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Summary and conclusion

This thesis set out to investigate the causes of the observed divergence since the early 1970s in Kenya in Sub-Saharan Africa compared with Malaysia in South East Asia. Special attention was given to the role of FDI in industrial development. At the outset, it was noted that the industrial success in the newly industrialized countries and the continued slow growth of countries in Sub-Saharan Africa has received a lot of attention, as governments and scholars try to understand why economies in countries within these two continents diverged over the last 50 years. Towards this end, several arguments are put forward here in brief, having received enough attention in Chapter 2.

The conventional wisdom presented by some neoclassical economists has claimed that success in Asia rested in “getting the prices right”, which they consider to be both a necessary and sufficient condition for maximizing the rate of long-term growth (“getting” in the sense of letting prices find their right levels, and “right” in the sense of the relative prices established in freely operating domestic and international markets). In addition, they further argue that most market failures are a result of government policies and that, even in the most uncommon cases where market failures occur for other reasons, the welfare costs of remedial government interventions can often be greater than the welfare gains.

Under such circumstances, growth is a natural or inherent property of capitalist economies. Governments are considered to have a major role in providing “public goods” that are difficult to arrange through private contracts, such as physical infrastructure, law enforcement, macroeconomic stability, and perhaps education. But roles beyond that, they should not take on, except in those rare cases of market failure referred to above. In this regard, African problems are partly considered to be a result of governments going well beyond these limits, adopting policies that interfere, intentionally or unintentionally, with the free working of the markets. In contrast, the newly industrialized countries in South
East Asia are believed to have adhered to these limits, and hence their success (World Bank 1993; Krueger 1995; Gore 2000).

An alternative view has been presented by the structuralists, in which it has been argued that the neoclassical view as presented does not capture the dynamics of industrial change in either the eighteenth or the nineteenth century, having largely ignored technology changes, innovations, and economies of scale, which are not easily incorporated in their models. As a result, they argue that late industrializers did not follow free-market principles but operated with a different subsidy allocation principle. These subsidies have been provided in exchange for concrete performance standards with respect to output, export, and, eventually, R&D. In addition, they observe that a low wage advantage cannot offset a high productivity advantage in enough industries to spur development. Government intervention is therefore a necessary evil. Hence, the more subsidy allocation is disciplined and monitored, the faster the growth.

Moreover, they argue that manufactured exports in these countries have entailed a lengthy period of subsidization through the use of incentives to encourage domestic sales over exports. Micro-efficiency in these industries they observe extended from the shop-floor level to the state. In addition, the government has been able to prevent the “wrong” prices from being incorrect. Market forces and the state divided the labour of disciplining business in these countries. The state was disciplinarian during the import substitution phase, while in the early export phase, that role went to the market. Furthermore, the government spearheaded efforts to move up the technology ladder through subsidies in R&D (Wade 1990; Amsden 1994).

Finally, a new thinking has emerged, which has challenged the traditional view of the market and government relations. This argues that market forces and private entrepreneurship ought to be in the driving seat of the development agenda, but governments should also perform a strategic and coordinating role in the productive sphere beyond simply ensuring property rights, contract enforcement, and macroeconomic stability. This is based on the fact that there are certain types of market failures that call for industrial policy and are located predominantly in the industry. These industrial policies are supposed to complement “distorted” market forces; they reinforce or counteract the allocation effects that the existing markets would otherwise produce. The task of industrial policies in this case will be as much about eliciting information from the private sector on significant externalities and their remedies as it is about implementing appropriate policies. Hence, in a departure from the structuralists’ arguments, the industrial policy is not so much about government applying Pigovian taxes or subsidies but about strategic collaboration between the private sector and the government with the aim of uncovering where the most significant obstacles to restructuring lie,
and what type of interventions are most likely to remove them\(^1\) (Lall 2004; Rodrik 2004).

According to the Tracking Development research outcomes, 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 entrepreneurs; and pro-poor, pro-rural public spending. The adequate macroeconomic management hypothesis is fulfilled when government finances are managed such that inflation does not exceed 20 per cent and when there is no administrative overvaluation of the national currency – that is, no black market exchange rate alongside the official rate. The ‘economic freedom for peasants and small entrepreneurs’ hypothesis is fulfilled where the state does not place coercive restrictions on the economic activity of small farmers and small entrepreneurs. Economic freedom means no state regulation, but it does not exclude subsidies. Finally, the pro-poor, pro-rural public spending criteria is fulfilled when public spending is directed more to agriculture, the countryside, and the poor than to industry, the cities, and the rich. As a very general rule of thumb, this precondition can be said to be met if, firstly, at least 10 per cent of all public spending and/or 20 per cent of development spending (public investment) goes to the agricultural sector as funding for research, extension services, input subsidies, crop price support, irrigation, drainage, and agricultural settlement schemes; and secondly, government spending on manufacturing and mining is low relative to agriculture (van Donge et al. 2012; Henley 2012).

In addition, these three conditions were believed to have been chosen on the basis of three main principals, namely outreach, urgency, and expediency. The primary criterion by which policies and interventions (outreach) is selected is the number of people to whom they provide direct material benefit. Interventions are not selected according to the size of the benefit which they bring to each individual beneficiary, and certainly not according to their theoretical elegance, technical sophistication, or aesthetic appeal. On the principle of urgency, Tracking Development notes that at least at the beginning of the development process, at the point of transition from persistent poverty to sustained growth, successful development strategies do not involve meticulous long-term planning based on what is desirable in the future. They involve establishing clear priorities based on what is undesirable in the present, and acting on those priorities quickly using the resources immediately at hand.\(^2\) Finally, on expediency they note that in successful developmental states, legal principles, administrative procedures, political rights,

\(^1\) A Pigovian tax is a tax levied on a market activity that generates negative externalities.

\(^2\) Undesirable in the sense that the reference point is not the desired idealized state of industrial modernity but rather, addressing the immediate and grim reality of rural poverty, the undesired starting point in the development process.
and ideological precepts all take second place to the goal of improving the material living conditions of as many people as possible, as quickly as possible. Achieving that goal may involve tolerating corruption, bending rules, and infringing rights.³

The relevance of the above interpretations of the industrial experience in South East Asia and Sub-Saharan Africa can be analyzed by considering the experiences of both Kenya and Malaysia, using the example of foreign direct investment mainly focusing on the manufacturing sector. At independence, although Malaysia’s per capita Gross Domestic Product was higher than that of Kenya, both countries had not undergone structural transformation. They were both dependent on the primary sector, which in Malaysia was largely dominated by rich resources (mainly tin and rubber) that were used to finance development. Kenya relied more on revenues from cash crops (mainly tea and coffee) and external borrowing to finance its development expenditure. The manufacturing sector at this stage was limited, and the existing firms were small and incapable of spearheading the process of industrial development. The government role was therefore important at this stage in providing the necessary push under the Import Substitution Industrialization (ISI), an approach widely recommended by the structuralists (Murphy et al. 1989). The aim of the ISI approach was to replace imports of specific activities with domestic production in order to move away from the over-reliance of the traditional sectors, whose export earnings were unsteady compared with that of manufactured goods, as described in the Prebisch-Singer hypothesis.⁴

The essence of ISI, according to Burton (1998), is to create a gap in the economy that makes obvious investment opportunities in non-traditional activities of the economy, usually manufacturing. Resources are then directed into new industrial channels and the capitalist sector is enlarged. New profits are expected in the latter sector, leading to an increase in the savings rate – as capitalists are assumed to be higher accumulators compared with other economic agents – which can then be used to purchase new capital goods, which will be paid for with the foreign exchange released by the reduction of imports of the commodities whose domestic production is encouraged. Initially, the first sector to be targeted at the

³ For more information see http://www.trackingdevelopment.net/resources/docs/Henley-three%20principles%20.pdf
⁴ This hypothesis argues that the terms of trade between primary and manufactured goods deteriorate over time. What this means is that countries that export primary goods that do not have the means to manufacture goods to export will lose out in the long term, as their goods will become relatively cheaper than the manufactured ones. Since most of the primary commodities’ exporters are developing countries, it therefore means that their chances of industrialization are slim without borrowing large amounts to invest in manufacturing.
initial stages of the ISI is the consumer goods industry. The first stage of the ISI process ends when the expansion of finished consumer goods capacity hits the limit of the domestic market. At this point, the economy needs a number of new activities whose survival depends on some form of protection and whose expansion cannot continue. Further growth must then take place in activities which are now being imported, or the recently established ISI activities must enter the export markets. This second stage is usually a challenge because the economy must move more heavily into intermediate or capital production. This shift not only raises the direct cost of growth, but also affects the cost of production and the level of existing protection in the new consumer goods industries. Hence, an ISI imposes a necessity of selective activities to be protected, and conventionally selection procedures have left a residue of high-cost, non-growing activities in many countries, as a result of their method of protection. Moreover, distortions seem to increase as ISI is pursued.

On the basis of the description of the ISI, the two countries successfully underwent the first stages of its implementation. The manufacturing sectors grew fastest compared with the other sectors, and by the end of the first decade manufactured output had increased tremendously. This was mainly by relying on FDI as well as government agencies established during this period, some wholly owned, while others were in partnership with foreign investors. However, by the end of the first decade, the ISI – although assisting in diversification – exhibited many weakness. It did not adequately address the employment needs of the country, and owing to its expensive nature it was likely to lead to BOP problems, especially embarking on the second phase. In addition, it exhausted local demand and there was a need to consider external markets. Worse still, most of these industries were still inefficient and relied much on government support, thus defeating the “infant industry argument” advanced by the neoclassical economists. These pitfalls had not been anticipated by the structuralists.

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5 This is usually because the cost advantage between domestically produced and imported consumer goods is less than for capital goods or for intermediate goods. Hence, at this early stage the ISI can be achieved at minimal cost. The cost advantage is supplemented by the existence of an obvious demand. Consumer goods are, however, universally deemed inessential to development; increases in their costs and in their prices are assumed to be less harmful than increases in the price of capital goods, and hence preferred initially. Therefore, the objective is to use policies that allow the importation of capital goods cheaply through discriminating tariffs and exchange rate policies that keep the import costs of capital goods below real costs. This is based on the belief that capital goods are essential for capital accumulation in the development process.

6 The essence of the infant industry argument is that certain industries possess a potential comparative advantage but have not yet exploited the potential economies of scale. Short-term protection from established foreign competition allows the ‘infant industry’ to develop its comparative advantage. At this point the trade protection can be relaxed, leaving the industry to trade freely on the international market. The danger of this form of protection is that the industry will never achieve full efficiency, and the short-term protectionist measures often begin to appear permanent.
Apart from the need for capital accumulation, FDI preference by these countries was informed by other reasons. Both countries chose FDI as an alternative to supporting the entrepreneurial minority, mainly the Chinese in Malaysia and Indians in Kenya. Most of South East Asia at the time was threatened by communist insurgency, mainly from Indonesia, and Malaysia in particular was greatly affected until a state of emergency was declared at the early stages of independence. The political alliance formed in Malaysia at independence, whose main leadership was from UMNO, an ethnic party representing the indigenous Malays, who had been marginalized before, also saw in FDI an opportunity to pursue policies that would empower this group. Similarly in Kenya, the government, keen on empowering the marginalized Africans, pursued the Africanization programs aimed to empower them, while discriminating against the Indians who were mainly involved in trade and commerce.

In order to facilitate sustained capital accumulation, the structuralists also emphasized the need for the development of social overheads as well as agriculture. Lewis (1954) had noted that the manufacturing and agricultural sectors were dependent on each other. In addition, Rostow (1956) had emphasized the need for development of social overheads such as an adequate transport network, hospitals, and schools as a precondition for take-off. Both countries after independence appear to have adopted this approach, resulting in the increased growth in the manufacturing sector. However, after 1970, it became increasingly difficult to pursue the big-push ISI program in Kenya owing to several problems, including severe exogenous shocks and BOP problems. Consequently, most of the sectors were either neglected or did not receive sufficient allocations to develop them. This was not the case, however, in Malaysia, where the discovery of oil in addition to returns from tin, rubber, and palm oil as well as domestic borrowing played an important role in developing other sectors.

Malaysia, unlike Kenya, which ignored advice to shift policy from ISI to an export-oriented industrialization strategy (EOI), by 1968 had set in motion various pieces of legislation aimed not only at attracting FDI but also encouraging export of manufactured goods. ISI was then restricted to the resource-based industries, which were involved in increased processing of older (rubber and tin) and newer (palm oil and timber) primary commodities for export, while non-resource industries mainly dominated by FDI were involved in producing for exports. This introduced competition and an environment which created an opportunity for much better learning and knowledge accumulation, compared with ISI, which had created an environment that discouraged learning. In addition, Malaysia, using FDI in export-oriented industries initially in the electrical and electronic sectors and later others, created a new comparative advantage based on the manufacturing sector. Labour-intensive industries also complemented govern-
ment efforts in providing employment opportunities for its citizens, thereby fighting poverty. Kenya followed the second level of ISI, which was characterized by further government involvement and high financial demands which was unsustainable, and had severe negative consequences. To deal with the growing unemployment, the government also encouraged the informal sector, which did not receive sufficient attention and therefore was unable to create the expected employment. Firms within the informal sector also lacked incentives aimed at encouraging them to integrate with the formal sector, hence creating duality in the manufacturing sector.

The response of the two countries at this point in time marks an important turning point. Why did the two countries, faced with similar situations, respond differently? Although there are no direct answers to this question, the nature of politics at this time may partly offer an explanation. In Kenya, ethnic-based politics within the African indigenous population had already gained prominence. President Kenyatta surrounded himself with members of his ethnic community, whose aim among other things was to increase their control through accumulation of resources. During this period, the opposition, largely comprising radicals within KANU who had defected, were oppressed and even had their party banned. There was no room for consensus, and policy implementation was largely influenced by ethnicity. This was in contrast with Malaysia, where ethnic tensions had resulted in riots in 1969 forcing the government to be suspended for two years. During this period, the Barisan National, a political coalition, was formed as a successor to the Alliance. The NEP was also introduced to address the existing poverty and inequality for the next twenty years and was largely a success. Thus, the fear of further escalation of economic tension, previous experience of the communist threat, and the already seeming disintegration of the Alliance forced Malaysian leaders to work together for the common good of the country. This shows the close association between politics, policy formulation, and implementation.7

Having resolved that FDI was to become an integral part of their development process, the next step was to create conditions which were favourable to attract foreign capital. Initially, Malaysia targeted export-oriented FDI with a labour component, which changed later as the labour market became tight, shifting the emphasis towards knowledge-driven FDI. The government also established joint ventures with foreign investors, especially in the resource-based sectors, which operated under the ISI. Kenya until the mid-1980s, when it embarked on the lib-

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7 It is, however, important to note the variations in the nature of the ethnic tensions in both countries. In Kenya, the competition was mainly between different ethnic groups within the black population, the Indians had aligned themselves with one of those groups, and the European settler population and Arab population no longer played a major political role. In Malaysia, the competition was mainly between Malay, Chinese, and Indian groups, and not so much within the Malay population.
eralization of the economy following the implementation of SAPs, focused mainly on attracting FDI under the ISI strategy, targeting both the domestic market in Kenya and the wider East African Community. From the 1990s onwards, there was a shift towards export-oriented industrialization, with a special focus on export-oriented FDI. However, compared with Malaysia, these efforts have not been very successful. An understanding of the FDI determinants in both countries yields important insights as to why Kenya has been unable to attract FDI.

On analyzing the determinants of FDI in the two countries, there is evidence that Malaysia’s success is due to several factors. The first is macroeconomic stabilization. FDI in both countries is sensitive to the exchange rate but in Malaysia it is also sensitive to changes in inflation, unlike in Kenya. In Kenya, FDI is found to be affected by exchange-rate appreciations, while in Malaysia it is sensitive to changes in the exchange rate. The Bank of Negara in Malaysia (i.e. the Central Bank) has a tradition of managing the exchange rate in order to serve the country’s national interests. It has been a useful macroeconomic tool in securing export competitiveness, which has also resulted in high FDI inflows from East Asian countries. In Kenya, the exchange rate has largely been market-driven, and the Central Bank has only intervened in very limited instances. Since the 1990s, the exchange-rate devaluation in Kenya has been important in encouraging export-driven FDI within the manufacturing and horticultural sectors. Changes in the rate of inflation are found to affect FDI in Malaysia but not in Kenya. Malaysia has a tradition of maintaining a very low inflation rate compared to Kenya where the rate of inflation is volatile and mostly high (i.e. double-digit). These short-term fluctuations in inflation have had an adverse effect on the growth of FDI in Kenya.

The main difference in the determinants of FDI in the two countries lies in agglomeration economies, economic growth, infrastructure development and institutional (governance) variables. When agglomeration economies are present, new investors mimic past investment decisions by others when choosing where to invest. By locating close to other firms, they benefit from positive spillovers from investors already in place. Malaysia has managed to attract FDI by various means, such as incentives, hand-holding initiatives and a keen interest in advancement, and has seen many foreign firms relocate their operations to Malaysia following positive publicity by existing companies. This has not been the case in Kenya where discontented multinationals might discourage their counterparts from relocating to Kenya. Similarly, the infrastructure variable has had a positive impact on FDI in Malaysia but limited infrastructure has slowed industrial development in Kenya. Until the NARC government took over power in Kenya in 2002, infrastructure development had been largely neglected. This had resulted in
increased costs when doing business and few new investors. By attracting FDI, governance and democracy have become more important in Malaysia, which is relatively better governed. In Kenya, governance is seen to affect FDI through the enhancement of other factors, such as agglomeration economies. In addition, trade openness does not appear to have had a significant impact on FDI in either country.

While trade openness, the development of social overheads and governance will appeal to efficiency-seeking FDI or export-driven FDI, market-seeking may not consider these factors. Balasubramanyam et al. (1996) observed that FDI tends to benefit countries that pursue an outward-oriented trade policy rather than an inward-oriented policy. However, export-driven FDI is not triggered by trade openness alone. It is largely dependent on the existence of absorption capabilities in the host country. Significant investments in social overheads in Malaysia and attention to improved governance have not only reduced the cost of doing business but also created certainty for foreign investors that the ‘rules of the games’ under which their business can operate will not change. These features have been largely absent in Kenya where social overheads, including infrastructure, have not been well developed and the cost of doing business has remained high. Although a lot of these factors have been addressed since 2002, they have not yet had any significant impact on attracting foreign investment. Dependable governance remains a key challenge in Kenya.

The results also reveal that financial development does not affect FDI very much in Malaysia. This is interesting given that conventional wisdom suggests that financial development is good for development. It does matter though for domestic firms, as was observed by Kinuthia (2010b) for Malaysia, and it is found to enhance the effect of economic growth on FDI. It also suggests that financial deepening may encourage capital flight by facilitating international capital transfers. However, this does not seem to be a problem in Kenya. Changes in wage rates in the two countries are not found to be an important FDI determinant. This is in contrast with the literature, where labour-intensive FDI seeking to minimize operational costs may consider cheap labour. However, cheap labour in Malaysia was critical in influencing FDI inflows in the 1970s but this is no longer the case. Kenya, which not only has a well-educated labour force nowadays but also high unemployment, could take advantage of this asset to attract efficiency-seeking FDI, which has been very low there compared with Malaysia.

FDI in both countries is found to be influenced by economic growth. This variable is based on market hypothesis and seems to be the most undisputed variable in literature (Agarwal 1980). As FDI is a long-term commitment, a promising future for the host country naturally attracts investment. Steady economic growth in Malaysia has thus been an important pull factor for FDI, unlike in
Kenya where a weak economy has discouraged potential investors. Contrary to many FDI studies in Malaysia, as in Kenya, there is no evidence of FDI having any direct impact on economic growth. This is largely attributed to the omission of important variables that may affect FDI in such studies.

In general, the direct impact of FDI is usually considered less significant than its indirect effects. This is because MNEs can have a minimal effect on the domestic economy if they operate in enclave sectors with limited contact with the domestic economy. The real benefit FDI brings to a country is usually measured in terms of its contribution to the development of the domestic firms’ level of competitiveness in the host country. Host countries consider FDI to be potential sources of spillovers since MNEs own technology – interpreted in a broad sense to include both product, process, and distribution technology, as well as management and marketing skills – which can be transmitted to local firms and therefore raise their productivity levels (Crespo & Fontoura 2009). This advanced level of technology is contained in MNEs based in a few technologically advanced countries. Furthermore, the markets for technology are often non-existent because of asymmetry that exists between buyers and sellers with regard to technology. Therefore, local firms in developing countries have no choice but to obtain technology and knowledge directly from MNE affiliates through spillovers. Hence, the generation of productivity and market-access spillovers – that is, positive externalities from MNEs to domestic firms – may be one of the most important effects foreign MNEs impart to local firms in developing countries (Takii 2005). If these benefits outweigh the competitive losses, then spillovers can take place; otherwise, they can be negative.

Since spillovers are not always positive or even generated, governments in host countries may offer generous incentives or even pursue industrial policy for FDI to have an impact on both domestic firms and the economy as a whole. The results of this study, based on the analysis of firm-level data for the period 2000-2005, suggest that there is a significant difference in the sizes of the manufacturing sector in both countries, as captured by the number of firms. Although Malaysia nowadays has only 65 per cent of Kenya’s population numbers, foreign-owned firms in Malaysia are found to be at least 5 times more than in Kenya and in possession of more capital. Domestic firms in Malaysia are at least 30 times more numerous than those in Kenya, suggesting the possibility of foreign firms having different impacts on the domestic firms in both countries. Moreover, this also suggests the enormous potential that exists in Kenya in terms of expanding manufactured output through increasing both the quantity of foreign and domestic firms. However, it is important to note that Malaysia did not settle just for any kind of FDI but targeted only specific kinds of FDI, depending on the existing needs in terms of labour, value addition, or otherwise, in the manufacturing sec-
tor. Furthermore, the resource-based sector in Malaysia has been well guarded from exploitation by MNEs through the ISI, and the government has established joint ventures in partnership with foreign investors and in some instances prevented foreign firms from accessing such sectors.

In analyzing the impact of foreign-owned firms on domestic firms in the two countries, two kinds of externalities are considered: Those related to productivity spillovers and those related to export spillovers. The study finds evidence of negative productivity spillovers from foreign firms to domestic-owned firms in Kenya, while in Malaysia there is evidence of both positive and negative productivity spillovers from foreign firms to domestic firms. In addition, there is evidence of reverse spillovers from domestic firms to foreign-owned firms, supporting the technology sourcing argument by foreign firms. The results of this study show that foreign firms in both countries are a source of negative productivity spillovers through the competition effects. Aitken & Harrison (1999) and Gorg & Strobl (2005a) observed that FDI can be a source of negative productivity spillovers by producing at lower marginal costs than host-country firms: They have an incentive to increase output and attract demand away from domestic firms in the host countries. Moreover, whereas in Kenya domestic firms’ inability is attributed largely to the ISI policy, in Malaysia, Henderson and Phillips (2007) attribute domestic firms’ lack of competitiveness to the ICA Act of 1975. In addition, Girund (2003) and Rasiah (2009) blame the Malaysian government for the lack of a clear technology development policy that focused on supporting catching up among local firms as well as foreign workers who slowed down the upgrading process. The negative productivity spillovers in Kenya affect both firms with high and low technology, whereas in Malaysia firms 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. The R&D activities of foreign firms seem to be an important source of domestic firms’ productivity. This may be attributed to the R&D incentives given through the Incentives Act of 1986. These spillovers are mainly concentrated within domestic firms that have low technology gaps compared with incoming FDI, where technology gap is defined in terms of average wage gap and labour productivity gap. However, there is also evidence of demonstration effects in firms with a high technology gap when it is defined in terms of capital intensity. Finally, in Malaysia there is evidence of positive productivity spillovers 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. The study also finds that foreign
firms in Kenya have a higher productivity than domestic firms. In addition, exporting firms in Kenya appear to have a 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.

With regard to export spillovers, the study finds positive evidence in both countries. In Kenya, there is evidence of limited positive export spillovers through the demonstration effects and negative spillovers through the competition effects. 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. Once again, positive spillovers in Malaysia are a result of the incentives programs for firms (Gustafsson 2007), whose eligibility has hinged on the local content requirements.

On the basis of this evidence, this study concluded by observing that FDI can play an important role in economic development. In Malaysia, export-oriented FDI has been a strong driver for growth indirectly, unlike in Kenya, where FDI is not only small in quantity but also growth-driven and with limited impact on domestic firms. However, it is worth noting that the spillover variables used in this study were mainly proxies and could lead to biased results. It may therefore be that some of the effects observed are either over – or understated. The government in Malaysia has played a significant role in matching FDI requirements with the country’s needs, through identification of the sectors to develop and a careful use of incentives administered through well-established institutions. The government has also provided a stable macroeconomic environment, the required social overheads, and institutions aimed at attracting FDI. Furthermore, the Malaysian government has used the ISI to develop its resource-based industries, while at the same time using a wide range of incentives to generate both productivity and export spillovers within the manufacturing sector. Finally, the government has created a stable political environment through which long-term economic activity could take place profitably without political disturbance.

In Kenya, on the other hand, the effect of FDI has been minimal if not negative, and there has been limited use of incentives encouraging the generation of spillovers. Apart from a stable macroeconomic environment, Kenya has yet to develop significant social overheads as well as address governance issues before it can experience the benefits of FDI. Although most of these issues have been addressed after 2002, they are yet to reach a threshold that can attract significant amounts of FDI. Moreover, from the Malaysian experience, it can be learnt that
Kenya has not explored the various incentives that might be important in encouraging the generation of spillovers or even attracting firms to specific sectors.

Finally, in terms of Tracking Development research outcomes, this study makes the following observations. Consistent with the Tracking Development observations, macroeconomic stabilization is found in this study to be an important pre-condition for economic growth, since it is an important determinant of FDI inflows in both countries and an important growth driver. Tracking Development further observe that macroeconomic stabilization alone does not produce developmental turning points unless it is accompanied by pro-poor policies with respect to agriculture and food (Donge et al. 2012). While this may be true though vague in terms of specific policies, the relationship between macroeconomic stabilization and poverty alleviation is complex and remains unclear for several reasons.

First, from Table 3.2 in Chapter 3, it is clear that on average the two countries have not experienced inflation exceeding 20 per cent. Although this may be consistent with Tracking Development’s observation, there is no empirical basis for such a threshold. What is clear from this table is that Malaysia has successfully maintained low inflation of below 5 per cent throughout the last four decades. This is not the case, however, in Kenya, where low inflation of below 5 per cent was experienced only in the first decade after independence. In addition, using this criterion, Kenya does not appear to have experienced macroeconomic instability, with the exception of 1992. This is erroneous, given that it has continuously experienced macroeconomic imbalances with inflation being mainly in double digits, compared with the low inflation in Malaysia. Hence, based on this evidence, the issue here is the ability to maintain low inflation rates. Kinuthia (2010b) observed that the Malaysian government intervened in the markets for a small number of food items and essential commodities, in order to maintain stable prices, aimed at benefiting the poor and the consumers in general. However, he notes that good as this may appear; empirical evidence of the effects of inflation on poverty, after controlling for economic growth, is at best mixed.

Secondly, on the issue of the exchange rate, there is also evidence that contrary to the Tracking Development’s assertion of the absence of a black market in Malaysia, there is evidence that in South East Asia (and also in Malaysia) there exists a black market, suggesting that these currencies are overvalued owing to the government restrictions placed on the foreign sector (Sarwar 1997; Kinuthia 2010b). As observed in this study, the government has managed its exchange rate in line with the national objective to be achieved at the time. For example, in 1987 it devalued the exchange rate in order to attract high FDI inflows. This restriction partly explains the 1997 currency crisis, which eventually led to greater controls until the crisis was resolved (Kinuthia 2010b).
Finally, an important component of macroeconomics management that the Tracking Development Project does not regard is the role of the interest rate. Table 3.2 suggests that low interest rates have been behind the phenomenal increase in credit expansion to the private sector in Malaysia but only marginally in Kenya. The enormous expansion in Malaysia, as indicated by the sheer number of domestic firms compared with Kenya, attests to this fact. This was largely made possible by MIDF, established in 1960 with the main objective of financing small and medium enterprises in Malaysia. This institution has successfully accomplished its mandate, with not only the number of manufacturing firms increasing in Malaysia but also many domestic firms developing over the years to become major players in the manufacturing industry.

Hence, the study concludes by observing that sound macroeconomic management can indirectly be instrumental in poverty reduction but that the relationship is not as easy as Tracking Development suggest. In addition, there is no empirical evidence in favour of any inflation threshold, as argued by Tracking Development, but rather the evidence is that low inflation may in fact benefit the poor. In addition, there is evidence of the existence of a black market in South East Asia (and Malaysia in particular) and, more importantly, evidence that the exchange rate management is accorded high priority. Low interest rates have also been critical in capital accumulation within the private sector. Thus, while it is true that macroeconomic stabilization is a necessary pre-condition for growth, the mechanism through which it leads to development turning points is not clear and remains an empirical issue. Furthermore, Azis (2009) has shown that under some conditions, macroeconomic stabilization can be detrimental to poverty alleviation. In addition, the study shows that only after identifying the detailed transmission mechanism from macro policy to poverty can we be certain of the impact. The mechanisms involve some complex relations, in which growth, income inequality, and poverty are all endogenously interrelated.

Secondly, on the issue of pro-poor, pro-rural public spending, there is evidence that Tracking Development’s arguments have been exaggerated. A review of development expenditure in the two countries suggests that there is a difference in the amounts spent as well as the sectors in which they were spent. In terms of the amounts spent, it is clear from comparing Tables 3.4 and 3.11, for Kenya and Malaysia respectively, in Chapter 3 that Malaysia has spent significantly higher amounts in development expenditure compared with Kenya. This alone can explain the differences in development outcomes. A further examination of the allocations of the development expenditure, as given in Table 3.4, shows that Kenya in the 1970s spent approximately 14.6 per cent of its development budget on agricultural services, compared with 21.6 per cent expenditure in agriculture and rural development in Malaysia around the same time. However,
in both countries this was the only period when such significant amounts were allocated towards the agricultural sector and rural development. This appears to contradict Tracking Development’s public spending criteria of over 20 per cent development spending in a country going towards the agricultural sector, as funding for agriculture-boosting research and extension services, among other areas.

As a matter of fact, what is clear in Malaysia from Tables 3.9 and 3.11 is that significant amounts of development expenditures went towards the development of social services such as education and training, health and housing, development of public utilities, trade and industry, and transport and communication. These sectors were developed simultaneously with financing that was obtained from rents. This can be compared with Kenya, which did not have sufficient resources to embark on such a comprehensive approach. The Malaysian approach is consistent with the big-push approach advocated by scholars like Rostow and Lewis within the structuralists’ literature (see Kinuthia 2010b). Hence, take-off requires sufficient allocations not only to agriculture and rural development, as Tracking Development would argue, but also to the development of other social overheads to support the industrialization process. Moreover, implementation of the Tracking Development hypothesis in the manner suggested would be a sure way of reinforcing the Prebisch-Singer hypothesis, leading to further impoverishment of developing countries.

The third argument in Tracking Development has to do with economic freedom for peasants and small entrepreneurs, where the state does not place coercive restrictions on the economic activity of small farmers and small entrepreneurs. This suggests that it is positive if there is no state regulation on what farmers produce, to whom they sell, and at what prices. Based on the experience of this study, it does suggest that it is the absence of government support towards small entrepreneurs that has resulted in limiting their growth in Kenya. In Malaysia, the government has supported small firms by first restricting the freedom of FDI within the sectors with many local small-scale firms. To date there are sectors in Malaysia that have been assigned to domestic firms and not foreign firms, thus restricting foreign entrepreneurs’ freedom. In addition, Malaysia’s government has also provided a wide range of incentives and programs such as hand-holding/hands-on assistance (to clients from the initial submissions of their applications until their projects have reached fruition and thereafter in all areas), where state-related institutions work closely with the firms in the course of their development. This is similar to ‘picking the winners’. This approach has largely been informed by the affirmative action aimed at developing the domestic sector while empowering marginalized communities. Hence, once again the experience
of Kenya and Malaysia does not fully support the Tracking Development hypothesis.

According to Tracking Development, poverty reduction is attained when the above three conditions are met simultaneously. While acknowledging that these may play an important role in poverty reduction, they do not take into account constraints that countries face in their fight against poverty. It is assumed, for example, that countries do not face budget constraints, when in real life countries will have to face some tough choices, which will involve sacrifices. In addition, all these three objectives are difficult to achieve without adequate capacity, including the relevant expertise, among other factors. In addition, poverty alleviation requires a multi-dimensional approach, and Tracking Development’s approach is too restrictive as it does not take into account other factors that could inhibit poverty reduction in spite of meeting the three hypotheses – for example, changing people’s attitude and mentality and cultural aspects.

Similarly, on the three principles of outreach, urgency, and expediency, which the Tracking Development Project suggests were followed in determining the three conditions discussed earlier, the industrial experience of these countries does not entirely support their observations. On the principle of outreach, Tracking Development argues that in successful development strategies, the key criteria by which interventions are selected are the number of people which they can reach and benefit in economic terms. It can be argued that leaders in both countries understood the problems that their countries were facing at independence. The most pressing problems in both countries at that time, though in varying degrees, was both high unemployment and poverty levels, and both countries pursued policies that were aimed at tackling these two issues. However, in Kenya this changed at the start of the 1970, when Kenya implemented inadequate approaches such as the development of the informal sector, recommendations adopted from a report by the International Labour Organization, aimed at addressing unemployment. This is in contrast with the New Economic Policy blueprint developed in Malaysia at the same time, which outlined specific steps the government was to undertake in order to address unemployment, poverty, and inequality over a period of twenty years.

In fact, the first decade after independence was considered largely a success in both countries, though they had not successfully addressed the same issues. In addition, the scale of outreach was largely determined by the resources that were available to these countries. While Malaysia could devote substantial resources to financing its programs, Kenya even with external borrowing could not achieve as much. What is also clear in Kenya was that after 1970, wrong policies were chosen, not based on quantity or quality but rather on an ideology that served the interests of the political class. In addition, Tracking Development argues that
unlike in Malaysia, where outreach was mainly conducted within the agricultural sector, in Kenya the focus was on education, which was in line with the elites’ aspiration. While they recognise the importance of education, they note that national obsession with education reflected elitism and an emphasis on quality rather than quantitative change, which made Kenyan agricultural development policy strategy so narrow and ineffective.

While this may be true, the Malaysian experience shows that the government embarked on an ambitious program aimed at creating synergies across sectors, agriculture and manufacturing included. The prevailing unemployment, poverty, and inequality in the early 1970s forced Malaysia to pursue export-oriented industrialization, largely focusing on labour-intensive industries. On the contrary, Kenya industrialization strategy was not targeted at addressing unemployment and poverty reduction. Complementary to these efforts were massive investments in education in both countries. Based on Tables 3.4 and 3.11, for Kenya and Malaysia respectively in Chapter 3, one observes that although in percentage terms Kenya devoted more resources to education in the 1970s, in terms of the amounts, Malaysia devoted more resources. In addition, this share increased drastically in Malaysia over the years compared with Kenya. Lucas (1988) has observed human capital development is an important input in a country’s growth process. While agricultural development may play an important role in outreach, Tracking Development does not seem to acknowledge the importance of human capital development in the growth process.

Following the outreach is the urgency principle. This principle largely emphasizes priorities and not plans. This, as Tracking Development acknowledges, is only partly true. Malaysia implemented the NEP, which was a carefully planned economic blueprint for the next twenty years. After its successful implementation, it was replaced by the NDP, which will be in place until 2020. In Kenya, this was not the case, however, until the year 2007, when the government launched Vision 2030. While Tracking Development may argue that this kind of planning is not necessary, there is no compelling reason to believe short-term planning is better. At least based on the Malaysian industrial experience, since 1970 there has been a clearly laid-out vision of its future, complemented by five-year plans and yearly budgets. This principle is well understood in the corporate world, and both long-term and short-term planning are important though not sufficient ingredients in a country’s development. Moreover, the notion that Malaysia’s policies towards economic take-off were not policies of long-term growth and industrial vision, but policies of rural crisis containment, is not true. This downplays the importance of NEP, which not only contained Malaysia’s vision of industrialization but also of poverty alleviation and wealth redistribution.
Finally, expediency (meaning the emphasis on results, not rules) is the final principle that Tracking Development advances for underlying policy choices for successful industrialization. In this principle lies the view that the rule of law and the eradication of corruption are not important pre-conditions for development. Based on the Malaysian industrial experience, most of the institutions that were established at independence to oversee industrial development, such as MIDA and MIDF, have performed better than similar institutions in Kenya (mainly Ken Invest and ICDC). Whereas those in Malaysia were well funded and given specific mandates, in Kenya they became avenues for rent-seeking and corruption. Although this does not mean that these institutions may not have been corrupt in Malaysia, there was enforcement from the government to ensure that they performed. This is not the case in Kenya, where such institutions tend to be politicized along ethnic lines, with little accountability and demand for performance. The results of this study show that dependable governance matters for foreign investors. Hence, once again the experiences of both Kenya and Malaysia do not support this argument as presented by Tracking Development.

On the basis of the industrial experiences of Kenya and Malaysia, this study concludes by observing that successful industrialization requires not only 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 demonstrated through dependable governance and independent 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 the 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 domestic-owned industries, which ultimately have a greater impact on the domestic economy compared with FDI once their competitiveness is enhanced. Finally, for countries like Kenya with limited resources and largely uncompetitive domestic firms, export-oriented industrialization may be a better option, since it is less resource-demanding compared with the import substitution strategy. On the basis of the Malaysian experience, this seems to be a feasible route through which domestic firms can improve their competitiveness.