Determinants Of Foreign Direct Investment

Theory And Evidence, With Zambia As Case Study

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ABSTRACT

Foreign Direct Investment (FDI) constitutes a resource flow which is widely considered particularly useful for the economic development of developing countries. This resource has however proved elusive for most countries in Africa, despite widespread moves to liberalise investment regimes and offer attractive incentives.

This paper reviews the determinants of FDI in the light of empirical evidence and using Zambia as a case study. Using Dunning's Eclectic Paradigm as an analytic framework, the paper shows that there are location specific variables which tend to constrain the inward flow of FDI into Zambia.

Key Words: Foreign Direct Investment, Eclectic Paradigm, Location Specific Factors

1. Introduction

Foreign Direct Investment (FDI) constitute a resource flow which is particularly useful for the economic development of developing countries, especially for their industrial development. It provides a unique combination of long term finance, technology, training, know how, managerial expertise and marketing experience (Jansen, 1995; OECD, 1983).

Recent trends towards globalisation of production and consumption patterns have led to a sharp increase in global FDI. At the same time, trade and investment liberalisation has brought more developing countries into the globalised economy. This has led to a dramatic surge in FDI flows to developing countries, which increased fivefold from 1990 to 1995, and exceeded $100 billion in 1996 (IFC, 1997).

The increase in FDI does not mean that they are easy to attract. In fact available data indicate a disproportionate concentration of FDI flows. The ten largest recipients accounted for 76% of total flows into the developing world, up from around 70% in the preceding ten years. The 47 Least Developed Countries (LDCs) continue to be marginal to FDI flows, and in 1992 declined by 15% to a total of $300 million (0.6% of total flows to developing countries) (Lall, 1995; Tharakan and Bulcke, 1998). Sub Sahara in particular received very little FDI and this is despite widespread moves to liberalise investment regimes and offer attractive incentives (UNCTAD, 1998).

Anecdotal evidence suggests that poor economic performance and years of political instability may be to blame for this state of affairs. In addition to these, problems of policy and administration have also been highlighted. According to the IFC (1997) restrictions on FDI have taken the form of complex approval mechanisms, high taxes and complex incentive regimes, restrictions on share of foreign ownership, and restrictions on use of land and expatriate labour. Others include the role of the State in the economy and the
process of privatisation. Zambia as one of these LDCS has similar problems and is the primary focus of this study.

2. Aim And Objectives

The aim of the study was to review, from the literature, the determinants of FDI in the light of empirical evidence and to apply these factors to the specifics of the Zambian case.

3. Method

The methodology consisted of three integrated components. The first component involved a survey of the literature on the determinants of FDI. This provided a conceptual framework for the analysis of secondary empirical data from sources like the IMF, the World Bank and UNCTAD on the specific Zambian situation. A comparative analysis was made with selected countries in sub Sahara Africa who have been relatively successful in attracting FDI. These countries are Botswana, Ghana, Mozambique, Namibia, Uganda and Tunisia.

4. Organisation

The rest of the paper is organised as follows. Section 5 offers definitions of key terms. This is followed in Section 6 with a presentation of the analytical framework. Section 7 reviews empirical studies regarding determinants of FDI, and applies the resulting template to the Zambian case. Section 8 draws the paper together by way of conclusions and recommendations.

5. Definitions

International capital flows typically consist of foreign direct investment (FDI), portfolio equity and debt investment, commercial lending and official flows (Razin et al 1998a). FDI may be broadly defined as the establishment of, or acquisition of substantial ownership in a commercial enterprise in a foreign country, or an increase in the amount of an already existing investment abroad to achieve substantial ownership (Wallace 1990 p.150). It must be stated that FDI involves more than just ownership, as in the case of portfolio investment. It also includes direct involvement in the management of the enterprise (Buckley, 1997 p. 36; IFC 1997p.9)

Dunning (1988 p.15) identifies two characteristics of FDI. First, FDI involves the transfer of other resources than capital, such as technology, management, organisational and marketing skills. Secondly, the resources are transferred internally within the firm, rather than externally between two independent forces. Because of this, de jure control is still retained over their usage. Dunning suggests that this is the essential difference between portfolio and direct investment (see also Razin et.al, 1998b p.54).

For statistical purpose, the International Monetary Fund (IMF) defines foreign investment as direct when the investor holds 10% or more of the equity of an enterprise (IFC 1997 p.9). As a rule of thumb this is usually enough to give an investor a say in the management of the enterprise.

6. Analytical Framework - The Eclectic Paradigm

Dunning (1993 p.63) suggests that an all embracing theory of FDI is unattainable given that it must integrate three distinct theories- the theory of international capital, the theory of the multinational firm and the theory of international trade (see also Buckley and Casson 1985 p.114). The most that can be done therefore is to formulate paradigms to provide analytical frameworks for explaining various aspects and theories of FDI.
Dunning 'eclectic' paradigm is probably the most authoritative treatment of FDI. He argues that an enterprise will seek cross border activities if it has or can acquire certain assets not available to another country's enterprises. These assets exist in the context of what is called the OLI paradigm: ownership specific advantages, location endowments and internalisation advantages. Ownership specific advantages that an enterprise may have include capital, technology, marketing, organisational and management skills. These enterprises may wish to exploit location specific variables in a host country such as factor endowments, investment incentives, tariffs, government policies, infrastructure etc. This is done through direct investment instead of trading because by internalisation the enterprise may circumvent or exploit market failure in order to reduce transaction costs (Dunning, 1993). Table 1 illustrates the eclectic paradigm.

Table 1. The eclectic paradigm of international production

<table>
<thead>
<tr>
<th>The OLI framework</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Ownership-specific advantages of an enterprise of one nationality over another</td>
</tr>
<tr>
<td>- Capital</td>
</tr>
<tr>
<td>- Technology</td>
</tr>
<tr>
<td>- Management &amp; organisation</td>
</tr>
<tr>
<td>- Marketing</td>
</tr>
<tr>
<td>- Synergistic economies</td>
</tr>
<tr>
<td>2. Internalisation incentive advantages (i.e. to exploit or circumvent market failure)</td>
</tr>
<tr>
<td>- To reduce transaction costs</td>
</tr>
<tr>
<td>- To avoid or exploit Government intervention (quotas, price controls, tax differentials etc)</td>
</tr>
<tr>
<td>- To achieve synergistic economies</td>
</tr>
<tr>
<td>- To control supplies of inputs</td>
</tr>
<tr>
<td>- To control market outlets</td>
</tr>
<tr>
<td>3. Location specific variables</td>
</tr>
<tr>
<td>- Political stability</td>
</tr>
<tr>
<td>- Government policies</td>
</tr>
<tr>
<td>- Investment incentives and disincentives</td>
</tr>
<tr>
<td>- Infrastructure</td>
</tr>
<tr>
<td>- Institutional framework (commercial, legal, bureaucratic)</td>
</tr>
<tr>
<td>- Cheap and skilled labour</td>
</tr>
<tr>
<td>- Market size and growth</td>
</tr>
<tr>
<td>- Macroeconomic conditions</td>
</tr>
<tr>
<td>- Natural resources</td>
</tr>
</tbody>
</table>

Source: Adapted from Dunning 1993 p.81

The location specific variables are significant in the context of this study. The eclectic paradigm does suggest that a particular country can alter its propensity to be a net importer of investment by making adjustments to those location specific variables under its control. Such variables include the legal framework, physical and institutional infrastructure, investment incentives and government policy. Given that the other two factors in the OLI framework are largely outside the control of host countries, location specific variables as a locus for government intervention assumes crucial importance.
7. The Evidence

Empirical studies that have attempted to apply some of the theoretical arguments pertinent to FDI have concentrated mostly on establishing the place specific conditions (i.e. the L- advantages of the OLI paradigm) necessary for inducing FDI inflows.

7.1 Methodological Issues

There are considerable methodological problems to be overcome in trying to establish the determinants of FDI and their relative importance. The fundamental problem is that FDI itself is diverse and responds to a wide variety of different factors. As UNCTAD (1998) puts it, the relative importance of different location specific determinants depend on at least four aspects of investment; the motive (e.g. resource seeking or market seeking (see Dunning, 1993 p.56 for an excellent taxonomy)), the type of investment (e.g. green field or sequential FDI), the sector of investment (e.g. service or manufacturing), and the size of the investor. This is compounded by the fact that national and global economies are in a state of continuos flux and determinants therefore change in spatial and temporal terms.

Two major types of studies on the determinants of FDI can be identified; surveys and econometric analyses. Surveys have been used extensively to identify key influences and the less quantitative variables (Dunning, 1993). They have employed questionnaires or interviews of decision makers in MNEs. The weaknesses of surveys are well known. But important for our purpose is the fact that they are useful only in identifying the \textit{ex post} determinants of particular FDI (UNCTC, 1992 p.39). Policy makers on the other hand are interested in general factors influencing FDI \textit{ex ante}.

Econometric studies, using cross-country or cross-industry data, go some way in meeting this need. The major weakness of these studies however is that it is difficult to find suitable proxies, especially for qualitative variables like political stability, government policy or institutional framework. In addition the paucity and unreliability of economic data in developing countries has meant that the overwhelming number of econometric studies are relevant only to developed countries.

These methodological problems notwithstanding, both surveys and econometric studies have provided valuable insights into the factors affecting FDI. Taking the L-specific factors identified by the eclectic paradigm (fig 2.2), and corroborated by the literature (see for instance Amirahmadi and Wu, 1994; de Mello 1997; Kenning, 1997; Tsai, 1991), as a framework it can be stated that the important determinants of FDI are the following; political stability, market size and growth, macroeconomic conditions, infrastructure, government policy, and investment incentives. Others include the presence of natural resources, cheap and skilled labour and an appropriate institutional framework. Due to word length limitations and also because they are thought not to be crucial to explain the Zambian case, the later factors are not discussed.

For the reasons already mentioned, the relative importance of these determinants cannot be determined \textit{a priori} but with respect to specific FDI and country. However it is worth pointing out that an econometric analysis of 142 countries over the period 1980 to 1995 suggest that host country market size is the dominant influence in inward FDI (UNCTAD, 1998 p.140).

7.2 Political Stability

Intuitively political stability is necessary for attracting investment. Political instability is expected to decrease FDI because it increases uncertainty. Curiously however, the empirical evidence does not unequivocally support this expectation. For instance Agarwal (1980 p.761) cites a study by Green (1972) which found no significant relationship between US foreign investment and a host country's political instability. Agarwal suggests that political instability is perceived like any other business risk and should not be singled out for special treatment.
The results of such studies must be viewed with caution as there are considerable methodological problems in estimating what is essentially a qualitative phenomenon (Clegg, 1992; Schneider and Frey, 1985). In fact a critical mass of studies are agreed that a perception of political stability is an important determinant of FDI (see for instance Amiramahdi and Wu, 1994; de Mello 1997, Brewer 1993, Kening 1997). In a comparative study of Ghana and Cote d' Ivoire McMillan (1995 p.164) found that periods of instability were followed by decreased foreign investment, but only if other economic factors were already weak.

China as an example of a nation that has been very successful in attracting FDI has enjoyed political stability since the cultural revolution in 1976 (Kening 1976). In addition the Chinese example suggests that democracy may not be as important as strong government control, a stable social order and consistent economic policies. Investors clearly prefer a stable to an evolving investment climate (Wallace 1990 p.7).

Zambia has enjoyed relative political stability since independence from the United Kingdom in 1964. The one party system peacefully gave way to a multiparty democracy in 1991. Stability has been maintained despite the radical economic reforms which have seen the elimination of food subsidies, the devaluation of the currency, and the privatisation of state enterprises with resultant increase in prices, unemployment and poverty (Sichone and Chikulo 1996).

The really crucial point is the perception of foreign investors of Zambia as a destination for investment. This is affected by several factors, not least of which is that Africa in general has been associated with wars and political instability. The fact that two of Zambia's neighbours are currently engaged in a civil war will inevitably tend to cloud investors perceptions. An idea of these perceptions can be gauged from table 3.5. Comparatively Zambia comes bottom in two out of the three ratings and occupies the median position on the third.

Clearly the ratings suggest that Zambia is viewed in relative unfavourable light by foreign investors. These ratings may be highly subjective and may not capture the actual situation but this is the reality that policy makers in Zambia must face in trying to create the right climate for foreign investment.

### Table 2 Country Risk Ratings

<table>
<thead>
<tr>
<th>Country</th>
<th>Composite ICRG Risk rating</th>
<th>Institutional Investor Credit rating</th>
<th>Euromoney country Credit-worthiness rating</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>81.0 December 1997</td>
<td>51.2 September 1997</td>
<td>53.4</td>
</tr>
<tr>
<td>Ghana</td>
<td>63.5</td>
<td>31.5</td>
<td>45.6</td>
</tr>
<tr>
<td>Malaysia</td>
<td>76.3</td>
<td>66.7</td>
<td>79.4</td>
</tr>
<tr>
<td>Mozambique</td>
<td>48.5</td>
<td>14.6</td>
<td>24.1</td>
</tr>
<tr>
<td>Namibia</td>
<td>81.0</td>
<td></td>
<td>33.0</td>
</tr>
<tr>
<td>Uganda</td>
<td>63.5</td>
<td>20.1</td>
<td>36.9</td>
</tr>
<tr>
<td>United</td>
<td>83.3</td>
<td>88.4</td>
<td>97.6</td>
</tr>
<tr>
<td>Kingdom</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tunisia</td>
<td>70.5</td>
<td>47.9</td>
<td>59.9</td>
</tr>
<tr>
<td>Zambia</td>
<td>64.4</td>
<td>16.0</td>
<td>24.0</td>
</tr>
</tbody>
</table>


Notes: (1).ICRG risk rating is an overall index based on 22 components of risk grouped into three categories: political economic and financial. Ratings below 50 are considered very high risk and those above 80 very low risk. (2). Institutional Investors credit rating ranks the chances of a county's default from 0 to 100.
Euromoney country credit worthiness rating is a measure of the riskiness of investing in an economy. Ratings are on a scale of 0 to 100, the higher the number the lower the risk.

7.3 Market Size And Growth

Market size and growth as measured by GNP or GDP is an obvious determinant especially for market seeking investment. Most studies conclude that there is a dependent relationship between market size and FDI (for instance Agarwal, 1980; Billington, 1999; Brewer, 1993; Brock, 1998; de Mello, 1997; Gastanaga, 1998; Haufler and Wooton, 1999; Liu, 1997; Wheeler and Mody, 1992). Kening (1997 p.20) cites the spectacular average annual growth of the Chinese economy as a key factor in drawing foreign investment. Between 1979 and 1994 the Chinese economy grew at an average rate of 9.5 percent.

A growing economy provides increased opportunities for profitable investment. African economies have relatively small domestic markets, low GNP per capita and low growth rates. This has constrained their ability to attract investment. Due to increased regional integration however, countries like Zambia are able to ameliorate the constraints of small domestic markets (Motta and Norman, 1996). In addition and as Agarwal (1980) points out, some FDI for example in mining is meant for export and in that sense domestic market size loses some of its significance.

Zambia had a population of 9.4 million in mid 1997 with a relatively low nominal GNP per capita of $380 (World Bank 1998). When Zambia economic growth is compared to that of the front-runners the differences are striking. Most of these countries had positive economic growth and all of them increased their real GDP per capita in the last ten years up to 1997.

7.4 Macroeconomic Conditions

Given that a lot of foreign investment is motivated by reducing transaction costs, the effects of the host country’s economic conditions on the foreign investor’s costs and competitiveness in foreign markets are of central concern. Thus inflation rates and foreign exchange rates are particularly important in this regard.

The LDCs have been plagued by persistent and high inflation and over valued exchange rates. As Schneider and Frey (1985) put it, a high rate of inflation is a sign of weak economic management and is negatively correlated with FDI. With regard to exchange rates popular wisdom suggest that weak currency should attract acquisition FDI (Brewer, 1993; Liu 1997; McCulloch, 1993; Sazanami and Ching, 1997) though this is mitigated by the fact that nominal returns also go down. Blonigen (1997) for instance finds a strong correlation between a weaker dollar and higher levels of Japanese FDI in the US. The regressions suggest that a 10 percent lower dollar increases Japanese FDI in a category of the manufacturing sector from 18 to 32 percent (p.463).

Macroeconomic stability is an important consideration for investment. As has been mentioned elsewhere, stability increases business certainty and reduces transaction costs. Zambia has been experiencing high levels of inflation for much of this decade. It compares very unfavourably with all the front-runner countries.

It must be pointed out however that the government has made good progress in stabilising the macroeconomy. As a result of strict control of government spending and improved efficiency of tax collection, the overall fiscal deficit declined from 8.3 percent of GDP in 1990 to 2.7 percent in 1997 (African Development Bank 1998). In addition the tight monetary and fiscal policies have brought about a downward trend in both inflation and domestic interest rates, and have helped to stabilise the exchange rate. Inflation dropped from 165 percent per annum in 1992 to about 19 percent in 1997(ZIC 1998).
7.5 Infrastructure

It is generally accepted that modern and efficient infrastructure is important in attracting investment. Transport and communications facilities, and reliable public utilities are obvious elements in an infrastructure an investor will seek (Wallace 1990). Wheeler and Mody (1992) for instance show that infrastructure development was significant in explaining US FDI to developing countries in the 1980s.

Zambia like many countries in the region has one of the lowest provisions of infrastructure in the world (Donaldson et al 1997). Most of the country's telecommunications, roads and transport facilities, electricity, water and sanitation are either inadequate or of poor quality.

For instance, only 9 out of 1,000 Zambians have telephone mainlines compared to 183 for Malaysia and 528 for the UK (World Bank 1998). Compared to the front runner countries, Zambia occupies the median position (see table 3). This low penetration rate is characterised by out dated technology which is unreliable and reflected in low call completion rates and high costs. The figures show that Zambia has the highest cost of local calls, though this is mitigated by cheaper international calls. The rates are high in absolute terms as can be seen by comparing with UK rates.

Table 3 Telecommunications

<table>
<thead>
<tr>
<th>Country</th>
<th>Telephone mainlines per 1000 people</th>
<th>Waiting list in thousands</th>
<th>Waiting time in years</th>
<th>Cost of local call $ per 3 min</th>
<th>Cost of call to US $ per 3 min.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>48</td>
<td>9.3</td>
<td>1.0</td>
<td>0.03</td>
<td>6.06</td>
</tr>
<tr>
<td>Ghana</td>
<td>4</td>
<td>28.3</td>
<td>2.9</td>
<td>0.08</td>
<td>.</td>
</tr>
<tr>
<td>Malaysia</td>
<td>183</td>
<td>160.0</td>
<td>0.4</td>
<td>0.04</td>
<td>5.99</td>
</tr>
<tr>
<td>Mozambique</td>
<td>3</td>
<td>22.7</td>
<td>10+</td>
<td>0.04</td>
<td>.</td>
</tr>
<tr>
<td>Namibia</td>
<td>54</td>
<td>4.5</td>
<td>0.7</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Uganda</td>
<td>2</td>
<td>6.3</td>
<td>0.7</td>
<td>0.19</td>
<td>9.29</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>528</td>
<td>81.8</td>
<td>1.5</td>
<td>0.19</td>
<td>6.47</td>
</tr>
<tr>
<td>Zambia</td>
<td>9</td>
<td>24.7</td>
<td></td>
<td>0.25</td>
<td>4.40</td>
</tr>
</tbody>
</table>


Perhaps Zambia's most severe infrastructure constraint is the road network which carries the major share of passengers as well as freight traffic. As Donaldson et al (1997) point out, the problem is not quantity as much as quality (see table 3.9). It must be noted that even where paved roads exist, they are often in poor condition for lack of regular maintenance. For example, only about 12 percent of the network in Zambia received the required maintenance in 1991 (Donaldson et al 1997).

There is clearly a need for Zambia to improve infrastructure provision if there is to be increased foreign investment.

There have been suggestions that export processing zones be set up, with dedicated infrastructure to service export based industries. The idea is attractive on the surface but needs careful analysis before it can be successfully implemented. To be successful, export processing zones need a combination of factors, including good infrastructure, skilled labour and easy access to markets of industrialised countries. These are difficult to bring together. There is potential for export processing zones in Zambia nevertheless, especially in labour intensive textiles.
7.6 Government Policies

Government policies towards trade and foreign investment are significant in determining foreign investment. At the broadest level, governments may pursue either an export promoting (EP) or import substituting (IS) strategies. Other relevant government policies include land policies, price controls, capital controls, labour policies and privatisation of the economy.

There is evidence to suggest that domestic policies play a role in FDI flows. India, the next largest developing country after China by population, received only 0.2 percent of GDP in FDI inflows in 1990-1996 compared to China's 5.4 percent (IFC 1997 p.2). Since both are populous low income countries, differences in population or income levels does not explain this disparity. The major difference between the two is that China, after years of strictly regulating FDI, changed the policy framework (see also Chen et al 1995 p.701; Kamath, 1990 p.107). It set up an administrative and legal framework to promote FDI and established Special Economic Zones (SEZs) as focal points for foreign investment. India on the other hand has maintained a restrictive foreign investment regime (Amiramahdi and Wu, 1994). The consensus is that FDI responds to liberal trade and economic policies (UNCTAD, 1998).

Balasubramanyam and Salisu (1991) analyse Jagdish Bhagwati's proposition that the magnitude of FDI attracted by countries pursuing an EP strategy will be higher than that attracted by those pursuing the IS strategy. Using data on a sample of 38 developing countries from 1970 to 1980 their analysis suggests that the proposition is true (p.191).

EP type FDI is said to be sustainable in the long run because it conforms to the dictates of comparative advantage and market forces. IS type on the other hand tends to be induced by policy oriented incentives such as tariffs and quotas which are transitory. Also policy induced incentives tend to be artificial in that they direct investments into activities in which the country does not have a genuine comparative advantage (ibid).

Government policy, especially with regard to trade, exchange and capital controls and privatisation sets the overall framework in which investment takes place. There is evidence to suggest that foreign investors do respond to the policy environment. Broad consensus lie in the direction of liberal trade policies, minimal capital controls and a reduced role for the state in economic activity.

After independence in 1964, Zambia embarked upon an interventionist state led development policy aimed at industrial import substitution, supported by a highly protective exchange and trade regime (IMF 1997). Since the early 1990s however there has been a radical shift in policy with emphasis now placed on liberalisation, deregulation and privatisation. The IMF acknowledges that Zambia 'now has one of the most liberal trade regimes in Africa' (p.18).

The privatisation programme has been acclaimed to be one of the fastest and most efficient privatisation ever. It has been a major avenue through which several MNEs have invested in Zambia. These include BP, Unilever, Lonrho, Commonwealth Development Corporation (CDC), Phelps Dodge, Binani Group and Tata. Others are Shoprite Checkers, Foodcorp and Bonnitta-Parmalatt.

In terms of exchange rate policy, the Zambian currency, the kwacha, is freely market driven and there are no capital controls. (African Development Bank 1998). The market determined rate and the total absence of capital controls means that foreign investors can convert and externalise their profits without hindrance.

Similarly, the government has a very liberal trade policy with minimal restrictions on international transactions (IMF, 1997). Despite this progress, the trade regime is still far from perfect. According to the IMF (ibid. p.19) areas of concern include high tariffs on intermediate and investment goods thereby affecting the competitiveness of exporters. In addition domestic producers have been under pressure from subsided or smuggled imports.
Table 4 shows the relative rankings of the FDI regulatory framework, according to an World Economic Forum survey. Zambia comes at the bottom of the front runners on all counts. Although these rankings are subjective, they suggest that there is scope for improvement in government policy towards FDI.

Table 4 Rankings of FDI regulatory frameworks

<table>
<thead>
<tr>
<th></th>
<th>Ranking of exchange policy</th>
<th>Ranking of FDI protection</th>
<th>Ranking of dividend remittance policies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Botswana</td>
<td>6.06</td>
<td>4.00</td>
<td>6.65</td>
</tr>
<tr>
<td>Ghana</td>
<td>4.89</td>
<td>4.94</td>
<td>6.09</td>
</tr>
<tr>
<td>Mozambique</td>
<td>4.32</td>
<td>4.68</td>
<td>5.33</td>
</tr>
<tr>
<td>Namibia</td>
<td>5.84</td>
<td>5.61</td>
<td>6.00</td>
</tr>
<tr>
<td>Tunisia</td>
<td>5.40</td>
<td>6.43</td>
<td>6.50</td>
</tr>
<tr>
<td>Uganda</td>
<td>4.79</td>
<td>4.96</td>
<td>6.04</td>
</tr>
<tr>
<td>Avg. front runners</td>
<td>5.22</td>
<td>5.10</td>
<td>6.10</td>
</tr>
<tr>
<td>Zambia</td>
<td>4.56</td>
<td>4.46</td>
<td>5.90</td>
</tr>
</tbody>
</table>

Source: UNCTAD 1998

Note: The investors in the particular countries were asked to give evaluations between 1 and 7 (1: Strongly disagree and 7: strongly agree) for the following statements.
(a). The exchange rate policy is favourable to export expansion
(b). Investment protection schemes are readily available
(c). Dividend policies do not impede business development.

7.7 Investment Incentives

Most LDCs invariably use a variety of incentives as major part of their strategy to attract foreign investment. In the literature country specific FDI incentives such as fiscal incentives (tax rebates and exemptions), financial incentives (subsidised loans and grants) and non financial incentives (e.g. infrastructure provision) are often cited as playing a role in determining investment (de Mello 1997 p.4).

These incentives are provided at enormous cost to the host countries and their persistence despite doubts about their efficacy suggests that they have some utility (Cable and Persaud, 1987). For instance the setting up of special economic zones (SEZs) has been a major strategy of China to attract foreign investment. (Kening 1997). The fact that these SEZs have been focal points of foreign investment suggests that that in part, investment incentives do work to attract capital.

Investment incentives however cannot be a substitute for the other factors that determine foreign investment. In fact taken by themselves, the empirical evidence that they have a positive relationship with FDI is at best inconclusive. Head (1999) offers evidence to suggest that Japanese FDI has been responsive to the provision of lower corporate taxes, employment subsidies and foreign trade zones in the United States. China’s SEZs are shown to have attracted 30 percent more investment than they would in an incentive free environment (Head and Ries, 1996). Regressions by Gastanaga (1998) show that corporate tax rates exert a significant negative effect on FDI in 49 LDCs (see also Shah and Slemrod 1991).

On the other hand Wheeler and Mody(1992) finds that incentives have had no significant effect on US FDI in developing countries. They suggest that incentives do not work at an early phase of development (p.71).
According to Claessens (1993) the general climate for investment and the specific sectoral policies rank above special incentives in influencing the allocation decisions of foreign investors.

It is our submission that investment incentives are necessary, if only to ensure that the individual country is not put at a competitive disadvantage vis-à-vis its competitors for foreign investment, who may be practising beggar-thy-neighbour policies. The nature and scale of these incentives however need to be carefully considered and streamlined in order to cut unnecessary costs and increase net benefits to host countries.

A number of fiscal incentives are available to foreign investors in Zambia. These include duty rebates on imports of capital equipment for mining and agriculture, and accelerated depreciation for equipment used for manufacturing, agriculture and tourism. Others are development allowances for certain agricultural activities.

According to the Zambia Investment Centre (ZIC), these incentives are inadequate and compare unfavourably with neighbouring countries. They are certainly limited in variety to fiscal measures only. There is a need to deepen and widen them.

But perhaps the major weakness is that all these incentives are administered by the Zambia Revenue Authority (ZRA). In practice they are used as a fiscal tool and are part of national budget making. This means that there is instability in the incentive regime. Clearly there is a need to vest powers for granting incentives into the ZIC.

As indicated above, incentives are by themselves not critical in determining the location of foreign investment, but may help to nudge it in the desired direction. Because of this the incentives must be competitive vis-à-vis other countries in the region. It is however impossible to verify the assertion that these countries are offering better incentives.

Conclusions And Recommendations

The foregoing sections have shown that several factors determine the magnitude of foreign investment in any country. The most important determinant appears to be market size and growth. A large market and a growing economy provides scale economies and opportunities for profitable investment. A stable macroeconomic environment is important especially for efficiency seeking FDI. In addition perceptions of political stability are crucial.

The study has shown that outward looking trade policies tend to be positively related to sustained FDI flows. Investment incentives, while not critical in the initial decision of whether or not to invest, are necessary for maintaining the competitive positions of individual countries. The study has underscored the importance of basic infrastructure which in developing countries may have to be provided by the state since the private sector is unable to do so.

With regard to Zambia, the study has identified a number of constraints against increased FDI inflows. The most severe of these are macroeconomic. Zambia has an extremely low GDP. This has been exacerbated by the fact that real GDP per capita has been in decline for much of the decade under review. Opportunities for foreign investment seeking markets or growth opportunities have therefore been extremely low. In addition high levels of inflation has created an unstable business environment. Given the importance of markets in determining FDI, these factors must be regarded as the major constraint.

Another major constraint is the lack of adequate and reliable infrastructure. The road network, while being adequate, is in a deplorable state for lack of regular maintenance. In addition the state run
telecommunications and electricity utilities are inefficient and lack new investment. International investors are unlikely to tolerate long waiting periods for connections and unreliable services.

There is evidence to suggest that perceptions about Zambia from international investors are less than optimal. These negative perceptions must be understood in the context of years of political instability in sub-Saharan Africa. Zambia itself has been relatively politically stable for much of the post independence, but foreign investors remain wary.

Government policies towards trade, investment and private enterprise are appropriate generally. The privatisation programme is widely acknowledged as one of the most successful in the world, with over 90 percent of the economy now in private hands. This programme has not only been a major avenue for FDI but also has demonstrated commitment to a private sector driven economy.

The constraints to increased FDI in Zambia are enormous and needs a multifaceted approach. The policy imperatives lie in restoring growth and macroeconomic stability, provision of infrastructure, and investment in education and training. Efforts must be made to improve the unfavourable perceptions international investors have about Zambia’s political stability. Part of this is a public relations exercise and deliberate image building campaign. Part of it lies in ensuring that democracy and the rule of law is maintained.

There is a strong case for accelerated regional integration. Open access to larger regional markets will tend to ameliorate some of the constraints pointed out, especially that of small market size.

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73
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74