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# ESSAYS ON FOREIGN DIRECT INVESTMENT IN UGANDA

BY

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# ABSTRACT

For over 20 years, Uganda has been aggressively promoting herself as one of the best investment destinations in Sub Saharan Africa. In an effort to make the country very attractive to the foreign investors, the government has introduced a wide range of incentives to motivate the flow of FDI into the country. However, other than the fact that the incentives are very expensive to the poor economy, FDI has been faulted for outcompeting domestic investors and driving them out of business as well as perpetuating imbalances in regional development. All this while and despite these concerns, very little effort has been made to establish empirically how FDI affects the Ugandan economy. This thesis is an attempt to comprehensively examine FDI in Uganda. It investigates inward FDI to Uganda from four dimensions with each dimension appearing as an essay in the thesis. Essay one probes the determinants of FDI to the country. The second essay investigates the effect of FDI on Uganda's economic growth. Essay three is an inquiry into whether FDI crowds-out domestic investment in Uganda while the last essay is an assessment of the regional distribution of FDI in Uganda. Overall, a number of policy implications from the study can be identified; for example, there is value in promoting the country for more FDI based on the fact that FDI makes a positive and significant contribution to economic growth. From the crowding evidence, it may be helpful to apply preferential policies with respect to the different sectors. In order to achieve the objective of balanced national development, it might be necessary to introduce special incentives in the regions which are lagging behind, or the government may consider creating industrial parks in those regions as a way of redistributing agglomerative advantages which are essential for determining the regional location of new FDI firms.

# ملخص البحث


على مدى أكثر من عقدين من الزمان سعت أوغندا لتعزيز مقوماتها لجعل أوغندا واحدة من أفضل أماكن الاستثمار في صحراء أفريقيا لجذب الاستثمار الأجنبي. وقد سعت حكومة أوغندا في إطار ذلك لتقديم عدد من الحوافز لجذب المستثمرين الخارجيين إلا أنه فضلاً عن التكلفة العالية لهذه الحوافز، والتي تشكل عبئا كبيرا على الاقتصادات الفقيرة، فإن إضعاف قدرة المؤسسات المحلية على المنافسة وإخراجهم من السوق و استدامة الاختلالات في التنمية الإقليمية تعتبر من أهم الآثار السلبية للاستثمار الأجنبي على الاقتصاد المحلي. وعلى الرغم من ذلك فإن آثار الاستثمار الأجنبي على الاقتصاد الأوغندي لم يحظ بقدر كبير من الاهتمام. ولهذا فإن هذه الأطروحة هي محاولة لدراسة شمولية لأثر الاستثمار الأجنبي على الاقتصاد الأوغندي. حيث قامت هذه الدراسة بتحليل الاستثمار الأجنبي المباشر لأوغندا من خلال أربعة محاور، تم تقديم كل محور من بحث مستقل. حيث تناول المبحث الأول دراسة لمحددات الاستثمار الأجنبي في أوغندا. بينما تم تحليل أثر الاستثمار الأجنبي على التطور الاقتصادي في أوغندا في المبحث الثاني. وفي المبحث الثالث تمت دراسة أثر الاستثمار الأجنبي على مزاحمة الاستثمار المحلي في أوغندا. بينما تناول المبحث الأخير تقييما للتوزيع الإقليمي للاستثمار الأجنبي في أوغندا. وقد توصل الباحث من خلال هذه الدراسة إلى عدد من التوصيات. على سبيل المثال، بناء على ما كشفت عنه الدراسة فإنه من المفيد تعزيز الاستثمار الأجنبي المباشر في أوغندا حيث وضحت النتائج وجود أثر إيجابي للاستثمار الأجنبي المباشر على النمو الاقتصادي. وفيما يتعلق بأثر الاستثمار الأجنبي على الاستثمار المحلي، فإنه قد يكون من المفيد تطبيق سياسات تمييز بين القطاعات المختلفة. وبهدف الوصول إلى تطوير إقليمي متوازن فإنه من الممكن تخصيص حوافز أو إنشاء مناطق صناعية في المناطق المتأخرة لإعادة توزيع مواقع شركات الاستثمار الأجنبي الجديدة.

# APPROVAL PAGE

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# DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

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*I dedicate this work to my dear family*

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# LIST OF ABBREVIATIONS

| | |
|---|---|
| AfDB | African Development Bank |
| BoU | Bank of Uganda |
| CMC | Common Man's Charter |
| CPI | Corruption Perception Index |
| DBI | Doing Business Index |
| DI | Domestic Investment |
| EAC | East African Community |
| GCF | Gross Capital Formation |
| GDP | Gross Domestic Product |
| HRW | Human Rights Watch |
| FAL | Foreign Assets and Liabilities |
| FDI | Foreign Direct Investment |
| IMF | International Monetary Fund |
| LDCs | Least Developed Countries |
| LRA | Lord's Resistance Army |
| MGLSD | Ministry of Gender, Labor and Social Development |
| MNCs | Multinational Corporations |
| MoFED | Ministry of Finance and Economic Development |
| NDP | National Development Plan |
| NRM | National Resistance Movement |
| PSIS | Private Sector Investment Survey |
| SAPs | Structural Adjustment Programs |
| SDR | Special Drawing Rights |
| SSA | Sub-Saharan Africa |
| TI | Transparency International |
| UBOS | Uganda Bureau of Statistics |
| UIA | Uganda Investment Authority |
| UDC | Uganda Development Corporation |
| UNCTAD | United Nations Conference on Trade and Development |
| UNRA | Uganda National Roads Authority |
| UPDF | Uganda Peoples' Defence Forces |
| WDI | World Development Indicators |
| WIR | World Investment Report |
| YLTT | Young Leaders Think Tank |

# INTRODUCTION AND BACKGROUND TO THE STUDY

## 1.1 INTRODUCTION

The growth of foreign direct investment (FDI) increased rapidly through the 1980s and the 1990s in virtually every single region of the world stimulating a controversial debate regarding the costs and benefits of inward FDI. One side of the debate has been based on the argument that given the assets associated with it, inward FDI has the potential to drive the process of economic growth in any country, although its precise impact depends on the specific country features and policies (Blomström & Kokko, 1998). However, negative externalities which may accrue from inward FDI such as worsening of the national Balance of Payments (B.O.P) account through profit repatriation, crowding out of domestic investment, weakening the productivity of domestic firms, threatening national sovereignty and the possibility of Multinational Corporations (MNCs) dominating local markets and thereby affecting the market structure in the host country have given credence to the counter arguments which voice the view that FDI can be potentially detrimental to the host economy (Hanson, 2001; Moosa, 2002).

Despite volumes of theoretical and empirical efforts, there is still no consensus on this debate which leaves it open. Some empirical studies have concluded that a significant positive relationship exists between inward FDI and the economic growth of a host country but on condition that the host economy has sufficient absorptive capacity to integrate and apply the advanced MNCs technology (Borensztein, De Gregorio, & Lee, 1998). Similarly, Balasubramanyam, Salisu, and Sapsford (1996) examined the effect of FDI on growth from a trade policy perspective. They confirmed the hypothesis that the volume and efficacy of inward FDI is a function of the trade policy followed by the host economy. Their findings revealed that the output elasticity of FDI was large

and significant for the set of countries which followed an export promotion strategy while in the import substituting countries, it was low and insignificant. These studies stand on the positive side of the debate and justify Blomström and Kokko (1998) observation above.

On the other hand, there are empirical findings suggesting that FDI's effects on growth are ambiguous and at worst negative to the host economy; (Alfaro, 2003; Carkovic & Levine, 2002; Falki, 2009; Omoniyi & Omobitan, 2011). Furthermore, in Görg and Greenaway (2004) comprehensive literature survey, at least six empirical papers are sighted which reported negative effects from the presence of MNCs on domestic firms. One of these papers authored by Konings (2001) established a negative spillover in Bulgaria and Romania. Overall, his findings suggested the presence of a negative competition effect from foreign firms which over shadowed the positive technological effect to the domestic firms resulting into a net reduction in domestic firm production. This evidence fortifies the Hanson (2001) and Moosa (2002) postulation that FDI may be disadvantageous to the host economy.

FDI literature is filled with many other unresolved issues over and above its vague contribution towards the growth of host economies, which call for more empirical effort. For example, Lipsey (2004) observes that there exist specific indictments against multinational enterprises which include; 1) dampening wages in recipient economies by exploiting the helpless labour force and 2) diminishing jobs in home countries through shifting production to foreign countries. In addition, Moosa (2002) identified other issues which include; 3) retarding the growth and advancement of domestic technology and 4) deteriorating the host country's terms of trade. These issues point to the fact that the research field with respect to FDI is still wide and researchers have a reasonable amount of work to do.

This thesis constitutes part of that effort with specific focus on Uganda. Since its independence in 1962, Uganda has had an on-and-off association with inward FDI until 1991 when the country made a new dedicated effort into the FDI field to compete with other countries for this global source of private investment capital. Emerging from two decades of political conflicts and with a shattered economy, Uganda desperately needed to invest and rebuild its economy. Inward FDI offered a viable and immediate solution. Hence at the beginning of the 1990s, the Uganda government which was motivated by the urgent desire to achieve fast economic growth enacted appealing laws, established the Uganda Investment Authority (UIA) to promote Uganda for FDI, provided wide ranging incentives, set aside huge chunks of land and continuously improved the political situation in order to attract foreign investors to the country. It is now over twenty years of devoted efforts to attract inward FDI. Uganda has made many sacrifices and indeed it has been successful in attracting foreign investors. But FDI has also generated issues and concerns within the domestic economy which are worth considering. This thesis attempts to address those issues in four essays.

The first essay investigates the determinants of inward FDI to Uganda. While Uganda has been very effective in attracting FDI over time, there is scarcity of information on the factors determining the inflow of FDI to the country. The first empirical attempt to investigate the FDI determinants by Obwona (2001) largely focused on macroeconomic policy related variables. The aim was to identify the economic variables which could be quickly adjusted in an effort to improve the country's investment climate. This was because during the 1990s, Uganda faced institutional and policy bottlenecks which were obstructing investors from establishing businesses in Uganda. This study extends the inquiry to other factors which are frequently mentioned in theory, including benefits sought by the MNCs due to their

ownership, location and internalization advantages as well as aggregate variables as determinants of FDI. The theoretical framework was based on the theory of industrial organization proposed by Dunning (1973). Empirical analysis was done using the autoregressive distributed lag (ARDL) model.

The second essay evaluates the effect of inward FDI on economic growth in Uganda. Considering the fact that Uganda was motivated into attracting FDI by the passionate desire to achieve economic growth and in view of the opportunity cost incurred in attracting FDI, it is worthwhile investigating how FDI has impacted the growth of the Ugandan economy so far. This study applied data spanning a period of 22 years (1991 – 2012) to investigate the effect of inward FDI to economic growth in Uganda. Like in the case of the first essay, the mixed nature of stationary and non-stationary variables in the growth equation meant that empirical analysis could best be done using the autoregressive distributed lag (ARDL) model. The bounds test for cointegration was based on Turner's (2006) response surface procedure which allows for adjustment of the critical value bounds to the exact size of the sample.

The third essay probes the concern about the crowding effects of FDI on Uganda's domestic investment. There are indicators that inward FDI might be crowding out domestic investment in Uganda. These indicators are supported by a public outcry about the 'undue' privileges enjoyed exclusively by foreign investors. This research is the first empirical study on the crowding effect of FDI in Uganda. Using data spanning 21 years (1992 – 2012), the study applied the Agosin and Machado (2005) model of investment to investigate the displacement effect of FDI on Uganda's domestic investment. It was motivated by the fact that if it could be empirically established that FDI is crowding out domestic investment, the country would have received an empirical justification for modifying its policies on inward FDI. All this

while, policy making for FDI has mainly relied on the theories which promise bundles of advantages to host countries, but as Moosa (2002) observed, the positive effects may not materialize or they might occur concurrently with a number of opposing effects, which might require changes in policy.

The last essay is an assessment of the regional distribution of FDI in Uganda. This was motivated by the need to establish empirically, whether the observed skewed concentration of FDI in the central region of the country has a significant effect on the regional location of inward FDI. The analysis was based on the standard locational choice model which is perhaps the most popular model in the FDI distribution literature. Panel data covering a period 21 years (1992 – 2012), from the country's four main regions was used. The study established that there are three robust regional locational determinants of FDI in Uganda. Based on these findings, it is recommended that some modifications to the FDI legal regime be made to ensure coherence with the national policy on balanced regional development.

Finally, overall conclusions are made, piecing together the general message from the four essays. An outline of the key findings is drawn and overall recommendations given, based upon the findings of the study. The aggregate implications drawn from the four essays are highlighted with practical policy suggestions towards targeting better benefits from Uganda's inward FDI. It ends with identification of some of the limitations of the research and identification of the direction for future research regarding FDI in Uganda.

## 1.2 TRENDS IN FOREIGN DIRECT INVESTMENT: AN OVERVIEW

Global inward Foreign Direct Investment (FDI) reached its highest point in 2007, when total inflows hit USD 1.976 trillion (UNCTAD, 2012). Due to the financial crisis which started in 2008, Worldwide FDI flows were affected, leading to a total decline equivalent to USD 777 billion in two years. By 2010, the world began to recover from this FDI slow down, with the overall inward FDI flows reported to have improved from USD 1.19 trillion in 2009, upwards to USD 1.31trillion and USD 1.52 trillion in 2010 and 2011, respectively (UNCTAD, 2012).

Before 1990, worldwide annual inward FDI flows were less than USD 200 billion, constituting less than 1 percent of global GDP on average. But over the last two decades, there occurred a phenomenal change in the international flows of FDI leading to an average growth rate of about 50 percent per annum. This has positioned FDI as one of the fastest growing drivers for worldwide economic growth and development. During the 1970s, international trade was the most significant global economic activity, but this has long been overtaken by FDI. The United Nations in its 1998 World Investment report observed that, in a period of only ten years starting from mid-1980s, the growth rate of the ratio of FDI to global GDP doubled the growth rate of the ratio of international trade to global GDP, implying that the interdependence of the global economy revolved around this unprecedented rise in international production (UNCTAD, 1998). According to Mody (2004), FDI in its various forms represents the crucial underlying power that has brought about international economic integration. This is especially true because the majority of nations together with their formal productive units have been integrated into the transnational FDI web. The significance of FDI in the world today is largely straight forward. In 2010 alone, the total output by all Multinational corporations (MNCs) brought forth a global value-addition of about

USD 16 trillion, representing over 10 percent of worldwide GDP and at least one-third of global exports. This remarkable performance was possible notwithstanding the fact that the global FDI flows were apparently 15 percent less than their pre-crisis mean level (UNCTAD, 2011).

In 2011, MNC associated companies around the world offered jobs to 69 million employees, whose aggregated effort was able to realise revenues amounting to $28 trillion[1]. Although by this time, the FDI global flows had significantly moved upwards to approximately $ 1.5 trillion, they were still less than their 2007 maximum by about 23 percent (UNCTAD, 2012). This rising tendency serves to emphasise the fact that FDI has substantial relevance to the economic growth and development of the world. This is not only because of the way that it affects international production, employment and global trade, but also due to its influence on capital formation, widening of the tax bases of host economies and the global competition among firms.

However it is worth noting that over the years, FDI has been highly concentrated in the developed world. For example, during the period 2001 to 2011, approximately 60 percent of all inward flows went to the developed countries. Developing economies together shared only 40 percent of total inflows. Fig 1.1 illustrates the distributional pattern of global inward FDI inflows in ten years.

[1] This represented a 9 percent growth in value-added over the 2010 performance.

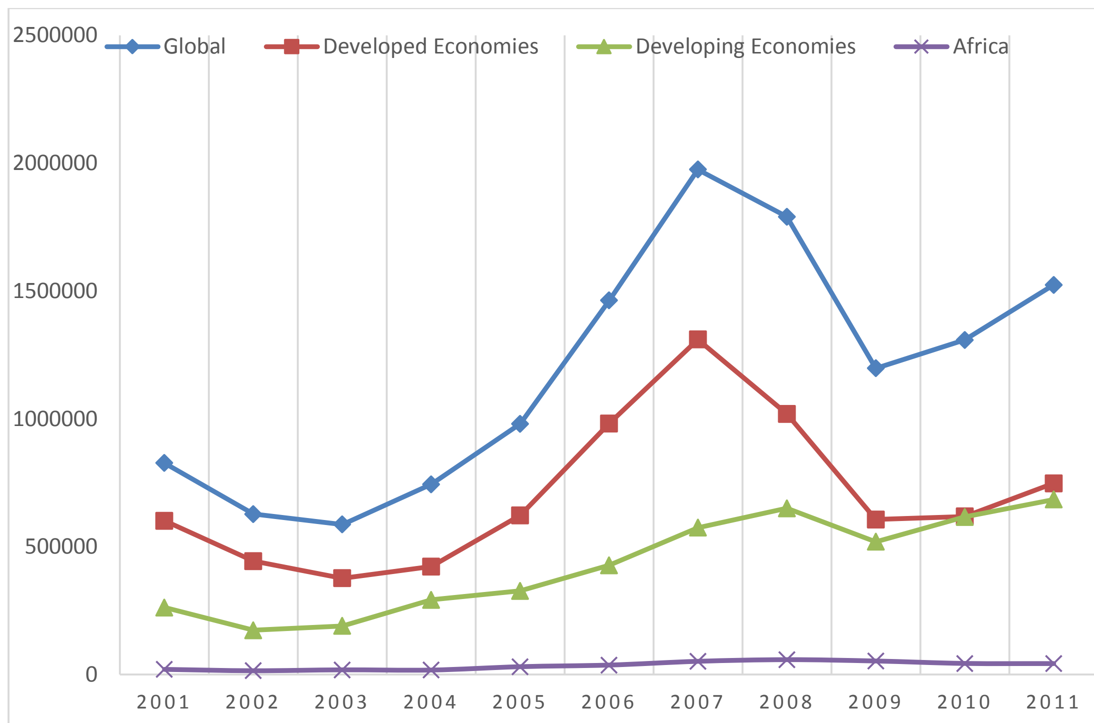


Figure 1. 1 Global distribution of inward FDI, 2001 - 2011 (millions of USD)[2]

Source: *Adapted from UNCTAD statistics database*

From the above trend, it may easily be argued that the worldwide growth and movement of FDI has been overwhelmingly a developed world affair. Looking at the statistics covering the last two decades (1990 - 2010) for example, Africa's share of the global FDI inflows was only 2.4 percent on average. This share improves marginally to 2.96 percent, if the period of focus is shifted to consider the last one decade (2001 - 2010). With this almost negligible performance in terms FDI attractiveness, it might seem credible to argue that FDI has not played a useful role in the development of Africa. Yet additional facts will most certainly give this nominal picture a different perspective.

In recent years, the ratios for inward FDI as a percentage of Gross Domestic Product (GDP) have been higher in Africa than in the rest of the world. In twenty years'

[2] Note that in 2010, inward FDI in the developed and developing world equalized.

time (1990 - 2010) for example, Africa's ratio of FDI to GDP was 2.3 percent while the aggregate world ratio was 2.1 percent. And in the last one decade (2001-2010), Africa's ratio improved to 3.1 percent, compared to just 2.3 percent for the rest of the world. It is clear in this case that Africa has had a proportionately better share of FDI than the more developed world. The statistics also imply inward FDI has been growing at a faster rate in Africa than the rest of the world.

Yet, even within Africa, the distribution of FDI was equally skewed. During the period 2001 - 2010, more than half of all FDI inflows to Africa went to the two dominating regions, namely; Northern and Western Africa as shown in figure 1.2. The average regional share of FDI followed a pattern where Northern Africa commanded the highest share amounting to 38 percent, followed by the Western region at 20.6 percent. Middle Africa was in third place with 16.1 percent, Southern Africa scooped 14.4 percent while Eastern Africa's share of the inflows was the lowest at 10.9 percent.

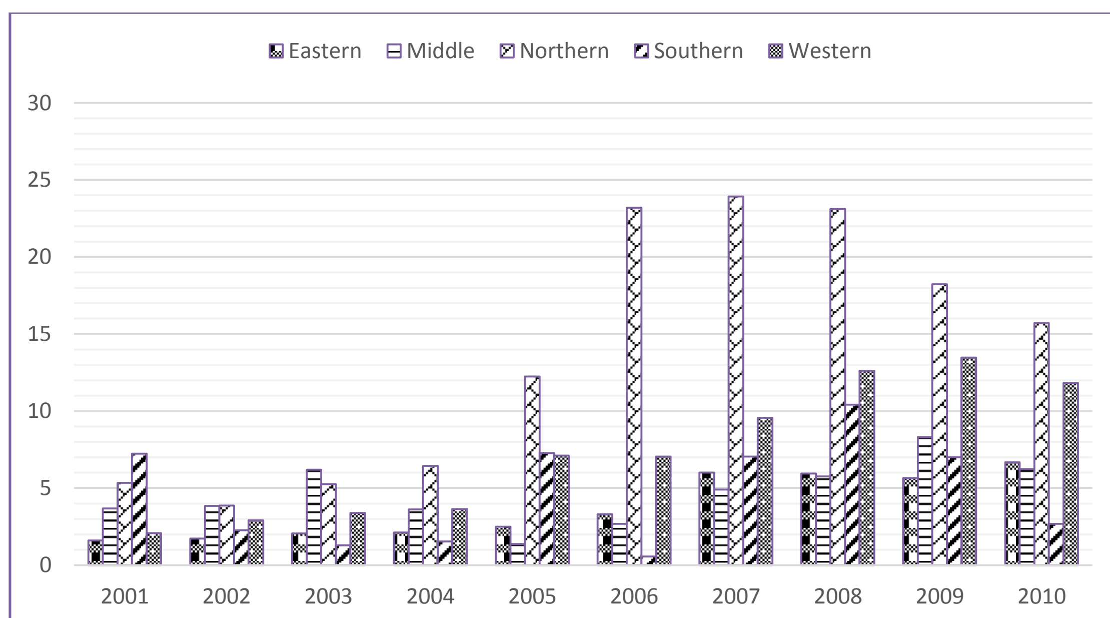


Figure 1. 2 Distribution of FDI inflows to Africa from 2001 to 2010 (in billion USD)
Source: *Adapted from UNCTAD statistics database*

Uganda is part of the Eastern region comprising seventeen African countries. In the section below, we make the case for the importance of inward FDI to Uganda.

## 1.3 FOREIGN DIRECT INVESTMENT IN UGANDA: ITS HISTORY AND SIGNIFICANCE TO THE ECONOMY

At the time of its independence in 1962, Uganda was a mixed economy, but investment was largely state-directed (Bigsten & Kayizzi-Mugerwa, 2001). Ten years earlier, the colonial government had established the Uganda Development Corporation (UDC) under the UDC Act (Cap 326), 1952 to "facilitate the industrial and economic development of Uganda". UDC's functions included, but were not limited to 1) financing new industrial projects, 2) managing and / or setting up systems and structures for better organization of government enterprises and 3) carrying out studies into both the industrial and mineral development prospects. By 1962, UDC was considered to be the leading entrepreneur in Uganda, employing over 18,000 people through all its subsidiary companies which included cotton textiles, industrial chemical factories and cement industries, located in different parts of the country (ASC-Uppen, 2010; UDC, 2012).

The immediate post-independence government aware of the fact that the colonialists who used to finance the country's development were not to play that role again, understood both the need and urgency of finding substitute sources of funding. Among those alternatives was inward FDI. In 1964, the foreign investment protection Act was enacted, spelling out the rights and privileges of foreign investors in Uganda (Obwona, 2001). However during that time, the political and economic environment in Uganda was changing very fast. Politically, there were tensions arising from the struggle for power between political parties and individual actors which started in the years leading to independence. The political tensions eventually exploded into to a military confrontation in 1966, leading to the overthrow of the first president, suspension of the federal constitution and abolition of kingdoms which were the pillars