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Summary

This thesis examines the causes of the divergence in economic growth between Kenya in Sub-Saharan Africa and Malaysia in South East Asia, and the role of foreign direct investment (FDI) in industrial development in the two countries. They were arguably at similar levels of development fifty years ago and have many similarities, which made them ideal for comparative purposes, even though they differ in terms of initial conditions and in some other aspects too. A more compelling reason for comparison is perhaps the growing interest within the Government of Kenya in Malaysia’s and other South East Asian countries’ development model to inform its own future development path. This has culminated in the development of Kenya’s Vision 2030, following Malaysia’s Vision 2020, as Kenya hopes to catch up with other countries. This thesis was undertaken as part of the research conducted in the Tracking Development project.

The conventional view in the literature based on the experiences of newly industrialized countries, such as Malaysia, attributes successful industrial development to ‘getting the prices right’, i.e. allowing prices to find their own levels in freely operating domestic and international markets. In such an environment, the government’s role is confined to the provision of public goods, such as infrastructure, law enforcement, macroeconomic stabilization and education. An alternative view upholds that late industrializers did not follow free-market principles but operated with a different subsidy-allocation principle, with government intervention being seen as a necessary evil. In this case, subsidy allocation is disciplined and monitored to facilitate growth. Recently, success in these countries has been attributed to strategic collaboration between the private sector and the government, with the aim of uncovering the most significant obstacles to restructuring and the type of interventions that are likely to remove them. Institutions and industrial policies matter when it comes to growth and industrial development.

The Tracking Development project has argued that three main preconditions for sustained growth and poverty reduction were met simultaneously in South East Asia, but not in Sub-Saharan Africa. These are adequate macroeconomic management; economic freedom for peasants and small-scale entrepreneurs; and pro-poor, pro-rural public spending. These conditions were believed to have been chosen on the basis of three main principals, namely outreach, urgency and expediency.

This thesis considers the validity of these arguments, using the example of FDI and focusing mainly on the manufacturing sector. Choosing FDI in both
countries at independence was done with considerable success to complement government efforts to provide an initial push in the import substitution industrialization strategy (ISI). Apart from capital accumulation, FDI was chosen in both countries as an alternative to supporting the entrepreneurial minority, mainly the Chinese in Malaysia and the Indians in Kenya. However, the benefits of ISI were short lived and demanded a change in industrial development strategy because of the threat of balance-of-payment problems due to its expensive nature. In 1970, Kenya responded by pursuing the second stage of ISI, which was characterized by further government involvement and high financial demands that were unsustainable and had serious negative consequences. Malaysia, on the other hand, implemented an export industrialization strategy, mainly targeting the non-resource sectors that were largely dominated by FDI, while still maintaining the ISI within resource-rich sectors.

The export industrialization strategy introduced competition and created an opportunity for better learning and knowledge accumulation. In Malaysia, this strategy was tied to the overall development plan and its main goal of creating employment. This was not the case in Kenya, however, where the government developed the informal sector, which did not receive sufficient attention and was thus unable to create new employment opportunities. The 1970s marked an important turning point for the two countries. There were political reasons that may have led to the adoption of different strategies by them both around this time. In Kenya, ethnic-based politics within the African indigenous population had already gained prominence and there was no room for consensus, policy implementation was largely influenced by ethnicity and opposing views went unheard. This was in contrast with Malaysia where ethnic tensions had resulted in riots in 1969 and forced the government’s suspension for two years and the formation of a coalition. The fear of a further escalation in economic tensions, communist threats and ever-increasing opposition forced Malaysian leaders to work together for the common good of the country.

The thesis identifies the factors that were crucial to Malaysia’s success compared to Kenya in attracting FDI with its macroeconomic stabilization, agglomeration economies, economic growth, infrastructure development and dependable institutions. There is evidence in both countries of economic growth but not FDI-led growth, which suggests that FDI does not have a direct impact on economic growth. However, the impact of FDI is usually considered less significant than the indirect effects (externalities). For the latter, there is evidence in favour of strong positive effects in Malaysia but not in Kenya. The thesis analyses two kinds of externalities: those related to productivity and those related to export spillovers and their transmission channels. In both countries, there are negative productivity spillovers from foreign-owned firms to domestic firms through
competition effects. The negative productivity spillovers in Kenya affect both firms with high and low technology, whereas companies in Malaysia with low technology suffer most. Negative spillovers in Malaysia are also transmitted through the backward linkages in domestic firms with both high and low technology levels.

There is also evidence of positive productivity spillovers from the foreign-owned firms to domestic firms through the demonstration effects in Malaysia. These spillovers are mainly concentrated in domestic firms that have low technology gaps compared with incoming FDI, where the technology gap is defined in terms of the average wage gap and the labour-productivity gap. Moreover, demonstration effects are concentrated in firms with a high technology gap when it is defined in terms of capital intensity. Finally, there are positive productivity spillovers in Malaysia from domestic firms to foreign firms through backward linkages. Hence, there is evidence of reverse spillovers where foreign firms benefit from technology spillovers when they locate close to domestic market leaders. Foreign-owned firms in Kenya were found to have higher productivity than domestic firms. In addition, exporting firms in Kenya appear to have higher productivity than non-exporting firms. This is not the case, however, in Malaysia where there is no significant difference between the productivity of foreign and domestic firms. Moreover, exporting firms are not found to have higher productivity levels than non-exporting firms, which may indicate that differences in productivity and innovation should not be attributed to foreignness but to multinationality. In particular, domestic firms may share many of the characteristics of foreign-owned firms in a given country and can be at least as productive, innovative and likely to invest in research and development.

There is evidence of limited positive export spillovers through the demonstration effects, and negative spillovers through the effects of competition in Kenya. In Malaysia, on the other hand, positive export spillovers emanate from backward linkages, while negative spillovers are concentrated through the information channel. The negative spillovers in Malaysia are concentrated mainly in firms that have low productivity levels. While the study did not examine the effects of government policies on the generation of externalities from FDI, there is evidence of increased use of incentives programmes for firms in Malaysia whose eligibility has hinged on the benefits accruing to domestic firms. These programmes in Malaysia, unlike in Kenya, could act as useful pointers to the role of government creation of linkages between firms, which is an important aspect in industrial development. However, it is worth noting that the results of this thesis are only accurate to the extent of the proxies used for the various spillover measures. This is a major limitation of this study.
The study did not find sufficient evidence to support most of the Tracking Development project’s assertions. Finally, on the basis of Kenya and Malaysia’s industrial experiences, this study concludes by observing that successful industrialization requires not only the right policies to be developed and implemented based on a long-term social economic plan with a clear objective for employment creation and poverty reduction, but also political commitment through dependable governance and independently functioning institutions. In addition, FDI can play an important role in industrial development both in terms of capital accumulation and technology transfer and thereby improve domestic firms’ competitiveness. It can also be a source of negative externalities, and governments can use incentives or other forms of control to minimize the potential effects of FDI on the host country. However, it is important to note that FDI alone cannot drive industrial development. It must be accompanied by development of domestically owned industries, which ultimately have a greater impact on the domestic economy compared with FDI once their competitiveness has been enhanced.