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# The Role of Foreign Direct Investment in Provision of Public Service

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**Abstract:**

*Foreign direct investment (FDI) is one of the key drivers of globalization. The challenge for developing countries is to tap FDI in a way that promotes their long-term development objectives. Governments of developing countries need to go beyond offering a "passive open door" regime for FDI to one that positively enhances required human resource skills for the absorption of FDI. In that regard, Governments, through the public sector, need to create a conductive policy environment that enables FDI to contribute towards enhancing the international competitiveness of the host country on the basis of a dynamic development of comparative advantage.*

## INTRODUCTION

Attitudes towards foreign direct investment (FDI) in least developed counties (LDCs) have changed considerably over the last two decades, in the context of widespread adoption of economic liberalization doctrine, whether taken up voluntarily or through World Bank-sanctioned structural adjustment programmes. These changing attitudes refer to the so called 'New Economic Model'), characterized by the adoption of outward looking economic policies, particularly in the emphasis of promoting economic growth through FDI and efforts for greater participation in international trade . Within this framework FDI is seen as having a central, important role to play in national development strategies and is viewed as the engine with which to exploit and sustain the competitiveness of their indigenous resources and capabilities.

The present policy stance vis-à-vis FDI represents in many ways a dramatic turnaround, particularly so in the case of those LDCs which until the 1980s practised the outright barring of FDI activity in domestic markets. The dramatic turnaround in attitudes of LDCs towards FDI also emanates from the recognition of the accelerating pace of technical change and the emergence of integrated production networks of MNEs. FDI can play an important role in national development strategies, particularly with

regards the potential contribution to host country industrial and technological development. Indeed, it is becoming increasingly clear that the less developed a country is, the greater are usually the expectations placed on FDI to alleviate resource and skill constraints through the application of ownership-specific advantages in the form of financial, human resources, technology and knowledge [1].

In this respect, LDCs explicitly seek to encourage MNE activity as a source of much-needed capital and technology and hope that inward FDI flows fill the savings, investment, and production gaps in these underdeveloped economic contexts. However, whereas, some 'gaps' can be filled immediately (investment, production, employment, tax revenue), other 'gaps' inextricably linked to industrial upgrading such as skills, capability and technology development take time to emerge or possibly never take place. Furthermore, benefits of inward FDI are more likely to emerge from that kind of FDI which is likely to generate positive spillovers. This 'right' kind of FDI tends to shy away from LDCs. All these factors place some uncertainty about the extent of realising this potential contribution of FDI in the host country industrial development.

On the political economic front, it is important to place this current policy 'fervour' towards FDI, in the context of what is actually happening with regards to the development and upgrading of the host country competitiveness and industrial development in general. Although there is a tendency to categorise economies within a dichotomy of either inward-looking, import/substituting policy orientation (IL-IS) or outward-looking, export-oriented policy stance this may be an oversimplification of reality, since in reality there tends to be a hybrid policy orientation. To explain, even though LDCs may be adopting outward-looking economic policies, to great extent industrial policies and productive capacities are still mired in development models implicitly based on inward-looking, import substitutions policy stances. Moving closer to the key focus of this paper, i.e. FDI, whereas LDCs have registered some success in attracting much needed FDI flows to their economies (as a result highlighting the benefits and success in the adoption of outward looking economic strategies), it is increasingly becoming evident that FDI receptor conditions may not be tenable for the undertaking of internationally competitive economic activity and greater participation in global markets. The extent of

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these underdeveloped domestic capacities is to a certain extent reflected in the generic location that LDCs possess, particularly with regards to the low quality of human capital and the weak absorptive capacity and capabilities of the domestic firms. Therefore, a possible, apparent mismatch between policy stance and host country capability for international competitiveness seems to undermine the potential to leverage FDI for industrial upgrading purposes and this may be argued as representing the limitations of FDI as a sine qua non for industrial development[2].

Notwithstanding the role of MNEs is seen as a means to actualise the process of technology transfer and FDI does represent the most efficient option to promote a process of industrial development, there are obvious limitations of FDI as a driver to technology and industrial development. FDI does not automatically lead to positive externalities in the host economy. For example, when MNEs seek to transfer knowledge, they prefer to use technologies that are suited (first and foremost) to their particular needs, and the purposes for which they have made the investment. MNEs tailor their investment decisions to the existing market needs, and the relative quality of location advantages (especially skills and capabilities that the domestic economy has a comparative advantage. Hence, the extent of FDI being a driver of industrial upgrading depends on the quality of location advantages and how these advantages are developed over time.

**Macro-economic performance in recent years**

It is important to highlight some important characteristics of the economy and provide an overview of recent macroeconomic performance.

Economic growth is an essential condition for poverty reduction. In the early economic performance was extremely weak, with growth in GDP often less than the growth in population. Growth appears to have increased steadily since and by 2013 it came near the six per cent target defined in the Poverty Reduction Strategy Programme [3].

In general, on average real Gross Domestic Product (GDP) has grown by 3.8 per cent per annum, over the whereas the population has grown by some 2.8 per cent. As highlighted economy may not have been growing enough to improve GDP per capita growth. Although in real terms, GDP per capita has slightly improved from US$ 43.7 in 1989 to reach US$ 296.8 in 2013, it is still far to low for development purposes. The main economic

concern is how far real GDP growth registered in recent years can be maintained and translated into poverty reduction. Poverty is characterized by low income and expenditure, high mortality and morbidity, poor nutritional status, low educational attainment, vulnerability to external shocks, and exclusion from economic, social and political processes. Poverty is particularly widespread in the rural areas, but is not insignificant in urban areas. There are also important regional differences in the levels and specific dimensions of poverty. Those most at risk are young children and youths, the very old, women, those in large households and those involved in subsistence agriculture, livestock production and small-scale fishing [4].

Targets for poverty reduction are set out in a number of important documents, including: the Assistance Strategy (TAS), a broad strategic framework for all development assistance to the country; the National Poverty Eradication Strategy (NPES), which sets out a broad range of poverty targets; and the Poverty Reduction Strategy Paper (PRSP), which links targets with resource allocation and monitoring processes. Within these strategies, has embraced the key international development goals and in some cases has set national targets that are even more ambitious than their global counterparts.

Figure 1: Growth of real GDP percentage

The economy is heavily dependent on agriculture which accounts for 46.8 per cent of GDP. Over the period 2015/16, the growth rate of the agriculture sector was, on average, 3.7 per cent. The manufacturing sector constitutes around 8.6 per cent of GDP and over the 2015/16 period, grew at an average rate of 3.8 per cent. An important growth sector is mining. Mining, which contributes to around 3.0 per cent of GDP, registered growth rates averaging 13.8 per cent over the period under

| | **Units** | **2015** | **2016** |
|---|---|---|---|
| Population | Millions | 33.6 | 34.2 |
| Real GDP growth | percentage | 6.2 | 5.6 |
| Gross Domestic Product | Mill. TZS | 8,699,887.0 | 9,811,553.0 |
| at current prices | Mill. USD | 9,000.5 | 10,150.6 |
| Gross Domestic Product, | Mill. TZS | 1,857,175.0 | 1,962,040.0 |
| at constant 1992 prices | Mill. USD | 1,921.3 | 2,029.8 |
| Gross Domestic Product per capita | TZS | 258,925.2 | 286,888.0 |
| at current prices | USD | 267.9 | 296.8 |
| Gross Domestic Product per capita | TZS | 55,273.1 | 57,370.0 |
| at constant 1992 prices | USD | 57.2 | 59.4 |
| Inflation, consumer prices | annual rate | 4.5 | 4.4 |
| Balance of merchandise trade | Mill. USD | -608.8 | -830.0 |
| Current Account balance | Mill. USD | -251.1 | -337.2 |
| Investment/GDP ratio | percentage | 18.9 | 18.5 |
| Foreign Reserves | months of imports | 8.3 | 8.9 |
| Money supply | Mill. TZS | 1,798,000 | 2,206,000 |
| | | **2014/15** | **2015/16** |
| **Public Finance** | | | |
| Recurrent Revenue | Mill. TZS | 1,042,955.1 | 1,217,517.0 |
| Recurrent Expenditure | Mill. TZS | 1,466,136.9 | 1,409,628.3 |
| Development Expenditure | Mill. TZS | 344,610.9 | 473,188.6 |
| Financing | | | |
| Domestic Resources (net) | Mill. TZS | - 22,606.6 | - 36,513.9 |
| Foreign Loans (net) | Mill. TZS | 121,842.5 | 172,723.9 |
| Total External Debt Stock | Mill. USD | 7,464.0 | 7,384.7 |
| Disbursed Debt | Mill. USD | 6,559.7 | 6,413.4 |
| Interest | Mill. USD | 904.3 | 971.3 |

review [5].

Growth in agriculture is essential if rural incomes are to increase. However, structural change in the economy requires that the other sectors grow faster still. Although the mining and manufacturing sectors have registered important real growth rates in recent years, growth was forthcoming from a low base and both sectors still have relatively small shares of overall GDP. Investment is important to bolster economic growth and development. A look at the investment to GDP ratio highlights that this indicator has been registering an upward trend since the increasing from 14.7 per cent to reach 18.5 per cent. Nonetheless, this rate is somewhat lower than that registered in which saw a boom of investment in the economy to the tune of 27.0 per cent of GDP and it goes without saying that it is far from the level of investment required to spearhead the development process [6].

**FDI – CROWDING IN OR CROWDING OUT OF DOMESTIC INVESTMENT?**

Does FDI crowd in or crowd out the domestic private sector? Does it redirect government capital expenditure to activities to promote FDI at the expense of others? Crowding out or in can take place in either product or financial markets. Crowding in means the development and upgrading of domestic firms to benefit from linkages with foreign affiliates to raise the efficiency of production and contribute to the diffusion of knowledge and skills from TNCs to the local enterprise sector, and the degree to which affiliates integrate themselves into the local learning system. It also includes new investment in upstream or downstream production by other foreign or domestic producers or increases in financial intermediation. Crowding in could also take the form of accelerating government investment in improving physical infrastructure and the educational system to promote FDI. By contrast, crowding out can take two forms. First, using the "infant industry" argument, FDI in the product market may abort or distort the growth of domestic capabilities in competing industries with direct exposure to foreign competition or retard the growth of the local innovative base.

This can make technological upgrading and deepening dependent on decisions taken by TNCs and could in some cases hold the host economy at lower technological levels than would otherwise happen with potentially efficient domestic enterprises. The second form of crowding out is in terms of access to finance and skilled labour, resulting in an uneven playing field for domestic firms. This

can raise the cost to local firms in terms of finance and skilled personnel. In some cases TNCs can create dual labour markets as well as raise the entry cost for local firms or simply deprive them of the best factor inputs [7].

In practice it is difficult to draw a distinction between crowding out and legitimate competition, and this is a policy challenge between regulating foreign entry and permitting competition. While the aim is to develop the domestic private sector, it should not lead to the propping up of local uneconomic firms for long periods at a heavy cost to domestic consumers and economic growth. For new industries, the test is whether these investments would have been made at all without FDI. At the same time, in some circumstances one could raise the question whether FDI is more efficient than domestic investment, particularly if its sustainability depends on the incentives provided. From the public investment point of view, there could be a diversion of public investment from domestic-oriented activities to those that serve the foreign investor in terms of infrastructure that facilitates foreign investment projects rather than those in regions that are insulated from such investment or those that could have been given to the domestic private sector to develop new and niche areas.

Most investigations of this issue consider the matter in terms of the contribution of FDI to economic growth. Does one dollar of FDI produce more or less of this in terms of new investment? De Mello (1997) surveys the recent literature on the impact of inward FDI on growth in developing countries. He concludes that the ultimate impact of FDI on output growth in the recipient economy depends on the scope for efficiency spillovers to domestic firms, by which FDI leads to increasing returns in domestic production and increases in the value added content of FDI-related production. Also FDI is believed to be a very important source of human capital augmentation and technological change in developing economies since it promotes the use of more advanced technologies by domestic firms and provides specific productivity-increasing labour training and skill acquisition [8].

**Physical infrastructure and business environment**

A supportive physical infrastructure and a favourable business environment represent important pre-requisites for FDI-led industrialization. Expensive, sporadic and unreliable transport and communications constitute a serious impediment to industrial growth. High transport costs, poor

infrastructure and constant power and water interruptions raise the costs of doing business and compound the problem of lack of information. A number of competitiveness and business climate surveys point to Physical infrastructure as a serious constraint to realise FDI potential. Constraints identified in the literature reflect a poor road network, inefficient and inadequate communication network facilities, inadequate, unreliable and costly power and water supplies and lack of waste disposal facilities. The poor physical infrastructure is a clear reflection of a country at an early stage of economic development and increases the costs of doing business, both directly through the availability, quality and cost of services, and indirectly through, for example, port delays and impassable roads during the rainy season. The advantage of not being landlocked but the disadvantage of the largest land area in East Africa and with the population concentrated on the periphery of the country. The infrastructure network needs to be upgraded to facilitate improved accessibility to productive locations. The transport network is geared towards serving an economy dependent on the outside world for output markets and imported inputs. This has left major gaps in creating a relatively more cohesive network to the development of a domestic market of the vast country economic activities of which are distributed partly following the location of natural endowments[9].

The cost of electricity is generally presented as the main barrier to potential foreign investors due to its unreliability and cost. Only 13 per cent of mainland has electricity and it is estimated that electricity costs exceeds that of most countries in Sub-Saharan Africa by as much as 30.0 to 50.0 percent. Other utility services such as water and telecommunications are highly erratic in provision and cost double. Costs are directly linked to underdeveloped physical infrastructure.

In currently implementing a large-scale utility sector privatization programme and it is hoped that the constraints in the physical infrastructure network are addressed for the benefit of the economy. It is ironic that whereas in principle a host country it is expected a priori to have the infrastructure with which to ‘receive’ and attract FDI, in reality countries like seek and give FDI a central role in the development of such infrastructure.

High transaction costs of operating are not only a resultant effect of inadequate physical infrastructure but also as a result of

inefficiencies in the business environment in which FDI has to operate. The legislation and regulations in a number of areas of the business environment (as in labour laws, the commercial justice system, local licences, permits, duties and levies) which are the 'leftovers' of the 2015 centrally planned economy. Despite more than a decade of structural adjustment efforts, the inability of the existing legal, regulatory, and judicial institutions to reduce the transaction costs and, in many instances, their tendency to raise such costs, may explain the poor industrial performance.

Inadequate business environment translates in extensive fiscal requirements on corporate entities, cumbersome planning processes, business registration, import/export procedures, bureaucratic administration systems as well as petty corruption [10].

The emerging business environment in the context of the new market economy with many actors, calls for a greater capacity on the part of public institutions to regulate various actors. Unfortunately, this capacity is only in its infancy. It is argued by foreign investors that legislation in force in the areas of incorporation, contracting and contract enforcement, banking, insurance, employment, property rights, dispute resolution, may have been more of an impediment than a facilitator of market exchanges.

For example, the framework of commercial and contract legislation and the judicial system is regarded by foreign investors as a constraint to the establishment and profitable operation of new international business ventures in the country. The business environment is hampered with an underdeveloped business culture based on inexistent commercial codes which leave contracts between business parties unguarded. Ownership of land is vested in the government and only availed on leasehold. This has been so far a major constraint to the development of commercial agriculture and constraining the use of land as collateral. Efforts to address these business environment inadequacies have been made with regards to the implementation of specific regulations and Acts of Parliament such as in the case of land reform and commercial legislation. But of course more needs to be done to do away with antiquated and burdensome systems of regulations on trade, commerce, employment, and resource utilization. It can be argued that the transformation process of the centrally planned economy to a market-based economy is still in its initial stages and it is to be

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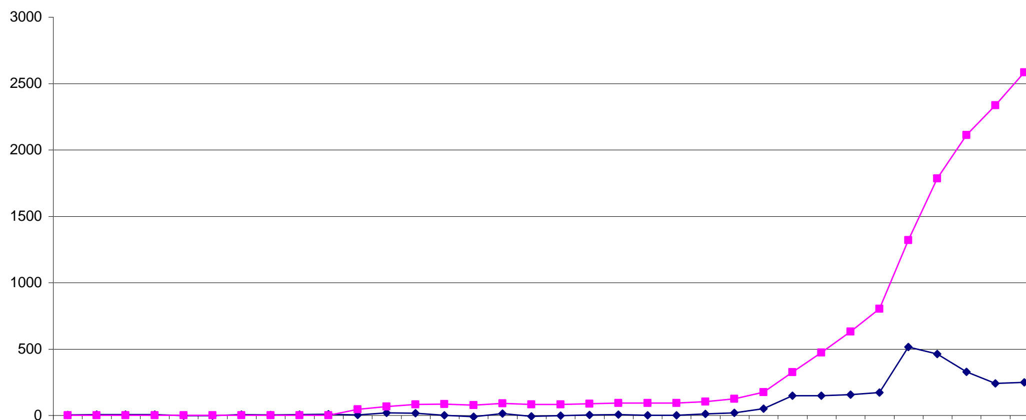
expected that the business environment may not be regarded as ideal to foreign investment. On the positive side, Government is cognisant of the measures needed to ameliorate the business environment and this is reflected in the evolving institutional framework [11].

**FDI Performance**

Having reviewed political economic developments and its location conditions, it is now the turn to specifically examine the country's FDI performance during recent years. To this end, it is noteworthy to analyse the trends of FDI flows and stocks directed to over the past decades as well as highlight key aspects driving this FDI performance.

Figure 2: FDI inward performance-flows and stocks




The recorded performance of FDI favourably compares to other countries in the region. Flows of foreign private capital are high to match or at times surpass the scale of FDI stocks and flows of most other African countries. FDI performance may actually have been better than that recorded by the international agencies. Here it is important to make a brief parenthesis and examine the most recent national source of comprehensive FDI data. This data pertains to joint studies undertaken, the National Bureau of Statistics (BoS) and the Investment Centre (IC) in 2015 and 2016 in the ambit of a country wide survey on private capital flows in the economy. The 2015 survey was primarily

aimed at re-assessing FDI macro figures (even those emerging from UNCTAD) and clarifies data on sectoral distribution of FDI and origin of investment. The main conclusion of the 2015 report is that previous data on foreign private capital flows severely underestimated the amount of FDI flows.

It is calculated that the flow of FDI into US$ 516.8 million, compared to the UNCTAD estimate at US$ 193.0 million. In the stock of FDI was valued at US$ 1,637.7 million and US$ 2,154.4 million, respectively, some US$834.7 million and US$ 1,167.4 million more than the official UNCTAD estimates. National data sources seem to confirm that in the recent past, FDI has been growing both in absolute terms and as a share of GDP, but differ in terms of the magnitude of FDI flows and stocks [12].

It is estimated that overall FDI accounts for over 85.0 percent of total stock of foreign private capital and over 75.0 percent of foreign private capital flows in the economy. On the basis of international standards, categorizes FDI in terms of direct equity investments, reinvested earnings and intra-company loans (both long and short term). The survey highlights the relative dominance of direct equity investment in the financing of FDI in the country. On average, new direct equity investment represented 40 percent of the total FDI financing for the period 2015/16 [12]. Reinvested earnings are still significantly low, whereas intra-company loans (long and short term), constitute a very significant financing source accounting for about 60 percent of FDI financing. Foreign direct investors in seem to rely more on intra-company loans as a source of financing and implying that private sector external debt is becoming significant with increased foreign investments in the economy [13]. It is argued that the monitoring of private sector external debt in should therefore be a matter of policy watch. In addition, it has been shown that short-term intra-company loans are dominated by suppliers' credits, reflecting that is becoming greatly susceptible to transfer pricing behaviour. Transfer pricing may also be the cause of insignificant re-invested earnings of only 0.3 per cent.

Although has registered a positive FDI performance in recent years and shows great potential to attract further FDI activity, it is clear that it still has a long way to go to reach a more adequate share of FDI more in tune with its development requirements and challenges [14]. As highlighted with the share of FDI in GDP and total investment as well as the structure of FDI in recent years, indicators

do suggest that there is greater potential to increase FDI activity in the economy as well as maximizing the FDI impact in the economy. Nevertheless, the share of FDI in total investment is still low vis-à-vis the capital requirements of industrial restructuring. In 2016, per capita FDI stock was just US 76. To realise the potential of registering further positive FDI performance, it is important to examine closely the prevailing scenario of FDI sources and drivers in the economy [15].

**CONCLUSION:**

The role of FDI in the current economic scenario is made more pronounced given the conditions of underdevelopment. Despite the country's FDI performance has been noteworthy during the past two decades, it has been highlighted that still faces a number of challenges in improving the specific location factors offered to foreign investment, notably weak human resources, local market demand conditions and the physical infrastructure. The discussion of the sectoral drivers of FDI has highlighted the potential impact in the economy. However the implications of FDI in specific sectors and in the economy in general, needs to reflect that the share of industries with FDI in the economy is still small. More efforts need to be undertaken to promote the country as an ideal base for FDI as well as measures to consolidate current foreign investment activity. The main development challenge which all efforts – including FDI - eventually aim to address, is widespread and persistent poverty. It is a major challenge for halve the proportion of people living in extreme poverty by 2015. Whereas has some potential for improved economic growth, the challenge will be to make this growth follow a pro-poor pattern.

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