of intellectual property rights add to the cost of trade in Tanzania.

Starting a business takes an average of 16 days in Rwanda and 30 days in Tanzania, compared to the world average of 48 days. However, both obtaining a business license and closing a business is more difficult in Rwanda than Tanzania. Regulations are sometimes opaque and inconsistent, causing unreliability of interpretation in both countries as well as

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<sup>130</sup> World Bank, *Trade, Investment and Development in the Middle East and North Africa: Engaging with the World* (Washington, D.C.: World Bank, 2003) p. 216

the overall freedom to start, operate, and close a business is restricted by the national regulatory environment.<sup>131</sup>

Total government expenditures in Rwanda, including consumption and transfer payments, are moderate but low in Tanzania. In 2005, government spending equaled 26.1 percent of GDP in Rwanda and 22.2 percent of GDP in Tanzania. At the same time, the Rwandan government received 11.5 percent of its revenues from state-owned enterprises and government ownership of property but Tanzania received only 8.4 percent of its revenues from the same sources. Privatization and restructuring of public enterprises have progressed in recent years but Tanzania scores more than Rwanda in this regard.

Inflation is one of the factors that affect the location of FDI. Growing distrust of inflation figures will cause domestic expectations to rise and act as a disincentive to foreign direct investment.<sup>132</sup> Inflation in Rwanda is high, averaging 9.8 percent between 2003 and 2005 and a little lower in Tanzania averaging 6.1 percent between 2003 and 2005. Relatively high and unstable prices explain most of the monetary freedom score. The Rwandan government influences prices through regulation and through state-owned enterprises and utilities, and it controls the prices of cement, electricity, water, telecommunications, petroleum, beer, and soft drinks. Although the Tanzanian government also influences prices, it does this on a lower scale than Rwanda.<sup>133</sup>

Both countries officially welcome foreign investment and have adopted several initiatives to facilitate investment, but corruption and political instability are persistent unofficial barriers. In Rwanda both residents and non-residents may hold foreign exchange

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<sup>131</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* op. cit.

<sup>132</sup> Alan Rugman and Richard Hodgetts, *International Business: A Strategic Management Approach* (New York: McGraw Hill, 1995) p. 246

<sup>133</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* op. cit.

accounts, but only if they provide supporting documentation and payments and transfers are subject to authorizations, maximum allowances and limits. Nearly all capital transactions require the central bank's approval. In Tanzania, residents may hold foreign exchange accounts only for funds acquired outside of Tanzania; otherwise, such accounts are restricted. Non-residents temporarily residing in Tanzania may hold foreign exchange accounts. All transfers of foreign currency from residents to non-residents must be approved by the central bank. Most capital transactions are subject to reporting requirements, and some are restricted. There is no limit on foreign ownership or control, but land ownership is restricted. Foreign purchase of real estate in Tanzania and purchase of real estate abroad by residents must be approved by the government.<sup>134</sup>

Although Tanzania's financial system is relatively small and underdeveloped, the Rwandan financial sector is even smaller and burdened by serious shortcomings in supervision, regulation, auditing and oversight. In Rwanda, non-performing loans are a problem for the financial sector, which consists primarily of small banks and microfinance institutions. The government reduced its involvement in the banking sector in 2004 when it sold an 80 percent stake of the Banque Commerciale du Rwanda and 80 percent of Banque Continentale Africaine du Rwanda to foreign investors, but it remains extensively involved in the sector and, according to the International Monetary Fund, controls about 22 percent of total assets. The state also plays a large role in the insurance sector. It owns the largest insurer, Sonarwa, and controls another insurance parastatal, and these two companies together account for a majority of the insurance market. There are no capital markets in Rwanda.

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<sup>134</sup> UNCTAD, *Investment Policy Review: the United Republic of Tanzania* op. cit., p. 73

Similarly, the central bank in Tanzania lists 22 commercial banks that are licensed to operate. Credit is allocated largely at market rates. There are minimal restrictions on foreign banks, and international banks are expanding their Tanzanian operations. Privatization of remaining government-owned banks is continuing. In September 2005, the government selected a consortium led by Rabobank of the Netherlands to buy 49 percent of the National Microfinance Bank, although the government will retain 30 percent. There are three non-bank financial institutions, including the government-owned Tanzania Investment Bank and Tanzania Postal Bank. The insurance sector is small, with 12 insurance companies licensed as of the beginning of 2004. The state-owned National Insurance Corporation is the largest insurer and controls 25 percent of premiums. Capital markets are rudimentary. The Dar es Salaam Stock Exchange is open to foreign investors, but foreign ownership of listed companies is restricted to 60 percent. Foreign investors may not participate in government securities.<sup>135</sup>

A conducive legal environment is essential for attracting FDI and one measure of an enabling this environment is adequate protection for property rights.<sup>136</sup> The Rwandan judiciary is influenced by the government and suffers from inefficiency, a lack of resources, and corruption. The judicial system does not have enough qualified magistrates or political independence, and legal procedures are subject to corruption. The legal system in Tanzania is slow and subject to corruption. A commercial court has been established to improve the capacity of the legal system to resolve commercial disputes. The World Bank Doing Business study shows that Rwanda only trails Tanzania in reforming rule of law issues like enforcing contracts, improved regulatory laws and other areas.

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<sup>135</sup> UNCTAD, *The Blue Book on Best Practice in Investment Promotion and Facilitation for Tanzania* (Geneva: UNCTAD, 2007) p. 85

<sup>136</sup> Alan Rugman and Richard Hodgetts, *International Business: A Strategic Management Approach* op. cit., p. 249

Corruption is one of the major difficulties encountered by foreign investors. Corruption is perceived as significant in Rwanda which ranks 83rd out of 158 countries in Transparency International's Corruption Perceptions Index for 2005. Similarly it is widespread in Tanzania which ranks 88th out of 158 countries in Transparency International's Corruption Perceptions Index for 2005.<sup>137</sup>

Although the labor market operates under restrictive employment regulations that could be improved to enhance overall productivity growth in Rwanda, the situation in Tanzania is even worse. While the non-salary cost of employing a worker is low in Rwanda it is moderate in Tanzania, but dismissing a redundant employee can be difficult. There are rigid regulations on increasing or contracting the number of work hours. The government sets minimum wages that vary by type of job.

**Table 8: Comparing liberalization of Policies in Tanzania and Rwanda by percentage**

	Rwanda %	Tanzania %
Business Freedom	50.8	44.8
Trade Freedom	60.6	63.6
Fiscal Freedom	82.6	87.1
Freedom from Government	80.3	85.7
Monetary Freedom	70.2	74.4
Investment Freedom	30	50
Financial Freedom	40	50
Property Rights	30	30
Freedom from Corruption	21	29
Labour Freedom	55.9	49.4

Source: compiled from The Heritage Foundation, 'Index of Economic Freedom' *The Wall Street Journal* 2007

<sup>137</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, 2007 *Index of Economic Freedom* op. cit.

## National Policies and Foreign Direct Investment: An Evaluation

This dissertation argues that the FDI national policy framework of a country is a very important determinant of FDI in a country. This generally consists of the rules and regulations governing the country and operations of foreign investors, the standard of treatment to them in respect of their commercial operation and the functioning of the markets within which they operate.<sup>138</sup> Other policies which work complimentary to FDI policies are trade policies and adherence to international trade and investment, privatization policies and adherence to international investment agreements.

The analysis in the above section establishes that policies of host countries have an important influence on foreign investment decisions. Host countries can adopt policies of stimulating foreign investment or they can restrict foreign participation in their economies in various ways. In addition, host country policies can be instrumental in channeling investment flows toward sectors considered to be of particular importance to the country's development.

Although the overall policy framework comprises quite heterogeneous elements, such as economic and political stability as well as regulations governing the entry and operations of FDI, they share one important characteristic. These elements are intended to induce FDI, but it is open to question whether MNCs will actually react in the expected manner. For example, the liberalization of national FDI frameworks has become the dominant type of FDI policy change in dozens of developing countries since the mid-1980s.<sup>139</sup> Likewise, the number of developing countries that have signed bi- or multilateral agreements, ensuring a liberal treatment of FDI and its protection after entry, increased

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<sup>138</sup> UNCTAD, *Recent Developments in International Investment and Transnational Corporations: Trends in Foreign Direct Investment* (Geneva: United Nations, 1995) p. 6

<sup>139</sup> UNCTAD, (var. issues) *World Investment Report* (New York: United Nations, 1998) p. 93

dramatically in the 1990s. Nevertheless, FDI inflows have remained small in several of these liberalizing countries. MNCs tend to take more liberal FDI regimes for granted, and consider the convergence of FDI regimes to be the natural consequence of globalization. As a result, the liberalization of FDI regulations may be characterized by diminishing returns. Developing countries not taking part in the general move towards liberalization are likely to suffer negative effects of restrictive policies on FDI inflows. But a liberal FDI regime does little more than enabling MNCs to invest in a host country. It is a completely different question whether FDI will actually be forthcoming as a result of FDI liberalization.

There may be one major exception to this line of reasoning in the overall policy framework, namely privatization. The privatization of inefficient state-owned enterprises will boost foreign investment. African countries have now recognized that the privatization of public corporations is necessary to reduce government fiscal deficits and several countries have instituted privatization programmes. As shown in chapter three, the privatization programme in Rwanda was established by a law dated 11 March 1996 on Privatization and Public Investment. The Presidential Decree dated 3 May 1996 put in place the institutions to implement this programme. Most companies are sold to a private owner, but some are also leased, particularly when the activity of the company involves the direct exploitation of natural resources, for instance Kigembe Fishery and Rubirizi Grazing Fields.<sup>140</sup>

At independence in 1961, the private sector in Tanzania was very small, and it was believed that private initiative would not be sufficient to act as an engine of growth,

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<sup>140</sup> World Bank, *Doing Business in 2004: Understanding Regulation* (Washington, D.C.: World Bank, 2004) p. 104

provide adequate marketing and distribution channels or act as an efficient allocation of resources. Privatization began eight years ago. Utilities and major transactions whose divestiture is underway include the Dar es Salaam Water and Sewerage Authority (DAWASA), all commercial sections of the Tanzania Harbours Authority (excluding the Container Terminal which has already been leased), the remaining shares of the Tanzania Telecommunications Company Limited (TTCL), Tanzania Railways Corporation (TRC), Tanzania Electric Supply Company Limited (TANESCO), Air Tanzania Corporation (ATC), National Micro-finance Bank (NMB) and the National Insurance Corporation (NIC). Both countries have carried out privatization programmes which would play a major role in FDI attraction. However, these programmes are more advanced in Tanzania than in Rwanda.

While the trend towards privatizing state-owned enterprises is almost as broadly based in developing countries as the liberalization of FDI regulations, privatization differs from the latter in that it induces substantial FDI inflows in various developing countries. Privatization contributes significantly to two structural shifts in the composition of FDI flows to developing countries: the rising share of FDI in services, and the growing importance of mergers and acquisitions (M&As) as opposed to Greenfield investment. Yet, privatization-induced FDI is controversially discussed for several reasons. First, FDI related to the sale of state-owned enterprises is frequently said to leave the overall volume of investment unaffected. This is true in the sense that M&As, in contrast to greenfield investment, are no more than a change in ownership (the same is obviously true when public assets are sold to domestic private investors). Whether or not M&As increase overall investment depends on the use of government revenues from privatization. Second, privatization-related FDI may be problematic from a competition-policy point of view. In



the case of “natural monopolies,” a state monopoly would be replaced by a private monopoly (again this also applies when public assets are sold to domestic private investors). Hence, privatization should go along with trade liberalization and competition policies preventing the misuse of monopoly power and enhancing competition by breaking up monopolies.<sup>141</sup>

Third, privatization-related FDI is often believed to be a one-off event. This is not necessarily true, however. Privatization contracts may specify further investment to be undertaken after the original purchase. Changes in ownership have frequently been associated with significant additional investment in the rationalization and modernization of privatized firms. Reinvested earnings of firms which foreign investors acquired through privatization may lead to FDI flows beyond those associated with the initial transaction. Finally, privatization programs help improve the climate for FDI in indirect ways, like by indicating the government’s commitment to economic reform. Hence, privatization-related FDI may prove to be the gateway to higher FDI inflows on a regular basis.

To a large extent, business facilitation relates to the context of efficiency-seeking FDI, namely the ease of doing business. Promotional efforts may well go beyond narrowly defined business facilitation and include fiscal and tax incentives. The latter are what Charles Oman has rightly labeled the perils of competition for FDI.<sup>142</sup> Business facilitation is typically dealt with by investment promotion agencies (IPAs). Investment-generating measures of IPAs include FDI campaigns, industry-specific FDI missions, and targeting particular MNCs. Particularly the latter reveals the shift of IPAs’ activities from image-

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<sup>141</sup> William L. Megginson, *The Financial Economics of Privatization* (New York: Oxford University Press, 2004) p. 49

<sup>142</sup> Oman Charles, ‘The Perils of Competition for Foreign Direct Investment’ In Inter-American Development Bank and OECD Development Centre, *Foreign Direct Investment versus Other Flows to Latin America* (Paris: Development Centre Seminars, 2001) pp. 72-108

building to more specific FDI generation. A survey conducted in the mid-1990s among 81 IPAs showed that the great majority of them tried to identify and attract foreign investors.<sup>143</sup> Investment-facilitation services consist counseling, speeding up the approval process, and assistance in obtaining permits. “One-stop shops” often provide these services. In addition, after-investment services related to day-to-day operational matters are offered to established foreign investors. Underlying many of these measures is the governments’ wish to do more in terms of proactive policies, given that FDI liberalization alone suffers from diminishing returns.

The Tanzania Investment Centre (TIC) assists in establishment of enterprise, obtains necessary licenses, work permits, visas, approvals, facilities or services; sorts out any administrative barriers confronting both local and foreign investments; promote both foreign and local investment activities; secures investment sites and assist investors to establish EPZ projects; grants Certificates of Incentives, investment guarantees and registers technology agreement for all investments and provides and disseminates up to date information on existing investment opportunities, benefits or incentives available to investors. On the other hand, the Rwanda Investment and Export Promotion Agency (RIEPA) assists investors in a variety of ways and acts on behalf of investors with related governmental agencies and provides all licences required for the establishment and operation of a project to an investor; and assists investors in site selection and land acquisition – whether for agricultural, industrial, or touristic activities.

The TIC was named as the world’s best Investment Promotion Agency of the year 2007 by the World Association of Investment Promotion Agencies (WAIPA) during a

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<sup>143</sup> UNCTAD, (var. issues) *World Investment Report* op. cit., p. 101

WAIPA World Investment Conference that took place in 2007 in Geneva, Switzerland. It was also branded the best IPA in sub-Saharan Africa in 2004 by the African Investor.<sup>144</sup>

Creating awareness of investment opportunities through the use of existing investors and information communication technologies such as the internet is important to FDI inflow. However, experience has shown that over-reliance on IPAs for investment promotion has not been very effective in the African region, so there is the need for a shift of emphasis from IPAs to existing investors. This is also relevant because studies have shown that existing investors play a very important role in attracting new investors to new investment locations. For example, in a recent study of foreign direct investor perceptions conducted by the United Nations Industrial Development Organization (UNIDO) in four African countries— Ethiopia, Uganda, Nigeria, and Tanzania—existing investors were found to be responsible for roughly 50% of foreign investor awareness of domestic investment opportunities.<sup>145</sup> There is also the need for African countries to adopt a more targeted investment promotion strategy. In other words, they should identify sectors where they have comparative and competitive advantages and then promote FDI into those sectors. This would make investment promotion less costly and more effective.

Economists have long argued that the use of discretionary fiscal and financial subsidies to attract FDI is ineffective. Ironically, it is precisely where economists claim to have presented conclusive results that the gulf between expert advice and actual policymaking is particularly wide. Policymakers argue that, even though discretionary incentives do not rank high among major FDI determinants, such incentives can make a difference at the margin. Investment decisions of foreign investors are considered to be a

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<sup>144</sup> TIC website at <http://www.tic.co.tz>

<sup>145</sup> UNIDO, *Foreign Direct Investor Perceptions in Sub-Saharan Africa* (Vienna: United Nations Industrial Development Organization, 2002) p. 52

two-stage process: after the location is broadly determined and potential candidates within a region are short listed according to economic fundamentals, the final site selection may be influenced by fiscal and financial incentives. These incentives are based on tax holidays and other instruments designed to reduce the effective rate of corporation tax. But such tax incentives increase investment flows only if projects are sensitive to differential taxation and it is very difficult in practice to correctly select such projects. Furthermore, in many cases, it is the most profitable, tax-insensitive investments that are most likely to receive incentives, even though these projects could have been undertaken in the absence of incentives. Caves argues that, under certain conditions, fiscal incentives increase investment, create jobs and other socio-economic benefits.<sup>146</sup> However, Chalk asserts that these incentives may not be the first-best mechanism for attracting FDI and the costs of incentives to attract FDI outweigh the benefits. He holds that incentives may exacerbate problems like governance and corruption and it would be better to improve the local infrastructure and stabilize the macro-economy.<sup>147</sup>

“Bidding wars” among governments may create major distortions in the allocation of investment resources. Subsidies discriminate against sectors and projects not targeted by incentives. Especially smaller investors and local investors may suffer discrimination. Moreover, “bidding wars” may be very costly and weaken public finances. While these costs are difficult to measure, Lipson collected some evidence according to which subsidies granted to foreign investors in the automobile industry soared from less than \$20,000 per job created in the early 1980s to more than \$200,000 in several instances in

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<sup>146</sup> Caves R., *Multinational Firms and Economic Analysis* (Cambridge, Cambridge University Press, 1996) p. 71

<sup>147</sup> Chalk N.A., *Tax incentives in the Philippines: A Regional Perspective* (Washington D.C.: International Monetary Fund, 2001) p. 38

the 1990s.<sup>148</sup> UNCTAD also noted that the use of investment incentives has proliferated; the range of incentives to foreign investors and the number of countries that offer incentives have both increased since the mid- 1980s.<sup>149</sup> Incentives-based competition for FDI has become pervasive not only among national governments, but also among sub-national authorities. Moreover, this type of competition is particularly fierce among neighbors, like governments in the same region. This may render it fairly difficult to strengthen cooperation among IPAs in a regional context. It is at least questionable whether competing agencies are eager to engage in an exchange of expertise and experience, unless they realize that “bidding wars” are counterproductive and unlikely to induce more FDI.

Openness to trade will signal commitment to outward-looking, market-oriented policies and enhance trading opportunities thereby attracting foreign investors intent on taking advantage of the new trading opportunities.<sup>150</sup>

Inflation reflects instability of the macroeconomic policy of the host country. This type of instability creates uncertainty in the investment environment. Therefore, High inflation discourages FDI for re-exportation since the relative costs of production in the host country rise. In contrast, falling price levels and the resulting contraction in economic activities might trigger a deflationary spiral and eventually bankrupt the host country's firms. This can induce local investors to sell off their interests in the host country's companies to foreign investors at low prices, thereby expanding the inflow of FDI.<sup>151</sup>

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<sup>148</sup> Lipson Charles, *Standing Guard: Protecting Foreign Capital in the Nineteenth and Twentieth Centuries* (Los Angeles: University of California Press, 1985) p. 13

<sup>149</sup> UNCTAD, (var. issues) *World Investment Report* op. cit., p. 102

<sup>150</sup> Buckley, P.J. and M.C. Casson (1976) *The Future of Multinational Enterprise*, Macmillan, London

<sup>151</sup> John Ellis and David Williams, *International Business Strategy* (London: Pitman Publishing, 1995) p. 57

In several African countries it is often difficult to tell what specific aspects of government policies are. This is due in part to the high frequency of government as well as policy changes in the region and the lack of transparency in macroeconomic policy. The lack of transparency in economic policy is of concern because it increases transaction costs thereby reducing the incentives for foreign investment. In summary, the lack of a favourable investment climate also contributes to the low FDI trend observed in the region. In the past, domestic investment policies—for example on profit repatriation as well as on entry into some sectors of the economy—were not conducive to the attraction of FDI.<sup>152</sup>

## Conclusion

Policies of host countries have an important influence on foreign investment decisions. Host countries can adopt policies of stimulating foreign investment or they can restrict foreign participation in their economies in various ways.

The Ficci survey<sup>153</sup> concurred with this contention by deducing a number of conclusions. It was evident that the ambiguities in the revised FDI guidelines and absence of time bound project clearances in India were some of the main reasons for the sluggish pace of FDI inflows in the real estate sector. The survey also showed that according to the participating companies, the rigidity in the country's labour laws is another major impediment in the way of greater FDI inflows.

The countrywide survey found overseas investors were not looking for special incentives or fiscal concessions to make their investment decisions but were more interested in having access to a consolidated document that specified procedures,

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<sup>152</sup> Basu A. and Srinivasan K.. *Foreign direct investment in Africa: Some case studies* op. cit., p. 46

<sup>153</sup> The Federation of Indian Chambers of Commerce and Industry (FICCI), Foreign Direct Investment survey 2004 on 'The experience of Foreign Direct Investors in India' June 2004, New Delhi

formalities and clearances. The survey said if these issues were not addressed quickly, the share of real estate in FDI would remain stagnant at about 10%, much lower than China's 30% share expected in 2005.

Tanzania is now recognized as one of the most investor friendly destinations in Africa<sup>154</sup> it consistently performs in the top five amongst non-oil exporters, this wasn't always the case however and is the result of a long period of economic reforms (and changing mentalities) beginning in 1986.

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<sup>154</sup> UNCTAD, *Foreign Direct Investment in Africa: Performance and Potential* (New York: United Nations, 1999) p. 51

## CHAPTER FIVE

### CONCLUSIONS AND RECOMMENDATIONS

#### Introduction

The 2006 World Investment Report by UNCTAD rates Rwanda as a country with both low foreign direct investment (FDI) potential and performance and Tanzania as a country with low FDI potential but high performance.<sup>155</sup> This study sought to explain why while both countries have low FDI potential; Tanzania has performed better than Rwanda in attracting FDI. This is done by attempting to establish the contribution of policy in increasing FDI inflow through the comparative analysis of FDI policy in the two countries. Therefore, the main objective of the study was to carry out a comparative analysis of FDI policy in Rwanda and Tanzania. Specifically, the research endeavoured to evaluate the causes of success of the already instituted policies in Tanzania and the causes of the failure of the already instituted policies in Rwanda. It also seeks to proffer policy recommendations for conducive business environment that can effectively attract FDI.

#### Conclusions and Recommendations

The first chapter lays the background in which the research problem is discussed. Increasing investment is crucial to the attainment of sustained growth and development in developing countries. This could be achieved through an increase in FDI flows. It is therefore imperative to examine the determinants of FDI flow in order to attract as much FDI as possible. The theory used by the study to and explain the problem under review is liberalism of the Political Economy that can be traced back to Adam Smith. The main

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<sup>155</sup> UNCTAD, *World Investment Report 2006 FDI From Developing and Transition Economies: Implications for Development* (New York: United Nations, 2006) p. 24



directives of the study include the following assumptions of this theory:- self-interest in a free society results in a rapid progress and economic growth; free market, while appearing chaotic and unrestrained, is actually guided to produce the right amount and variety of goods by a so-called 'invisible hand';<sup>156</sup> government intervention as a forced partner in administration of gains but not in losses is a strong deterrent against investment; and states are not the only actors on the international plane but non-governmental organizations and individuals also influence the operations in the international sphere.<sup>157</sup> All these assumptions are in line with the hypotheses of the research.

In tackling the above-mentioned problem, the study utilized both primary and secondary sources of data. Primary sources included direct interviews with civil servants in various ministries and officers in managerial positions from selected foreign direct investment institutions from the two countries. Personal interviews were used and probing/open-ended questions facilitated the collection of a lot of data. Secondary sources of data entailed the analysis and review of published books, journals, papers, periodicals, and unpublished works; Government documents from the two countries including both policy documents and sessional papers, media sources and the internet. Key literature reviewed revealed that there is no ultimate consensus on determinants of FDI but that they include natural resources, market size, government policies, political instability and the quality of the host country's institutions on FDI among others. The literature also plunged itself into the debate concerning the role of FDI in development. The debate examined works of scholars who have argued for and against this contention. However, the study as

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<sup>156</sup> Muller Jerry, *Adam Smith in his Time and Ours: Designing the Decent Society* (Princeton: Princeton University Press, 1995) p. 38

<sup>157</sup> Goldstein Joshua, *International Relations* 4th ed (New York: Longman, 2000) p. 65

seen from one of the hypotheses supported the argument that FDI helps to spur development in Developing Countries.

The second chapter looked into the conceptual debates which include the meaning of FDI taking into consideration its definitional impact on Africa and the development impact of FDI in third world countries by examining FDI roles in employment, security, economic growth, technology transfer and environment, corporate social responsibility, Training, Research and Development and the strength of the host country. The study defined FDI as the movement of capital across national frontiers in a manner that grants the investor control over the acquired asset. The chapter established that new trends have reinforced the importance of private investment for many developing countries. As a result of the move towards neo-liberal policies, the role of the State shifted from an active economic player with productive activities to a provider of an environment of doing business and of social risk insurance. Private investment, both domestic and foreign, is viewed as the driving force of the economy. The chapter concluded that both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on developing host countries. However, it noted that recent work also points to the following potential risks: it can be reversed through financial transactions; it can be excessive owing to adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. It proffers that policy recommendations for developing countries should focus on improving the investment climate for all kinds of capital, domestic as well as foreign.

These conceptual debates gave way to an in-depth examination of the different FDI policy orientations adopted by Rwanda and Tanzania in the third chapter. This laid a basis

for a comparative analysis of the policies of the two countries in the chapter that followed. The chapter used government documents and their websites, sessional papers, development plans and policy documents of the two countries to identify FDI policies that are exhorted in these countries. The issues that were tackled include taxation, investment incentives, laws on privatizations, legal reforms, land law, the strength of the judiciary and the state of corruption, bureaucracy and cross border issues in the two countries.

Chapter four did a comparative analysis of the regional FDI policies in Eastern Africa. According to this study, Eastern Africa is composed of Kenya, Uganda, Tanzania, Rwanda and Burundi. However, specifically the study does a comparative analysis of FDI policies in Rwanda and Tanzania. It sought to find out why there exists a difference in the two countries' FDI performance by analyzing the impact of each identified policy issue on FDI inflow. It then compared the policy orientations of the two countries as outlined in the previous chapter and analyzed the implications of their differences. It was established however that both countries were adding a substantial volume of FDI every year since the 90s. Nevertheless, the disparity in volume of FDI between the countries is stunning.

The dissertation established that the main factors influencing investment decisions in third world countries include political risk, economic freedom, business freedom, fiscal incentives, trade freedom, government expenditure, inflation, corruption, property rights, status of financial system and labour regulations. However, the study argues that the FDI national policy framework of a country is a very important determinant of FDI in a country. This generally consists of the rules and regulations governing the country and operations of foreign investors, the standard of treatment to them in respect of their

commercial operation and the functioning of the markets within which they operate.<sup>158</sup>

Other policies which work complimentary to FDI policies are trade policies and adherence to international trade and investment, privatization policies and adherence to international investment agreements. Host countries can adopt policies of stimulating foreign investment or they can restrict foreign participation in their economies in various ways.

It was deduced that although Africa is politically unstable because of the high incidence of wars, frequent military interventions in politics, religious and ethnic conflicts, Tanzania is one of the most politically stable countries in the region and in Rwanda, governance reforms and the reconciliation process, have laid the foundation for stability.

The study established that the liberalization of national FDI frameworks in third world countries has been substantially successful in attracting FDIs in those countries. Nevertheless the benefits thereof are debatable. According to a 2007 Index of Economic Freedom assessment, Tanzania's economy is more open at 56.4 per cent while Rwanda's economic freedom steers at 52.1 per cent.<sup>159</sup> This justifies why Tanzania performs better in attracting FDI since they perceive the country to have a better investment environment than Rwanda due to the liberalization of its economy.

Besides, it was also acknowledged that some policy orientations can be disparaging. For instance although privatization induces substantial FDI inflows in various developing countries, the study held that FDI related to the sale of state-owned enterprises leaves the overall volume of investment unaffected. In addition, privatization-related FDI may be problematic from a competition-policy point of view. In the case of "natural

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<sup>158</sup> UNCTAD, *Recent Developments in International Investment and Transnational Corporations: Trends in Foreign Direct Investment* (Geneva: United Nations, 1995) p. 6

<sup>159</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2007) also available at [www.heritage.org/index](http://www.heritage.org/index)

monopolies,” a state monopoly would be replaced by a private monopoly. Both Tanzania and Rwanda have adopted privatization policies with the hope to encourage more private investment. The real effect of these privatization policies have varied in the two countries given their difference in political standings.

Both Tanzania and Rwanda use their investment promotion agencies (IPAs) to identify and attract foreign investors.<sup>160</sup> But the study established that over-reliance on IPAs for investment promotion is not very effective in the African region and recommended a shift of emphasis from IPAs to existing investors. It found out that existing investors play a very important role in attracting new investors to new investment locations. In general, there is need for African countries to adopt a more targeted investment promotion strategy by identifying sectors where they have comparative and competitive advantages and then promote FDI into those sectors. This would make investment promotion less costly and more effective.

The two countries have put in place fiscal and financial subsidies to attract FDI. Investment decisions of foreign investors are considered to be a two-stage process: after the location is broadly determined and potential candidates within a region are short listed according to economic fundamentals, the final site selection may be influenced by fiscal and financial incentives. As much as these subsidies may yield positive results, the study held that they discriminate against some sectors and projects especially those carried out by smaller and local investors. This creates “bidding wars” which are very costly and weaken public finances. Rwanda has moderately higher tax rates than Tanzania and investors would prefer the country with less tax rates and higher subsidies. Moreover, trade

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<sup>160</sup> UNCTAD, (var. issues) *World Investment Report* op. cit., p. 101

freedom in Tanzania is wider than that in Rwanda since Rwanda's weighted average tariff rate was 9.7 percent in 2005 and 8.2 percent in the same year for Tanzania.<sup>161</sup>

On the other hand, inflation reflects instability of the macroeconomic policy of the host country which creates uncertainty in the investment environment. High inflation discourages FDI for re-exportation because the relative costs of production in the host country rise. In contrast, deflation bankrupts the host country's firms inducing local investors to sell off their interests in the host country's companies to foreign investors at low prices, thereby expanding the inflow of FDI.<sup>162</sup> Inflation in Rwanda is high, averaging 9.8 percent between 2003 and 2005 and a little lower in Tanzania averaging 6.1 percent between 2003 and 2005.<sup>163</sup> This coincides with the above argument because Tanzania's FDI performance is way above that of Rwanda.

The dissertation found out that although Tanzania's financial system is relatively small and underdeveloped, the Rwandan financial sector is even smaller and burdened by serious shortcomings in supervision, regulation, auditing and oversight. It was also established that the judicial systems in the two countries are influenced by government and suffer from inefficiency, a lack of resources, and corruption. Corruption is perceived as significant in Rwanda which ranks 83rd out of 158 countries in Transparency International's Corruption Perceptions Index for 2005. Similarly it is widespread in Tanzania which ranks 88th out of 158 countries in Transparency International's Corruption Perceptions Index for 2005.<sup>164</sup>

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<sup>161</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* op. cit.

<sup>162</sup> John Ellis and David Williams, *International Business Strategy* (London: Pitman Publishing, 1995) p. 57

<sup>163</sup> Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2007 Index of Economic Freedom* op. cit.

<sup>164</sup> Ibid

Finally, the study gave an in depth analysis and showed how policy can affect the choice of country for business. It concluded that policies of host countries have an important influence on foreign investment decisions. Host countries can adopt policies of stimulating foreign investment or they can restrict foreign participation in their economies in various ways. The main factors used such as political risk, economic freedom, business freedom, fiscal incentives, trade freedom, government expenditure, inflation, corruption, property rights, status of financial system, labour regulations and independence of the judicial system exhibited that Tanzania had an upper hand in attracting FDI than Rwanda.

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