



## **East Africa International Business Forum 2008**

***“Trade and Investment Opportunities:  
East Africa– One Market One Destination”***

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## **IMPROVING THE INVESTMENT CLIMATE: STATUS AND PROPOSALS ON THE WAY FORWARD**

**Background Paper**

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## **List of Acronyms**

BCI	Business Climate Index
BES	Business Environment Survey
CBC	Commonwealth Business Council
CPI	Corruption Perception Index
CPIA	Country Policy and Institutional Assessment
EABC	East African Business Council
EAC	East African Community
EPI	Environmental Performance Index
FDI	Foreign Direct Investment
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GPI	Global Peace Index
HDI	Human Development Index
HIV/AIDS	Human Immunodeficiency Virus/Acquired Immunodeficiency Syndrome
LDCs	Least Developed Countries
MDA	Government Ministries, Departments and Agencies
NTBs	Non-Tariff Barriers
TI	Transparency International
USA	United States of America
USD	United States Dollar
WEF	World Economic Forum

## 1.0 Introduction

East Africa continues to struggle with the challenge of poverty and is one of the world's regions most in need of the economic benefits resulting from more investment and trade. Part of the reason why these have not been forthcoming, at least in the desired quantity and quality, is the high cost of doing business in the region. Investors already operating in the region often come across expensive impediments in the form of different rules, approaches and business conditions prevailing in each country.

The purpose of this Briefing Paper<sup>1</sup> is to bring to the attention of EABC members and policy makers in East Africa, in a concise manner, the status of business climate in the region. This is aimed at improving focus on what needs to be done in order to improve investment, trade and business in general in East Africa. The paper draws from some of the recent surveys in business/investment climate that include the East African region in their samples:

- World Bank's "Doing Business" survey for 2009 and "Enterprise Survey" for 2006;
- World Bank's Country Policy and Institutional Assessment (CPIA) Fiscal Policy Rating;
- Heritage Foundation's Index of Economic Freedom for 2008;
- World Economic Forum's Global Competitiveness report 2007/2008;
- Commonwealth's Business Environment Survey 2007;
- EABC's Business Climate Index Survey for 2006/2007;
- Transparency International (TI)'s Corruption Perception Index (CPI); and,
- Mo Ibrahim Foundation's Ibrahim Index of African Governance.

In addition to these, the paper is also informed by findings of the East African Border Survey Study commissioned by the EABC and other relevant literature. These surveys collect the information from business leaders covering issues like current business conditions, investment forecasts, and employment forecasts.

### 1.1 What is Business Environment?

*Business environment* may be defined as the nexus of policies, institutions, physical infrastructure, human resources, and geographic features that influence the efficiency with which different firms and industries operate. At firm level, the business environment directly influences costs of production; at the industry level, it often relates to market structure and competition. Its impact is felt more heavily in traded sectors that are not particularly intensive in natural resources (that is, manufacturing, high-value services) than in primary production and extractive resource sectors because the former tend to more intensively require "inputs" of logistics, infrastructure, and regulation. According to the World Development Report of 2005, *Investment climate* is a combination of factors and perceptions that shape decision making by business on investment. It consists of location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand. Government policies and behaviour play a critical role by affecting the costs, risks and barriers to competitive action by firms. The two terms are closely linked and are therefore used to mean the same thing in this paper.

The combination of macroeconomic instability, crime and poor security, a weak and politicized financial system, poor local roads and electricity systems, high transport costs, and predatory local officials may have devastating impact to the operations and productivity of businesses. Even

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<sup>1</sup> The EABC acknowledges the support of Mr. Protase Echessah in the preparation of this paper.

efficient firms able to transform inputs into outputs with high efficiency and low “factory-floor” costs can be driven out of business by a poor business environment.

The rest of the paper is organized as follows. It begins by looking at key indicators of the business environment. The paper then assesses the performance of the East African countries on these indicators compared with other countries in the region and outside the region, before assessing the attractiveness of the region to foreign direct investment (FDI), and concluding with recommendations on priority interventions required to improve the business environment.

## 2.0 East Africa’s Performance on Key Indicators of Business Environment

There are many indicators of business environment, and they are increasing in number as this is an active area of research. Table 1 below presents 10 such indicators of key aspects of the business environment, and the performance of the 5 countries of East Africa on these indicators. Two issues immediately pop out of the table. First, in general East African countries rank very poorly on all the indicators except on the CPIA Fiscal Policy Index where Kenya, Tanzania and Uganda are ranked among top 10 out of 75 countries. Second, there is a wide difference among the East African countries themselves. The widest difference is perhaps between Kenya and Burundi with respect to the ease of doing business. There is no country with a consistently better business environment on all aspects. Details on each of the 10 indicators and the performance of the East African countries are discussed below.

**Table 1: Ranking of East African Countries on Different Aspects of Business Environment**

Index	Burundi	Kenya	Tanzania	Uganda	Rwanda	Out of
Ease of doing business ( <i>2009 Report</i> )	174	72	130	118	150	178
Index of Economic Freedom ( <i>2007</i> )	146	82	103	59	136	157
Corruption Perception Index ( <i>2008</i> )	158	147	102	126	102	180
Human Development Index ( <i>2007/2008</i> )	167	148	159	154	161	177
Global Competitiveness Index ( <i>2008/2009</i> )	132	93	113	128	--	134
Ibrahim Index ( <i>2008</i> )	35	17	15	19	18	48
Environmental Performance Index ( <i>2008</i> )	132	96	113	117	131	149
Global Peace Index ( <i>2008</i> )	--	119	58	114	76	140
Inward FDI Performance Index ( <i>UNCTAD 2005-07 Data</i> )	--	135	72	77	130	141
CPIA Fiscal Policy Index ( <i>2005</i> )	34	8	2	6	33	75

Source: Various

## 2.1 Ease of Doing Business

The *Ease of Doing Business Index* is an index created by the World Bank to assess and rank 181 countries every year with respect to the regulatory costs of business and can be used to analyze specific regulations that enhance or constrain investment, productivity, and growth. Higher rankings on this index (with 1 being the highest) indicate better, usually simpler, regulations for business and stronger protection of property rights, which is conducive to the operation of business. Empirical research shows that the effect of improving these regulations on economic growth is strong. The rankings reported in Table 1 are from the *Doing Business 2009* report, covering the period April 2007 to June 2008.

The *Ease of Doing Business Index* averages each country's rankings on 10 key indicators, giving equal weight to each indicator. The indicators correspond to various stages of the life of business: starting it up, dealing with licenses/permits, employing and laying off workers, registering property, getting credit, paying taxes, trading across borders, enforcing contracts and closing it down. The data is based on published laws and voluntary submissions of more than 6,700 local experts (business consultants, lawyers, accountants, and government officials, and leading academics) around the world. Table 2 shows the ranking of the 5 East African countries on the basis of each of the 10 indicators that make up *Ease of Doing Business Index*. Details of these indicators are found in Annex I.

Burundi performs very poorly in all indicators of ease of doing business except with respect to the ease of employing workers. Indeed, the country is the worst of the countries ranked with respect to the ease of closing a business. Kenya is the best ranked country in the region with respect to overall ease of doing business and has performed excellently with respect to ease of getting credit and dealing with construction permits. The country's worst performance is with respect to ease of paying taxes and of trading across borders. Tanzania outperforms the neighbours with respect to enforcement of contracts, protection of investors and the ease with which its business people are able to trade across borders. However, the country is the worst in the region when it comes to ease of employing workers. Within the region, Uganda is the best ranked when it comes to ease of employing workers and closing business but is the worst when it comes to ease of registering property. On its part, Rwanda leads the region on the ease of starting a business, registering property, and paying taxes. Surprisingly, it shares the bottom ranking with Burundi when it comes to the ease of closing a business and is worst in the region with respect to protection of investors. Moreover, the difficulty with which its business people are able to trade across borders is only second to Burundi.

What these relative rankings suggest is that East African countries have an opportunity to share their experiences on the areas they have successfully made reforms. The collective value of this could be considerable.

**Table 2: Ranking of East African Countries on the Ease of Doing Business, out of 181 Countries**

Economy	Burundi	Kenya	Tanzania	Uganda	Rwanda
Ease of Doing Business (Overall Rank)	177	82	127	111	139
Starting a Business	138	109	109	129	60
Dealing with Construction Permits	173	9	172	81	90

Employing Workers	70	68	140	11	93
Registering Property	125	119	142	167	60
Getting Credit	163	5	84	109	145
Protecting Investors	150	88	88	126	170
Paying Taxes	114	158	109	70	56
Trading Across Borders	170	148	103	145	168
Enforcing Contracts	170	107	33	117	48
Closing a Business	181	76	111	51	181

Source: World Bank (2008): Doing Business 2009 Report

Kenya was ranked as one of the top 10 reformers overall, largely as a result of implementing major trade reforms including reduction of the overall time taken to import by 11 days; extension of operating hours of customs and port authorities; reduction of the number of inspection points between Nairobi and Mombasa port; introduction of an electronic system that allows traders to submit their documents online; reduction of the time required to start a business due to improvements in communication between agencies and the upgrading of the registry. Nevertheless, Kenya is in the bottom 11% of countries with respect to the cost of exporting and importing a container (\$ 2055 and \$ 2190, respectively) although it still stands favorably against other EAC Member States except Tanzania.

Major reforms in Rwanda included dealing with construction permits, registering property, trading across borders and enforcing contracts. The country streamlined construction permits for the second year in a row by combining the applications for location clearance and a building permit in a single form and introducing a single application form for water, sewerage, and electricity connections. The time and cost to register a property also fell. A new fixed registration fee was introduced, and centralization of the tax service reduced the time taken to obtain a certificate of good standing. Rwanda facilitated trade by extending the opening hours of the customs border offices, implementing an electronic data interchange system, and introducing risk-based inspections. In addition, Rwanda made improvements in the time taken to import and export as well as cost of exports, jumping up 12 places. It is no longer the worst ranked country globally with respect to trading across borders.

In Burundi, Uganda and Tanzania, no major reforms were recorded. For Uganda, the number of procedures to start a business and register property is almost twice the regional and income group averages. Tanzania ranks 172 out of 181 countries in the Dealing with Licenses indicator.

## **Business Climate Index**

The findings of World Bank's *Doing Business* 2009 report largely corroborate those of the East African Business Council's Business Climate Index (EABC BCI) Survey 2006/2007, although Kenya improved considerably in 2007/2008. The EABC BCI survey focussed on six trade-related clusters of issues: customs procedures, immigration and work permits, business registration and licensing, police roadblocks, weighbridge stations, and quality standards and export certification. For each of the clusters, the survey sought to find the level of professional and fair treatment, time spent on procedures, and existence/prevalence of corruption in Kenya, Tanzania and Uganda. The survey found that businesses experience obstacles under all six non-tariff barrier clusters, with customs procedures being perceived as the most problematic and Kenya being perceived to be the worst in this area compared to Tanzania and Uganda.

### *Customs Procedures*

The survey found that, on average 69% of businesses in the three East African countries (with 74% in Kenya, 69% in Tanzania and 64% in Uganda), find professional and fair treatment at customs as sometimes or always problematic. On average, 81% of businesses in the three countries (85% of the businesses in Kenya and Uganda and 70% of those in Tanzania) spend between 1 hour and half day at customs. About 66% of businesses in the region (70% of those in Kenya, 58% of those in Tanzania and 67% of those in Uganda) spend extra costs of USD 101 - over 5,000 per annum at customs. Corruption is rife within customs departments with 73% of EAC businesses (78% of those in Kenya, 72% of those in Uganda, and 70% of those in Tanzania) perceiving corruption at customs as an obstacle.

### *Immigration Procedures and Work Permits*

About 63% of EAC businesses perceive professionalism at immigration border crossings and in issuance of work permits as problematic. This stands at 65% for Kenya, 62% for Uganda, and 61 percent for Tanzania. On average, 70.6% of EAC businesses spend between 1 month and 1 year in obtaining work permits with country-level statistics as follows: Kenya (80%), Uganda (67%) and Tanzania (64.4%). About 61.5% of EAC businesses (67.6% of those in Kenya, 62.5% of those in Tanzania and 54.8% of those in Uganda) spend between 30 minutes and over 2 hours at immigration border crossings. Corruption is perceived as a major problem in the immigration department, with 66% of businesses in the region (68.4% of those in Kenya, 66% of those in Uganda and 62% of those in Tanzania) perceiving corruption at immigration border crossings and with respect to issuance of work permits.

### *Business Registration and Licensing Procedures*

About 59% of EAC businesses perceive professional and fair treatment in business registration and licensing as problematic. The respective numbers for businesses located in Kenya, Tanzania and Uganda are 70%, 57% and 49%. Over 60% of the businesses (70%, 59% and 51% of those in Kenya, Tanzania and Uganda, respectively) spend between 11 days to over 2 months to obtain business registration and licenses. Corruption is a big issue, with 60% of the businesses in the region (and 61% of those in Kenya, 56% of those in Tanzania and 54% of those in Uganda) perceiving corruption as an obstacle.

### *Police Roadblocks*

Police roadblocks continue to be an important barrier to conducting business in East Africa. About 82% of businesses perceive professionalism<sup>2</sup> of police officers as problematic, with Kenya being the major culprit (93% of businesses), Tanzania (83%) and Uganda (71%). A lot of time is spent at roadblocks: 33% of EAC businesses (42% of businesses in Tanzania, 32% of those in Kenya, and 29% of those in Uganda) mentioned that that they spend between 30 minutes and over 2 hours at police roadblocks while 67% indicated they spend between 5 and 30 minutes. An overwhelming majority (80%) of businesses in the region (90% of businesses in Kenya, 78.4% of those in Tanzania, and 70.4% of those in Uganda) cited corruption at these roadblocks as a major business impediment.

### *Weighbridge Stations*

Sixty six per cent (66%) of EAC businesses (75% in Kenya, 66% in Tanzania and 58% in Ugandan) perceive professional and fair treatment at weighbridges as sometimes or always problematic. In 2004, 47% respondents had found weighbridge procedures as an obstacle, suggesting that the severity of the problems has increased. Seventy seven percent (77%) of EAC

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<sup>2</sup> Professionalism of police officers is measured by competence of officers, fairness of treatment, explanation of reasons for stopping vehicles and reliance on rules at roadblocks.

businesses (90% of businesses in Kenya, 70% in Tanzania, and 68% in Uganda) spend between 1 hour and 1 day at weighbridge stations. Corruption is rampant at weighbridges, with 75% of EAC businesses (82% in Kenya, 78% in Tanzania, and 64% in Uganda) perceiving it as a major obstacle.

#### *Quality Standards Inspections and Export Certification*

Sixty four per cent (64%) of EA businesses (69% in Kenya, 68% in Tanzania, and 56% in Uganda) perceive professional and fair treatment with respect to quality standards inspection and export certification as problematic. A lot of time is spent by businesses in seeking these services with 58% (66% in Kenya, 58% in Uganda, and 50% in Tanzania) taking 1-4 weeks. About 49% of businesses (57% in Kenya, 46% in Tanzania and 43% in Uganda) spend USD 100 - over 1,000 per annum for these procedures. Corruption in quality standards inspection and export certification is also rife, as 66% of EAC businesses (90% in Tanzania, and 54% in both Kenya and Uganda) perceive it to be problematic.

#### *Other Factors*

The survey identified other important factors impacting on business environment. In Kenya, over 80% of businesses indicated that access to affordable and reliable energy, security, quality and cost of transport, and access to affordable and reliable telecommunications to be extremely important. In Tanzania, only 2 factors were perceived as extremely important by over 80% of the businesses. These were access to affordable and reliable energy, and access to affordable and reliable telecommunications. Access to affordable and reliable energy was the only factor mentioned as critically important by 80% businesses in Uganda.

## **2.2 Economic Freedom**

The 2008 Index of Economic Freedom, prepared by the Heritage Foundation of the USA, covers 162 countries although five of them are not ranked. The countries are ranked across 10 specific freedoms such as trade freedom, business freedom, fiscal freedom, freedom from government, monetary freedom, investment freedom, financial freedom, freedom from corruption, labour freedom and property rights. The Index uses data-driven equations to score the countries on a range of 0 to 100.

The highest ranked country in East Africa on this index is Uganda, which is ranked 59<sup>th</sup> globally and 5<sup>th</sup> in Sub Saharan Africa with a score of 63.4%, and falls under the category of “moderately free”. Kenya, Tanzania and Rwanda with scores of 59.4%, 56.4% and 52.1% are categorised as “mostly un free”. Burundi with a score of 46.8% is categorised as “repressed”.

In all the East African countries, the rankings fell in 2008, with Tanzania having the greatest drop, reflecting decreases in freedom from government, monetary freedom and financial freedom.

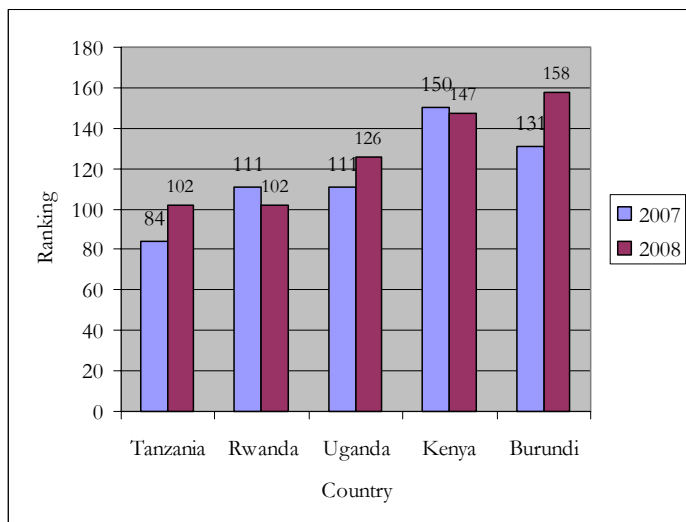
## **2.3 Corruption**

The Corruption Perception Index (CPI), published by Transparency International (TI), ranks 180 countries on the basis of their perceived levels of corruption. The TI CPI measures the perceived levels of public sector corruption in a given country and is a composite index, reflecting the views of businesspeople and analysts from around the world, including experts who are resident in the country.

The 2008 CPI, based on data for 2007/08, ranked Rwanda and Tanzania as the least corrupt countries in the East African Community (EAC). The two countries were jointly ranked at 102 out of the 180 countries surveyed and having scored 3 out of 10 points (Figure 1). The other EAC countries were ranked as follows: Uganda (126), Kenya (147) and Burundi (158).

The results show that corruption was perceived to have increased in Tanzania, which had been ranked 84 in the previous year. The report hails Rwanda's efforts in the fight against corruption, which saw the country improve its ranking from 111 the previous year to 102. Among the other EAC countries, Kenya improved its ranking marginally while Uganda and Burundi slid (Figure 1).

Figure 1: Ranking of East African Countries on CPI, 2007-2008



The report highlights a fatal link between failed institutions and graft and poverty. In the poorest countries, corruption can mean the difference between life and death, when money for hospitals or clean water for instance is involved. The report estimates that unchecked levels of corruption could add US\$50billion (nearly half of annual global aid outlays) to the cost of achieving the Millennium Development Goal (MDG) on water and sanitation. A tougher approach to tackling corruption is needed through strong oversight through parliaments, law enforcement, independent media and a vibrant civil society.

## 2.4 Global Competitiveness

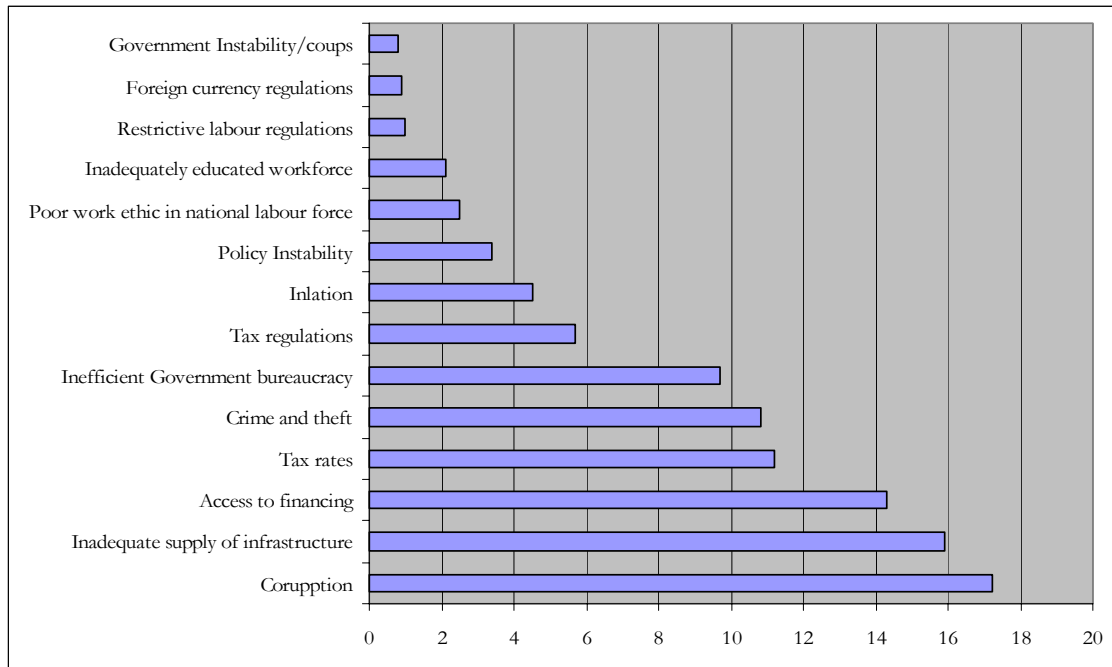
Prepared by the World Economic Forum since 1979, the Global Competitiveness Report ranks the competitiveness of over 130 countries annually. The report assesses the ability of countries to provide high levels of prosperity to their citizens, which in turn depends on how productively a country uses available resources. Therefore, the *Global Competitiveness Index* (Table 1) measures the set of institutions, policies, and factors that drive productivity and thus, enable sustained economic growth and long-term prosperity. It has been widely cited and used by many scholarly and peer-reviewed articles.

The 2008/09 Global Competitiveness Report ranks Kenya as the most competitive economy in East Africa followed by Tanzania, while Burundi is the least competitive. Out of the 134 countries ranked, the East African countries were ranked as follows: Kenya (93), Tanzania (113) and Burundi (132). Kenya is characterized by improved financial sophistication, efficient labour market, excellent capacity for innovation and a very sophisticated business culture. According to the report, the most problematic factors for doing business in the country are corruption,

inadequate supply of infrastructure, access to financing, high tax rates, inefficient government bureaucracy and insecurity (Fig. 2). The World Bank’s Enterprise Survey also ranks corruption and access to financing as the top two constraints, followed by crime.

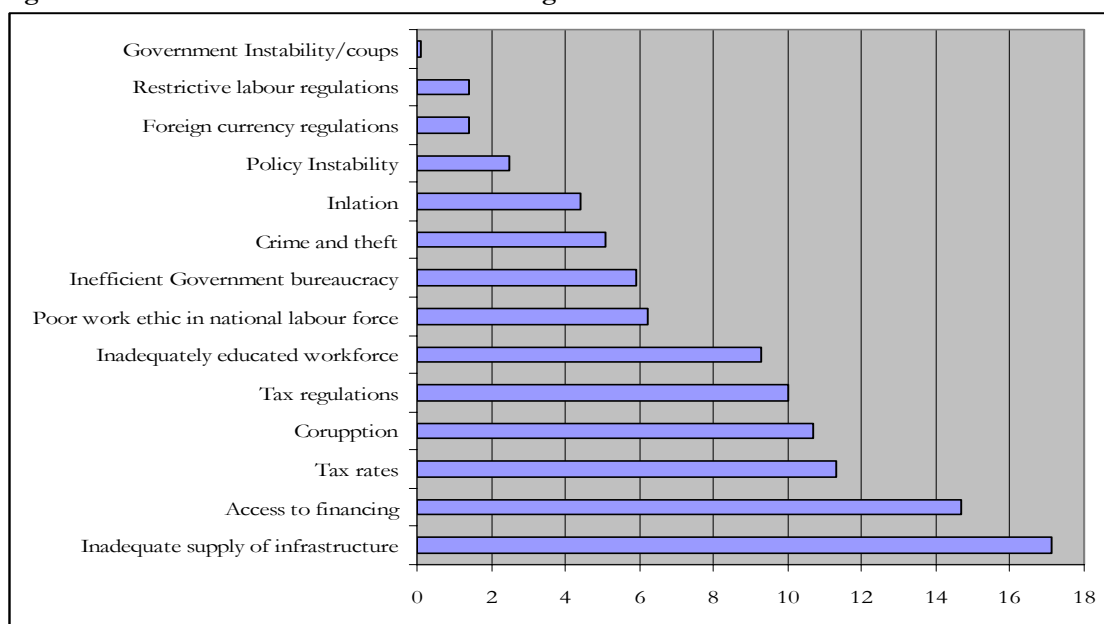
Tanzania derives substantial advantage from its macroeconomic stability, health and primary education (reduced infant mortality), financial sophistication and institutions (government spending, absence of crime, strength of accounting standards & efficacy of corporate boards). The most problematic factors for doing business in the country are inadequate infrastructure, access to financing, corruption, tax rates, and tax regulation (Fig. 3). Over 70% of the firms in the Enterprise Survey ranked electricity as the greatest obstacle to firm investment.

**Fig. 2: The Most Problematic Factors for Doing Business in Kenya**



Uganda is ranked number 120 with a score of 3.3 while Burundi is the lowest ranked country in East Africa, at 130 with a score of 2.84 (the USA scores the highest, 5.67 out of 6). Both Uganda and Burundi have to thoroughly re-examine their institutions and policies as they strive to improve on factors that impact on competitiveness. Both countries are faced with similar challenges for doing business, which include access to finance, corruption, and tax regulation (Annex 2). According to the 2006 Enterprise Survey, over 60% of the firms in Uganda and 40% of those in Burundi cited electricity as the largest constraint to firm investment.

**Fig. 3: The Most Problematic Factors for Doing Business in Tanzania**



#### **Commonwealth's Business Environment Survey 2007**

The findings of the 2007/08 Global Competitiveness Report are largely in line with those of the Commonwealth's Business Environment Survey 2007<sup>3</sup>. The latter observes that member countries have less than ideal scores on the critical areas of infrastructure, skills, business friendly tax policies and corruption. These challenges were found to be more pronounced in the lesser developed countries such as East African countries.

The Commonwealth survey also noted that unlike the previous survey conducted in 2005, limited capital flows was not a major issue, a reflection of enhanced global financial liquidity and freer movement of capital including into emerging markets and developing countries. The availability of free flowing funds for investment from countries such as India and China means access to finance is no longer a critical issue for developing countries. However, the report warns that financial markets might tighten in the near future in response to the credit crunch experienced in mid 2007. In 2007 and 2008, bad debts arising out of the US mortgage markets are expected to lead to global tightening of credit as banks become more cautious in their lending policies.

For the 33 countries surveyed, the average score on infrastructure was low, mainly due to concerns about energy supplies, road and water availability but less so with telecommunications, which sector has experienced a boom in recent years. Accelerating economic growth has added to strains on the already creaking infrastructure. The report notes that countries that have invested in infrastructure are reaping the benefits.

The report also notes that there was increased private sector involvement in infrastructure projects. Thus, by the end of 2001, developing countries had received over \$755 billion in private investment flows for nearly 2500 infrastructure projects.

The report's most startling revelation concerns the level of brain drain from lesser developed

<sup>3</sup> The report is based on a survey of business peoples' perceptions on business environments. The survey is conducted in a range of Commonwealth countries that are engaged in substantial international trade and investment. Rwanda and Burundi were not included.

commonwealth countries to the richer members, which erodes the business environment further. The report estimates that in 2004, 1 million skilled persons from the world's LDCs lived and worked in developed countries. The LDCs most affected by this problem are African LDCs, Haiti and some island LDCs. Regrettably, the trend is expected to continue.

## 2.5 Investment Climate

### *Investment Trends*

Kenya experienced significant growth in FDI inflows, from an annual average of USD 10 million in the 1990s to USD 111 million in 2000. However, soon after the flows became very erratic. Thus, in 2001 inflows fell to USD 5 million, and then increased to 82 million in 2003. In 2004, FDI halved to USD 46 million and dropped even further to 28 million in 2005, the lowest since 2002. Much of FDI in Kenya has been in the tourism, agriculture, and manufacturing sectors.

For Tanzania, FDI inflows peaked at USD 527 million in 2003, but subsequently declined to USD 470 million in 2005. As a country reliant on agriculture, Tanzania's FDI can be influenced by agriculture revenues which are largely driven by weather. Other than agriculture, FDI inflows have largely been into mining (diamonds, gold); IT and telecoms; and tourism. FDI inward stock has increased year-on-year in the 2000s from USD 1.63 billion in 2000 to USD 2.34 billion in 2002, and USD 2.58 billion in 2003.

FDI inflows to Uganda rose slowly between 1998 and 2003 from USD 73 million to USD 202 million by 2003. The growth rate subsequently accelerated, with the inflows reaching USD 222 million in 2004 and a high of USD 258 million in 2005. FDI has been largely in the areas of retail, oil, manufacturing, food processing and telecommunications. Overall, FDI inward stock has increased in the 2000s, rising from USD 1.28 billion in 2000 to 1.76 billion two years later (a 37.3% increase) and again in 2003 to USD 2.04 billion (a 16.1% increase). With the discovery of oil, investment flows into the country are projected to rise further.

### *Inward FDI Performance Index*

The Inward FDI Performance Index ranks countries by the foreign direct investment (FDI) they receive relative to their economic sizes. It is the ratio of a country's share in global FDI inflows to its share in global GDP. A value greater than one indicates that the country receives more FDI than its relative economic size, a value below one indicates that it receives less, while a negative value means that foreign investors disinvested in that period.

The index thus captures the influence of factors other than market/economic size on FDI. These other factors can be diverse, ranging from the business climate, economic and political stability, the presence of natural resources, infrastructure, skills and technologies, to opportunities for participating in privatization or the effectiveness of FDI promotion.

Tanzania, the best performer under this criterion in East Africa is ranked 72 out of 141 countries with Kenya being the worst performer at position 135. Besides historical and political issues (mainly nationalization and heavy regulation), governments of East African countries have erected other barriers to foreign entry. Perhaps most importantly, there is a range of indirect obstacles to the business climate that acts as *de facto* barriers to FDI. Indirect barriers typically include bureaucratic and other informal impediments such as ambiguous regulatory approval, delays in customs clearance, visas for expatriate workers, or weaknesses in the legal system. Issues pertaining to weak corporate governance along with concerns on corruption and lack of accountability have led to a reduction in FDI in Kenya in 2004 and 2005.

Analysis of data from recent firm surveys by the World Bank and the World Economic Forum shows that foreign firms often operate in a very difficult business environment and that both foreign and domestic firms complain about macroeconomic instability, unreliable electricity, corruption, tax administration, and crime. Most of the foreign firms complain about corruption in all five countries (albeit with differing magnitude), suggesting that they bear a greater burden of non-official payments.

#### *Investment Climate Reforms*

The East African countries are working on various reforms to improve the business and investment climates. The Commonwealth Business Council's (CBC) Business Environment Survey 2007 (BES 2007) highlights some of these reforms. Tanzania is working on financial sector, governance and anti-corruption reforms, among others. The reforms in the financial sector are geared towards improving fiscal policy especially enhancement of tax collection. The reforms are also targeted to address concerns on governance and transparency, having approved Anti-Money Laundering Act and the National Corruption Strategy Plan.

Kenya has undertaken a number of reforms as part of the requirements for further World Bank and IMF funding. Financial sector reforms topped the list of priorities. The Banking Amendment Bill has been implemented to improve regulation. This has been coupled with the Anti-Money Laundering Bill, further reforms for a pension scheme and the development of an insurance market. The implementation of Governance, Justice, Law and Order Sector Reform Programme has been designed to assist with policy reforms to address governance, corruption and accountability concerns. A new Privatisation Act was implemented in 2006 to streamline the privatisation process.

Uganda has developed a multi-pronged approach to fiscal consolidation. This includes widening its tax base and restructuring the Uganda Revenue Authority to increase capacity, and accelerating taxpayer registration and regular tax compliance audits. To deepen the financial sector, authorities are considering new supervision and legal arrangements. Under the proposed changes, the financial sector would be expected to provide long-term capital and promote financial services in rural areas. Diversification of the economy will take a new turn with the objective of developing Uganda into Africa's information technology business centre, riding on the country's high-end IT talent base.

#### *Policy Implications*

The investment climate obtaining in East Africa has several policy implications. Most obviously, the host governments should reconsider some of their scepticism toward foreign investment and move to lower barriers to entry and operations through further liberalization. Rather than imposing blanket limitations on foreign investment or insisting on joint ventures, governments should be focused on attracting investment that generates jobs and builds human capital. This implies that issues that impede firm competitiveness should be thoroughly addressed and that attention to investment climate issues should be increased. Development partners should also continue to work with African governments to ameliorate some of the binding constraints on firm entry and expansion.

The CBC BES 2007 highlights action points that can help to attract investment and provide a favourable environment for business in East Africa (Table 4):

**Table 4: Action Points to Attract Investment in East Africa**

Country	Key Action Points
Tanzania	Increasing capacity to respond to inadequately skilled human resources
	Developing business-friendly tax policies supported by access to finance
	Enforcing legislation on environmental protection
	Approving legislation on the reduction of corruption and red tape
Kenya	Increasing budget expenditure for rehabilitation of road networks
	Harmonising tax policies
	Strengthening the financial sector and privatising all financial institutions
	Continuing anti-corruption efforts, especially to the civil service's middle and lower ranks
Uganda	Strengthening the financial sector and increasing access to finance for small business
	Investing in energy and road infrastructure
	Creating a competition policy along with a mandated regulatory authority
	Implementing appropriate business regulation frameworks which can be enforced

Source: CBC Business Environment Survey 2007.

### Country Policy and Institutional Assessment (CPIA) Fiscal Policy Rating

The CPIA Fiscal Policy Rating is the World Bank's scorecard for borrowing countries. The ratings are prepared annually and consist of 20 criteria (grouped in four clusters) related to a government's policy and institutional performance. The four clusters are:

- *Economic management*, including management of inflation and current account; fiscal policy; management of external debt; and management and sustainability of the development program.
- *Structural policies*, including trade policy and foreign exchange regime; financial stability and depth; banking sector efficiency and resource mobilization; competitive environment for the private sector; factor and product markets; and policies and institutions for environmental sustainability.
- *Policies for social inclusion*, including gender equity and equality of economic opportunity, equity of public resource use, building human resources, safety nets; and poverty monitoring and analysis.
- *Public sector management and institutions*, including property rights and rule-based governance; quality of budgetary and financial management; efficiency of revenue mobilization; efficiency of public expenditures; and transparency, accountability and corruption in the public sector.

Under these criteria, Tanzania is ranked second overall out of the 75 countries considered. All the East African countries performed exceptionally well except Rwanda and Burundi positioned at 33 and 34, respectively.

## 2.6 Human Resource Development

The human development index (HDI) is a summary measure of human development in a country in three basic dimensions: Life expectancy at birth, as an index of population health and longevity; knowledge and education, as measured by the adult literacy; and standard of living, as measured by gross domestic product (GDP) per capita.

Kenya is the best ranked among East African countries on the HDI index for 2007/08, at position 148 out of 177 countries ranked (Table 1). In CBC BES 2007, human resources received a high score relative to other factors, as the private sector acknowledged that there is now a large pool of trainable human resources and technical colleges to offer the right training in Kenya. The

country's labour force remains relatively well educated and there is a sound network of vocational and education training providers. Adult literacy is 85% and youth literacy is 96%. Public expenditure on education constituted 29.2% of total government expenditure in 2004. HIV prevalence, at 6.7%, is one of the lower rates in Africa. This can be attributed to Kenya's Industrial Properties Act which obliged industry to contribute to anti-retroviral programmes. Life expectancy has risen to an estimated 55.24 years in 2007 compared to 48 years in 2005. Kenya has reduced infant mortality to 57.44 deaths per 1,000 live births.

Uganda, the next best ranked country in the region under HDI, has its education policy hampered by scarce resources. Although it remained at only 5.2% of GDP between 2002 and 2004, spending on education as a proportion of GDP improved by 67% through the 1990s. Adult literacy rates were at 69% in 2002 but appear to have marginally dropped to 66.8% in 2005.

The Ugandan government's successful efforts to reduce HIV infection resulted in a comparatively low prevalence rate of 4.1% in 2003 compared to the Sub-Saharan Africa average of 7.7% for the same period. HIV/AIDS sufferers and the 1.4 million persons displaced by insurgency in the north of the country were prioritised under the Poverty Action Fund. Health care spending is relatively high for a sub-Saharan African country at 3.4% of GDP. Human development indicators are slowly improving with life expectancy increasing to 52 in 2005 (up from 43 in 1999), more people gaining access to improved water sources and better nutrition. Infant mortality was high at 82 per 1000 live births, in 2004 but has decreased to an estimated 67.22 per 1,000 live births in 2006.

Tanzania was ranked number 159. According to BES 2007, the country's commitment to health still needs further improvement with only 2.4% of GDP spent on health expenditure in 2003. Life expectancy was 50.71 years in 2007 compared to 46 years in 2005, while infant mortality rate was 71.69 deaths out of every 1,000 live births in 2007. Infant mortality rates have significantly reduced compared to 104 deaths per 1,000 in 2005. Adult literacy rate stands at 69.4% of the population in 2007, a reduction from 77% in 2003. HIV prevalence rate statistics have remained static at 8.8%.

## ***2.7 Ibrahim Index of African Governance and Global Peace Index***

The Ibrahim Index<sup>4</sup> is a new comprehensive ranking of sub-Saharan African (SSA) nations according to governance quality. It was created in recognition of the need for a more comprehensive, objective and quantifiable method of measuring governance quality in SSA. The ultimate goal of the Ibrahim Index and the efforts of Mo Ibrahim Foundation and the Kennedy School of government at Harvard University, are to strengthen governance in Africa in order to improve the lives of Africans. The index assesses national progress in five key areas, which together constitute a holistic definition of good governance. The five areas are: safety and security; rule of law, transparency and corruption; participation and human rights; sustainable economic development; and human development. The 2008 index is based on 2006 data. Under this ranking, Tanzania scores favourably among the East African countries and is comparable to the ranking under the *Global Peace Index* (GPI). Under GPI, countries most at peace are ranked highest. The 2008 GPI reveals that Kenya is the worst performer and this can be attributed to the crisis that arose after the disputed general election of 2007. Kenya is ranked at 119 out of the 140 countries considered under the survey. The best ranked is Tanzania at position 58. GPI is an attempt to measure the relative position of nations' and regions' peacefulness. It is maintained by the Institute for Economics and Peace and developed in consultation with an international panel

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<sup>4</sup> The index, sponsored by Mr. Ibrahim, a cell phone magnate and founder of Celtel, is compiled under the direction of the Kennedy School of Government at Harvard University.

of peace experts from peace institutes and think tanks, together with the Centre for Peace and Conflict Studies, University of Sydney, Australia with data analysed the Economist Intelligence Unit.

## ***2.8 Environmental Performance Index***

The 2008 Environmental Performance Index (EPI) ranks 149 countries on 25 indicators tracked across six established policy categories: Environmental Health, Air Pollution, Water Resources, Biodiversity and Habitat, Productive Natural Resources, and Climate Change. The EPI identifies broadly-accepted targets for environmental performance and measures how close each country comes to these goals. As a quantitative gauge of pollution control and natural resource management results, the Index provides a powerful tool for improving policymaking and shifting environmental decision-making onto firmer analytic foundations. The index is developed by Yale University (Centre for International Earth Science Information Network. For 2008 index, the experts concluded that “analysis of the drivers underlying the rankings suggests that wealth is a major determinant of environmental success”. This conclusion is reflected in the ranking of the east African countries where Kenya is ranked highest at position 96 (See Table 1), followed by Tanzania (113) and Uganda (117), while Burundi is the worst performer among EAC countries at position 132. In general terms, all the EAC countries score relatively poorly in reducing environmental stress and in the promotion of ecosystem vitality and sound natural resource management.

## **3.0 Summary of Challenges to Improving Business Environment in East Africa**

The various indices reviewed in this paper agree generally on the key bottlenecks to business and investment growth in East Africa. Key among these include:

*The challenge for a better investment climate:* Competitiveness in Africa in general and the East African region in particular must come from increased productivity, non-labour costs and greater development of worker skills. And the emphasis for improving productivity must include the business environment factors that drive up non-labour costs and drive down productivity in Africa. This includes factors associated with weak financial systems, macro-economic instability, concentrated market structure, infrastructure and service deficiencies, over-regulation in some areas and under-regulation in others, corruption and poor security.

*The challenge of good governance:* The governance challenge in East Africa is very broad. It includes the need for better public governance in state institutions, as well as the need for better corporate governance. The challenge of good public governance includes requirements to reduce corruption, increase transparency and accountability, and improve public services. Poor service delivery has handicapped firms in the region as a result of unreliable transport and power, and unreliable courts.

*The challenge of human resource development and entrepreneurship:* the 2007/2008 HDI reveals that the level of human capital is extremely low in SSA. Thus, the development of human resource is a major challenge. It is one that affects the potential of African countries to improve their productivity and competitiveness in the global market place. Sadly, the little capacity is seriously being eroded by the HIV/AIDS epidemic, which mainly affects working adults, including those who are well educated. It is also interesting to note that many of Africa's brightest and most skilled move from lesser developed countries to the richer developed countries, further eroding the business environment.

*The challenge of inadequate business infrastructure:* The impact of many reforms in the countries in the region has been undermined by inadequate infrastructure. The inadequacy of infrastructure and services continues to act as a disincentive for investors, as well as a major constraint to economic growth, and human and social development. Quality infrastructure is imperative in attracting investments.

While most of these challenges are not new, the urgency to address them has reached a critical point. The failure to do so will further marginalise these countries at a time when integration and participation in the world economy has become a prerequisite for achieving sustained economic growth and sufficient social development.

#### **4.0 What can be done?**

East African governments have made substantial efforts towards improvement of the business and investment environment. However, as this review has shown, much more has to be done. Greater urgency is required. Moreover, effort should be directed at the major obstacles to conducting business in the region. The review points us to the areas and issues where greatest attention should be directed:

1. *Improving the policy, legal and regulatory framework for investment and growth.* This should include support for the design, implementation and monitoring of policy reforms; the improvement of the legal and regulatory framework for private sector development and investment; the privatisation of state-owned enterprises; the introduction and application of competition policy, laws and institutions.
2. *Improving governance.* This spans the public and private sectors. Reducing corruption, improving transparency, and improving the delivery of government services are important aspects to improving governance in public institutions. Within the private sector, efforts should be directed towards the design and enforcement of corporate governance principles and codes of conduct, while also facilitating processes that improve private sector representation in dialogue between government and the private sector.
3. *Improving infrastructure and utilities.* While donor support for infrastructure is not new, this review highlights the need to involve the private sector. Donor support in creating opportunities and mechanisms for private investment into infrastructure development and maintenance represents a potent opportunity for the mobilisation of domestic investment and the attraction of investments from elsewhere in Africa as well as the broader international investment community.
4. *Facilitating international trade.* Efforts should be directed at trade-related institutions, improving the legal and regulatory regime for trade, creating new foreign trading opportunities, and building capacity to comply with international standards and protocols, along with their capacity to participate effectively in trade negotiations. The East African countries should strive to eliminate non-tariff barriers (NTBs) that continue to frustrate trade even after the Customs Union has been in operation for several years.
5. *Improving financial services.* Greater attention should be directed towards the functioning of financial markets and identifying those features that limit access to finance by firms. Thus, attention should be turned to improving financial regulation and management, improving access to and affordability of financial services, as well as to the performance of commercial financial institutions.

6. *Developing human capital and entrepreneurship.* The East African governments should support programmes that develop human resources in the region (for instance, through education, vocational training, and provision of health services). These kinds of interventions have been longstanding. While this kind of effort contributes to the long-term capacity of a country to compete in the global economy (that is, with a skilled and productive workforce), this review focuses more on those measures that have supported the promotion of entrepreneurship and enterprise development.
7. *Providing incentives for private investment, guarantees and risk mitigation.* Governments in the region should also undertake micro level interventions to improve investment in their respective countries through the provision of incentives for private investment, investment guarantees and risk mitigation. Because Africa suffers from a negative perception among many foreign investors, greater attention should be directed to reversing investor perceptions and reducing risk.

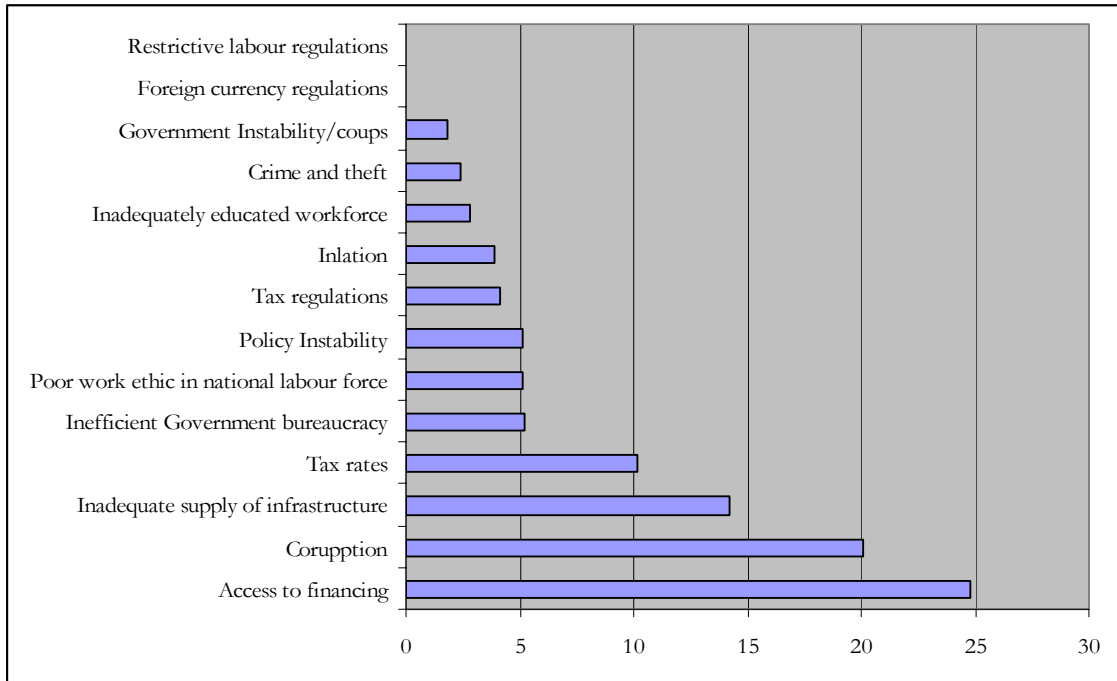
**ANNEX 1: Summary of Doing Business Indicators for East African Countries**

		Burundi	Kenya	Rwanda	Tanzania	Uganda
<b>Starting a Business</b>	Procedures (number)	11	12	8	12	18
	Duration (days)	43	30	14	29	28
	Cost (% GNI per capita)	215.0	39.7	108.9	41.5	100.7
	Paid in Min. Capital (% of GNI per capita)	0.0	0.0	0.0	0.0	0.0
<b>Dealing with Construction Permits</b>	Procedures (number)	20	10	14	21	16
	Duration (days)	384	100	210	308	143
	Cost (% of income per capita)	8515.8	46.3	607.1	2087.0	703.5
<b>Employing Workers</b>	Difficulty of Hiring Index	0	22	44	100	0
	Rigidity of Hours Index	60	0	40	40	0
	Difficulty of Firing Index	30	30	30	50	10
	Rigidity of Employment Index	30	17	38	63	3
	Firing costs (weeks of salary)	26	47	26	18	13
<b>Registering Property</b>	Procedures (number)	5	8	4	9	13
	Duration (days)	94	64	315	73	227
	Cost (% of property value)	10.7	4.1	0.6	4.4	4.1
<b>Getting Credit</b>	Legal Rights Index	2	10	2	8	7
	Credit Information Index	1	4	2	0	0
	Public registry coverage (% adults)	0.3	0.0	0.3	0.0	0.0
	Private bureau coverage (% adults)	0.0	2.1	0.0	0.0	0.0
<b>Protecting Investors</b>	Disclosure Index	4	3	2	3	2
	Director Liability Index	1	2	5	4	5
	Director Liability	5	10	1	8	5

		Burundi	Kenya	Rwanda	Tanzania	Uganda
	Index					
	Investor Protection Index	3.3	5.0	2.7	5.0	4.0
Paying Taxes	Payments (number)	32	41	34	48	32
	Time (hours)	140	417	160	172	222
	Profit tax (%)	17.7	32.5	20.1	19.8	22.0
	Labor tax and contributions (%)	7.8	6.8	5.7	18.0	11.3
	Other taxes (%)	253.3	11.6	7.9	7.3	1.3
	Total tax rate (% profit)	278.7	50.9	33.7	45.1	34.5
Trading Across Borders	Documents for export (number)	9	9	9	5	6
	Time for export (days)	47	29	42	24	39
	Cost to export (US\$ per container)	2147	2055	3275	1262	3090
	Documents for import (number) 8	10	8	10	7	7
	Time for import (days)	71	26	42	31	37
	Cost to import (US\$ per container)	3705	2190	5070	1475	3290
Enforcing Contracts	Procedures (number)	44	44	24	38	38
	Duration (days)	832	465	310	462	535
	Cost (% of claim)	38.6	26.7	78.7	14.3	44.9
Closing a Business	Time (years)	No practice	4.5	No practice	3.0	2.2
	Cost (% of estate)	No practice	22	No practice	22	30
	Recovery rate (cents on the dollar)	0.0	31.6	0.0	21.3	41.1

## ANNEX 2: Constraints to Business Environment in Uganda and Burundi

The Most Problematic Factors for Doing Business in Uganda



The Most Problematic Factors for Doing Business in Burundi

